BACKGROUND INFORMATION TO THE FINANCIAL AUDIT OF THE GENERAL FUND OF THE STATE OF HAWAII WITH A SYNOPSIS OF SOME MAJOR FINDINGS

Office of the Legislative Auditor
State of Hawaii

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BACKGROUND

With the issuance of the report entitled, *Financial Audit of the General Fund, State of Hawaii, for the Fiscal Year Ended June 30, 1968,* the Legislative Auditor completes his reporting responsibilities in connection with the major financial audit engagement undertaken by his office in the current fiscal year. The aforementioned report, together with two recently-issued reports, *Financial Audit of the State Department of Budget and Finance* and *Financial Audit of the Judicial Branch, State of Hawaii,* comprise a three-part report of the Legislative Auditor's examination of the State's general fund.

Purpose of Auditing the General Fund. While financial audits may be undertaken on a department-by-department basis, the approach followed in this particular audit was to take the general fund, rather than the department, as the entity to be examined. This approach was adopted as a more economical way of examining a fund which affects most of the departments and agencies of the State and counties. One of the main reasons for having selected the general fund for audit at this time, rather than other State funds, is that it is the largest fund of the State with revenues in FY 1967-68 totaling $339,835,775, or nearly 70 percent of the total receipts of the State. The second main reason for auditing the general fund is that it had not previously been audited in its entirety.

Conduct of the Audit. The examination of the general fund was conducted by certified public accountants contracted by the Legislative Auditor. To facilitate the examination, the audit was pursued in three phases by the auditing firms who were under the direction of the Legislative Auditor and governed by his audit instructions and specifications. While the three parts of the audit were conducted separately, they are related in that each comprises a portion of the total examination of the State's general fund. The following accounting firms participated in the audit: Peat, Marwick, Mitchell & Co. and a joint venture of Clay, Wulfekuhler & Co.; Hokada & Hayashi; Inagaki, Mukai & Fo; Ishimoto, Imamoto & Co.; and Lemke & Co.

Scope of the Audit. The scope of the audit is defined in the introduction to each part of the audit. In general, the audit of the general fund covered the financial procedures, internal controls and transactions of one of the three principal branches of government (the Judiciary), those of the two major financial controls agencies of the State government (Department of Accounting and General Services and Department of Budget and Finance), and the procedures and practices, particularly as they relate to revenue collections, of eight executive agencies and departments (Department of Taxation, University of Hawaii, Department of Education, Department of Agriculture, Attorney General's Office, Department of Social Services, Department of Transportation, and Department of Planning and Economic Development).

SYNOPSIS OF MAJOR FINDINGS

Details of the findings and recommendations of the audit may be found in each of the three parts of the audit. In addition, each part of the audit contains a summary of the findings and recommendations. This synopsis presents certain significant findings in the sequence of what the auditors found, the response of the agency, comment by the auditors, and where appropriate, background information concerning the condition. Where information is included which is not directly extracted from the issued audit reports, it is presented in italics. Page references are references to the appropriate part of the audit report.

Investment Policies and Practices of State Government (Refer to *Financial Audit of the State Department of Budget and Finance*)

The auditors found that better cash planning by the Department of Budget and Finance could result in the State earning significantly more interest income than it does under policies and practices prevailing at the time of the audit. *At any period of time in recent years, the State normally has had more funds than there were immediate demands for such funds. As with private businesses, an objective of governmental jurisdictions is to keep only so much "ready cash" as is necessary to satisfy immediate obligations and to put any additional cash "to work" in interest-bearing investments. To the extent that governments fail to capitalize on the opportunity to earn interest on their funds, pressure on other revenue sources, such as taxation, is increased, assuming a given expenditure level.*

As identified by the auditors, the principal reason why the State has not fully availed itself of the opportunity to increase its interest income is that the department does not prepare any cash forecasts for the purpose of determining the State's short- and long-term requirements to meet financial obligations. In the absence of such forecasts, the department has had to maintain relatively large sums of money in (non-interest bearing) demand deposits, rather than in (interest-bearing) time deposits, to avoid overdrafts in the State's bank accounts. The department had been following a rule of thumb of maintaining 60 percent of the State's funds in time deposits and 40 percent in demand deposits. In FY 1967-68, the average monthly balance of State funds in time deposits was $58.2 million, and the average balance in demand deposits was $38.2 million. It is the auditors' contention that with the preparation of cash forecasts, demand deposits could be decreased, time deposits increased, and the result would be a significant rise in the State's interest income. (Part II, pp. 7-12)

How much additional interest income the State could have earned, but did not, was estimated by the auditors. They were informed that the City and County of Honolulu was able to maintain an average of 85 percent of its cash in time certificates of deposit, which earned interest at an average rate of 5.02 percent. The auditors indicated that if the department had been able to improve its average of approximately 60 percent invested in time certificates of deposit to the 85 percent average of the City and County of Honolulu, the State would have realized more than $1.2 million of additional interest income in FY 1967-68, assuming an average interest rate of 5.02 percent.

In his response, Mr. Andrew T. F. Ing, Director of Finance, acknowledged that the proper ratio of State funds to be deposited in (interest-bearing) time deposits and (non-interest bearing) demand deposits will depend on cash flow forecasts, but that it has been difficult to forecast general fund revenues and such expenditures as cash advances for capital improvement projects. He stated: "As soon as a meaningful cash flow statement can be achieved, the maximum of funds will be invested." (Part III, Attachment 3, pp. 1-2)

Commenting on the response of the Director of Finance, the auditors stressed the importance of taking prompt measures to prevent the continued loss of interest income "...we urge the Director of Finance to move with all the swiftness possible in providing these forecasts. With the price of money being what it is today, the State cannot afford to have any funds idle. Furthermore, we are confident that any cost incurred by the State in developing these forecasts will be recovered many times over in additional investment income."

Security Controls over State Funds (Refer to *Financial Audit of the State Department of Budget and Finance*)

The auditors found that there is a lack of satisfactory security measures with respect to the safekeeping of cash and securities in the Finance Division. They were critical of the inadequate physical controls exercised over the cashier's section of the Finance Division, where funds are received and accounted for, as well as controls over the division's vault, where securities and cash in excess of normal requirements are stored. They noted that because of the lack of controls, unauthorized access to cashier's area and vault would be possible.

Adding to the security problem is the practice of permitting State employees to cash payroll checks at the Finance Division. This practice has required the division to keep additional cash on hand of more than $100,000 every pay period. The auditors noted that ample commercial banking facilities are available within a short distance of the State offices, and they recommended that the department discontinue its check-cashing service. (Part II, pp. 16-18)

The Director of Finance stated that the auditors' recommendations concerning the security measures are valid, and that the measures will be complied with. He stated also that the practice of cashing checks will be discontinued when the Finance Division is relocated in the new State Capitol in April. (Part III, Attachment 3, p. 3)

Inadequacies of the State Accounting System and the Statewide Information System (Refer to *Financial Audit of the General Fund, State of Hawaii*)

In order for the departments and agencies of the State to properly plan and manage their activities and exercise financial controls over their operations, timely fiscal information is required. The Department of Accounting and General Services, the accounting office of the State, has not been able to supply the required fiscal information to the various departments early enough to be of assistance to departmental officials in the planning and expenditure control process. For this reason, it has been necessary for the departments to duplicate, in part, the record-keeping process of the Department of Accounting and General Services.

The lack of an adequate accounting system has been recognized for several years, and it has been a major project of the State to implement a Statewide Accounting System supported by electronic data processing. The accounting system was to have been developed as part of the development of the Statewide Information System (SWIS). As indicated in a

1963 administrative directive, the State plan for SWIS was that a centralized accounting system was to have been developed in the first phase of SWIS in FY 1963-64. The auditors found that original implementation schedules have not been met and that the Statewide Accounting System is still in the "early developmental stage."

Among the reasons cited by the auditors as contributing to the problem of getting the accounting system under way has been the lack of formalized project planning and control. The auditors state that there has been almost "a complete lack of normal project management controls, such as clearly-defined responsibilities, documented project goals, work controls, and expenditure budgets." Especially significant, in the auditors' view, was that the responsibility and authority for systems development of the accounting system has not been clearly defined, and that because SWIS officials and the officials of the Department of Accounting and General Services have different ideas and "competing approaches" of systems design, "it is doubtful if any measurable progress will be made," unless these problems are resolved. (Section III, pp. 1-10)

The auditors also reviewed the Statewide Information System (SWIS) to assess its effects on the development of the Statewide Accounting System. SWIS development was to have followed an April 1963 report submitted by the management consulting firm of Cresap, McCormick and Padget, which had been retained to develop a long-range data processing plan for State government. The basic framework of the study was incorporated in a State Administrative Directive on August 29, 1963, under which the Statewide Information System was to have been implemented in four successive phases, beginning in 1963 and ending in 1967. The auditors conclude that "it is readily apparent that this timetable was not maintained," and that "today only minor segments of the Cresap study have been implemented."

Among the recommendations made by the auditors is that specific goals and the plans for attainment of these goals should be developed for the Statewide Information System. These should include schedules for accomplishing clearly-defined tasks and resource requirements and should be clearly spelled out "to provide direction to SWIS itself" and to allow other agencies to act effectively in relation to SWIS. In addition, "long-term and competent leadership must be assured in the positions of SWIS Director and SWIS Chief." The auditors note that since the inception of the Statewide Information System, there have been three directors and that the position of Chief of the SWIS Division has never been filled since the system was initiated in 1963. The auditors urge that "it is especially important that the position of SWIS Chief be filled as soon as possible in order to provide overall technical direction . . . ." (Section IV, pp. 1-17)

Mr. KeNam Kim, State Comptroller, disputes the auditors' finding that the lack of clearly-defined responsibility and authority, as between his Department of Accounting and General Services and the Statewide Information System, is a cause for the lack of progress in development of the Statewide Accounting System. He states that "there is no basis for confusion as to the accounting responsibilities of the State of Hawaii or for any related confusion as to the relationship between those accounting responsibilities and the data processing responsibilities of SWIS. Because we believe our accounting responsibilities have been and continue to be clearly defined, we do not believe that a need to define those responsibilities is a cause for lack of progress in revising the State's accounting system." (Section VII, Attachment A to Attachment 4, p. 1)

The State Comptroller also states that "there is general agreement among everyone affected as to the results desired from a revised accounting system." While acknowledging that "it is obvious that a difference in approach exists, it has not resulted in the impasse that the auditors seem to suggest." He states that both SWIS and his department have been working together on the payroll subsystem of the revised accounting system, and states further: "It is agreed, however, that we would also like to be at work under the same team arrangement on other of the accounting subsystems." (Section VII, Attachment A to Attachment 4, p. 3)

Mr. Eugene Harrison, Director of the Statewide Information System, was requested by the Legislative Auditor to submit his comments on the findings and recommendations made by the auditors, but no reply was received.

In their comments, the auditors note that in his denial that there is confusion as to responsibility for the development of the Statewide Accounting System, the Comptroller cites the statute which empowers him "to make such changes and modifications in such (accounting and internal control) systems as from time to time appear to be in the best interest of the state and counties." The auditors state that the Director of SWIS has indicated that while he feels that the statute does apply to changes and modifications to the present accounting system, he believes that "the responsibility for the design of a completely new accounting system is NOT covered by the above quoted statute."

The auditors state: "The opposing positions of (the two agencies) on the interpretation of the intent of the statute is evidence of the confusion that exists as to the accounting responsibilities of their groups." The auditors conclude that "the confusion and lack of coordination in the exercise of these responsibilities, regardless of where they are vested by law, must be resolved by higher authority if satisfactory progress is to be made in the Statewide Accounting System." (Section VII, Attachment 1, pp. 1-2)

Delay by the University of Hawaii in Transmitting Revenues to the State Treasury

State laws require that every public accountant in Honolulu (those charged with the duty of collecting or receiving State revenue or other money) shall pay weekly into the treasury all sums of money collected or received by him, and that he shall also submit monthly reports to the Comptroller of all funds collected or received.

The auditors found that the University of Hawaii neither remitted to the State Treasury nor reported to the Comptroller, within the time limit prescribed by law, general fund revenues which it received and collected in the amount of $383,430.93 in FY 1966 and $1,136,758.36 in FY 1967. The FY 1966 revenues, which represented June 1966 receipts, were not transmitted to the State Treasury until November 1966, and the FY 1967 revenues, which represented receipts during the period March to June 1967, were not transmitted until August and September of 1967.

Instead of transmitting the funds to the State Treasury, the revenues were deposited in the University's own general account. Because the University has had a requirement to make certain expenditures on federally-funded projects prior to the actual receipt of funds from reimbursing federal agencies, it has been the practice of the University to use the general fund revenues it collected to finance these expenditures pending reimbursement by the federal government.

The auditors point out that this practice of delaying the transmission of general fund revenues, and using such revenues for federally-funded projects, was not only illegal but unnecessary. They note that certain specific legislative acts empower the State Director of Finance to advance funds to the University when required to meet reimbursable costs of federal research and training projects. The University indicated that it had submitted a written request in January 1968 to secure a cash advance from the Department of Budget and Finance, in lieu of delaying and using the revenues it received, but that it had not received any response to the request. (Section V, pp. 21-24)

In his written comments to the audit findings, Dr. Robert W. Hiatt, Acting President, states that the University was able to correct the problem at the beginning of the current fiscal year, and that all cash transmittals to the State Treasury are now current. (Section VII, Attachment D to Attachment 4, p. 2)