

# OVERVIEW

## *Financial Examination of the Department of Budget and Finance*

Report No. 10-03, March 2010

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### Summary

The Office of the Auditor and the certified public accounting firm of Accuity LLP conducted a financial examination of the Department of Budget and Finance for the fiscal year July 1, 2008 to June 30, 2009. Our examination evaluated the financial processes and related systems of internal controls of the department and involved inquiry and review of relevant policies, procedures, systems, transactions, and records. The firm also assessed the design and operating effectiveness of internal controls over the department's financial accounting and reporting process for the fiscal year ended June 30, 2009.

Our examination revealed a lack of proper leadership and accountability in the Department of Budget and Finance and resulting deficiencies in its execution of statutorily mandated fiscal responsibilities. We found that the department is not efficiently and effectively managing the State's \$3.8 billion treasury. Its investment policy, which is meant to delineate investment procedures and requirements, has neither been formally updated since 1999, nor reviewed in detail since 2002. Management of state cash and investments is governed by the 1999 policy and general statutory guidance and is carried out via informal, manual procedures that increase risk and hamper efficiency. Neither the director of finance nor the Financial Administration Division (FAD) administrator has exercised proper oversight of investment decisions and activities.

As a result, the state treasury now holds approximately \$1 billion of illiquid auction-rate securities (ARS). We found that the department significantly increased ARS holdings to more than \$1 billion in FY2008, shortly before the ARS market froze. Although the investment policy states that yield is of secondary importance to safety and liquidity, we found the department continued investing in ARS primarily based on their high yields, which generally indicate greater risk. However, the department did not perform a risk assessment or cost-benefit analysis prior to purchase, nor did it obtain and review the securities' offering documents that disclose related risks.

We also found the FY2008 purchases of ARS violated state law and policy. Although student loan-backed ARS are an allowable type of investment, state law requires that investments have maturity dates of five years or less from the date purchased. The department believed the securities met that limit because auctions were held every seven to 49 days, providing investors the option to sell. However, maturities are determined by the maturity dates of the underlying loans, which range from 2016 to 2045. We found that neither the director of finance nor the FAD administrator was consulted prior to purchasing the ARS. Additionally, because auctions for the securities have failed since early 2008, they cannot be liquidated at par until auctions become functional, securities are called, or underlying loans mature. Consequently, the State wrote down the value of these securities by \$114 million as of June 30, 2008; an additional write-down of over \$140 million is expected for FY2009.

The department also failed to perform other required financial administration functions essential to proper oversight and safeguarding of funds. For example, FAD did not timely prepare and review monthly bank reconciliations, a fundamental control used to

ensure cash balances are properly stated and to reduce the risk of misappropriation. For the budget process, we found that while the Budget, Program Planning and Management Division provides detailed written instructions and forms to other agencies to assist in budget preparation, the division's internal procedures and practices are largely informal and undocumented. We also observed deficiencies in the department's information technology (IT) management and controls. Given the vital role of the department and its fiscal responsibilities, it should improve IT controls to ensure its systems and data are reasonably protected. Enhancing IT functions could also address shortcomings identified in the financial administration processes.

With respect to Accuity's LLP's assessment of internal controls, in the opinion of the firm, because of the material weaknesses identified in the department's financial administration processes, the department has not maintained effective financial accounting and reporting processes and related internal controls for the fiscal year ended June 30, 2009.

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## Recommendations and Response

We made several recommendations regarding the department's management and accountability of state funds. Among them, we recommended the department formalize the policies, procedures, and practices used in its financial administration and budget processes. We recommended improvements to the cash and investment management process, including formally reviewing the investment policy at least annually, updating procedures to improve efficiency and decrease risk, and ensuring proper oversight of investment activities. We also made specific recommendations for the department to improve its IT management and controls.

In its response to our draft report, the department charged our report with being improperly classified as an *examination* and replete with false and misleading statements. However, our work was performed in accordance with *Government Auditing Standards* (GAS), and our findings and conclusions are based on specific, well-documented evidence. Unlike the department's response, we counter the department's claims with supportable and reasoned explanations.

The department first claims our report is misleading in being entitled a *financial examination*. However, GAS classifies an *examination* as a type of attestation engagement that "can cover a broad range of financial or nonfinancial objectives" and "consists of obtaining sufficient, appropriate evidence to express an opinion . . ." The primary objectives of the examination were to examine the effectiveness of the department's financial accounting and financial reporting processes and internal controls, and assess the adequacy, efficiency, and effectiveness of its financial administration organizational structure, systems, procedures, and practices. GAS also requires auditors conducting attestation engagements to report any material weaknesses and significant deficiencies in internal controls. Consequently, it would be misleading not to label the report a *financial examination*.

The director of finance further claims our findings are inconsistent with those of annual independent audits, which are the *financial statement audits* of the State's Comprehensive Annual Financial Report (CAFR). Consistent with GAS, our *examination* involved examining the department's internal controls for the purpose of providing an opinion on their effectiveness, as well as evaluating the efficiency of the department's financial systems and processes. In contrast, the CAFR audit focuses on fair presentation of the State's financial statements and provides no assurances related to the State's internal controls or compliance with laws. Far from "inconsistent" with our *examination*, the most recent *Report on Internal Control Over Financial Reporting and On Compliance and Other*



*Matters*, issued in conjunction with the annual CAFR audit, actually includes a *material weakness* relating to the State's valuation of auction-rate securities.

The department also contends our report should have relied on a February 3, 2010 Standard & Poor's "credit rating report" that notes the State's management practices are "good." Aside from demonstrating its lack of understanding of GAS, basic audit principles, and the purpose and scope of ratings reports, the department conveniently overlooked reports by two other ratings agencies dated February 2 and 3, 2010—Fitch Ratings and Moody's Investor Services, respectively—that assigned a "negative" outlook to Hawai'i's general obligation bond ratings. Those reports indicated that the negative outlook reflected the State's narrowed financial operations and limited flexibility underscored by reduced reserve levels, funding gaps, and liquidity challenges.

The department's contentions against our finding that ARS do not comply with state law are flawed for a number of reasons. First, it is indisputable that ARS holdings currently do not comply with state law. Because many of their ratings have dropped below AAA, they do not meet the statutory requirement that investments maintain a AAA rating. Second, the department primarily relies on a March 1, 2010 memorandum from the attorney general (AG memorandum) as support. However, the AG memorandum is merely an *interpretation* of the statute with which we respectfully disagree based on its unsound analysis. The foremost rule of statutory construction is that statutory meaning and intent must be "obtained primarily from the language contained in the statute itself[.]" Section 36-21, HRS, is clear and unambiguous as to intent. It is entitled *Short-term investment of state moneys* and explicitly states that investments are allowable "provided that the investments are due to mature not more than five years from the date of investment." Instead of applying the statute's plain language, however, the AG memorandum makes a number of vulnerable presumptions in concluding the maturity limit is inapplicable to ARS, including comparing ARS to investments that have *no* stated maturity dates and going so far as to liken ARS to bank savings accounts. It also delves into an extensive and unnecessary review of the statute's legislative history, which should only be used to interpret intent when the statutory language is ambiguous. The maturity provision in Section 36-21, HRS, is unambiguous as it applies to ARS. In fact, a plain reading indicates it applies to all investments made under the statute. Third, the AG memorandum would have more significance had the department obtained it in FY2008 when it escalated ARS investments, or at least during our examination. We requested any documentation the department had related to ARS, including on the issue of compliance. The AG memorandum, dated the same day as the department's response, was the first document provided on the issue. The fact that the department did not previously obtain a written opinion on this issue underscores our overall finding that the director is not exercising sufficient oversight to ensure proper management of the state treasury.

In downplaying the severity of the State's predicament, the department attempts to compare the State's situation with numerous other public and private entities who were "all impacted by the freeze and collapse of the ARS market." However, few have been impacted to the same extent as Hawai'i. The State currently holds approximately \$1 billion of the *total* \$330 billion ARS market. As an objective basis of comparison, a survey by a national valuation services firm of public companies with ARS holdings as of September 30, 2009 found that of 430 public companies identified with a total par value of \$21 billion in ARS, the highest par value held by a single company was \$1.1 billion. The remaining top four ARS holders held par values at or below \$500 million. It is thus unsurprising that the State's ARS situation has garnered attention on a national level.

The primary significance of the State's ARS holdings is that the department continued increasing them due to their higher yields despite increasing risk, in direct conflict with its



own policy providing that yield is of secondary importance to safety and liquidity. Moreover, the department escalated those investments without exercising basic, prudent investment principles—it did not gain a full understanding of the securities, did not perform a risk assessment or cost-benefit analysis prior to purchase, and invested almost 30 percent of the State’s portfolio in that single investment type. Although the department now denies its statements that it did not perform a risk assessment prior to escalating ARS investments in FY2008, it has been unable to produce any evidence of its “ongoing” risk assessment. Further, the FAD administrator confirmed in an email (included in our comments) that the only form of “risk assessment” done was to check for inclusion of ARS in the statute as allowable, which does not qualify as a risk assessment.

The department also claims that it could not have known or understood the risks in FY2008. However, as laid out in our report, the cover page of an offering document for ARS held by the department stated: **“You should carefully consider the risk factors beginning on page 12 of this offering memorandum.”** As the first risk listed warns that **“you may have difficulty selling your notes,”** it is remiss that the department did not obtain and review copies of offering documents prior to purchase. Further, had the department heeded the investment guidelines and limitations in the statute and its own investment policy, it might not have invested such significant amounts in this one type of investment. The department rebukes our finding on its violation of the policy’s diversification requirements by simply stating that the policy allows for exceptions. Our report describes that exception provision—that exceptions “shall be approved by the [FAD] Administrator prior to being executed” and that “significant exceptions shall also be approved in advance by the Director of Finance.” However, the director, FAD administrator, and department staff repeatedly stated that the director and administrator were not consulted prior to increasing ARS in FY2008 and did not approve in advance the deviation from the 20 percent limit. The FAD administrator confirmed in an email (included in our comments) that “the Director was not consulted prior to increasing our position in ARS. I was informed of our increased holding due to the favorable yields.” At an August 27, 2009 meeting, the director admitted she had never been consulted prior to any ARS investment decision. That meeting was attended by nine individuals.

The director contends that holding \$1 billion of illiquid ARS poses no harm to the State, rejecting the merit of any write-down and touting actual “gains.” However, the bottom line is the State’s ARS lost approximately \$255 million in value as of June 30, 2009. Contrary to the director’s belief, the department’s valuation (conducted through its own broker) was prepared using a “discounted cash flow” method, which estimates *actual* losses to be incurred by holding the ARS to maturity. Further, having a large portion of the treasury tied up in ARS for seven to 35 years may hinder the State’s ability to cover anticipated cash disbursements.

While the director’s response accuses our report of being “an undeserved attack on the hard working men and women of this department,” we reiterate our overall conclusion that *The Department’s Lack of Leadership and Accountability Puts the State’s Funds at Risk*. The director’s deflection of findings to her staff highlights this same concern. Additionally, the department urges that failure to substantially amend the report would “be a gross disservice to the public and could mar our hard-earned reputation as a prudent fiscal manager of the public’s resources.” We fail to see how ignoring risks and chasing yields on the way to tying up \$1 billion of state funds has not already accomplished this.