

Office of the Auditor General
Performance Audit Report

**Commercial Forest Program and
Forest Development Fund**
Department of Natural Resources

August 2016

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

Article IV, Section 53 of the Michigan Constitution



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Office of the Auditor General

Report Summary

Performance Audit

Commercial Forest (CF) Program and Forest Development Fund

Department of Natural Resources (DNR)

Report Number:
751-0152-15

Released:
August 2016

The CF program was enacted in 1925 to provide a property tax incentive for private landowners to retain and manage forestland for long-term timber production in support of Michigan's forest products industry. More than 2.2 million acres of private forestland are enrolled in the CF program.

The Forest Development Fund was established in 1993 and operates under Section 324.50507 of the *Michigan Compiled Laws*. The Fund's primary revenue source is timber sales from State forestlands. Money in the Fund shall be used to pay principal and interest on bonds issued for forest management operations; for reforestation, forest protection, and timber stand improvement; and to obtain and maintain certification of sustainable forestry standards in the State forests. DNR expends approximately \$35 million annually from the Fund. An audit of the Fund was required by Section 324.50507(5) of the *Michigan Compiled Laws*.

| Audit Objective | | | Conclusion |
|--|--------------------|----------------------|-----------------------------|
| Objective #1: To assess the effectiveness of the Forest Resources Division's (FRD's) monitoring of landowner compliance with State laws, rules, and regulations related to the CF program. | | | Effective |
| Findings Related to This Audit Objective | Material Condition | Reportable Condition | Agency Preliminary Response |
| FRD did not obtain forest management plan (FMP) certifications for all properties enrolled in the CF program. FRD lacked assurance that landowners managed their forestlands in compliance with CF requirements (<u>Finding #1</u>). | | X | Agrees |
| Observations Related to This Audit Objective | Material Condition | Reportable Condition | Agency Preliminary Response |
| DNR is limited in its ability to collect CF information and to monitor landowner compliance with CF requirements and FMPs (<u>Observation #1</u>). | Not applicable | Not applicable | Not applicable |

| Audit Objective | | | Conclusion |
|---|---------------------------|-----------------------------|------------------------------------|
| Objective #2: To assess DNR's compliance with State laws, rules, and regulations for expenditures from the Forest Development Fund. | | | Complied |
| Findings Related to This Audit Objective | Material Condition | Reportable Condition | Agency Preliminary Response |
| None reported. | Not applicable | Not applicable | Not applicable |

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: www.audgen.michigan.gov

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August 4, 2016

Mr. Keith Creagh, Director
Department of Natural Resources
Constitution Hall
Lansing, Michigan

Dear Mr. Creagh:

I am pleased to provide this performance audit report on the Commercial Forest Program and Forest Development Fund, Department of Natural Resources.

We organize our findings and observations by audit objective. Your agency provided a preliminary response to the recommendation at the end of our fieldwork. The *Michigan Compiled Laws* and administrative procedures require an audited agency to develop a plan to comply with the recommendations and submit it within 60 days of the date above to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Doug Ringler
Auditor General

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AUDIT OBJECTIVES, CONCLUSIONS, FINDINGS, AND OBSERVATIONS

MONITORING OF CF PROGRAM LANDOWNERS

BACKGROUND

The Commercial Forest* (CF) program was enacted in 1925 to provide a property tax incentive for private landowners to retain and manage forestland for long-term timber production in support of Michigan's forest products industry. The incentive for landowners is that they do not pay ad valorem general property tax. Instead, the landowners pay a specific tax of \$1.25 per acre per year for land enrolled in the CF program. In addition, the State of Michigan makes an annual payment of \$1.25 per acre to counties where the land is enrolled to help make up for the tax reduction. Landowners must pay a withdrawal penalty to the township when land is withdrawn from the program.

Section 324.51103 of the *Michigan Compiled Laws* requires CF landowners to manage the property for commercial timber production and to have a written forest management plan* (FMP). An FMP outlines how a landowner will optimize the production, utilization, and regeneration of forest resources.

Section 324.51113(1) of the *Michigan Compiled Laws* prohibits the use of the land for agricultural, grazing, industrial, residential, resort, or commercial purposes. The law also requires landowners to not deny the general public the privilege of hunting and fishing unless otherwise specified by the Department of Natural Resources (DNR) or the Michigan Legislature. More than 2.2 million acres of private forestland are enrolled in the CF program.

AUDIT OBJECTIVE

To assess the effectiveness* of the Forest Resources Division's (FRD's) monitoring of landowner compliance with State laws, rules, and regulations related to the CF program.

CONCLUSION

Effective.

FACTORS IMPACTING CONCLUSION

- FRD generally obtained FMP certifications for enrolled properties.
- FRD generally followed up on complaints related to landowner compliance.
- Reportable condition* related to the need for additional FMP certifications (Finding #1).
- Observation* related to impediments to collecting CF information and monitoring compliance with CF requirements and FMPs (Observation #1).

* See glossary at end of report for definition.

FINDING #1

Additional FMP certifications needed.

FRD did not obtain FMP certifications for all properties enrolled in the CF program. FRD lacked the assurance that landowners managed their forestlands in compliance with CF requirements.

Section 324.51103(3)(c) of the *Michigan Compiled Laws* requires landowners to provide FRD with a certification to confirm that an FMP is in effect. An FMP prepared by a registered forester helps optimize the production, utilization, and regeneration of forest resources. Although certifications were not always obtained by FRD, the landowner may have had a current FMP prepared and in effect without FRD's knowledge.

FRD did not obtain certification for 3 (9%) of 32 randomly and judgmentally sampled properties:

- a. For one property, the landowner acquired a portion of a piece of property in July 2013 that was already enrolled in the CF program. The acquired 10-acre property did not meet the minimum 40-acre requirement for enrollment in the CF program. During the two tax years that the ineligible property remained in the CF program, the landowner paid property taxes of \$1.25 per acre rather than the higher ad valorem taxes. In addition, the State of Michigan paid a match to the county where the property resides of \$1.25 per acre, which is likely much less than the county would have received if the land was not in the program.

In October 2015, FRD notified the landowner that they must submit an application to withdraw from the program.

- b. For the second property, the landowner acquired the 320-acre property in 2014 and, as of October 2015, had not yet prepared an FMP.
- c. For the third property, the lack of FMP certification was likely due to an oversight by FRD resulting from a database error.

While performing our audit procedures, we noted a backlog of ownership changes related to hundreds of pieces of property that had not yet been processed by FRD. FRD informed us that this was due to a lack of funding for sufficient staffing.

RECOMMENDATION

We recommend that FRD obtain FMP certifications for all properties enrolled in the CF program.

AGENCY PRELIMINARY RESPONSE

DNR provided us with the following response:

DNR agrees with the recommendation and will initiate contact with those property owners who have not submitted an FMP certification.

OBSERVATION #1

Statutory impediments hamper DNR's ability to collect CF information.

DNR is limited in its ability to collect CF information and to monitor landowner compliance with CF requirements and FMPs.

Ownership changes

DNR is not always notified of changes in CF property ownership. Timely notification is essential to DNR's ability to identify the current landowners in order to inform them of CF requirements and obtain documentation such as the legal description of the property on the deed, the FMP certification, and a copy of the FMP. Section 324.51115 of the *Michigan Compiled Laws* requires that, not more than 30 days after the county equalization office receives notice of the ownership change, the county shall notify DNR in writing of the ownership transfer. Prior to June 2013, the property owner was required to notify DNR of ownership.

Section 324.51115 also states that a transfer of title does not affect that forestland's classification as a CF if the forestland continues to meet all of the eligibility requirements. However, certain conditions of the ownership change could cause the property to be ineligible. For example, if the new owner acquired less than the minimum 40 acres or did not acquire the timber rights on the property, the forestland would no longer meet eligibility requirements.

DNR informed us that it noticed a significant decline in the number of ownership change notifications it received since the responsibility to notify was given to the county equalization offices. DNR was not aware of any recourse it would have against counties that do not provide timely notification of ownership changes.

Authority to require CF landowners to provide certain disclosures

DNR lacks legal authority to require CF landowners to disclose FMPs or provide copies of the property deeds, impairing DNR's ability to evaluate CF property for eligibility and monitor compliance with FMP requirements.

Section 324.51103 of the *Michigan Compiled Laws* requires landowners to provide FRD with an FMP certification; however, it does not require landowners to submit the FMP or the property deed to DNR.

The CF application process instructs landowners to provide a copy of both the FMP and the property deed with their applications. However, DNR, in most instances, did not receive FMPs or property deeds for properties enrolled in the CF program prior to 2007.

Resources to monitor commercial forestlands

DNR lacks resources to monitor commercial forestlands.

Section 324.51119 of the *Michigan Compiled Laws* provides FRD with the right to enter commercial forestlands at any time to determine compliance with program requirements and to review

any documents related to timber harvests or the owner's FMP. For example, the *Michigan Compiled Laws* require the CF landowner to:

- Not use the land for agricultural, mineral extraction, wind energy development, grazing, industrial, residential, resort, commercial, or development purposes.
- Not deny the general public the privilege of hunting and fishing on commercial forestlands.
- Include in the FMPs the schedules and timetables for the various silvicultural practices* used on commercial forestlands, including timber harvesting.

Although statute does not mandate that DNR monitor the commercial forestlands, it does provide DNR with the authority to monitor.

FRD does monitor landowners upon receiving complaints; however, it does not regularly monitor to ensure that landowners refrain from prohibited activities, not deny hunting and fishing access to the general public, and harvest in compliance with the schedules and timetables within the FMP.

DNR should work with the Legislature and county equalization offices to increase its ability to collect CF information and to monitor landowner compliance with CF requirements and FMPs.

* See glossary at end of report for definition.

COMPLIANCE WITH LAWS, RULES, AND REGULATIONS FOR EXPENDITURES FROM THE FOREST DEVELOPMENT FUND

BACKGROUND

The Forest Development Fund was established in 1993 and operates under Section 324.50507 of the *Michigan Compiled Laws*. The Fund's primary revenue source is timber sales from State forestlands. Money in the Fund shall be used to pay principal and interest on bonds issued for forest management operations; for reforestation, forest protection, and timber stand improvement; and to obtain and maintain certification of sustainable forestry standards in State forests.

Section 324.50507(5) of the *Michigan Compiled Laws* requires an audit of the Fund at least once every three years.

AUDIT OBJECTIVE

To assess DNR's compliance with State laws, rules, and regulations for expenditures from the Forest Development Fund.

CONCLUSION

Complied.

FACTORS IMPACTING CONCLUSION

- Fund expenditures were in compliance with the *Michigan Compiled Laws*.
- Fund expenditures were consistently reported between DNR's financial schedules and the State's accounting records.

SUPPLEMENTAL INFORMATION

UNAUDITED

COMMERCIAL FOREST PROGRAM AND FOREST DEVELOPMENT FUND

Department of Natural Resources

Forest Development Fund Expenditures For Fiscal Years 2013 Through 2015

| Expenditure Category | Fiscal Year | | |
|--|----------------------|----------------------|----------------------|
| | 2013 | 2014 | 2015 |
| Salaries, wages, and fringe benefits | \$ 25,747,043 | \$ 25,478,517 | \$ 24,487,616 |
| Cash transfer expenditure credit funding | 4,330,246 | 3,562,843 | 3,665,042 |
| Contractual services | 2,670,556 | 2,657,161 | 4,661,533 |
| Supplies | 1,225,626 | 887,175 | 1,127,181 |
| Building rent, lease, and purchase | 389,655 | 436,301 | 695,256 |
| Interfund transfers | 436,855 | 456,712 | 447,051 |
| Equipment rent, lease, and purchase | 264,271 | 161,956 | 486,886 |
| Workers' compensation claims | 185,301 | 220,563 | 121,202 |
| Grant inventories, leases, and purchases | 42,180 | 45,613 | 151,503 |
| Miscellaneous | 63,151 | 33,319 | 39,992 |
| Total expenditures | <u>\$ 35,354,884</u> | <u>\$ 33,940,161</u> | <u>\$ 35,883,263</u> |

Source: The Office of the Auditor General prepared this exhibit based on data obtained from the Michigan Administrative Information Network (MAIN).

AGENCY DESCRIPTION

FRD's mission* is to manage, protect, and provide for the sustainable use of Michigan's forest resources. For fiscal year 2015, FRD was appropriated 292.5 full-time equated positions.

The CF program was initiated in 1925 to encourage property owners to retain forestland for long-term timber production in support of Michigan's forest products industry by providing property tax incentives. Landowners in the CF program do not pay ad valorem general property taxes but instead pay a specific tax of \$1.25 per acre annually. The State pays an additional \$1.25 per acre on behalf of the landowner to the county annually. Listed land must be a minimum of 40 contiguous forested acres and be open to the public for fishing, hunting, and trapping.

Section 324.51103 of the *Michigan Compiled Laws* requires landowners to have an FMP in effect, prepared by a registered forester or natural resources professional. The FMP describes how the land will be managed and schedules treatments such as reforestation and timber harvesting. More than 2.2 million acres of private forestland are enrolled in the CF program. For fiscal year 2015, 2.1 full-time equated positions were allocated to the CF program.

The Forest Development Fund was established in 1993 and operates under Section 324.50507 of the *Michigan Compiled Laws*. Allowable expenditures from the Fund include forest management activities, such as reforestation and timber stand improvement, and forest fire protection activities. The Fund can also be used to obtain and maintain certification of sustainable forest standards in the State forests. The Fund's primary revenue source is timber sales from State forestlands. In fiscal year 2015, DNR expended \$35.8 million from the Fund.

* See glossary at end of report for definition.

AUDIT SCOPE, METHODOLOGY, AND OTHER INFORMATION

AUDIT SCOPE

To examine the program and other records related to the CF program and the Forest Development Fund. We conducted this performance audit* in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.

PERIOD

Our audit procedures, which included a preliminary survey, audit fieldwork, report preparation, analysis of agency responses, and quality assurance, generally covered the period October 1, 2012 through June 30, 2015.

METHODOLOGY

We conducted a preliminary survey of FRD to formulate a basis for establishing our audit scope and methodology. We:

- Interviewed FRD management and staff to obtain an understanding of their responsibilities and processes.
- Reviewed applicable laws, rules, regulations, policies, procedures, manuals, and guidelines.
- Reviewed DNR's FMPs, including regional management plans and strategic plans.
- Reviewed external forest certification reports and the related process for obtaining and maintaining certification.

OBJECTIVE #1

To assess the effectiveness of FRD's monitoring of landowner compliance with State laws, rules, and regulations related to the CF program.

To accomplish our first objective, we:

- Met with CF program management to obtain information regarding processes and procedures used for approving CF applications and for monitoring landowners for compliance with CF laws, rules, and regulations.
- Met with Resource Protection and Cooperative Programs Section management to obtain information regarding processes and procedures used for approving CF applications and for monitoring landowners for compliance with CF laws, rules, and regulations.

* See glossary at end of report for definition.

- Randomly selected a sample of 20 CF landowner files and judgmentally selected 3 counties with land enrolled in the CF program. From each of the 3 counties, we selected 4 CF landowners to determine whether FRD had a copy of the FMP, FMP certification, property deed, and documentation that FRD monitored landowners for compliance.

OBJECTIVE #2

To assess DNR's compliance with State laws, rules, and regulations for expenditures from the Forest Development Fund.

To accomplish our second objective, we:

- Interviewed DNR staff to obtain an understanding of key processes for ensuring that Fund expenditures were in compliance with State requirements, properly coded, in the proper amount, and properly authorized.
- Performed analytical review procedures on Fund expenditures for our audit period.
- Assessed DNR's compliance with laws, rules, and regulations for Fund expenditures.

CONCLUSIONS

We base our conclusions on our audit efforts and the resulting material conditions* and reportable conditions.

AGENCY RESPONSES

Our audit report contains 1 finding and 1 corresponding recommendation. DNR's preliminary response indicates that it agrees with the recommendation.

The agency preliminary response that follows the recommendation in our report was taken from the agency's written comments and oral discussion at the end of our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and the State of Michigan Financial Management Guide (Part VII, Chapter 4, Section 100) require an audited agency to develop a plan to comply with the recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

SUPPLEMENTAL INFORMATION

Our audit report includes supplemental information that relates to our second audit objective. Our audit was not directed toward expressing a conclusion on this information.

* See glossary at end of report for definition.

GLOSSARY OF ABBREVIATIONS AND TERMS

| | |
|------------------------------|---|
| commercial forest (CF) | A section of at least 40 contiguous acres or a survey unit consisting of 1/4 of 1/4 of a section of forestland that is capable of producing not less than 20 cubic feet per acre per year of forest growth upon maturity, producing tree species that have economic or commercial value, and producing a commercial stand of timber within a reasonable period of time. |
| DNR | Department of Natural Resources. |
| effectiveness | Success in achieving mission and goals. |
| forest management plan (FMP) | A written plan prepared and signed by a registered forester or a natural resources professional that prescribes measures to optimize production, utilization, and regeneration of forest resources. |
| FRD | Forest Resources Division. |
| material condition | A matter that, in the auditor's judgment, is more severe than a reportable condition and could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program. |
| mission | The main purpose of a program or an entity or the reason that the program or the entity was established. |
| observation | A commentary that highlights certain details or events that may be of interest to users of the report. An observation differs from an audit finding in that it may not include the attributes (condition, effect, criteria, cause, and recommendation) that are presented in an audit finding. |
| performance audit | An audit that provides findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability. |

reportable condition

A matter that, in the auditor's judgment, is less severe than a material condition and falls within any of the following categories: an opportunity for improvement within the context of the audit objectives; a deficiency in internal control that is significant within the context of the audit objectives; all instances of fraud; illegal acts unless they are inconsequential within the context of the audit objectives; significant violations of provisions of contracts or grant agreements; and significant abuse that has occurred or is likely to have occurred.

silvicultural practices

The management and manipulation of forest vegetation for the protection, growth, and enhancement of forest products.

