

**AN OVERVIEW BY THE LEGISLATIVE AUDITOR
OF THE FINANCIAL AUDIT OF THE
DEPARTMENT OF REGULATORY AGENCIES
STATE OF HAWAII**

FOREWORD

This audit report is the result of an examination of the financial statements and records of the department of regulatory agencies for the fiscal year ended June 30, 1973. The audit was conducted by the firm of Main Lafrentz and Co., certified public accountants, under contract with our office.

The auditors (1) examined the financial statements and related accounting records of the department and reported on the accuracy with which the financial statements reflected the financial transactions of the department; (2) evaluated the adequacy and effectiveness of the systems and procedures for financial accounting and reporting and for internal and operational controls; and (3) reviewed the reasonableness of the fees, licenses, and fines being assessed by the department, the fairness of the fee and license structure, and the department's adherence to prescribed policies and legal requirements.

Prior to the finalization of the audit report, a draft copy of the report was submitted to the department of regulatory agencies and other State agencies affected by the audit. The agencies were requested to respond to the audit findings and recommendations directed to the respective agencies and to indicate what action they have taken or intend to take regarding the recommendations. The agencies' responses and the auditors' comments on the responses are included in the last part of the audit report.

SYNOPSIS OF MAJOR FINDINGS

The audit identified a number of deficiencies in the department's systems and procedures for financial accounting and internal and operational controls. The more serious deficiencies related to: (1) departmental practices (some stemming from existing statutory provisions) which have resulted in a substantial loss of revenues to the State, and (2) security weaknesses over departmental receipts.

Loss of revenue. The departmental practices that were found to have resulted in a substantive loss of revenues to the State included: (1) charging banks and insurance companies for the costs of examinations at rates insufficient to recover the full costs, (2) assessing professional and occupational groups licensing and regulatory fees at disparate and inadequate rates, and (3) collecting insurance premium taxes on an annual basis.

1. Insufficiency of bank and insurance company examination fees. The statute provides that the bank examined be charged the cost of such examination calculated "on cost per hour per examiner plus travel, per diem and other related expenses." The audit disclosed that the examiners' hourly rate charged the banks is lower than the actual hourly rate of the examiners' salaries, and the 25 percent of the hourly rates charged for "other related expenses" is grossly insufficient to recover the overhead costs of the examinations. The auditors believe that the overhead rate should be at least 49 percent of the hourly rate, if the costs of supervisory employees (as contrasted from those employees who actually conduct the audit in the field), the costs of fringe benefits enjoyed by the examiners, and the costs of clerical and other audit support personnel are properly considered. The auditors noted that the overhead rate would be higher than 49 percent and the loss to the State in revenues would be greater if the costs of such items as training, sick leaves, and employee administration are included.

The auditors estimated, based on the actual salaries of the examiners and the 49 percent rate for overhead, that the loss to the State in unrecovered costs for bank examinations totaled in excess of \$600,000 over the period from 1967 to 1973 and would total \$182,000 for the fiscal year ending June 30, 1974 if the hourly and overhead rates remain unchanged.

Although no estimate of losses was made, the auditors indicated that the current billing rates for the examination of insurance companies are also inadequate to recover the costs of the examination.

The auditors recommended that the hourly and overhead billing rates for bank and insurance examinations be revised so as to recover all costs of examinations, including all related overhead costs.

2. Insufficiency of licensing and regulatory fees. The audit found that the licensing and regulatory fees charged certain occupational and professional groups are insufficient to recover costs. Licensing and regulatory fees include those charged for examining applicants for occupational licenses (e.g., real estate salesman's license, license to practice dentistry), issuing licenses and certificates to practice a trade or engage in business, and renewing licenses and certificates.

An example of the inadequacy of the fees charged cited by the auditors was those fees charged insurers for the issuance of certificates of authority to engage in the business of insurance and for annual services. The auditors found that in the fiscal year ended June 30, 1973, the cost (\$152,800) of the regulatory services performed for insurers exceeded the fees collected (\$92,000) by about \$60,800. Another example cited was the re-examination fee for registered nurses. It costs the State at least \$30 to administer the examination and yet the fee is only \$5.

In addition to the inadequacy in the amounts charged, the auditors noted widely differing amounts being charged in the various occupational and professional fields, the differences not being directly attributable to differences in the costs of regulating them.

The auditors recommended that the licensing and regulatory fee structure be re-examined and revised to ensure recovery of costs.

3. Method of payment of insurance premium tax. Insurance companies pay insurance premium taxes in lieu of the State general excise and income taxes. The insurance premium tax is computed on the gross premiums earned and is payable annually. The tax on a calendar year's gross is payable in March of the following year. The auditors concluded that there is no real reason why the insurance premium tax should not be paid monthly in the same fashion as the general excise tax, since both taxes are based on gross receipts.

The State collected a total of \$9 million in premium tax for the fiscal year 1972-73. The auditors reported that, if the premium tax had been payable in monthly installments, the \$9 million could have been invested as it was collected throughout the year. At a 6 percent per annum interest rate, the auditors estimated the State could have realized additional revenues in excess of \$350,000.

The auditors recommended that legislation be introduced in the legislature to provide for the payment of the premium tax in monthly installments. In its response, the department raised no objection to the payment of the premium tax on a monthly basis but indicated that "instead of 500 tax returns, we would have 6,000 to cope with." The department further stated that it would "need to review this matter completely to determine whether additional workload expenditures would exceed interest earnings."

The auditors in their comments to the department's response acknowledged that a change from an annual to a monthly basis in the payment of the premium tax would result in some additional work for the department. However, they estimated that the costs of handling this additional workload should not even amount to 10 percent of the estimated interest earnings.

Collection of revenues. The auditors' findings regarding the department of regulatory agencies' systems and procedures for the collection, handling, and disposition of revenues included: (1) inadequate security over cash receipts, and (2) the untimely depositing of receipts. The existence of these operational deficiencies increases the risks of misappropriation or theft and unless corrected could lead to losses from theft, robbery, or embezzlement.

1. Inadequate security over cash receipts. The inadequacies in security over cash receipts found by the auditors were, among others, the following:

- . There are no locks on the doors to the cashiers' enclosures and the walls of the enclosures are low, making it possible for unauthorized persons to have easy access to the cashiers' enclosures. In its response, the department stated that in June 1971 it requested the assistance of the State comptroller in planning and redesigning the lobby area where the cashiers' enclosures are located. As a result of this audit, the department has again written to the State comptroller for assistance.
- . Cash collected during the day is not kept under lock, and moneys placed in money bags for armored car pickup are left on top of the cashiers' desks where they are accessible to employees and outsiders.
- . Cashiers have ready access to the tapes in the validating machines. The tapes' accessibility negates the purpose for requiring the tapes, which is to verify that all collections received by the cashiers have been accounted for. The cashiers could easily misappropriate receipts by removing the tapes, not accounting for the receipts misappropriated, then replacing the tapes into the machines.
- . Persons who have no custodial responsibilities over cash and securities have access to a walk-in vault which stores the collections which have been validated as well as those which have yet to be validated and the securities which the commissioner of securities holds for safekeeping. The vault is also used as a storage room. The auditors observed that misappropriations of moneys and securities could easily occur under these circumstances. They recommended that entry into the vaults be more tightly controlled.

2. Delay in depositing receipts. An examination of a sample of daily receipts disclosed delays in the depositing of daily receipts. These delays ranged from two to eighteen working days and were experienced most often during the peak license renewal dates of December 31 and January 1. Delays in depositing receipts increase the risk of loss or misappropriation and postpones the availability of these funds for use by the State. The auditors recommended that the cashiering operations be linked to an electronic data processing system to expedite the processing of collections. They also recommended that the department, if it finds it necessary, propose legislation which would stagger the license renewal dates so that workload in collection and deposit may be spread more evenly throughout the year.

CONCLUSION

The department of regulatory agencies and other agencies affected by this audit report are in general agreement with the auditors' findings and recommendations. They have indicated that they have implemented or will be implementing the recommendations. We think that the deficiencies relating to security over cash receipts should be corrected expeditiously. They expose the State unnecessarily to possible misappropriation of funds and acts of robbery.