REPORT NO. 88-13
FEBRUARY 1988

FINANCIAL AUDIT OF THE DEPARTMENT OF AGRICULTURE

A REPORT TO THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF HAWAII

FINANCIAL AUDIT
OF THE DEPARTMENT OF AGRICULTURE

Conducted by the

Office of the Legislative Auditor

State of Hawaii

and

Peat Marwick Main & Co.

Certified Public Accountants

A Report to the Governor and the Legislature of the State of Hawaii

Submitted by the

Legislative Auditor of the State of Hawaii
Honolulu, Hawaii

Report No. 88-13
February 1988

FOREWORD

This financial audit report is the result of an examination of the financial statements and records of the Department of Agriculture for the fiscal year ended June 30, 1987. The audit was conducted by the Office of the Legislative Auditor and the certified public accounting firm of Peat Marwick Main & Co.

This report is divided into three parts. Part I contains an introduction and some background information on the Department of Agriculture. Part II presents our findings and recommendations on the department's financial and accounting practices. It also includes the department's financial statements and the audit opinion of the fairness and accuracy of the statements. We have followed our customary practice of requesting the agency affected by the audit to comment on the findings and recommendations. Part III contains the response of the Department of Agriculture to this report and our comments on the department's response.

We wish to express our sincere appreciation for the cooperation and assistance extended by the staff of the Department of Agriculture.

Clinton T. Tanimura
Legislative Auditor
State of Hawaii

February 1988

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INTRODUCTION

This is a report of our financial audit of the Department of Agriculture.

The audit was performed pursuant to Section 23–4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivision. The audit was conducted by the Office of the Legislative Auditor and the certified public accounting firm of Peat Marwick Main & Co. (Peat Marwick).

Objectives of the Audit

The objectives of the audit were:

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the Department of Agriculture; to recommend improvements to such systems, procedures, and reports; and to render an opinion on the reasonable accuracy of the financial statements of the department.

2. To ascertain whether expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with state laws, rules and regulations, and policies and procedures.

3. To ascertain the extent to which prior recommendations made by the Legislative Auditor in Audit Report No. 78–1, *Financial Audit of the Loan and Grant Programs of the Department of Agriculture*, have been implemented.

Scope of Audit

The audit's scope included an examination of the financial statements, internal control system, and legal compliance of the department for the period July 1, 1986 to June 30, 1987. The accountants' opinion as to the fairness of the financial statements presented is that of Peat Marwick.

Organization of the Report

This report is organized as follows:

Part I (Chapters 1, 2, and 3) presents this introduction, background information on the department, and a description of the department's loan and grant programs.

Part II (Chapters 4, 5, and 6) presents our audit findings and recommendations on the loan and grant programs, the financial accounting practices and procedures, and system of internal control of the department. It also includes the department's financial statements and the accountants' opinion on the statements.

Part III contains the response of the department to our recommendations, together with our comments on the department's response.

Chapter 2

BACKGROUND

This chapter describes the organization and programs of the Department of Agriculture.*

The department is responsible for promoting the conservation, development, and utilization of agricultural resources in the State; assisting farmers; improving the well-being of those engaged in agriculture; increasing the productivity of lands; and administering such programs as animal husbandry, entomology, farm credit, development and promotion of agricultural products and markets, and enforcement of the grading and labeling of agricultural products.

The Board of Agriculture establishes the operating policies of the department. The board consists of eight members: one from each of the counties of Hawaii, Maui, and Kauai; four at-large; and the chairperson of the Board of Land and Natural Resources who serves as an ex-officio voting member. The members are appointed by the Governor with the advice and consent of the Senate. The Governor selects the chairperson of the board from its members. The chairperson of the Board of Agriculture serves as a full-time administrator, performing such duties and exercising such powers and authority as delegated by the board.

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*Descriptions were drawn from the Department of Agriculture's *Annual Report Fiscal Year 1986*; relevant portions of the Hawaii Revised Statutes; and the Legislative Reference Bureau's *Guide to Government in Hawaii*, August 1984.

There are a number of advisory committees mandated by statute to advise and assist the department in developing or revising laws and regulations. The members of the committees are appointed by the Governor. Active committees include the advisory committees on agricultural products, flowers and foliage, markets, pesticides, and plants and animals.

Organization and Programs of the Department

The following summarizes the department's organization and programs.

Administrative Services Office. This office provides support services to the department in the areas of personnel, fiscal, budget and management, office services, motor pool, facilities management, and office automation.

Planning and Development Office. This office provides review, research, analytical planning, and development functions in an advisory capacity to the Board of Agriculture.

Agricultural Loan Division. This division administers the loan programs of the department designed to promote the development of agriculture and aquaculture. The division grants loans to qualified farmers. It also provides loans in participation with private lenders and guarantees loans made by private lenders. A detailed description of the agricultural loan program is provided in Chapter 3.

Animal Industry Division. This division is responsible for the detection, control, and prevention of diseases among livestock and poultry. The division conducts animal disease surveillance and epidemiology, laboratory diagnosis, meat and poultry inspection, animal and bird importation inspection, voluntary meat grading, and brand registration. It also operates the animal quarantine station.

Marketing and Consumer Services Division. This division provides services and enforces regulations designed to improve the efficiency of agricultural production and marketing. It collects and publishes agricultural statistical data on estimated and actual acreage planted and harvested; the value of crops; the movement of stock; and the marketing, processing, and utilization of crops, livestock, and other agricultural products. The division is responsible for programs to improve the market quality of agricultural, horticultural, and processed commodities. It provides for the inspection and grading of processed foods, the enforcement of labeling requirements, and the promotion of fair trade and honesty in the marketing of agricultural products.

Measurement Standards Division. This division is responsible for assuring equitable transactions relating to weights and measures, packaging and labeling, petroleum products, and odometers. It assures that state standards conform to federal standards in weights and measures and determines length, volume, and mass standards through comparisons with the National Bureau of Standards.

Milk Control Division. This division regulates and supervises the production, transportation, processing, storage, and distribution of fresh milk. The division also provides for setting and adjusting minimum prices to producers; adjusting production quotas for producers; and licensing of producers, producer–distributors, and distributors.

Plant Industry Division. The programs of this division are designed to protect agricultural industries and natural resources from the entry and establishment of detrimental insects, diseases, noxious weeds, and other pests, and to minimize the adverse effects of pesticides on the environment.

Chapter 3

DESCRIPTION OF LOAN AND GRANT PROGRAMS

This chapter describes the loan and grant programs of the Department of Agriculture. These programs, which are administered by the department's Agricultural Loan Division, include the agricultural loan program, the aquaculture loan program, the independent sugar growers loan program, and the Hawaii agricultural products program.

Agricultural Loan Program

The objectives of the agricultural loan program as stated in Section 155-2, Hawaii Revised Statutes (HRS), are to "encourage the growth, development, and well being of agriculture in the State by maximizing the use of limited state funds and resources in encouraging development of new farmers and new crops; assisting qualified farmers with loans; encouraging private lenders to make loans to qualified farmers directly, or in cooperation, or in participation with the State; and providing relief to farmers in times of emergencies."* There are three types of loans which are authorized for qualified farmers: insured loans, participation loans, and direct

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*Section 155-10, HRS, sets forth the general eligibility requirements for loans. In general, it states that an applicant be (1) a qualified farmer or a person under the new farmer program, (2) a citizen of the United States who has resided in the State for at least three years, (3) a sound credit risk with the ability to repay the money borrowed and (4) willing to carry out recommended farm management practices.

loans. These loans are available for various purposes as described in Section 155-9, HRS. In general, loans may be made only if a qualified farmer is unable to secure financing from the U.S. Department of Agriculture's Farmers Home Administration (FmHA), the Production Credit Association of Hawaii, the Federal Land Bank Association of Hawaii, or the Sacramento Bank for Cooperatives; and two private lenders. The following describes the types of farm loans and the purposes for which the different types of loans may be made.

Types of loans. 1. ***Insured loans.*** The department may guaranty repayment of loans up to 90 percent of the principal and interest on a loan made by a private lender to a qualified farmer. The interest rate charged on insured loans is set by the department at a rate consistent with similar loans issued by private lenders. In return for the guaranty, the department receives from the lender an insurance fee of one-half of 1 percent per year on the unpaid, insured principal balance. Under certain conditions, the insured principal balance of the loan, or a portion of it, may be converted to a participation loan.

2. *Participation loans.* The department may participate with private lenders in providing loans to qualified farmers. The department's share of a loan is limited to 90 percent of the principal amount of the loan. Up to 90 percent of the private lender's share of the loan may also be insured by the department. The interest rate charged on participation loans is limited to 2 percent above the lowest rate of interest charged by all banks in Hawaii for short-term loans to borrowers having the highest credit rating. The private lender may be paid a fee for servicing the loan. The fee is limited to 1 percent of the unpaid principal balance.

3. *Direct loans.* The department may provide loans directly to qualified farmers who are unable to obtain financing at reasonable interest rates from private lenders under the insured or participation programs or from the FmHA. The interest rate charged on such loans is dependent upon the class of the loan as indicated in Table 3.1.

Table 3.1

Interest Rates on Direct Loans

Class	Interest Rate
A and B	Interest rate charged by the Federal Land Bank Association of Hawaii on similar loans.
C	Interest rate charged by the Production Credit Association of Hawaii on similar loans.
D	Interest rate limited to 3 per cent per year.
E	Interest rate at 2 per cent less than the rate charged by the Sacramento Bank for Cooperatives on similar loans.
F	Interest rate at 2 per cent less than the rate charged by the appropriate farm credit bank for similar loans.

NOTE: If the amount loaned under any of the above classes of loans is borrowed by the department, the interest rate charged to the farmer is the greater of the interest rate on loans charged by the appropriate credit bank or the interest rate charged to the department on the amount borrowed.

Classes of farm loans. The six classes of purposes for which loans may be made are: Class A—farm ownership and improvement, Class B—soil and water conservation, Class C—farm operating, Class D—emergency, Class E—cooperatives and corporations, and Class F—new farmers.

1. *Class A.* Farm ownership and improvement loans provide funds for the purchase or improvement of farm land and the purchase, construction, or improvement of essential farm buildings. Class A loans are for an amount not to exceed $100,000 and for a term of not more than 40 years.

2. *Class B.* Soil and water conservation loans provide funds for soil conservation practices and for the development, conservation, use, and drainage of water. Class B loans to individuals are for an amount not to exceed $35,000 and for a term of not more than 20 years; loans to associations (nonprofit organizations engaged primarily in extending services directly related to Class B purposes to its members) are for an amount not to exceed $200,000 and for a term of not more than 40 years.

3. *Class C.* Farm operating loans provide funds for the purchase of farm equipment and livestock; the payment of production and marketing expenses, including materials, labor, and services; and the payment of living expenses. Class C loans are for an amount of not more than $100,000 and for a term of not more than ten years.

4. *Class D.* Emergency loans provide relief and rehabilitation to qualified farmers stricken by extraordinary rainstorms, windstorms, droughts, tidal waves, earthquakes, volcanic eruptions, and other natural catastrophes; livestock disease epidemics; crop blights; dock strikes; and economic emergencies caused by such conditions as overproduction and excessive imports. Emergency loan funds may be used for any purpose specified in loan classes A, B, and C. The maximum amount and period of an emergency loan are determined by the Board of Agriculture.

5. *Class E.* Loans to cooperatives and corporations provide facility and operating funds to farmers' cooperative associations and corporations engaged in marketing, purchasing, processing, and providing farm business services. Facility

loans to purchase or improve land, structures, and equipment are limited to $500,000 and are for a term not to exceed 20 years. Operating loans to finance inventories of supplies, warehousing, shipping of commodities, extension of consumer credit to farmer-members, and other operating expenses are limited to $300,000 and are for a term not to exceed three years.

6. *Class F*. Loans to new farmers provide funds to defray the costs of establishing a farm enterprise. These loans may be used only for Class A or Class C purposes. After an initial loan, any subsequent loan must be made from Classes A to D, depending upon the purpose for which the loan funds are to be used. Class F loans are made for an amount of not more than $100,000, or 85 percent of the cost of the project, whichever is less.

Types and classes of loans made. Table 3.2 summarizes the types of loans that may be made by the department and the purposes for which and the terms under which they may be made.

Table 3.2

Summary of Types of Loans by Classes

Class of Loan	Purpose	Maximum amount	Maximum length (years)	Type of Loan		
				Insured	Participation	Direct
A	Farm ownership and improvement	$100,000	40	X	X	X
B	Soil and water conservation:			X	X	X
	Individual	$ 35,000	20			
	Association	$200,000	40			
C	Farm operations	$100,000	10	X	X	X
D	Emergency	Amount and length is determined by the Board of Agriculture		X	X	X
E	Cooperatives and corporations:			X	X	X
	Facility	$500,000	20			
	Operations	$300,000	3			
F	New farmers	$100,000 or 85% of the project cost whichever is less	*			X

*Dependent upon purposes specified in Classes A & C.

As the table shows, all three types of loans, i.e., insured, participation, and direct, may be made for purposes specified in Classes A to E, but for Class F (loans to new farmers), only direct loans may be made.

Farm loans outstanding. At June 30, 1987, farm loans outstanding totaled $21,867,223. This sum represented the statewide total, including principal and interest on 703 loans. A summary of the loans outstanding by island is shown in Table 3.3.

Table 3.3

Outstanding Loans by Island
June 30, 1987

Island	Number of Loans Out-standing	Loan Balance			Percent of Total
		Principal	Interest	Total	
Hawaii	550	$ 12,592,784	$ 2,350,142	$ 14,942,926	68.3
Oahu	80	3,387,533	466,995	3,854,528	17.6
Maui	13	434,385	45,556	479,941	2.2
Kauai	60	2,321,259	268,569	2,589,828	11.9
	703	$ 18,735,961	$ 3,131,262	$ 21,867,223	100.0

As reflected in Table 3.3, the majority of the loans are to borrowers on the island of Hawaii.

Aquaculture Loan Program

The aquaculture loan program, established by Act 181, SLH 1971, provides capital and operating loans to individuals or associations engaged in aquaculture farming, produce processing, and development.

Independent Sugar Grower Loan Program

Act 19, First Special Session Laws of Hawaii 1977, authorizes the department to provide supplemental direct loans of an unlimited amount to independent sugar growers to cover deficits during periods where there are insufficient national protections over sugar importation. Interest rates on these loans are limited to 2 percent per year. The sugar grower is not required to provide collateral to secure the loan amount.

Hawaii Agricultural Products Program

This program, established by Act 75, SLH 1963, provides allowances and grants to qualified agriculturists for the development and production of new agricultural products. The statute provides that, under a joint agreement with agriculturists, the department may share in the proceeds derived from the sale of developed crops and products.

PART II

FINDINGS AND RECOMMENDATIONS

Chapter 4

LOAN MANAGEMENT

This chapter contains our findings and recommendations relating to the administration of the department's agricultural loan programs. It focuses on the managerial and operational practices followed by the department. Although the primary focus is on the agricultural loan program, this chapter also discusses a specific deficiency regarding the administration of the independent sugar grower loan program.

Summary of Findings

Our findings on the administration of the department's loan programs are as follows:

1. The department has continued to provide loans to farmers with extremely poor repayment histories under the independent sugar grower loan program.

2. Excessive cash balances are maintained in the department's special revenue loan funds.

3. The department has continued to accrue interest on delinquent and problem loans, a practice which is contrary to its policies and procedures manual. In addition, the department charges interest on loans prior to the date that the loan proceeds are made available to the borrower.

4. The department has failed to write off loans determined to be uncollectible by the Attorney General.

5. The department is not enforcing its requirement for the submission of annual financial statements from borrowers, which should be used to assist the department in monitoring the financial condition of borrowers.

6. Loan officers are not performing initial field visits within the time period set by departmental policy. In addition, the results of field visits are not fully documented.

7. The department has not always documented its basis for determining the value of property offered as collateral.

Agricultural Loan Approval Process

To provide perspective to our findings concerning the administration of the agricultural loan program, we summarize in this section the approval process established by the department in making loans to farmers.

In general, farmers obtain loans through the State's agricultural loan program in one of two ways: (1) they are referred by a bank which has agreed to participate in a joint bank-state loan, or (2) they are unable to obtain financing from any other source and must thus apply for a direct state loan. Section 155-3, HRS, requires all prospective borrowers to prove that they have been unable to secure a loan from the Farmers Home Administration, the Production Credit Association of Hawaii, the Federal Land Bank Association of Hawaii, or the Sacramento Bank for Cooperatives; and two private parties.

After the necessary loan rejections are received, the prospective borrower is screened by a loan officer. The prospective borrower must be a "qualified farmer" within the meaning of statute and otherwise meet the statutorily prescribed requirements such as citizenship and residence.

Once eligibility has been established, the applicant completes the "application for agricultural loan" and discloses the purpose of the loan, the amount, and information about the applicant. The application is accompanied by financial statements consisting of a balance sheet for one year and income statements for three years. Financial statements certified by an independent accountant are normally required for loans in excess of $100,000.

The applicant also completes the "monthly cash flow projection" form, which includes a three-year projection of farm income and expenses; capital expenditures, if any, which are to be made with the loan proceeds; a cash summary indicating the amount available for debt repayment; and a debt repayment schedule showing all outstanding debts at the time of the loan request. The loan officer may also request that the applicant submit income tax returns from prior years. In the majority of cases, however, the two forms are all that are required for a loan request to be considered and acted upon.

After the two forms are reviewed for accuracy and completeness, the loan officer then performs an analysis of the data contained in the forms. The loan officer's task is to determine whether the applicant has sufficient debt-paying power and whether the applicant's net worth provides an adequate cushion between assets and total obligations. Through an analysis of projected sales, gross profit, operating expenses, and net profit, the loan officer determines whether the applicant will generate sufficient income to repay the proposed loan. In addition, the loan officer examines the value of the security offered as collateral to determine if it is adequate.

If the loan officer believes the request should be disapproved, all relevant documents, together with the reasons for recommending disapproval, are submitted to the agricultural loan division head for the latter's review and final disposition. If the applicant is found to be a "sound credit risk" with the ability to repay the loan, the loan officer would recommend approval of the request and a loan report would be completed. The loan report includes comments on the eligibility of the applicant, a narrative on the farmer's past history, the status of prior agricultural loans, the purposes of the loan, the value of the security pledged as collateral including the loan to security ratio, and the repayment terms and financial condition of the applicant.

The loan officer also completes the "loan approval conditions" form, which sets forth the conditions under which the loan will be approved, i.e., financing statement on collateral pledged, lien search, real estate mortgage on real estate, etc. The loan report together with the application, projection of income and expense statement, and loan approval conditions are then forwarded to the agricultural loan division head for review and approval. In the case of participation loans, should the bank require that a portion of its share be insured by the department, the loan officer will also submit the participation agreement between the bank and the State indicating the percentage of the bank's share of the loan to be insured.

Upon review and recommendation for approval by the division head, the application and all pertinent documents are submitted to the chairperson of the Board of Agriculture. If the loan request is for an amount less than $25,000, the chairperson may grant approval of the loan without presenting it to the full board. All loan requests in excess of $25,000 must be submitted to the full board for approval.

After loan approval from either the chairperson or the board, the loan officer is notified and instructed to prepare all necessary documents, i.e., financing statement, promissory note, assignment of crops, etc. These completed documents are then forwarded to the agricultural loan division head for review and approval. If the loan is secured by a real estate mortgage in fee or lease, the mortgage document is sent to the Attorney General for review and approval. A title search is also performed to ensure that title to the property is free of any liens or encumbrances.

After all documents have been reviewed, approved, and signed by the parties concerned, they are returned to the loan officer who contacts the applicant. The applicant and the loan officer review the terms and conditions of the loan. The documents are signed and witnessed. The loan officer and the borrower then initiate a "request for loan funds" for release of the funds. The request is submitted to the department's accounting office for processing and forwarded to the Department of Accounting and General Services (DAGS).

The Department of Accounting and General Services releases the funds to the agricultural loan division which in turn transfers the funds to the appropriate district office. If required by the loan approval conditions, the funds are deposited into a "supervised account" at a bank selected by the borrower. The account, which bears the name of the borrower and the "state agricultural loan program," is a state-controlled account through a deposit agreement executed by the borrower, bank, and the State. It is used like a regular checking account except that all checks drawn on the account must be signed by both the borrower and the loan officer. The individual checkbooks are retained by the loan officer. Funds that do not require the supervised account are disbursed by a check in the borrower's name.

In the case of participation loans, the State's share is disbursed to the lender for disbursement to the borrower. The lender maintains the account for the borrower and receives out of the interest collected a participation fee of not more than 1 percent on the unpaid balance of the loan.

The entire loan approval process, from the time the application is submitted until the time the funds are deposited into a supervised account (or disbursed to the borrower), may take anywhere from 30 days to 8 months depending on the purpose of the loan and the type of collateral provided.

Independent Sugar Grower Loan Program

Section 155-15, HRS, authorizes the department to provide direct loans to independent sugar growers. The intent of this statute is to assist the independent sugar growers with supplemental direct loans to cover deficits through time periods in which there are insufficient national protections concerning sugar importation.

These loans have a maximum annual interest rate of 2 percent and a principal balance due on demand. Collateral on these loans is not required. There is no limit on the amount loaned or on the number of loans provided to an independent sugar grower. Since the program's inception in 1977, the department has made approximately $7 million in loans. Repayment of principal has totaled approximately $5 million. The balance of the department's sugar loans receivable at June 30, 1987 was $950,000.

Many of the sugar loans issued during the fiscal year ending June 30, 1987, were made to farmers who received loans periodically during the past several years to fund operating deficits. The examples in Table 4.1 are of loans to independent sugar growers with multiple loans for relatively large amounts. In addition to these loans, there are numerous farmers having similar borrowing patterns with smaller loan amounts. As the table indicates, very little, if any principal has been repaid on these loans. For example, Farmer D received 32 loans since 1979 amounting to $104,989. As of June 30, 1987, the farmer has made principal payments of only $1,107 on his outstanding loans. The payment history of these loans is actually even poorer than the table reflects because the accrued interest due to the State is not shown.

Despite the poor loan repayment histories of these sugar growers, the department has continued to approve additional loans without the benefit of an analysis to determine economic viability of their operations. Note that Farmer D received seven loans amounting to $24,572 during the 1987 fiscal year even though no payments had been made on loans in the previous five years and nearly all of the original loan amounts are still outstanding for two other years. As the program currently operates, there is not much incentive for problem farmers to improve operations. Instead of increasing the efficiency of their sugar operations, the program apparently encourages some growers to continue to rely on future financial support from the State to fund their operating deficits.

We believe that the department should exercise extreme caution before providing additional loans to sugar growers with poor loan repayment histories. For these problem sugar growers, the department should perform an analysis to determine whether their operations are economically viable. Such analysis should include a comparison of their operations with the operations of profitable farmers which may uncover poor financial management practices or operational inefficiencies. This analysis should result in practical solutions to identified problems which should be recommended and implemented. When all efforts fail and practical solutions are not possible, it would be incumbent upon the department to discontinue providing any future loans to these sugar growers.

Table 4.1

Farmers with Four or More Sugar Loans
Totaling $25,000 or More

Farmer	Year of Loan	Number of Loans	Original Loan Amount	Balance at June 30, 1987
A	1983	1	$ 72,275	$ 61,116
	1984	1	42,711	39,773
	1986	1	9,800	7,797
	1987	1	9,800	9,800
			$ 134,586	$ 118,486
B	1981	1	$ 6,678	5,912
	1983	2	9,128	9,053
	1984	1	5,439	5,439
	1986	2	3,334	3,334
	1987	1	2,839	2,839
			$ 27,418	$ 26,577
C	1982	4	3,165	2,492
	1983	1	3,068	3,068
	1984	1	3,368	3,368
	1986	3	7,755	7,755
	1987	2	7,858	7,858
			$ 25,214	$ 24,541
D	1979	1	5,128	4,528
	1980	6	24,222	23,715
	1981	6	10,651	10,651
	1982	7	7,193	7,193
	1983	2	15,703	15,703
	1984	1	11,587	11,587
	1986	2	5,933	5,933
	1987	7	24,572	24,572
			$ 104,989	$ 103,882
E	1982	1	1,483	1,454
	1984	1	11,716	11,716
	1986	2	35,208	35,208
	1987	1	11,323	11,323
			$ 59,730	$ 59,701
F	1980	2	8,024	8,024
	1981	2	8,086	8,086
	1982	1	2,345	946
	1983	3	24,818	24,818
	1984	1	2,679	2,679
	1986	1	5,600	5,600
	1987	1	1,218	1,218
			$ 52,770	$ 51,371
G	1984	1	14,277	14,277
	1986	1	4,026	4,026
	1987	4	63,055	63,055
			$ 81,358	$ 81,358

Recommendation. We recommend that the department take the steps necessary to address the problem of whether to continually make additional loans to independent sugar growers with poor loan repayment histories. Such steps should, at least, include a requirement that additional loans will not be granted until an analysis is made and the department is satisified that the sugar growers operation is economically viable.

Excessive Cash Balances in Special Funds

During our examination, we noted that excessive cash balances are maintained in the department's special funds for loans. This excessiveness is evidenced by the fact that the sum of the cash balances of these special funds has been increasing by significant amounts over the years. Table 4.2 depicts the increase in these cash balances over the past several years. This growth results from the excess of loan repayments and interest earned on loans and cash investments, over loan disbursements and operating expenses. Moreover, based on a consistently declining balance of outstanding loans, which has decreased from $18.5 million in 1984 to $13.7 million in 1987, there is no indication that there will be a significant demand for loans in the future.

Table 4.2

Cash Balances of
Special Funds for Agricultural Loans

Fiscal Year	Cash Balance
1984	$ 4,025,000
1985	9,550,000
1986	10,925,000
1987	12,075,000

Recognizing the possibility of excess funds being accumulated in special funds, the Legislature under Section 37-53, HRS, has provided a mechanism whereby departments may transfer excess funds from the special funds to the general revenues of the State. The reason for this mechanism is that excess funds should be made available for other public use. Before making any transfers, however, a review is needed to determine the extent to which funds are excessive. We understand that the department has not made such a determination.

Recommendation. *We recommend that the department conduct a review of the special loan funds to determine the level at which the balance of these funds should be permitted to accumulate. All amounts in excess of this fund level should then be transferred to the general revenues of the State in accordance with Section 37-53, HRS.*

Interest on Loans

Failure to discontinue the accrual of interest. Section 25901 of the department's *Agricultural Loan Division Policies and Procedures Manual* states that accrual of interest on a delinquent or problem loan should be discontinued when the sum of the accrued interest and outstanding principal approximates the recoverable value of the collateral but in no case should interest be accrued for nonreal estate loans delinquent 90 or more days and for real estate loans delinquent 180 or more days. The reason for not accruing interest on delinquent loans is because there is doubt of its collectibility. Similarly, most private financial institutions do not accrue interest on loans that are delinquent beyond 90 days.

We find that the department is not complying with its policy. The department has been accruing interest on several loans with payments delinquent in excess of the periods stipulated by its policy.

We were informed that the department has continued to accrue interest on these loans since these loans are still considered to be collectible. They believe that the farmer's inability to pay is temporary, and that accordingly, interest should continue to be accrued. However, we believe that the department should not deviate from its stated policy, especially when one considers the inherent high credit risk associated with the loans in the agricultural loan program and the limited value of collateral securing these loans. In any event, if a delinquent farmer is able to provide payment in the future, it would not preclude the department from collecting any unaccrued interest.

Recommendation. We recommend that the department discontinue the accrual of interest on loans that are delinquent beyond the period stipulated by its policy.

Interest charged on loans prior to loan disbursement. State warrants issued for loans to farmers are processed by DAGS. Upon receiving the completed warrants from DAGS, the department forwards them to the respective district office for disbursement to the farmers. Consequently, there is a time lapse of one to two weeks between the date of the warrant and the date the farmer receives the loan proceeds. The department charges interest on loans from the date the state warrant is prepared. As a result, interest is being charged to the farmer prior to the time funds are available to him. We believe that in fairness to the borrower, the department should charge interest from the time the loan proceeds are made available to the borrower.

Recommendation. We recommend that the department begin charging interest on loans from the date loan proceeds are made available to borrowers instead of the date of the warrant.

Failure to Write Off Uncollectible Loans

Section 40-82, HRS, states: "The directors, boards, or executive heads of departments may from time to time prepare and submit for the review of the attorney general a list of all uncollectible accounts in their departments. Such accounts as the attorney general finds to be uncollectible shall be . . . deleted from the accounts receivable records of the departments . . . ."

The department has not written off loans determined to be uncollectible by the Attorney General. At June 30, 1987, there were 164 such loans amounting to approximately $1,604,000 included in the department's loan receivable balance.

Besides the overstatement of data for financial reporting purposes, the department's failure to write off uncollectible receivables creates an unnecessary burden of recordkeeping associated with the maintenance of these uncollectible accounts.

Recommendation. We recommend the department write off receivables determined to be uncollectible by the Attorney General.

Nonenforcement of the Requirement for the Submission of Annual Financial Statements

Section 23304 of the department's *Agricultural Loan Division Policies and Procedures Manual* states that all division authorizations for loans shall include as a requirement the submission of annual financial statements. Accordingly, all loan agreements contain a standard provision that requires the borrower to provide annual financial statements, plus such interim financial statements as may be requested by the department during the life of the agreement.

During our examination of loan files for problem loans, we noted that in many instances, the department did not enforce the requirement for the submission of annual financial statements. Of the 32 problem loans examined, financial statements were not always received on an annual basis for 16 of the loans. For four of these loans, financial statements were never received subsequent to the initial loan application.

The submission of annual financial statements allows the department to perform an ongoing credit analysis of the outstanding loan. Such analysis is essential because of the high-risk nature of the loans in the agricultural loan program. Financial data, together with production data obtained in field visits, should be compared with initial financial projections to identify any adverse changes in the farmer's operations. If an analysis indicates deterioration in the financial condition of the farmer, immediate action by the loan officer may be required to determine the nature of the problem, and the extent of assistance and corrective action to be performed by the department.

Recommendation. We recommend that the department enforce its policy of requiring the submission of annual financial statements from borrowers. Such financial statements should be analyzed to continually monitor the financial condition of borrowers.

Field Visits

The department's *Agricultural Loan Division Policies and Procedures Manual* requires loan officers to make on-farm visits at least twice each year for the duration of the loan. Emergency loans, delinquent loans, and loans with limited collateral may require more frequent visits. The primary purpose of the field visit is to ensure that the collateral is being maintained in good condition, that the loan funds are being used for the purposes intended, and that the terms and conditions of the loan are being met. They are also made to assist farmers found to be in violation of loan terms and conditions, to collect from delinquent borrowers, and to generally keep abreast of the borrower's operations and financial status.

In our previous report, Audit Report No. 78-1, we found that the requirement for a minimum of two field visits a year was not being met. In addition, documentation of field visits was absent from loan files. Although the department has improved its performance in both areas, certain deficiencies continue to exist.

Untimely field visits. Section 25201 of the department's manual requires an initial on-farm visit at the earliest possible date after loan approval with such visit being made within three months of the loan disbursement. The principal reason for a timely initial visit is to ensure that loan funds are being used for the purposes intended. In addition, the loan officer may observe the early progress of the farm operation and, as appropriate, advise and counsel the farmer on financial management and compliance with loan conditions.

Our review of loan files for 32 problem loans indicated that the department is not complying with this policy. For 22 of the 32 loans, the initial field visits were made after three months, several in excess of two years after loan disbursement.

Recommendation. We recommend that the department conduct timely initial on-farm inspections within three months of loan disbursement as required by its loan policy.

Incomplete documentation of field visits. There are procedures for loan officers to document field visits on a loan servicing report. This report provides information on the loan amount and terms, present balance, collateral, insurance, and budgeted and actual financial data. However, our review of loan servicing reports indicates that the section on budgeted and actual financial data is often not completed. Thus, there is no evidence that a financial analysis of comparing budgeted to actual financial data was performed. Such comparison is important in monitoring the farmer's financial status and ability to repay the loan. This is especially true for loans with annual payment terms. Without the complete data from field visits, the department would not learn of any financial difficulty until the payment became delinquent, and by then, it would have lost the opportunity to assist the farmer in a timely way.

Recommendation. We recommend that the department take the steps necessary to ensure that the results of field visits be fully documented by completing the budgeted and actual financial data section of the loan servicing report.

Lack of Proper Documentation of Value of Property Held as Collateral

In our previous report on the department, Audit Report No. 1978-1, we found that the department did not insist upon proper appraisal or full documentation of the value of the property offered as collateral for a loan. Our current examination revealed that to some extent, this practice continues to exist. We noted that in three of the ten direct loans issued during the fiscal year 1986–87, the department failed to document its basis for determining the reasonableness of the values assigned to the property offered as collateral. These properties primarily consisted of crops and improvements. In such cases, we believe that sufficient details, such as the quantity and unit prices upon which the value of the crops are computed or some verification of the actual, replacement, or insured value of improvements, should be documented as evidence of the department's basis for assessing the reasonableness of the stated market value of the crops and improvements.

In Chapter 6, we noted that Peat Marwick, a certified public accounting firm which examined the financial records of the department, was unable to attest to the fairness of the loans receivable balance since the collectibility of the outstanding loans could not be ascertained. The department's failure, over the years, to substantiate and otherwise document the values assigned to the property pledged as collateral was one of the reasons for Peat Marwick's inability to ascertain the collectibility of the outstanding loans.

Recommendation. *We recommend the department document, at all times, its basis for determining the value assigned to property offered as collateral.*

Chapter 5

FINANCIAL ACCOUNTING AND INTERNAL CONTROL

This chapter contains our findings and recommendations on the Department of Agriculture's financial accounting and internal control practices and procedures.

Summary of Findings

Our findings on financial accounting and internal control practices and procedures are as follows:

1. The department's practice of limiting its investment of available cash in time certificates of deposit having maturities of 90 days or less does not provide the flexibility to maximize interest earnings.

2. There are unnecessary delays in the depositing of cash receipts.

3. The department is not claiming federal reimbursement of laboratory costs for meat and poultry inspection services which are chargeable to federal grants.

4. Controls over cash receipts are deficient. The appropriate segregation of duties between the receipting, depositing, and recording of cash receipts is lacking.

Maximizing Interest Earnings

The department is responsible for managing its investment of available cash in its loan funds. At June 30, 1987, the balance of such investments amounted to $12,075,000.

During our examination, we noted that the department's cash management practice has been limited to investing its available cash only in time certificates of deposit (TCDs) having maturities of 90 days or less. This practice is unnecessarily restrictive and should be revamped to provide the flexibility necessary to maximize interest earnings. Such flexibility should include the option to consider other authorized investments, such as U.S. Treasury securities which are more liquid and, at times, have higher yields than TCDs. Investments with maturities longer than 90 days should also be part of investment strategy.

The selection of the type and maturity of investments should be made based upon projected cash flow requirements and market conditions for interest rates. For example, in economic periods where interest rates are level or decreasing, a higher yield will be returned by investing cash in investments with long rather than short maturities. During the fiscal year 1987, the monthly balance of cash invested in TCDs ranged from $11,000,000 to $12,075,000. The average interest rates on TCDs held by the State were 5.4 percent for 90-day TCDs and 5.5 percent for one-year TCDs. Had the department invested the minimum monthly amount of $11,000,000 into one-year TCDs instead of 90-day TCDs, interest earnings, based upon the difference of .1 percent in interest rates, would have increased by $11,000 for the fiscal year.

Conversely, when interest rates are rising, cash should be invested in investments with shorter maturities. This is due to the expectation that in the future, investments with shorter maturities will have a higher yield than the yield presently offered on investments with longer maturities.

Recommendation. *We recommend the department revamp its cash management practices to maximize interest earnings. Such practices should provide for the consideration of investing available cash in TCDs and U.S. Treasury securities with various maturities, the selection of which should be based on projected cash flow requirements and market conditions for interest rates.*

Delays in Depositing Receipts

The department receives loan repayments, animal and plant quarantine fees, meat inspection and grading fees, federal grants, and other miscellaneous fees. Preparation of receipts and deposits to the bank are performed by the department's Fiscal Office and by the various divisions. We find that checks received by the department were held for as long as seven days before being deposited. These delays, which result in the State losing interest on their deposits, were due to the department's procedures for routing certain cash receipts. This happens when checks mailed to the Fiscal Office are not accompanied by any documentation indicating the reason for the payment. Such checks are routed to the division and compared to the division's records. Once the determination of the nature of the payment has been made, the check is returned to the Fiscal Office and deposited.

We believe that the routing of checks in the foregoing instances is unnecessary and the department's Fiscal Office should deposit all receipts on a daily basis. To resolve the identity problem, a copy should be made of checks in which the nature of the payment is not readily known. In this manner, the check can be deposited immediately, and the copy sent to the division for a subsequent determination of the nature of the payment.

Recommendation. We recommend that the department's Fiscal Office deposit all receipts on a daily basis.

Failure to Claim Full Federal Reimbursements

The department is responsible for meat and poultry inspection services under the Hawaii Meat Inspection Act and the Hawaii Poultry Inspection Act. It received federal grants amounting to approximately $900,000 during the past fiscal year to support this service under the Cooperative Meat and Poultry Program from the United States Department of Agriculture's Food Safety and Inspection Service.

The department's laboratory is utilized to perform certain tests in connection with the inspection services. Under the provisions of the grants, laboratory costs incurred by the department attributable to the inspection services are reimbursable from the federal government. We found that the department has not claimed reimbursement for these allowable laboratory costs. The department's claims for reimbursement of costs have been limited to payroll, payroll taxes, and fringe benefits of meat inspectors, whereas the department's claims should also have included laboratory costs consisting of payroll costs for laboratory personnel, materials, and equipment and building overhead. Based upon the time spent by laboratory personnel on meat inspection services, the allocable laboratory costs for the year was approximately $5,000.

Recommendation. *We recommend that the department's claim for federal reimbursement under the meat inspection program include laboratory costs.*

Lack of Adequate Segregation of Duties

One of the basic principles of internal control is that duties should be appropriately segregated and assigned in a manner that no one individual controls all phases of a transaction without the interrelated function of a cross-check by some other individual. Ideally, the function of receiving cash, depositing the cash, and recording the cash receipts in the accounting records should be separated and performed by different individuals.

Although there is sufficient staff to permit the segregation of duties at the department's Administrative Services Office, such separation of duties does not exist. The same account clerk is responsible for receiving the cash, preparing receipts, and preparing the deposit slip. This separation of duties also does not exist at the department's divisions and outer island offices. We understand, however, that due to the limited number of fiscal personnel at these offices, the separation of duties is not practical. Under such circumstances, some alternate controls should be instituted such as having the department conduct periodic, unannounced reviews of collection records.

Recommendation. We recommend that the cash receipt duties at the Administrative Services Office be separated and performed by different clerks. For the divisions and outer island offices, where separation of duties is not practical, the department should conduct periodic, unannounced reviews of collection records.

Chapter 6

FINANCIAL STATEMENTS AND ACCOUNTANTS' OPINION

This chapter presents the results of the examination of the financial statements of the Department of Agriculture for the fiscal year ended June 30, 1987. It contains the opinion of Peat Marwick Main & Co. (Peat Marwick) regarding the fairness and accuracy of the department's financial statements. It also presents various financial statements of the general fund, special revenue funds, capital projects funds, trust and agency funds, general fixed assets account group, and general long-term debt account group administered by the department, together with explanatory notes.

Summary of Findings

A basic purpose of a financial audit is the issuance of an opinion on the reasonable accuracy of the financial statements of the agency examined. Ordinarily, an auditor is able to render such an opinion. However, in the financial audit of the Department of Agriculture, Peat Marwick was not able to and did not express an opinion on the reasonable accuracy of the department's financial statements. The primary reason for this denial of an audit opinion is that Peat Marwick was unable to attest to the fairness of the loans receivable balance. This is because the collectibility of the outstanding loans and the fairness of the provisions for loan losses could not be ascertained.

Accountants' Opinion

Peat Marwick filed the following report on the financial statements with the Legislative Auditor:

"To the Legislative Auditor
State of Hawaii
Honolulu, Hawaii:

We have examined the general purpose financial statements of the Department of Agriculture, State of Hawaii, as of and for the fiscal year ended June 30, 1987, as listed in the accompanying table of contents. Except as stated in the third and fourth paragraphs, our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in the notes to the general purpose financial statements, the general fund presented in the financial statements represents only that portion of the State of Hawaii general fund applicable to the department.

The Department has $21,867,223 of outstanding loans and interest receivable included as assets of the special revenue and agency funds of which substantial portions were delinquent at June 30, 1987. Although a provision for possible loan losses has been recorded, the Department was unable to evaluate the collectibility of each loan outstanding and it was not practicable to extend our procedures in order to ascertain the fairness of the provision for loan losses.

Due to lack of centralized detailed historical fixed assets accounting records, it was not practicable to extend our auditing procedures to satisfy ourselves as to the general fixed assets account group balances totaling $9,487,716. Accordingly, we do not express an opinion on the financial statements of the general fixed assets account group which are included within the aforementioned general purpose financial statements.

In addition, the accompanying general purpose financial statements do not include the statements of revenues, expenditures and changes in fund balance – budget and actual – general and special revenue fund types which should be included to conform with generally accepted accounting principles.

Because of the restrictions in scope as noted in the second and third preceding paragraphs, we are unable to and do not express an opinion on the accompanying general purpose financial statements of the Department.

/s/ PEAT MARWICK MAIN & CO.

Honolulu, Hawaii
November 6, 1987"

Descriptions and Definitions

Descriptions of financial statements. The following is a brief description of the financial statements examined by Peat Marwick. The financial statements are attached at the end of this chapter.

1. *Combined Balance Sheet—All Fund Types and Account Groups (Exhibit A).* This statement presents the assets, liabilities, and fund equity of all the funds and account groups used by the department on an aggregate basis.

2. *Combined Statement of Revenues, Expenditures and Changes in Unreserved Fund Balances (Deficit)—All Governmental Fund Types and Expendable Trust Funds (Exhibit B).* This statement presents the revenues, expenditures, and changes in unreserved fund balances (deficit) for the governmental fund types and expendable trust funds used by the department on an aggregate basis.

Definition of terms. Technical terms are used in the financial statements and in the notes to the financial statements. The more common terms and their definitions are as follows:

1. *Fund.* An independent fiscal and accounting entity with a self-balancing set of accounts that records cash and/or other resources together with all related liabilities, obligations, reserves, and equities which are segregated for the purpose

of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

2. *Allotted appropriations.* Authorization to incur obligations and to make expenditures pursuant to the appropriation made by the Legislature.

3. *Appropriation.* An authorization granted by the Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are of two types: (a) funds which are available for use until completely expended, and (b) funds which lapse if not expended by or encumbered at the end of the fiscal year.

4. *Revenue.* A financial resource which is both measurable and available to finance expenditures of the fiscal year.

5. *Encumbrance.* Obligations in the form of purchase orders, contracts, or other commitments which are chargeable to an appropriation and for which a part of the appropriation is reserved. They cease to be encumbrances when paid.

6. *Expenditure.* Cost of goods delivered or services rendered, whether paid or unpaid, including expenses and capital outlays. Expenditures are distinguished from encumbrances in that expenditures relate to goods delivered or services rendered whereas encumbrances represent commitments or obligations for goods to be delivered or services to be rendered and for which no actual liability has been incurred.

7. *Unrequired balances of appropriations lapsed.* The balance of funds authorized, which is unexpended and uncommitted at the end of the prescribed time period. The balance reverts to the designated fund and is available for appropriation by the Legislature in the ensuing fiscal year.

8. *Operating transfers.* Legally authorized transfers from a fund receiving revenue to the fund through which the resources are to be expended.

9. *Personnel costs.* Salaries and wages paid to employees.

10. *Reserve.* An account used to earmark a portion of the fund balance to indicate that it is not available for expenditure.

Notes to General Purpose Financial Statements

Explanatory notes to the financial statements of the funds administered by the department are discussed below.

Financial statement presentation. The accompanying general purpose financial statements of the department present the financial position of the various fund types and account groups and the results of operations of the various fund types as of and for the fiscal year ended June 30, 1987.

The department has defined its reporting entity in accordance with National Council on Governmental Accounting Statement 3, as adopted by the Governmental Accounting Standards Board, "Defining the Governmental Reporting Entity." This statement provides guidance for determining which governmental activities, organizations, and functions should be included in the reporting entity and how information about them should be presented.

Summary of significant accounting policies. The accounting policies of the department conform to generally accepted accounting principles as applicable to governmental units. The following is a summary of the more significant policies:

1. *Basis of presentation—fund accounting.* A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts that records cash and other financial resources, together with all related liabilities and residual equities or balances and changes therein, which are segregated for the purpose of carrying on

specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

The accounts of the department are organized on the basis of funds or groups of accounts, each of which is considered to be a separate set of self-balancing accounts which comprise its assets, liabilities, fund balances, revenues, and expenditures. The various funds are grouped by type in the financial statements. The following fund types and account groups are used by the department.

a. *Governmental fund types.* Governmental funds are those through which the acquisition, use, and balances of the department's expendable financial resources and the related liabilities are accounted for. The measurement focus is upon determination of changes in financial position, rather than upon net income determination.

The general fund is the general operating fund of the department. It is used to account for all financial resources except for those required to be accounted for in another fund. The general fund programs presented are a part of the State's general fund and are limited to only those appropriations and obligations of the department.

The special revenue funds are used to account for resources legally restricted to expenditure for specific current operating purposes. Federal grants received by the department to fund various programs are accounted for as special revenue funds.

The capital projects funds are used to account for purchases or construction of major capital facilities of the department. Capital projects funds must be used when they are legally mandated or when projects are financed wholly or in part by bond issues or intergovernmental revenues.

b. *Fiduciary fund types.* Fiduciary funds are used to account for assets held by the department in a trustee capacity or as an agent. Fiduciary fund types are comprised of expendable trust funds and agency funds.

Expendable trust funds account for assets held in trust to be expended for designated purposes. Agency funds account for assets held by the department as an agent for individuals, private organizations, other governmental units, and/or other funds.

c. *Account groups.* Account groups are used to establish accounting control and accountability for the department's general fixed assets and long-term debt.

- General Fixed Assets Account Group. This group of accounts is established to account for all general fixed assets of the department.
- General Long-Term Debt Account Group. This group of accounts is established to account for all long-term obligations of the department.

2. ***Basis of accounting.*** The modified accrual basis of accounting is followed by the governmental funds and expendable trust and agency funds. Under the modified accrual basis of accounting, revenues are recorded when susceptible to accrual, i.e., both measurable and available. Available means collectible within the current period or soon enough thereafter to pay for liabilities of the current period. Expenditures are generally recognized under the modified accrual basis of accounting when the related fund liability is incurred.

Exceptions to this general rule are accumulated unpaid vacation, which is recognized as an expenditure when paid from available financial resources; and loans made to foster economic growth and development, which are charged to expenditures when made and repayments thereon are recorded as revenues when received.

3. *Encumbrances.* The general, special revenue, capital projects, and trust funds follow encumbrance accounting under which purchase orders, contracts, and other commitments are recorded as a reserve of fund balance and provide authority for the carryover of appropriations to the subsequent year in order to complete these transactions. Encumbrances are not reported in the financial statements for commitments related to grants which have not yet been recognized as revenues in the funds.

4. *Appropriations.* Appropriations for the operating budget lapse at the end of the fiscal year to the extent that they have not been expended or encumbered. Appropriations for capital projects continue in force until the purpose for which they were appropriated has been accomplished or abandoned after a specified time limitation.

5. *General fixed assets.* Fixed assets acquired for general purposes are recorded as expenditures in the fund financing the purchase and are capitalized at cost in the general fixed assets account group.

No depreciation has been provided on general fixed assets, nor has interest been capitalized.

6. *Reserves.* Portions of fund balances are reserved for the following: (1) continuing appropriations which include specific legislative appropriations which do not lapse at the end of the fiscal year and encumbrances; (2) receivables, advances and investments which are not currently available for expenditures at the balance sheet date; and (3) expendable trust fund balances which are restricted to the purpose of the account.

7. *Employee-benefit costs.* Employee-benefit costs include costs for pension, health and federal social security benefits, and workers' compensation. Employee-benefit costs of the department's general fund employees are recorded by the State's general fund in accounts budgeted to make those expenditures, and are not presented in these financial statements. Employee-benefit costs of the department's capital projects fund and special revenue fund employees are recorded by the respective funds.

8. *Total columns.* Total columns on the combined statements are captioned "memorandum only" to indicate that they are presented only to facilitate financial analysis. Data in these columns do not present financial position or results of operations in conformity with generally accepted accounting principles. Such data is not comparable to a consolidation since interfund eliminations have not been made.

Restricted cash. At June 30, 1987 restricted cash of the department consisted of the following:

Funds committed - undrawn balance of loans made	$ 150,000
Funds earmarked for pending loans	330,000
Insurance reserve	492,990
	$972,990

The department maintains a restricted cash account (insurance reserve) equal to approximately 25 percent of all outstanding loans insured by the department. At June 30, 1987, the department had outstanding insured loans of approximately $2,031,000.

Notes receivable. At June 30, 1987, notes and the related interest receivable consisted of the following:

Program	Fund	Notes Receivable	Interest Receivable
Farm loan reserve fund	Special Revenue	$ -	$1,396,556
Farm Loan revolving fund	Special Revenue	13,097,633	-
Hawaii aquaculture loans	Special Revenue	500,495	48,465
Hawaii agricultural products loan program	Special Revenue	139,564	22,138
Less provision for loan losses	Special Revenue	(1,070,806)	-
		$12,666,886	$1,467,159
North Kohala task force loans	Agency	3,465,426	1,473,801
Kauai task force	Agency	1,176,280	157,064
Independent sugar growers loan program	Agency	356,563	33,238
Less provision for loan losses	Agency	(3,700,000)	-
		$ 1,298,269	$1,664,103

A description of each loan program follows:

1. ***Farm loan reserve fund.*** This fund accounts for all interest and fees collected on loans made under the farm loan program. Excess monies in the fund are transferred to the farm loan revolving fund at the discretion of the department.

2. ***Farm loan revolving fund.*** This special fund, created by Act 278, SLH 1959, accounts for monies loaned under the farm loan program. All receipts of loan repayments and monies transferred from the farm loan reserve fund are also accounted for in this fund.

3. ***Hawaii aquacultural loan.*** Act 181, SLH 1971, established a loan program to assist in the development of aquacultural enterprises. All loan payments on account of principal and interest are deposited into this fund.

4. *Hawaii agricultural products loan program.* Act 75, SLH 1963, established a fund for the purpose of providing allowance and grants to qualified agriculturists in the development of new crops, products, or production techniques. All moneys received as repayments of allowances and grants are deposited into this fund.

5. *North Kohala task force.* Act 197, SLH 1972, established a loan and grant program for the development for North Kohala. All loan payments received on account of principal and interest are deposited to the State's general fund.

6. *Kauai task force.* Act 82, SLH 1973, established a loan and grant program to encourage the growth and development of the economy of Kauai. All loan payments received on account of principal and interest are deposited to the State's general fund.

7. *Independent sugar growers loan program.* Act 19, First Special Session Laws of Hawaii 1977, established a direct loan program to independent sugar growers to cover deficits during a period of insufficient national protection against foreign sugar imports. All loan payments received on account of principal and interest are deposited to the State's general fund.

Other receivables. At June 30, 1987, other receivables in the agency fund consisted of the following:

Animal quarantine fees	$ 251,938
Milk control fees	18,011
Less allowance for doubtful receivables	(133,129)
	$ 136,820

Fixed assets. A summary of changes (unaudited) in general fixed assets of the department shown in Exhibit A follows:

	Balance July 1, 1986	Additions	Deletions	Balance June 30, 1987
Land	$ 136,503	-	-	$ 136,503
Building and improvement	5,658,849	-	$ 38,094	5,620,755
Equipment	2,943,882	$823,621	168,878	3,598,625
Materials and supplies	50,457	131,833	50,457	131,833
	$8,789,691	$955,454	$257,429	$9,487,716

Employees' retirement system. All eligible employees of the State and counties are required by Chapter 88 of the Hawaii Revised Statutes to become members of the State Employees' Retirement System (ERS). Prior to June 30, 1984, the plan was only contributory. In 1984, legislation was enacted to create a new noncontributory plan for members of the ERS who are also covered under social security. Police officers, firefighters, judges, elected officials and persons employed in positions not covered by social security were excluded from the noncontributory plan. The noncontributory plan which provides for reduced benefits covers most eligible employees hired after June 30, 1984. Employees hired before that date were given the option of remaining in the contributory plan or joining the new noncontributory plan and receiving a refund of employee contributions.

The ERS consists of a Pension Accumulation Fund which provides basic pension benefits and a Post Retirement Fund which provides annual increases to individuals receiving pensions. Employer contributions to both funds are comprised of normal cost plus level annual payments required to liquidate the unfunded accrued liability of both funds. The ERS uses the frozen initial liability method and the entry age normal cost method for the Pension Accumulation Fund and Post Retirement Fund, respectively, to calculate the unfunded accrued liability for each fund.

Required contributions to the ERS are based on actuarial valuations and include the amortization of accrued unfunded liability over 50 years from July 1, 1964. The State's policy is to fund its required contribution annually. Contributions by the department for the fiscal year ended June 30, 1987 amounted to approximately $56,200.

Actuarial valuations are prepared for the entire ERS and are not separately computed for the State and each county. The actuarial report does not provide the actuarially computed value of vested benefits. Instead, the following data for the entire ERS (contributory plan) is provided as of the latest available report dated June 30, 1986 as follows:

Net assets available for benefits	$ 2,690,810,800
Present value of future employee contributions	429,051,200
Present value of future employer normal cost contributions	1,314,777,700
Unfunded accrued liability	470,117,400
	$4,904,757,100
Present value of benefits to current pensioners and beneficiaries	$ 1,267,986,300
Present value of future benefits to active employees and inactive members	3,636,770,800
	$4,904,757,100

The actuarial valuation as of June 30, 1986, is based on an assumed investment yield of 8 percent. Estimated earnings in excess of the assumed rate are used to reduce required contributions.

Post retirement health care and life insurance benefits. In addition to providing pension benefits, the department provides certain health care and life insurance benefits for retired department employees. Contributions are based upon negotiated collective bargaining agreements. Department contributions for post retirement benefits which are funded as accrued aggregated $34,400 in 1987.

Contingent liabilities. 1. ***Litigation.*** The department is one of several defendants in suits filed alleging responsibility for heptachlor contamination in milk and dairy products. The complaints seek damages in total in excess of $40,000,000. The department and its counsel are unable to express opinions as to the outcome of the litigation. It is their opinion that any potential liability arising therefrom will not affect the department because any judgments against the department are judgments against the State and would have to be paid by legislative appropriation of the State's general fund and not by the department.

2. ***Questioned costs.*** The department has a contingent liability for federal grant expenditure amounting to $19,128 which may be disallowed as improper expenditures by various grantor agencies.

3. ***Insurance coverage.*** Insurance coverage is maintained at the state level. The State is substantially self-insured for all perils including workers' compensation. Expenditures for workers' compensation are appropriated annually from the State's general fund.

Exhibit A

STATE OF HAWAII
DEPARTMENT OF AGRICULTURE

Combined Balance Sheet - All Fund Types and Account Groups

June 30, 1987

Assets	Governmental fund types: General	Governmental fund types: Special revenue	Governmental fund types: Capital projects	Fiduciary fund types: Trust and Agency	Account groups: General fixed assets (unaudited)	Account groups: General long-term debt	Totals (memorandum only)
Cash and short-term investments:							
Restricted	$ -	972,990	-	-	-	-	972,990
Unrestricted	567,711	12,486,857	399,172	89,824	-	-	13,543,564
	567,711	13,459,847	399,172	89,824	-	-	14,516,554
Receivables:							
Notes	-	12,666,886	-	1,298,269	-	-	13,965,155
Interest	-	1,467,159	-	1,664,103	-	-	3,131,262
Others	-	47,710	-	136,820	-	-	184,530
	-	14,181,755	-	3,099,192	-	-	17,280,947
Other assets:							
Fixed assets	-	-	-	-	9,487,716	-	9,487,716
Amount to be provided for retirement of general long-term debt	-	-	-	-	-	2,139,297	2,139,297
Total assets	$ 567,711	27,641,602	399,172	3,189,016	9,487,716	2,139,297	43,424,514

(Continued)

STATE OF HAWAII
DEPARTMENT OF AGRICULTURE

Combined Balance Sheet - All Fund Types and Account Groups, Continued

	Governmental fund types			Fiduciary fund types	Account groups		
Liabilities and Fund Equity	General	Special revenue	Capital projects	Trust and Agency	General fixed assets (unaudited)	General long-term debt	Totals (memorandum only)
Liabilities:							
Accounts payable	$ 59,844	28,891	-	14,318	-	-	103,053
Accrued vacation payable	-	-	-	-	-	2,139,297	2,139,297
Due to individuals, businesses and counties	-	21,000	-	16,327	-	-	37,327
Due to State General Fund	-	-	-	3,108,719	-	-	3,108,719
Due to Hawaii Housing Authority	-	-	225,000	-	-	-	225,000
Deferred revenue	-	16,051	-	-	-	-	16,051
Total liabilities	59,844	65,942	225,000	3,139,364	-	2,139,297	5,629,447
Fund equity:							
Investment in general fixed assets	-	-	-	-	9,487,716	-	9,487,716
Fund balances:							
Reserved for investments	-	12,075,000	-	-	-	-	12,075,000
Reserved for receivables	-	14,181,755	-	-	-	-	14,181,755
Reserved for continuing appropriations	507,867	1,334,956	174,172	49,652	-	-	2,066,647
Unreserved (deficit)	-	(16,051)	-	-	-	-	(16,051)
Total fund balances	507,867	27,575,660	174,172	49,652	-	-	28,307,351
Total fund equity	507,867	27,575,660	174,172	49,652	9,487,716	-	37,795,067
Commitments and contingencies							
Total liabilities and fund equity	$ 567,711	27,641,602	399,172	3,189,016	9,487,716	2,139,297	43,424,514

See accompanying notes to general purpose financial statements.

STATE OF HAWAII
DEPARTMENT OF AGRICULTURE

Combined Statement of Revenues, Expenditures and Changes in Unreserved Fund Balances (Deficit) - All Governmental Fund Types and Expendable Trust Funds

Year ended June 30, 1987

	Governmental fund types			Fiduciary fund type	Totals
	General	Special revenue	Capital projects	Expendable trust	(memorandum only)
Revenues:					
Allotted appropriations	$ 9,057,766	-	-	-	9,057,766
Licenses and fees	-	280,588	-	-	280,588
From other agencies	-	1,010,068	-	-	1,010,068
Interest income	-	1,609,105	-	-	1,609,105
Charges for current service	-	-	-	202,145	202,145
Proceeds from loan repayments	-	1,652,877	-	-	1,652,877
Miscellaneous	-	242,103	-	-	242,103
Total revenues	9,057,766	4,794,741	-	202,145	14,054,652
Expenditures:					
Personnel costs	7,663,055	1,556,405	-	172,389	9,391,849
Issuance of new loans	-	1,626,061	-	-	1,626,061
Equipment	297,227	14,071	-	-	311,298
Other	1,853,032	349,235	194,937	11,849	2,409,053
Total expenditures	9,813,314	3,545,772	194,937	184,238	13,738,261
Excess (deficiency) of revenues over expenditures	(755,548)	1,248,969	(194,937)	17,907	316,391
Other financing sources (uses):					
Operating transfers in	1,227,493	-	225,000	-	1,452,493
Unrequired balances of appropriations lapsed	(139,074)	-	-	-	(139,074)
Total other financing sources	1,088,419	-	225,000	-	1,313,419
Excess of revenues and other financing sources over expenditures and other financing uses	332,871	1,248,969	30,063	17,907	1,629,810
Other changes in reserved fund balances:					
Reserve for other receivables	-	998,543	-	-	998,543
Reserve for continuing appropriations	(32,201)	(1,113,563)	(30,063)	(17,907)	(1,193,734)
Reserve for investments	-	(1,150,000)	-	-	(1,150,000)
Net increase	(32,201)	(1,265,020)	(30,063)	(17,907)	(1,345,191)
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses and other changes in reserved fund balances	300,670	(16,051)	-	-	284,619
Unreserved fund balances (deficit):					
At beginning of year	(300,670)	-	-	-	(300,670)
At end of year	$ -	(16,051)	-	-	(16,051)

See accompanying notes to general purpose financial statements.

PART III

RESPONSE OF THE AFFECTED AGENCY

COMMENTS ON AGENCY REPONSE

On January 11, 1988, copies of a preliminary report of this financial audit were transmitted to the Governor, the presiding officers of the Legislature, and the Department of Agriculture. A copy of the letter of transmittal to the department is included here as Attachment 1. As is our practice, we invited the department to comment on the recommendations made in the report. The department responded by letter dated January 26, 1988, which is included here as Attachment 2.

Except for one recommendation, the department concurs with our recommendations and stated that corrective actions have been or will be implemented. With respect to our recommendation that the department address the problem of loans to independent sugar growers with poor loan repayment histories, the department did not directly address this recommendation except to state that the department believes it has been following the intent of the Legislature in granting loans to independent sugar growers.

ATTACHMENT 1

THE OFFICE OF THE AUDITOR
STATE OF HAWAII
465 S. KING STREET, RM. 500
HONOLULU, HAWAII 96813

CLINTON T. TANIMURA
AUDITOR

January 11, 1988

COPY

Ms. Suzanne Peterson, Chair
Board of Agriculture
Department of Agriculture
1428 South King Street
Honolulu, Hawaii 96814

Dear Ms. Peterson:

Enclosed are two preliminary copies, numbered 4 and 5, of our report on the *Financial Audit of the Department of Agriculture.* We call your attention to the recommendations affecting the department which are made in Chapters 4 and 5 of the report. If you have any comments on our recommendations, we ask that you submit them in writing to our office by January 25, 1988, for inclusion in the final report.

The Governor and the presiding officers of the Legislature have been provided with copies of this preliminary report.

Since the report is not in final form and there may be changes to it, access to this report should be restricted to those officials whom you might wish to call upon to assist you in the review of the report. Public release of the report will be made solely by our office and only after the report is published in its final form and submitted to the Legislature.

We appreciate the assistance and cooperation extended to us.

Sincerely,

Clinton T. Tanimura

Clinton T. Tanimura
Legislative Auditor

Enclosures

ATTACHMENT 2

JOHN WAIHEE
GOVERNOR

SUZANNE D. PETERSON
CHAIRPERSON, BOARD OF AGRICULTURE

Robert Y. Tsuyemura
Acting Deputy to the Chairperson

State of Hawaii
DEPARTMENT OF AGRICULTURE
1428 So. King Street
Honolulu, Hawaii 96814-2512

Mailing Address:
P. O. Box 22159
Honolulu, Hawaii 96822-0159

January 26, 1988

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

Mr. Clinton T. Tanimura
Legislative Auditor
State of Hawaii
465 S. King Street, Room 500
Honolulu, Hawaii 96813

Dear Mr. Tanimura:

Thank you for this opportunity to review and provide comments to the preliminary report on the Financial Audit of the Department of Agriculture.

Comments to specific findings and recommendations are enclosed. Some of the the recommendations were previously identified by our staff and had been corrected prior to the audit report.

We wish to commend the Peat, Marwick and Main staff for the cooperative and professional manner in which they conducted themselves. Please feel free to call Ann Oshiro of my staff at 548-7106 if there are any questions or if additional information is required.

Sincerely yours,

Suzanne D. Peterson

SUZANNE D. PETERSON
Chairperson, Board of Agriculture

Enc.

COMMENTS ON LEGISLATIVE AUDITOR'S FINANCIAL AUDIT OF THE DEPARTMENT OF AGRICULTURE

January 25, 1988

LOAN MANAGEMENT
Summary of Findings and Comments:

1. The Department has continued to provide loans to farmers with extremely poor repayment histories under the independent sugar grower loan program.

   Comment: The Department believes it has been following the intent of the Legislature in granting loans to independent sugar growers.

2. Excessive cash balances are maintained in the department's special revenue loan funds.

   Recommendation: We recommend that the department conduct a review of the special loan funds to determine the level at which the balance of these funds should be permitted to accumulate. All amounts in excess of this fund level should then be transferred to the general revenues of the State in accordance with Section 37-53, HRS.

   Comment: The department will review its needs annually to determine the excess amount to be transferred to the general revenue fund.

3. The department has continued to accrue interest on delinquent and problem loans, a practice which is contrary to its policies and procedures manual. In addition, the department charges interest on loans prior to the date that the loan proceeds are made available to the borrower.

   Recommendation: We recommend that the department discontinue the accrual of interest on loans that are delinquent beyond the period stipulated by its policy.

   Comment: The department concurs and began implementation of its policy in June, 1987.

Recommendation: We recommend that the department begin charging interest on loans from the date loan proceeds are made available to borrowers instead of the date of the warrant.

Comment: The department concurs and began implementation in June, 1987.

4. The department has failed to write off loans determined to be uncollectible by the Attorney General.

Recommendation: We recommend the department write off receivables determined to be uncollectible by the Attorney General.

Comment: The department concurs with the recommendation and is in the process of implementation.

5. The department is not enforcing its requirement for the submission of annual financial statements from borrowers, which should be used to assist the department in monitoring the financial condition of borrowers.

Recommendation: We recommend that the department enforce its policy of requiring the submission of annual financial statements from borrowers. Such financial statements should be analyzed to continually monitor the financial condition of borrowers.

Comment: The department will review and reevaluate its policy and procedures.

6. Loan officers are not performing initial visits within the time period set by departmental policy. In addition, the results of field visits are not fully documented.

Recommendation: We recommend that the department conduct timely initial on-farm inspections within three months of loan disbursement as required by its loan policy.

Comment: The department will strive to comply with its policy. While field visits are currently made on a timely basis, loan officers will be reminded to schedule field visits within the time frame and submit the proper documentation.

Recommendation: We recommend that the department take the steps necessary to ensure that the results of field visits be fully documented by completing the budgeted and actual financial data section of the loan servicing report.

Comment: The department will remind loan officers to make every effort to submit complete documentation of field visits.

7. The department has not always documented its basis for determining the value of property offered as collateral.

Recommendation: We recommend the department document, at all times, its basis for determining the value assigned to property offered as collateral.

Comment: The department concurs and will review procedures and make adjustments to ensure that there is proper documentation. This information will be included as part of our data base for recoverability on loans.

<u>FINANCIAL ACCOUNTING AND INTERNAL CONTROL</u>
Summary of Findings and Comments:

1. The department's practice of limiting its investment of available cash in time certificates of deposit having maturities of 90 days or less does not provide the flexibility to maximize interest earnings.

Recommendation: We recommend the department revamp its cash management practices to maximize interest earnings. Such practices should provide for the consideration of investing available cash in TCD's and U.S. Treasury securities with various maturities, the selection of which should be based on projected cash flow requirements and market conditions for interest rates.

Comment: The department will make every effort to review its objectives and will make long-term investments when deemed feasible. Currently, the department submits an application for investment of various amounts to the Department of Budget and Finance (B&F) who in turn determines which institution the money is to be invested in and the amount. There have been past instances when several applications were combined for investment in one TCD by B&F. Also there have been a few times when the amount stated on the application was broken down to purchase two separate TCDs. It is our understanding that investments would be made at the highest available interest rate. We have found that two of our recent investments were at a higher interest rate than others which were renewed on the same date.

2. There are unnecessary delays in the depositing of cash receipts.

Recommendation: We recommend that the department's Fiscal Office deposit all receipts on a daily basis.

Comment: The department concurs; however, in some cases it is not feasible, such as location of office, the number of personnel in the office to maintain coverage/service, and the amount of the deposit.

3. The department is not claiming federal reimbursement of laboratory costs for meat and poultry inspection services which are chargeable to federal grants.

Recommendation: We recommend that the department's claim for federal reimbursement under the meat inspection program include laboratory costs.

Comment: In our report for federal fiscal year ended September 30, 1987, we included a claim for $5,085.46 which represented laboratory costs for our Veterinary Laboratory.

4. Controls over cash receipts are deficient. The appropriate segregation of duties between the receipting, depositing, and recording of cash receipts is lacking.

Recommendation: We recommend that the cash receipt duties at the Administrative Services Office be separated and performed by different clerks. For the divisions and outer island offices, where separation of duties is not practical, the department should conduct periodic, unannounced reviews of collection records.

Comment: The Administrative Services Office is currently working on a system for adequate segregation of duties, without incurring needless duplication of efforts.