

# ALASKA STATE LEGISLATURE

## LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit



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SUMMARY OF: A Special Report on the Alaska Aerospace Development Corporation, April 11, 2007.

### PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Alaska Aerospace Development Corporation (AADC) administrative and financial controls in place to compensate for the centralized state government controls that were removed. Additionally, we were directed to review and assess (1) the reasonableness of the compensation of the AADC staff and governing board; (2) the validity of the corporation's college scholarship program; (3) the adequacy of the corporation's investment policy; and, (4) the feasibility of the corporation paying a dividend to the State.

### REPORT CONCLUSIONS

The conclusions are as follows:

- AADC has adequate financial management controls in place;
- Administrative controls over personnel practices are weak primarily due to minimal documentation of the basis for employee compensation and job performance;
- AADC board member compensation is consistent with provisions of the corporation's statute;
- AADC's scholarship program is allowed under the corporation's statutory authority;
- AADC's investment policy should be improved to address important aspects of fiduciary care; and
- AADC's current operations do not support payment of a significant dividend to the State.

## FINDINGS AND RECOMMENDATIONS

1. The AADC Board of Directors (Board) should direct the President to establish a documented personnel management system that includes a formalized salary structure system and more formalized evaluation process.
2. AADC's Board of Directors should direct the President to develop regulations or policy for the corporation's education programs.
3. AADC's Board of Directors should take action to improve the corporation's investment policy and document that key precepts are understood and followed by corporate staff and outside investment managers.
4. To encourage AADC's Board of Directors to actively consider distribution of a dividend to the State, the legislature should require the Board to formally evaluate such action each year, and report to the legislature.

There is now interest in directing AADC to distribute a dividend to the State from the earnings of the corporation. For an organization such as AADC, with a business model and a market that are not fully matured, the income and asset balances do not reflect the corporation's capacity to pay a significant dividend to the state. Capacity to pay dividends is not clearly reflected in financial statement account balances.

Any assessment of dividends must consider using the "fees and profit" proceeds generated by the corporation's primary operating contract. These proceeds are available to be spent on what are termed "non-billable" items. While these proceeds are reflected in the corporation's financial statements, they are not specifically identified as revenues available for spending on discretionary items – such as bonuses and scholarships. Accordingly, trying to develop legislation that would require a certain amount or percentage of these funds be paid in dividends would be difficult to define and clearly set out in state law. Such action could not adequately account for such factors such as cash flow, other commercial prospects, and infrastructure needs.

Whether funds used to pay for such things as scholarships or bonus compensation could alternatively be used to fund a relatively small dividend to the state's General Fund, is a valid policy question. Developing a specific language, however, that requires dividends be paid based on a formula applied to balance sheet accounts would be difficult.

Accordingly, we recommend the legislature amend state law related to AADC to require the Board to annually consider payment of a dividend to the state. The statute could require that the Board report to the legislature whether a dividend is available or not, and the basis used by the Board in making its determination.

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April 11, 2007

Members of the Legislative Budget  
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

### DEPARTMENT OF COMMERCE, COMMUNITY, AND ECONOMIC DEVELOPMENT ALASKA AEROSPACE DEVELOPMENT CORPORATION

April 11, 2007

Audit Control Number

08-30039-07

The purpose of the audit was to review the Alaska Aerospace Development Corporation's (AADC) administrative and financial controls in place to compensate for the centralized state government controls that were removed. Additionally, we were directed to review and assess (1) the reasonableness of the compensation of AADC's staff and governing board; (2) the validity of the corporation's college scholarship program; (3) the adequacy of the corporation's investment policy; and, (4) the feasibility of the corporation paying a dividend to the State.

The audit was conducted in accordance with generally accepted government audit standards. Fieldwork procedures utilized in the course of developing the findings and discussion presented in this report are discussed in the Objectives, Scope, and Methodology.

Pat Davidson, CPA  
Legislative Auditor



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# OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we conducted a performance audit of the Alaska Aerospace Development Corporation (AADC).

## Objectives

The specific objectives of the audit were to review:

- the adequacy of AADC's administrative and financial controls.
- AADC's process for determining employee salaries.
- if AADC's board member compensation is consistent with state law.
- AADC's statutory authority to fund scholarships.
- the adequacy of AADC's investment policy.
- if AADC funds are available to pay a dividend to the State.

## Scope and Methodology

We examined the FY 06 financial statements and single audit of AADC and the associated workpapers kept by AADC's external financial auditor.

We reviewed FY 93 through FY 07 Legislative Finance budget documents, FY 93 through FY 06 State Comprehensive Annual Financial Reports, the corporation's audited financials for various years from FY 95 through FY 06, and financial reports and schedules for FY 06 and FY07.

We consulted with Legislative Affairs Division of Legal and Research Services staff regarding AADC's statutory authority to fund scholarships.

We reviewed AADC statutes, regulations, policies and procedures; board minutes and resolutions; and other various agency documents, contracts, and reports. We examined the manuals and reports from AADC's automated accounting system.

We reviewed the Department of Revenue's Treasury Division investment policies and procedures manual and other state agency investment policies. We compared these various policies and procedures with those adopted by AADC.

We also reviewed personnel information from the Alaska Statutes, Administrative Code, Administrative Manual and from Division of Personnel including data from AKPAY. We reviewed the 2006 compensation for both the Board of Directors and AADC employees.

In order to assess AADC's capacity to pay a dividend to the State, we primarily reviewed the revenues generated by the corporation; examined financial schedules and documents prepared by AADC staff; and analyzed historical financial cash flow information.

We also conducted interviews with AADC personnel, board members, external auditor, and other state agency and federal personnel.

# ORGANIZATION AND FUNCTION

The Alaska Aerospace Development Corporation (AADC) is a public corporation of the State. For administrative purposes AADC is located within the Department of Commerce, Community, and Economic Development (DCCED) and is affiliated with the University of Alaska (UA).

AADC's Board of Directors (Board) consists of nine members appointed by the governor. Board members are: the UA's president or designee; the director or designee of UA's Geophysical Institute; the DCCED commissioner or designee; three state residents with significant business experience with two residents from Kodiak if qualified; two individuals with experience in the aerospace or commercial space industry;<sup>1</sup> and one public school educator or public member. Additionally, two members of the legislature serve as ex officio nonvoting members of the Board. See Exhibit 1 for a listing of board members names.

As set out in state law,<sup>2</sup> the purpose of the corporation is to allow the State to take a lead role in the exploration and development of space, to enhance human and economic development, and to provide a unified direction: (1) for space-related economic growth; (2) for space-related educational and research development; (3) to promote the continued utilization of the Poker Flat Research Range as a launch site and for polar research efforts; (4) for promotion of space-related tourism activities; and, (5) for development of a state strategy for and to implement the acceleration of space-related economic growth and educational and research development in the State. See Exhibit 2, on the following page, for AADC's mission statement.

AADC's corporate headquarters and administrative offices are located in Anchorage. The Kodiak Launch Complex (KLC) is located at Narrow Cape on Kodiak Island. Currently AADC has 38 employees, of which more than half are located in Kodiak.

## Exhibit 1

### AADC Board of Directors (as of April 1, 2007)

Mark Hamilton, Chair  
President, University of Alaska

Roger Smith  
Director, Geophysical Institute,  
University of Alaska –Fairbanks (UAF)  
Designee: Joe Hawkins, Ph.D., UAF

Emil Notti  
Commissioner, Dept. of Commerce,  
Community, and Economic Development

Mike Nizich  
Deputy Chief of Staff, Office of Governor

John Sweeney  
Sweeney Insurance, Inc., Owner (Kodiak)

Tom Walters  
Maritime Helicopters, Owner (Kodiak)

Sharon Anderson  
Anderson Consulting, Principal

Jack Eidson  
Lockheed Martin Space Operations Co.

Wally Sawyer  
NASA retired

#### Ex Officio (nonvoting)

Senator Gary Wilken  
Alaska State Senate

Representative Gabrielle LeDoux  
Alaska State House of Representatives

<sup>1</sup>Per AS 14.40.826(b) aerospace or commercial space industry members may be nonresidents of the State.

<sup>2</sup>AS 14.40.861

Since its inception in July 1991, most of AADC's funding has been spent on building its organizational structure and space launch infrastructure. Specifically, KLC was primarily built and funded by the federal government through contracts and agreements with the U.S. Department of Defense. Since FY 03, AADC has not received any general fund appropriations for its operations and capital projects. Previously, over a period of ten years, the Alaska Science and Technology Foundation provided approximately \$16 million to AADC in operating and capital funding.<sup>3</sup>

**Exhibit 2**

**AADC Mission Statement**

The mission of the AADC includes establishing and operating in Alaska, a commercial launch facility promoting aerospace-related economic growth and developing corresponding technologies and support services. Concurrent goals are to strengthen the Alaskan technological infrastructure, assist in advancing science and engineering research and aerospace in polar disciplines at the University of Alaska and attract space-related businesses from outside the state to locate in Alaska.

*Source: AADC 2002 Annual Report*

The corporation's KLC facility launches orbital and suborbital rockets for its customers. AADC provides tailored, launch support services for each customer's launch. The following is a description of the services from AADC's website that is offered at the KLC facility.

Kodiak Launch Complex Services

The Alaska Aerospace Development Corporation provides a wide array of launch support services to KLC customers. These services are tailored to meet the specific needs of each customer's launch campaign. Services consist of range operations support, range safety and telemetry instrumentation, logistics on- and off-range, communications, meteorology, security, and facilities support services. AADC's staff and support subcontractors are responsive to customer needs and are experienced in adapting the KLC capabilities to specific requirements. Additional information on these services is detailed below.



- **Range Operations Support**

AADC provides program coordination and technical interface for customer's launch programs. Support includes, but is not limited to, the mission operations, documentation, scheduling, integration testing, design and implementation of on- and off-range communications support and installation of government and user furnished equipment.

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<sup>3</sup>All funding of the Alaska Science and Technology Foundation was from general fund appropriations and related interest earnings.

- Range Safety and Telemetry Instrumentation

AADC is responsible for ensuring that KLC range operations are safe with appropriate safety policies and procedures, and for providing operations oversight. AADC provides ground safety management and oversight and flight safety oversight during rocket launch operations. AADC's integrated Range Safety and Telemetry Systems (RSTS) also provide global positioning system (GPS) and telemetry receiving. AADC's instrumentation technical staff develop and implement solutions based on each mission's requirements.

- Logistics Services

AADC offers planning, coordination, implementation and controlling of personnel, equipment and supplies to/from Alaska, the KLC site and off-range locations.

- Meteorology Support

AADC meteorology support includes weather forecasting, ground and upper air observations, data processing including balloon preparation and release, cloud height measurements, precipitation forecasts, as well as, lightning monitoring.

- Site Security Support

The KLC, with support from a security contractor, provides site and facility access control in accordance with customer requests. Physical security is maintained 24-hours a day during pre-mission testing and mission operations. Authorized personnel entry is managed by a computer controlled electronic badging system.

- KLC Facilities and Support Services

AADC ensures that the checkout and readiness of KLC facilities and support services required for mission operations are completed on schedule. Trained and experienced technicians provide: assistance adapting to booster and payload processing facilities as required; facility environmental monitoring and controls; medical and environmental health services; fire protection; and certified operators for handling equipment, including cranes, as well as associated utilities.



AADC maintains an extensive network of experienced industry professionals who support AADC in specialty areas.

Since 1998, AADC has had ten successful launches from its KLC facility. Additionally, AADC participates in the K-12 Space Explorers Program, funds UA scholarships for Alaska graduating seniors, offers a summer internship program at its KLC facility, and participates in Challenger Learning Center of Alaska activities.



## BACKGROUND INFORMATION

The legislature has given the Alaska Aerospace Development Corporation (AADC) extensive autonomy in its operations. The corporation can adopt its own regulations, procurement procedures, and set up its own personnel system independent of the process and requirements followed by departments. Most recently, AADC was allowed full control over accounting and managing of the state's AADC fund. Specifically, under state law, AADC:

1. has authority over all funds in the AADC fund, and can manage the funds in accordance with an investment policy adopted by the corporation. AS 14.40.841(b)
2. employees are exempt from the State Personnel Act. AS 39.25.110(11)(f). AADC can “*establish a personnel management system for hiring employees and setting employee-benefit packages.*” AS 14.40.866(b)(3)
3. “*can establish procedures, rules, and rates governing per diem and travel expenses of the employees of the corporation in substantial conformity to statutes, procedures, rules, and rates governing state employees.*” AS 14.40.866(b)(4)
4. can “*adopt procedures to govern the procurement of supplies, services, professional services, and construction*” that are substantially equivalent to state procurement requirements. AS 36.30.015(e)
5. is exempt from the AS 44.62 – *Administrative Procedure Act* regarding the adoption of regulations. AS 14.40.871(b)
6. can “*undertake a program of advertising to the public and space-related businesses promoting the space-related projects of the corporation and space-related businesses.*” AS 14.40.866(11)
7. can use “*innovative development methods designed to stimulate space-related business and educational and research development and improve the entrepreneurial atmosphere in the state.*” AS 14.40.861(6)
8. can “*maintain the confidentiality of a trade secret, or other proprietary technical information.*” AS 14.40.881

### AADC's Legislative Budget Process

AADC is required by statute to submit a budget to the legislature annually. AADC staff prepares a budget for its Board of Director's (Board) review and approval before submitting the information to the Department of Commerce, Community, and Economic Development (DCCED). DCCED is then responsible for submitting AADC's budget into the Office of Management and Budget (OMB).

At fiscal year end, AADC reports its actual operating expenditures to DCCED for input into the state's budget system. Reporting capital expenditures on an appropriation basis is upon request of DCCED or OMB.

AADC has authority through the legislative budget language to receive and expend its receipts above the budgeted appropriation amounts. For the last five years, AADC did not receive and expend more than its legislative budgeted operating appropriations.

### AADC Scholarship Process

In December 2004, AADC's Board passed a resolution to fund a scholarship program starting with the 2005-2006 school year. The resolution limited scholarship winners to graduating high school students from the Kodiak Island Borough School District. Ten scholarships up to \$5,000 each were authorized. In September 2005, the Board authorized another ten scholarships for high school seniors, while continuing scholarship funding for previously awarded recipients. The Board also approved expanding the eligibility for the scholarships to students throughout the State for the 2006-2007 school year.

The Board authorized that AADC's scholarship program be administered by the University of Alaska Foundation (UA Foundation). The UA Foundation is a nonprofit corporation, operated as a public foundation, which was established in 1974 to solicit, manage, and invest donations for the exclusive benefit of the University of Alaska. The UA Foundation is legally separate and distinct from the University of Alaska and is governed by its own Board of Trustees.

AADC sets the criteria to be used in selecting recipients of the scholarship. AADC writes a check to the UA Foundation to award applicants using those criteria. AADC has no input in the selection of awardees other than creating the criteria used for selecting recipients. The UA Foundation has instituted a fee on donations beginning July 1, 2006. As of January 22, 2007 no fee has been charged to AADC's scholarship fund. Due to the gift nature of the scholarship funding, no money is returned to AADC.

Scholarship recipients may receive their award in two installments of \$2,500 each. This money is deposited into the recipient's account at the University of Alaska and can only be spent on tuition, books, supplies, and other appropriate items. If a student loses eligibility,

the awarded amount stays with the UA Foundation and will be used to fund future AADC scholarships.

The current scholarship program could cost AADC up to \$200,000 a year, when the program completely matures after four years. In actuality, since there is an inevitable attrition, actual costs would likely be significantly less. For the first two years of the program, five of the ten new applicants did not receive the full amount of the \$5,000 award. The cumulative distribution total for the first two years could have been \$150,000. However, only \$82,500 of the \$150,000 provided by AADC to the UA Foundation has been distributed to recipients. The President of AADC states that AADC plans to recommend that the Board continue funding the scholarship program as long as AADC has the financial resources available.

Exhibit 3 provides actual funding distributions to recipients by community.

<b>Exhibit 3</b>					
<b>AADC Scholarship Funding</b>					
<b>By Community</b>					
<b>as of January 31, 2007</b>					
<b>(Unaudited)</b>					
	2005-2006 School Year		2006-2007 School Year		Total
	Number of Students	Amount	Number of Students	Amount	
High School Community					
Anchorage			2	\$ 10,000	\$ 10,000
Juneau			1	5,000	5,000
Kodiak	7	\$ 27,500	4 <sup>a</sup>	17,500	45,000
Kotzebue			1	2,500	2,500
North Pole			1	5,000	5,000
Old Harbor			1	2,500	2,500
Port Lions	1	5,000	1	2,500	7,500
Soldotna			1	5,000	5,000
Total Foundation Distribution	8	\$ 32,500	12 <sup>a</sup>	\$ 50,000	\$ 82,500
Total AADC Funding Provided to the Foundation		<u>50,000</u>		<u>100,000</u>	<u>150,000</u>
Foundation Remaining Balance		\$ 17,500		\$ 50,000	\$ 67,500

<sup>a</sup>Total includes three continuing scholarship recipients. Source: UA Foundation

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## REPORT CONCLUSIONS

The legislature has given the Alaska Aerospace Development Corporation (AADC) a large amount of discretionary authority over the funds generated by the corporation. AADC is no longer required to use the state accounting system to record its day-to-day transactions. This delegation of fiscal management control was the most recent operational area over which AADC was given autonomy. Under state law AADC has discretion to adopt its own regulations, develop procurement procedures, and establish a personnel system. In this context, we were directed to review and report on whether there were appropriate and effective administrative and financial controls in place at AADC to compensate for the centralized state government controls that were removed.

Additionally, we were directed to review and assess (1) the reasonableness of the compensation of the AADC's governing board; (2) the validity of the corporation's college scholarship program in the context of AADC's statutory authority; (3) the adequacy of the corporation's investment policy; and, (4) AADC's financial position and the feasibility of the corporation paying a dividend to the State.

In summary, we have developed the following conclusions:

- AADC has adequate financial management controls in place;
- Administrative controls over personnel practices are weak primarily due to minimal documentation of the basis for employee compensation and job performance;
- AADC board member compensation is consistent with provisions of the corporation's statute;
- AADC's scholarship program is allowed under the corporation's statutory authority;
- AADC's investment policy should be improved to address important aspects of fiduciary care; and
- AADC's current operations do not support payment of a significant dividend to the State.

### AADC has adequate financial management controls in place

In 2002, AADC began using a job cost accounting system to track and allocate operating costs in accordance with the federal government contract requirements. In 2003, the U.S. Department of Defense Contract Audit Agency (DCAA) examined AADC's system and determined it adequate to meet funding and contracting standards of the U.S. Department of Defense.

In FY 05, as authorized by newly enacted state law, AADC went off the state accounting system. The cash balance of the AADC fund<sup>4</sup> was transferred from the responsibility of the Department of Commerce, Community, and Economic Development (DCCED) to AADC. We confirmed the funding transferred was all received by UBS Financial Services in AADC's accounts.

The financial reports generated from the corporation's accounting system meet the financial and compliance reporting requirements for AADC. Additionally, corporation staff provides both management and the Board of Directors (Board) informative financial reports from its accounting system regarding AADC's operations.

An accounting firm chosen by the Board's audit committee conducts the financial and federal single audit of AADC annually. In FY 06, the external auditor did not identify any internal weaknesses, reportable conditions, or findings. The audited financial statements are submitted to the Division of Finance for inclusion in the State's Comprehensive Annual Financial Report (CAFR). AADC is also regularly audited by DCAA in conjunction with the corporation's contracts with the U.S. Department of Defense. Additionally, AADC is required to follow the State's Executive Budget Act and submits its budget annually to DCCED for inclusion in the Governor's budget request.

Accordingly, we conclude appropriate and adequate financial controls are in place at AADC to safeguard state funds administered by the corporation.

#### Administrative controls over personnel practices are weak due to minimal documentation

AADC is exempt from the State Personnel Act. However, state law<sup>5</sup> requires AADC to *establish a personnel management system for hiring employees and setting employee-benefit packages*. The AADC Board is responsible for establishing and modifying the compensation of the President and Chief Executive Officer (President).<sup>6</sup> Determining and modifying the compensation of the other AADC employees have been delegated by the Board to the President.

All staff salaries are set by the President. The President reports he relies on his knowledge and experience, considers many factors, and utilizes various sources of information when setting salaries or awarding pay raises and bonuses.<sup>7</sup> He was not able to provide any documentation of these sources and factors including no established salary schedules. Under the corporation's policy manual the President "*shall prescribe the nature and form of the*

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<sup>4</sup>AS 14.40.841(a) established the AADC fund as follows:

*The fund consists of appropriations made to the fund by the legislature, and rents, fees, or other money or assets transferred to the fund by the corporation. Amounts deposited in the fund may be pledged to the payment of bonds of the corporation or expended for the purposes of the corporation.*

<sup>5</sup>AS 14.40.866(b)(3)

<sup>6</sup>Currently, one individual holds both the title of President and Chief Executive Officer.

<sup>7</sup>In FY 05, two vice presidents were paid bonuses of \$15,000 each.

*employee evaluations for determining pay increases and/or promotions.”* The President states no written evaluations are performed.

Likewise, AADC’s Board has not developed any documentation of the basis for the bonuses<sup>8</sup> paid to the President. Until recently, the Board did not have any documentation to support the basis for the President’s compensation.<sup>9</sup> Currently, the President’s compensation is based on a survey conducted by a compensation advisor.<sup>10</sup> To date, the Board has not developed any written performance evaluations to the President.

AADC does not have a documented personnel program that clearly links salaries to the nature of work performed. Salary schedules normally used by state agencies and state public corporations are not used by AADC. AADC also does not have any documentation setting out the basis for the award of pay raises. Such documentation would confirm employees are being treated equally when pay increases, promotions, and bonuses are considered and awarded. Currently, AADC has a staff of 38 employees and approximately \$3 million in salaries.<sup>11</sup> Given the current size and complexity of AADC, it is time for the corporation to develop a more formal personnel system. We discuss our concerns related to the personnel system in Recommendation No. 1.

#### AADC’s board members compensation is consistent with provisions of state law

Under state law<sup>12</sup> board members, not employed by the State, receive \$100 for each day spent on official business of the corporation. Board members do not receive any bonuses for their services. Board members also receive reimbursement for travel and living expenses when attending board meetings or for other corporation business.

Currently, AADC’s board members per diem and travel are reimbursed by using the federal rates per the federal contract requirements. However, state law requires travel and per diem reimbursements be made in accordance with the state’s administrative manual. The State requires out-of-state meals and incidental reimbursements follow the federal rate. However for in-state travel, the Board is to use the state rates which are lower than the federal rate. In the Anchorage area, the federal rate is higher than the state rate by \$37 or \$29 depending on the time of year. Even though the Board typically has limited travel, AADC should modify their reimbursement procedures to follow state law or seek statutory change regarding board travel.

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<sup>8</sup>In FY 05, the President was paid a \$10,000 bonus. In FY 06, the Board approved a \$15,000 bonus that was paid in FY 07.

<sup>9</sup>Over twenty-four months, the President’s salary went from \$165,000 a year to \$231,000.

<sup>10</sup>Using data from seven survey source groups, the contractor compared the AADC President/CEO compensation to other CEO positions. In November 2006, the contractor provided the information to the Board’s compensation committee. Based on contractor’s review, the Board voted to increase the salary of AADC’s President/CEO position effective January 1, 2007.

<sup>11</sup>AADC is a participant of the public employees’ retirement system (PERS) but the amount of salaries in the report does not include any benefits.

<sup>12</sup>AS 14.40.826(c)

AADC's scholarship program is allowed under the corporation's statutory authority

In 2004, AADC pursued establishment of a college scholarship program for graduating high school seniors. After obtaining an opinion from corporate counsel that such a program was consistent with corporation statutes, AADC funded the award of ten \$5,000 scholarships.<sup>13</sup>

In the first year of the program applicants were limited to students of the Kodiak Island Borough School District. In the second year high school graduates statewide could apply for the funding. Students receiving the scholarship can receive \$5,000 a year for each year of school up to a total of four years. Accordingly, when fully funded the scholarship program could cost as much as \$200,000 a year to sustain.

One component of AADC's operational mission as set out in state law is the development and implementation of space-related educational opportunities. The scholarship program is one way AADC accomplishes this mission. However, it is not clear how the program fits into the overall corporate strategy involved with meeting AADC's responsibilities related to space-related educational development. At a minimum, board resolutions connected with authorizing the program need to be clearly worded to tie the scholarship program to the corporation's purpose in this area. This has not always been the case. See Recommendation No. 2 for further discussion about improving the documentation involving the program, in order to better connect these activities with the education development aspect of the corporation's responsibility.

AADC's investment policy does not address important aspects of fiduciary care

In 2004, state law was enacted<sup>14</sup> allowing AADC to independently manage and account for the corporation's funds. At the time, AADC was given greater autonomy for the approximately \$37.5 million in cash transferred to the corporation's control. The corporation is now responsible for managing and investing the balance and proceeds of the State's AADC Fund.

In the last five years, AADC's cash and cash equivalents at fiscal year-end ranged from a low of approximately \$16 million to a high of approximately \$34 million. At the end of FY 06, approximately 79 percent of AADC's cash and cash equivalents consisted of federal funds that have been advanced under the terms of a multi-year grant award. The funds and related earnings are owed to the funding agency upon completion or termination of the award. Since AADC is now responsible for managing its own investments and for the

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<sup>13</sup>The primary statute cited as authority for the scholarship program is AS 14.40.861(6). This section of the statute lists one of the purposes of AADC as providing direction

*for development of a state strategy for and to implement the acceleration of space-related economic growth and educational and research development in the state by the use of innovative development methods designed to stimulate space-related business and educational and research development and improve the entrepreneurial atmosphere in the state.*

<sup>14</sup>SLA 2004 §§ 4, 5 ch 175

corporate beneficiaries – the federal government, it now has the fiduciary duty to develop and follow a prudent investment policy.

The investment policies and procedures manual of the Department of Revenue, Division of Treasury, provides information regarding fiduciary responsibilities and information for developing an investment policy. See Exhibit 4 for a listing of responsibilities of the primary fiduciary. The primary fiduciary of AADC would be the President and his staff.

<b>Exhibit 4</b>
<b>Responsibilities of the Primary Fiduciary</b>
<ul style="list-style-type: none"> <li>▪ prepare written investment policies and document the investment process in writing</li> <li>▪ diversify assets in light of the risk/return objectives pertinent to the purposes of the fund</li> <li>▪ use “prudent expert” to make investment decisions</li> <li>▪ control investment expense</li> <li>▪ avoid conflicts of interest</li> <li>▪ for assets held in trust, take actions with respect to those assets for the sole benefit of trust beneficiaries</li> </ul>
<p><i>Source: SOA Department of Revenue Treasury’s Investment Policies and Procedures Manual</i></p>

AADC’s staff developed an investment policy which was approved by the Board. When AADC’s policy is compared to recommended guidelines in Division of Treasury’s investment manual, the corporation’s policy lacks key components of a comprehensive investment policy. AADC’s investment policy had no discussion or reference to ethics or conflicts of interest on the part of corporate officers, staff, and investment managers.

The policy lacked adequate description of the corporation’s funds and had little discussion as to duties and responsibilities of parties involved in the investment process including who will be responsible for the investment decisions. Although AADC is using an investment advisor, there is no reference in its policy as to using one, how an advisor should be selected, and how the advisor’s performance should be evaluated. Recommendation No. 3 discusses expanding the policy to address these missing elements.

AADC’s current operations do not support payment of a significant dividend to the State

AADC has posted a net operating loss in each of the last five fiscal years. Before depreciation, a noncash expense, the corporation did have a gross operating profit for four of the years. This pattern suggests the revenues generated have not been sufficient to cover the wear and tear, and the eventual replacement of the corporation’s durable assets. Exhibit 5, on the following page, provides a historical perspective of AADC’s gross operating income.

Currently, most of AADC’s revenues come from a contract with the U.S. Department of Defense, Missile Defense Agency (MDA). Under the contract, AADC is to provide launch services in conjunction with the nation’s missile defense program. An important aspect of the contract is that MDA allows for what is termed “operations and sustainability” during periods of inactivity. Basically, MDA agrees to fund and maintain the Kodiak Launch Complex (KLC) facility until MDA is ready to launch its vehicle. This is important because AADC is compensated for limiting its capacity to seek other customers. At this time AADC

cannot provide launch services for two customers, at the same time, due to launch pad limitations.

In the contract between MDA and AADC, various types of services are reimbursed using different funding formulas. One component of the funding formula for various services is a percentage paid for what is termed “fees or profit.” The amount paid for fees and profit depends on the type of service involved. Smaller contracts with other customers may also provide for fees and profit for the corporation.

<b>Exhibit 5</b>				
<b>AADC</b>				
<b>Gross Operating Income (Loss)</b>				
<b>(Unaudited)</b>				
<b>Fiscal Year</b>	<b>Operating Revenues</b>	<b>Operating Expenses<sup>1</sup></b>	<b>Gross Operating Income (Loss)<sup>1</sup></b>	<b>Net Operating Income (Loss)<sup>2</sup></b>
1993	0	216,000	(216,000)	(221,000)
1994	0	678,000	(678,000)	(690,000)
1995	0	702,249	(702,249)	(717,551)
1996	0	1,076,860	(1,076,860)	(1,104,270)
1997	0	856,478	(856,478)	(880,917)
1998	65,000	852,968	(787,968)	(810,506)
1999	1,266,238	1,725,085	(458,847)	(485,128)
2000	877,797	1,260,897	(383,100)	(409,925)
2001	4,225,231	3,100,614	1,124,617	1,097,633
2002	7,483,866	6,900,950	582,916	(1,160,415)
2003	3,627,954	3,663,516	(35,562)	(1,917,521)
2004	13,902,160	12,282,012	1,620,148	(677,961)
2005	18,321,495	16,464,593	1,856,902	(1,566,424)
2006	17,188,193	16,547,990	640,203	(3,073,566)

For comparability purposes, cooperative agreement revenues and expenses included as operating. <sup>1</sup>Does not include depreciation. <sup>2</sup>Does include depreciation.  
*Source: AADC financial statements and State CAFRs*

These fees and profit revenues offer the most promising source of possible dividends to the State. However, these funds are used to pay for AADC operational expenses that are not, or cannot be billed to customers. Such expenses are termed “non-billable” by AADC.

The funding of scholarships, business development expenses, and bonuses<sup>15</sup> are examples of non-billable expenditures that were paid from the fees and profits of the corporation. Exhibit 6 summarizes AADC’s non-billable expenditures that were paid from AADC’s fees and profit by account category for FY 06.

A relatively small dividend can possibly be paid from the fees and profits of the corporation. However, the current operations of the corporation will limit the amount of any periodic dividend payment. This assessment is based on the following:

<b>Exhibit 6</b>	
<b>AADC</b>	
<b>FY 06 Non-billable Operating Expenditures</b>	
<b>(Unaudited)</b>	
<b>Account Category Name</b>	<b>Amount</b>
Personal Services	\$ 44,510
Travel	33,267
Services	
scholarship program:	\$100,000
open house functions:	\$ 22,578
space explorers program:	\$ 50,080
employee recruitment:	\$ 25,940
business develop video:	\$126,445
economic impact study:	\$ 47,000
business development:	<u>\$159,309</u>
Total Services	531,352
Supplies	1,540
Furniture and Equipment	20,669
<b>Total</b>	<b>\$ 631,338</b>

*Source: AADC financial documents*

<sup>15</sup>In FY 06 no bonuses were paid. However, in FY 05 and FY 07, bonuses were captured as a non-billable expenditure under personal services.

- AADC is not a fully matured business operation. When the corporation was building the infrastructure and trying to build a customer base there was anticipation that the telecommunication satellite market would be an expanding source. This did not occur.

The MDA launch services contract is currently the central source of revenue for AADC. In the near term there are limited prospects for any substantial revenue producing business. AADC continues to try to find other customers and markets. Currently, AADC plans to construct another launch pad to accommodate more than one customer at time. However, AADC currently does not have enough cash reserves and is trying to secure other funding sources.

- The available cash reserves are relatively low. At FY 06's year-end the amount of AADC's cash and cash equivalents was approximately \$15.5 million; however, less than \$2 million was available for discretionary use. Most of these funds involved cash advances from a federal grant that cannot be spent for other purposes.

AADC has little cash reserves for maintenance and upkeep of its KLC facilities and to make any technological upgrades to remain competitive.

Recommendation No. 4 offers discussion of possible statutory change regarding AADC's consideration of a state dividend.

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# FINDINGS AND RECOMMENDATIONS

## Recommendation No. 1

The AADC Board of Directors (Board) should direct the President to establish a documented personnel management system that includes a formalized salary structure system and more formalized evaluation process.

As previously discussed in the Report Conclusions section, the basis for salaries, performance evaluations, pay raises, and bonuses at AADC is – to a large extent – undocumented. All pay is essentially set by a single individual – the President on a case-by-case basis. Such informality in determining staff compensation may be appropriate in small scale organization. For an organization of almost 40 people with payroll of \$3 million spread over two sites more than 250 miles apart, a more formal and documented system better serves the interest of the State and the corporation. Specifically, consideration should be given to developing a salary schedule and a formal, documented performance appraisal process.

The State’s constitution<sup>16</sup> requires the merit principle be the central tenet of state employment. Exhibit 7 lists what aspects are involved with the State’s merit principle. Since AADC’s Board has been given authority in state law to establish a personnel management system, the Board should ensure the corporation’s personnel management system is based upon merit principles.

We recognize the existence of a structured compensation schedule is not necessary to provide a workable merit base personnel system. However, the size of AADC’s workforce and increasing complexity of many of its jobs requires a more

formalized documented system to ensure: (1) employees compensation is based upon merit; (2) employees are being treated equally; and, (3) that employees are formally put on notice as to management’s perspective regarding their job performance. The Board should direct the President to establish written policies and procedures to ensure employee salaries are based

<p><b>Exhibit 7</b></p> <p style="text-align: center;"><b><u>Merit Principle</u></b></p> <p>The merit principle of employment includes:</p> <ul style="list-style-type: none"><li>• recruiting, selecting, and advancing employees on the basis of their relative ability, knowledge, and skills, including open consideration of qualified applicants for initial appointment;</li><li>• a regular integrated salary program based on the nature of the work performed;</li><li>• retention of employees with permanent status on the basis of the adequacy of their performance;</li><li>• equal treatment of applicants and employees with regard only to consideration within the merit principles of employment;</li><li>• selection and retention of an employee’s position secure from political influences; and,</li><li>• allowance for the employee to make reasonable efforts to correct inadequate performance, and separation for cause.</li></ul> <p><i>Source: State Personnel Act: AS 39.25.010</i></p>
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<sup>16</sup>Article XII, § 6

on merit. A formal salary structure should be established, and employee performance evaluations should be in writing. Such actions, in our view, would more clearly demonstrate AADC's commitment to operating in accordance with established state personnel policy.

### Recommendation No. 2

AADC's Board of Directors should direct the President to develop regulations or policy for the corporation's education programs.

As discussed in the Report Conclusions section, AADC's scholarship program is permitted under the corporation's statutes. One of the purposes of the corporation is to develop and implement a state strategy for promoting space-related education and research.

In the first year of the scholarship program, the Board resolution authorizing funding for the program set out clearly that the intent of the program was to help accomplish this aspect of the corporation's mission. The Board resolution, governing authorization of the second year's participation, did not clearly cite the basis for the Board's action.

This disparity between the resolutions takes on a more significant meaning given the lack of any other corporation regulations, policies, and procedures related to carrying out the space-related educational aspect of the corporation's mission. Without regulations or policies referencing how the corporation accomplishes this aspect of its established purpose, it is difficult to understand how the scholarship program fits into an overall corporate strategy. Funding and supporting programs without guidance in regulations or policy that provides no direct link to the corporation's purpose results in questions regarding the legitimacy of the actions of AADC.

AADC's management and Board of Directors should adopt regulations, or at a minimum policies and procedures, that set out the corporation's strategy in supporting development of space-related education programs. The documentation would establish a clearer link between the Board resolutions related to the scholarship program with the space-related education and research aspects in the corporation's statutes. Such regulations or policies should provide for periodic assessment of how effectively the scholarship program is carrying out the corporation's mission. Such action would formalize the role the scholarship program plays in AADC accomplishing the mission and would lend greater legitimacy to spending operational revenues on educational programs.

### Recommendation No. 3

AADC's Board of Directors should take action to improve the corporation's investment policy and document that key precepts are understood and followed by corporate staff and outside investment managers.

Currently, certain key elements are not explicitly included in AADC's investment policy. The policy does not explicitly discuss expectations that investments will be handled in an ethical manner, free from real or perceived conflicts of interests. The policy scarcely addresses the duties and expectations of various individuals involved in the investment process.

We suggest the Board refer to policies and procedures established by the State of Alaska's Department of Revenue, Division of Treasury, regarding certain requirements and language relevant to the funds managed by the corporation. Specifically, we recommend an expanded policy incorporate three key procedures or provisions:

1. The investment firm should periodically sign a document attesting that it is managing the corporation's business in accordance with certain standards. At a minimum, such certification should attest that the firm has no commercial relationship with AADC managers responsible for investing state funds. The certification should also attest no incentive, involving the personal interests of AADC managers, has been offered or requested. Such a requirement formally puts the firm on notice it is expected to manage AADC assets for maximum return consistent with corporate direction. The attestation also puts the firm on notice it has a responsibility to recognize and avoid potential, apparent, and real conflicts of interest when investing state funds.
2. All AADC staff and board members, involved with the investment process, should also periodically certify as to having no personal conflicts of interest or financial relationship with the investment firm. As with the corporation's investment advisors, we suggest AADC's staff and board members periodically certify they are free from potential or real conflicts of interests involving the firm responsible for managing state funds. Specific attestations should be included such as the individual has no personal investment account with the firm and does not receive personal investment or counseling from firm representatives. Documenting such assertions serves to make individuals more mindful of potential conflicts of interest and personal business relationships that should be avoided, given their corporate responsibilities.
3. Establish a process and basis for evaluating the performance of the investment firm. AADC should establish a basis and process for evaluating the performance of the corporation's investment management firm. Performance benchmarks should be developed to reflect investment objectives and levels of acceptable risk related to the funds involved. Such performance criteria should be incorporated into the contract with the investment firm and a formal evaluation of investment performance, utilizing the criteria, should be carried out. Results of the evaluation should be reported to the Board, and be referred to, when considering whether to renew the existing contract or advertise for investment management services.

Although funds are under the control of AADC, the legal basis for funding is derived from state law and, as discussed, most of the proceeds are cash advances from the federal government. Adoption of these and perhaps other measures would allow AADC to better

fulfill its fiduciary responsibilities to both the state and federal government. Adoption of such policy and procedures would better ensure that:

1. investment decisions are made in the best interest of AADC;
2. all parties involved in the investment management process are aware of their duties and responsibilities – while affirmatively being put on notice they are responsible for observing ethical guidelines; and
3. continuity of policy and practice in the event of management or investment advisor turnover.

#### Recommendation No. 4

To encourage AADC’s Board of Directors to actively consider distribution of a dividend to the State, the legislature should require the Board to formally evaluate such action each year, and report to the legislature.

The legislature historically has given AADC a great deal of discretion over administration of its operations. This ostensibly has been done because AADC operates in a highly technical and competitive commercial market. Under such circumstances, legislators have been willing to give the corporation extensive flexibility in the areas of finance, budget, procurement, personnel administration, and limiting disclosure of information that is typically available to the public for other state agencies and organizations.

There is now interest in directing AADC to distribute a dividend to the State from the earnings of the corporation. For an organization such as AADC, with a business model and a market that are not fully matured, the income and asset balances do not reflect the corporation’s capacity to pay a significant dividend to the state. Capacity to pay dividends is not clearly reflected in financial statement account balances.

Any assessment of dividends must consider using the “fees and profit” proceeds generated by the corporation’s primary operating contract. These proceeds are available to be spent on what are termed “non-billable” items. While these proceeds are reflected in the corporation’s financial statements, they are not specifically identified as revenues available for spending on discretionary items – such as bonuses and scholarships. Accordingly, trying to develop legislation that would require a certain amount or percentage of these funds be paid in dividends would be difficult to define and clearly set out in state law. Such action could not adequately account for such factors such as cash flow, other commercial prospects, and infrastructure needs.

Whether funds used to pay for such things as scholarships or bonus compensation could alternatively be used to fund a relatively small dividend to the state’s General Fund, is a valid

policy question. Developing a specific language, however, that requires dividends be paid based on a formula applied to balance sheet accounts would be difficult.

As set out in our conclusions, in our view, AADC operations currently, and in the near term, would not generate sufficient revenues to pay a significant dividend to the State. Notwithstanding our conclusion, we suggest if the legislature wants AADC to give due consideration to paying such a dividend it require in state law that such analysis be done.

Accordingly, we recommend the legislature amend state law related to AADC to require the Board to annually consider payment of a dividend to the state. The statute could require that the Board report to the legislature whether a dividend is available or not, and the basis used by the Board in making its determination.

Such an approach would, at a minimum, put the concept of dividend distribution on the operational agenda of the corporation. Making the final assessment of whether to pay a dividend the Board's decision, and requiring the Board to report on the basis for that decision, clarifies legislative expectations. At the same time the legislature would continue to recognize the Board's discretion and authority historically provided for in state law.

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June 27, 2007

Ms. Pat Davidson, Legislative Auditor  
Division of Legislative Audit  
PO Box 11300  
Juneau, AK 99811-3300

RE: Alaska Aerospace Development Corporation (AADC)  
Preliminary Audit Report No. 08-30039-07 dated April 11, 2007

Dear Ms. Davidson,

We appreciate the professionalism extended to our staff and appreciate the consideration that has been taken regarding disclosure of proprietary information. As we discussed, AADC is in a highly competitive industry and to protect State's interest, it is important that the information provided to the general public does not impact our ability to be competitive and secure new business.

We have had the opportunity to reviewed Legislative Budget & Audit Agency's preliminary audit report. Below is AADC's response to preliminary audit report.

**Background Information – AADC Scholarship Process**

However, only \$82,500 of \$150,000 was provided to the UA Foundation by AADC and has been distributed to recipients (excerpt from page 9)

It is AADC's understanding that the audit report is going to be modified to clarify the Scholarship Process. AADC concurs with the following modification to the audit report "However, only \$82,500 of the \$150,000 provided by AADC to the UA Foundation has been distributed to recipients".

### **Recommendation No. 1**

The AADC Board of Directors should direct the President to establish a documented personnel management system that includes a formalized salary structure system and more formalized evaluation process.

AADC concurs with the agency's recommendation that a documented personnel management system needs to be developed and implemented. AADC's management will assist the President in drafting a personnel management system to be approved by the AADC Board of Directors. The management system will take into consideration the merit principles as outlined in the preliminary audit report while meeting the contractual requirements as outlined in the Federal Acquisition Regulations.

### **Recommendation No. 2**

AADC's Board of Directors should direct the President to develop regulations or policy for the corporation's education programs.

As discussed in the preliminary audit report, one of the statutory purposes of the corporation is to develop and implement a strategy for promoting space related education and research. The Board of Director's established the scholarship program to accomplish this aspect of the corporation's mission. AADC management will work with the President to develop policies and procedures that will document a clearer link for how the educational programs support the corporation's missions and provide information to the Board of Directors on how effectively the programs are carrying out the corporation's mission.

### **Recommendation No. 3**

AADC's Board of Directors should take action to improve the corporation's investment policy and document that key precepts are understood and followed by corporate staff and outside investment managers.

AADC will review the investment policy and take into consideration the recommendation that the policy explicitly discuss the expectation that investments will be handled in an ethical manner, free from real or perceived conflicts of interest.

Furthermore, AADC will review the investment policy of the Department of Revenue and Treasury and incorporate those procedures that are applicable to AADC. AADC will also review the corporation's investment policy taking into consideration the expected standards of the investment firm, ensure key Management and Board of Directors have no conflicts of interest with the investment firm, and develop a process for evaluating the performance of the investment firm.

#### **Recommendation No. 4**

To encourage AADC's Board of Directors to actively consider distribution of a dividend to the State, the legislature should require the Board to formally evaluate such action each year, and report to the legislature.

AADC is operating in a highly technical and competitive commercial market. Furthermore, AADC is starting to emerge from a start-up business phase to an early development business phase. As in any organization, to mature into a healthy and viable organization, reinvestment into the organization is vital to ensure future cash flows and growth.

AADC concurs that the corporation does not have sufficient capacity to support a cash dividend to the State at this time. However, AADC has worked hard to provide other dividends to the State by bringing new monies from outside Alaska to local communities. This money provides new jobs to local citizens as well as providing new business opportunities for local vendors. AADC plans to continue to work closely with its customers to continue to provide these dividends to the State.

During the last AADC Board of Director's meeting the President & CEO recommended to the board that they annually review AADC's financial status to determine whether a dividend can be provided. This will be a board agenda item.

Based upon guidance received from your office, we have forwarded an electronic copy of our response to [Linda.Day@legis.state.ak.us](mailto:Linda.Day@legis.state.ak.us).

Again, we would like to thank you for giving AADC an opportunity to respond to Legislative Budget and Audit Agency's recommendations and the level of professionalism extended to our staff.

Sincerely,



Ms. Sharon Anderson  
Chair, AADC Board of Directors

Cc: AADC Board of Directors  
Mr. Pat Ladner, President/CEO  
Mr. Dale Nash, COO  
Ms. Monica James, CFO  
Ms. Jodi Andres, Controller