
Financial Audit of the Department of Business, Economic Development, and Tourism

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

Report No. 92-12
April 1992

THE AUDITOR
STATE OF HAWAII

OVERVIEW

THE AUDITOR
STATE OF HAWAII

Financial Audit of the Department of Business, Economic Development, and Tourism

Summary

The Office of the Auditor and the certified public accounting firm of Nishihama & Kishida, CPA's, Inc. conducted a financial audit of the Department of Business, Economic Development, and Tourism pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct post audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State.

The financial audit was for the fiscal year July 1, 1990 to June 30, 1991. The audit examined the department's financial records and its systems of accounting and internal controls. Systems and records were also examined for compliance with applicable laws and regulations.

In the opinion of Nishihama & Kishida, CPA's, Inc., the department's financial statements present fairly its financial position and the results of its operations as of June 30, 1991. Except for the presentation of the Foreign Trade Zone as a special fund instead of an enterprise fund, all were in conformity with generally accepted accounting principles. Nishihama & Kishida, CPA's, Inc. found no instances where the department did not comply with applicable laws and regulations, nor did the firm find weaknesses in the department's control measures that would affect an opinion on the financial statements.

We found that the department has engaged in practices that violate the intent of state law and the requirements of state financial administration. In one instance the department entered into a contract with the Department of Accounting and General Services (DAGS) to avoid the Constitutional provisions on the lapsing of funds. The contract allowed the department to prevent the funds from lapsing and to avoid having to resubmit a funding request to the Legislature. This practice violates the intent of Constitutional provisions on the lapsing of funds, that is, that the Legislature be given the opportunity to review and reconsider the project for continued funding.

We found also that the department has avoided the required approval process for individual consultant contracts by executing master contracts with the Research Corporation of the University of Hawaii (RCUH). The master contracts are merely pro forma contracts whereby RCUH, on behalf of the department, contracts with consultants who must then report directly to the department.

In addition, we found that the department has administered contracts inconsistently because it lacks written procedures. There are no written guidelines for loan

administration; the processing of loan payment receipts needs to be improved; and procedures at the Foreign Trade Zone Division with respect to tariffs charged, security deposits, and petty cash need to be improved.

Recommendations and Responses

We recommended that the department and DAGS not enter into contracts merely to avoid lapsing of funds. We also recommended that the department be required to comply with the State Accounting Manual and the governor's budget execution policies. We further recommended that the department develop written guidelines for the content of contracts and their administration, and for the evaluation of loan applications and documentation of loan activities. Additionally, we recommended that loan receipt and recording duties be segregated and receipts be deposited to the state treasury daily. Finally, we recommended that the Foreign Trade Zone include all charges in its tariff booklet, record all security deposits, and improve controls over its petty cash.

Department of Business, Economic Development, and Tourism. The department generally concurs with our recommendations. The department states it contracted with DAGS in order to carry out the legislative intent of the appropriation in an expedient and efficient manner. It deferred to DAGS to comment on our recommendation on interdepartmental contracts. The department disagrees with our recommendations about its master contracts with RCUH. It states it has obtained the necessary approvals because this practice of contracting for consultant services through RCUH was approved by the Governor in 1986. We believe that a blanket authorization received some four years in the past is insufficient for current contracts.

Two of our recommendations concerning the Foreign Trade Zone seem to have been misunderstood by the department. The department does not agree that security deposits should be recorded in DAGS' accounting records because they have not been cashed and recorded as revenues. This is not the point. DAGS maintains the official accounting records of the State and the requirement that security deposits and the related liability be recorded on those accounting records has nothing to do with cashing them and recording the cash as revenues. We also recommended that the overage in petty cash be returned to the state treasury. The department interpreted state treasury to mean the general fund and therefore does not agree with our recommendation. The state treasury is comprised of all cash of the State, to include special fund cash as well as general fund cash. We made no recommendation to return the cash to the general fund, but that the cash be returned to the state treasury.

Department of Accounting and General Services. The department does not disagree with our finding concerning the use of interdepartmental contracts to avoid constitutional lapsing of appropriations. It believes that any attempt to prohibit this contracting process should be debated and decided through the legislative process.

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the State of
Hawaii

Conducted by

The Auditor
State of Hawaii
and
Nishihama & Kishida,
Certified Public
Accountants

Submitted by

THE AUDITOR
STATE OF HAWAII

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Foreword

This is a report of a financial audit of the Department of Business, Economic Development, and Tourism for the fiscal year July 1, 1990 to June 30, 1991. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct post audits of all departments, offices, and agencies of the State. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Nishihama & Kishida, CPA's, Inc.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Department of Business, Economic Development, and Tourism.

Marion M. Higa
Auditor
State of Hawaii

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Chapter 1

Introduction

This is a report of our financial audit of the Department of Business, Economic Development, and Tourism (DBEDT). The audit was conducted by the Office of the Auditor and the certified public accounting firm of Nishihama & Kishida, CPA's, Inc.

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct post audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Objectives of the Audit

1. To provide a basis for an opinion on the fairness of the presentation of the combined financial statements of the DBEDT.
2. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for financial accounting, internal control, and financial reporting, and recommend improvements to such systems, procedures, and reports.
3. To ascertain whether expenditures and other disbursements have been made and all receipts have been collected and accounted for in accordance with applicable laws, rules, and policies and procedures of the State of Hawaii.
4. To ascertain the extent to which recommendations contained in Chapter 3 of the State Auditor's Report No. 84-7 "Financial Audit of the Department of Planning and Economic Development for the Fiscal Year Ended June 30, 1983," have been implemented.

Scope and Methodology

We examined the financial records and transactions and the related systems of accounting and internal controls of DBEDT for the fiscal year July 1, 1990, to June 30, 1991. Included were all fund types and account groups except the general fixed assets account group. We also tested transactions, systems, and procedures for compliance with applicable laws and regulations.

The audit examined the accounting, reporting, and internal control structures to identify deficiencies and weaknesses and to make appropriate recommendations for improvement. We included in our examination the existing accounting and operating systems and procedures.

The auditors' opinion as to the fairness of the financial statements presented is that of Nishihama & Kishida, CPA's, Inc. The audit was conducted from July 1991 through October 1991 in accordance with generally accepted government auditing standards.

Background

In 1963, the Legislature established the Department of Planning and Economic Development. In 1990, the department's name was changed to the Department of Business, Economic Development, and Tourism. Section 26-18, Hawaii Revised Statutes, enumerates the department's responsibilities:

The department shall undertake statewide business and economic development activities, undertake energy development and management, provide economic research and analysis, plan for the use of Hawaii's ocean resources, and encourage the development and promotion of industry and international commerce through programs established by law.

Organization of the Department

The department is headed by an executive known as the Director of Business, Economic Development, and Tourism. The director has overall responsibility for planning, directing, and coordinating the various programs of the department. The department is organized into staff offices and operating divisions.

Staff offices

Three staff offices provide support services to the department.

- The Administrative Services Office provides general internal management, as well as fiscal, budgetary, and personnel assistance to the director.
- The Information Office informs the public on DBEDT activities and maintains the department's library.
- The Office of Space Industry directs the planning, evaluation, and coordination of space-related activities in the state.

Operating divisions

Six operating divisions carry out the programs of the department.

- The Research and Economic Analysis Division prepares statistical data and basic research studies on the state's economy. This division also develops the analysis, plans, and recommendations on various economic issues for policy decisions.

- The Energy Division engages in energy management and conservation programs and the development of Hawaii's alternate energy resources.
- The Business Services Division facilitates the growth of small businesses by providing financial, management, technical, and other assistance to new and existing businesses. It administers state and local government activities partially funded under the U.S. Economic Development Administration, and federal and state statutes on enterprise zones.
- The Foreign Trade Zone Division operates and maintains the Foreign Trade Zone. In addition, it promotes Hawaii as a center for international trade activities, encourages establishment of new industry and employment, expands export markets for the state's business firms, and provides services to diversify Hawaii's industrial base through establishment of neighbor island subzones.
- The Industry Promotion Division promotes statewide economic development by ensuring the stability and growth of preferred major industries in Hawaii through planning, development, and promotion of tourism, the film industry, and industries relating to ocean resources.
- The Business Development and Marketing Division promotes the stability, growth, and diversification of commerce and industry in Hawaii through planning, organizing, and implementing activities, projects and programs to attract selected industries to Hawaii.

Units assigned for administrative purposes

Six additional units are assigned to DBEDT for administrative purposes.

- The Hawaii Community Development Authority coordinates public and private sector efforts to implement community development plans and programs in areas designated by the Legislature as "underdeveloped or blighted." The authority consists of eleven voting members.
- The High Technology Development Corporation plans, initiates, and carries out activities for the development of industrial parks for high technology enterprises. It assists in the construction of such facilities through the issuance of special purpose revenue bonds. The High Technology Development Corporation is directed by a managing board consisting of nine voting members.

- The Natural Energy Laboratory of Hawaii Authority (NELHA) is responsible for managing and operating research facilities that are sites for research, development, demonstration, and commercialization of natural energy resources and other compatible scientific and technological investigations. The NELHA is directed by a managing board consisting of seven ex-officio members, including the Director of DBEDT.
- The Land Use Commission is responsible for preserving, protecting, and encouraging development of state lands for their best use. The commission consists of nine members appointed by the governor.
- The Aloha Tower Development Corporation is responsible for planning, initiating, and carrying out the redevelopment of the Aloha Tower Complex in downtown Honolulu. The corporation is directed by a board of directors consisting of seven voting members.
- The Waikiki Convention Center Authority is responsible for reviewing the proposed convention center development pursuant to the convention center development plan. The authority is directed by a board of directors consisting of seven voting members.

Chapter 2

Internal Control Practices

This chapter presents general findings and recommendations on the financial accounting and internal control practices and procedures of the Department of Business, Economic Development, and Tourism (DBEDT).

Summary of Findings

We find that the department has engaged in practices that violate the intent of state law and the requirements of state financial administration. We also found weaknesses in the department's financial management.

1. The department entered into an interdepartmental contract to avoid constitutional provisions on the lapsing of funds.
2. It executed contracts with the Research Corporation of the University of Hawaii (RCUH) to avoid requisite state approvals.
3. The department has administered contracts inconsistently because it lacks written procedures.
4. The department has not developed written guidelines for loan administration, and there is no assurance that loans are being evaluated fairly and administered properly. In addition, the processing of loan payment receipts needs to be improved.
5. Procedures at The Foreign Trade Zone Division with respect to tariffs charged, security deposits, and petty cash need to be improved.

DBEDT Entered into an Interdepartmental Contract to Avoid Lapsing of Funds

In Act 216, 1987, the Legislature appropriated \$7.195 million to DBEDT for the design and construction of a filming facility. To avoid the constitutional requirement that unexpended appropriations for capital improvement projects must lapse three years after they are appropriated, in 1990, DBEDT entered into a contract with the Department of Accounting and General Services (DAGS) to encumber virtually the entire appropriation for this project.

The purpose of this contract was to keep the unexpended and unencumbered balance of the appropriation from lapsing. While not specifically illegal, this practice violates the intent of the State

Constitution which limits appropriations for capital improvement projects to a specified period of three years. Article VII, Section 11 of the Constitution states:

All appropriations for which the source is general obligation bond funds or general funds shall be for specified periods, and *no such appropriation shall be made for a period exceeding three years*. Any such appropriation or any portion of any such appropriation which is unencumbered at the close of the fiscal period for which the appropriation is made shall lapse. (emphasis added)

In April 1990, the department found that it would not be able to complete the project before June 30, 1990—the date the appropriation would lapse. The department then contracted with DAGS for DAGS to select the construction contractor(s) and to oversee the construction of the filming facility. The contract amount was \$5.94 million.

This interagency contract is different from the delegation which is permitted by Act 216, SLH 1987. The act authorizes the departments to “*delegate* to other state or county agencies the implementation of such projects when it is determined by such agency that it is advantageous to do so.” When an expending agency delegates the implementation of a project to another agency, the agency normally transfers the appropriation also. Delegation of the project does not protect the unexpended appropriation from lapsing.

Interagency contracts to encumber funds are apparently legal. In an opinion relating to a different contract, the Department of the Attorney General (AG) advised DAGS in 1988 that contracts between state agencies are a legal basis for encumbering funds. But in its memorandum, the AG cautioned that its conclusion on the ability to encumber funds through interagency contracts was limited to that particular case and should not be applied to other circumstances.

Even though interagency contracts may be legal, we believe that it is not a sound practice for capital improvement projects. The rationale for the lapsing of unused appropriations is to strengthen legislative oversight of capital improvement projects. It requires departments to resubmit their requests for projects authorized in prior legislative sessions for legislative review and reconsideration. Lapsing provisions allow the Legislature to determine if such projects are still valid when compared with other projects currently being requested.

By encumbering the funds for the filming facility, DBEDT avoided having to resubmit a request for continued funding to the Legislature, thereby negating the Legislature’s authority to exercise the oversight responsibility intended by the constitution. While the contract between DAGS and DBEDT may have provided a legal basis for encumbering

the funds, we believe that DAGS as the State Comptroller should not continue this practice.

Recommendations

We recommend that DBEDT cease the practice of contracting with other state agencies to avoid constitutional provisions on the lapsing of appropriations. We also recommend that DAGS not enter into such contracts.

Contracts with the Research Corporation of the University of Hawaii (RCUH) Circumvent State Approval Process

The department has avoided going through the required approval process for individual consultant contracts by executing two master contracts with RCUH for \$5.7 million. This is contrary to the requirements of the State Accounting Manual and the governor's budget execution instructions.

Section 430, paragraph 2 of the State of Hawaii Accounting Manual requires contracts for consulting services to be subject to approval by the governor or some other competent authority. The governor's memorandum, Memo No. 90-10, establishing fiscal year 1990-91 budget execution policies and procedures, states that "Each department head is authorized to engage the services of consultants, *with the prior approval of the Governor.*" The intent is clear—consultant services are to be approved in advance by the Governor.

The department has avoided obtaining the required approvals for consultant services by contracting with RCUH which in turn contracts for consultant services on behalf of the department. The department obtains the governor's approval only for its contracts with RCUH. It does not obtain that approval for the contracts between RCUH and the "subcontractor" consultants.

The department stated that obtaining the governor's approval takes about three months and that the contracting process was more efficient with one contractor versus with many different contractors. This is not a valid reason for circumventing the State Accounting Manual and the governor's budget execution instructions, particularly since DBEDT continues to deal directly with those subcontractors.

In 1990 and 1991, the Energy Division executed one contract with RCUH and amended another for programs funded mostly by the U.S. Department of Energy. The contract and amendment amounted to \$5.7 million. These were pro forma contracts. Services were actually provided by different individuals and organizations via subcontracts with RCUH. RCUH was merely a funding conduit. DBEDT's Energy Division continued to administer the contracts and programs.

This is apparent from a reading of the standard contract agreement between RCUH and a subcontractor which reads:

WHEREAS, RCUH *on behalf of the Department of Business and Economic Development (DBED)*, desires to engage <name of subcontractor>, to <service desired>; (emphasis added).

The standard contract also states:

“DBED shall have the right to terminate this Agreement by giving written notice to the <CONSULTANT>,” and “the <CONSULTANT> shall not be relieved of liability to DBED for damages sustained by DBED because of any breach by the <CONSULTANT>.”

The “consultant” with which DBEDT was dealing was not RCUH, but the corporation’s subcontractor. For one contract, the Energy Division solicited, selected, and monitored about 80 individual subcontractors. The division drafted the contracts between RCUH and the consultants/subcontractors and approved for payment by RCUH all invoices submitted by the subcontractors. The terms of the subcontracts required the subcontractors to report to and deal directly with DBEDT personnel.

Recommendation

We recommend that the department be required to comply with the State Accounting Manual and the governor’s budget execution policies.

Contract Administration Practices are Weak

A contract is a binding agreement between two or more persons that creates an obligation to perform or to do a particular activity. It is important that all contract terms and conditions are clear and complete to avoid any misunderstanding. It is also important that the department monitor the progress and status of contracts to ensure that the contractor is performing in accordance with the terms of the contract.

The department has no written procedures for the administration of its contracts. Each division or branch of the department prepares specifications and drafts contracts for services. For the most part divisions and branches generally follow standard practices in developing specifications and preparing contract documents, but we found contracts that omit critical elements contained in the specifications. We also found that the department often did not document its monitoring of contracts.

Inadequate contract documents

To protect the interests of the State, contracts should contain: (1) a time schedule for the commencement and completion of each phase or section

of the project, (2) an expenditure budget by cost element showing the allocation of resources by phase, and (3) a list of persons assigned to the project. The personnel list should include their qualifications and the amount of time each would spend on the project. These specific provisions would enable the department to monitor and evaluate the contractor's specified time schedule, budget, and assignment of personnel.

We found that time schedules, budgets, and personnel resources are sometimes contained in the *specifications* but often were not included in the terms of the *contracts*. The divisions generally defended these omissions by saying that the provisions were mutually understood by the contractor and the divisions. The divisions also said that including the provisions would be too restrictive for services that were subject to many changes. We believe that the division should be able to define clearly the services it needs before it contracts for them.

Lack of documentation of contract progress

The department has no guidelines for its divisions on how contract monitoring should be documented. Without such documentation, DBEDT has no history of the progress of contracts or evidence that the interest of the State has been protected. We were unable to verify whether contracts were, in fact, being monitored.

The divisions and branches say they maintain close and frequent contact with the contractors, but the contracting division or branch did not always document its monitoring of contract progress. Departmental personnel should document in writing their monitoring of the status of contracts to provide assurances that the contractor is in compliance with contract terms and schedules.

Recommendations

The department should develop written guidelines for the content of contracts and their administration. These guidelines should require that:

1. Contracts contain time schedules, expenditure budgets, and identification of contractor personnel and their qualifications; and
2. Department personnel document their monitoring of contracts in writing to assure that contractors are performing as agreed.

Written Guidelines are Needed for Loan Administration

We noted during this audit that many problems in loan administration that we found in our 1984 audit report still exist. The department administers several loan programs through the Financial Assistance

Branch of its Business Services Division. Loan activities are handled by three loan officers and a branch chief.

In our 1984 financial audit report of DBEDT, we found several deficiencies in loan administration including inadequate evaluation of applicants and poor loan disbursement practices. The branch still has not developed written guidelines for the administration of loans. As a result, loan approval, review, and documentation practices are inconsistent within the branch. We found some poor loans that could have been avoided had the department issued adequate written guidelines.

Inadequate loan evaluation

A loan is meant to be repaid. The prospective ability of a loan applicant to repay is a material factor in granting or refusing a loan. Section 15-2-7(c) of DBEDT's rules and regulations for the Hawaii Capital Loan Program states: "The department shall not approve a loan unless the applicant provides reasonable assurance that the loan can and will be repaid pursuant to its terms. Reasonable assurance of repayment shall be based upon consideration of the applicant's record of past earnings or projections of future earnings which indicate that the applicant will be able to repay the loan from the income of the business."

Section 15-2-5(5) also states in part, "Adequate collateral is required to reasonably protect the State's interest...."

But the department has no guidelines on how this rule is to be interpreted. The department requires loan applicants to demonstrate the ability to repay the borrowed money and to have adequate collateral, but does not tell its loan officers how to evaluate income and collateral. This means that loan officers have much leeway in how they evaluate income and collateral.

For example, a capital loan for \$150,000 was granted on December 7, 1990. The applicant presented projected cash flow statements for 1991 and 1992 that showed profit margins that were almost double those achieved in the past. No explanation for the large increase was documented. There was no evidence that DBEDT had analyzed the projected cash flow or compared it to past performance. It appears that the division accepted the projections as presented.

Collateral for the loan was real estate owned by an officer of the company. An appraisal of the real estate was included with the loan application. The loan officer considered the appraised value to be too low and established a higher value based on the prices of properties in the same neighborhood listed by the Multiple Listing Services. The loan officer apparently did not consider that the parcel used for collateral was smaller than the properties used for comparison. Since there are no

written guidelines for loan officers on how to determine the value of collateral, the loan officer was allowed to establish a value independently.

This loan is now in default and has been referred to the Department of the Attorney General for action.

No documentation of significant loan activities

Documentation of loan activities provides a historical record of a loan that is available for subsequent analysis and verification that the interest of the State was protected. Loan activities should include periodic follow-up and confirmation of business activity and inspection of collateral. Loan officers said that they made site visits to confirm the existence of collateral and proper use of the loan proceeds. Their activities could not be verified since the visits were rarely documented in the loan files.

Recommendations

The department should establish written guidelines for evaluating loan applications which include guidelines for evaluating and accepting cash flow projections and collateral valuation.

The department should also establish guidelines for loan officers to document their loan activities.

Improvements are Needed in Processing Loan Payment Receipts

Checks received for loan repayments were usually received and processed by the Administrative Services Office accountant. During our audit we found weaknesses in the processing of these receipts. Our findings are detailed here.

Inadequate segregation of loan receipts responsibilities

One of the basic principles of internal control is that duties should be appropriately segregated and assigned in such a manner that no one individual controls all phases of a transaction without a cross check by another 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.

Such segregation of duties would allow errors and irregularities in recording cash receipts to be detected. Although there is sufficient staff to permit the segregation of duties at the administrative services office, such separation of duties does not exist. The same individual is responsible for receiving the checks, preparing the treasury deposit receipt, and recording the receipts in the accounting records.

Delays in depositing cash to the treasury

The Administrative Services Office does not always remit checks to the Department of Budget and Finance for deposit in a timely manner. At times, checks were remitted four to six days after they had been received. Delays in depositing cash to the treasury result in lost interest earnings to the State. Also, delays in making deposits increase the possibility that checks may be lost or misplaced.

Recommendations

The loan receipt and recording duties at the Administrative Services Office should be separated and performed by different individuals. Receipts should be deposited to the state treasury on a daily basis.

Procedures at the Foreign Trade Zone Division (FTZ) Need to be Improved

Foreign trade zones were authorized by the United States Congress in 1934 to expedite and encourage foreign commerce and for other purposes. Their operations are subject to conditions and restrictions established by Congress. The FTZ was established within the department to operate a foreign trade zone pursuant to a grant to the State from the Foreign Trade Zones Board in Washington, D. C.

The FTZ maintains and operates a foreign trade zone facility at Pier 2 in Honolulu Harbor. It coordinates activities among zone users, business and industry groups, regulatory agencies and other groups involved in the operation and use of the foreign trade zone. All fiscal matters dealing with the zone's daily operations are handled by the FTZ. We found several problems at the Foreign Trade Zone.

Charges do not comply with applicable federal regulations

The Foreign Trade Zone No. 9, located at Pier 2, is a state-operated public utility. Federal regulations contained in *15 CFR Ch. IV (1-1-91 Edition)*, Sections 400.1003 (a) and (b), require that rates and charges for all services or privileges within a zone be uniform and that schedules containing all rates and charges be published, posted, and filed with the Foreign Trade Zones Board in Washington, D. C. During our audit, we found that electricity charges and administrative fees were negotiated orally and were not included in the published tariff booklet.

Rates for usage of the trade zone are supposed to be those in its Tariff No. 1 which is on file with the Foreign Trade Zones Board. Item 270 of the Tariff states:

Grantee <the FTZ> shall apply the rates and charges set forth in this Tariff and applicable to the zone/subzone operation *uniformly* to all zone/subzone occupants, operators and users. (emphasis added)

The failure to incorporate all charges in the tariff booklet places the FTZ in noncompliance with applicable federal regulations. Without written charges, it was difficult to determine whether amounts charged to tenants complied with the requirement that all charges be uniform. We found also that the FTZ did not always adhere to charges in the tariff booklet for equipment rental.

Security deposits not accounted for

We found that the FTZ had security deposits on hand that were not recorded in state accounting records at DAGS. Section 40-81 of the Hawaii Revised Statutes states in part, "All state officers, departments, boards, bureaus, commissions, or agencies collecting or receiving any moneys not required by law to be deposited in the state treasury shall report to the comptroller all receipts and disbursements on account thereof for each quarterly period of the calendar year not later than the fifteenth day following the end of each quarterly period...."

FTZ tenants are required to provide a security deposit equal to three months' rent. The deposit may be paid in cash or some other acceptable form. Security deposits which were received in cash were deposited into the state treasury and properly recorded in the accounting records. However, noncash security deposits with a value of approximately \$92,000 were not recorded in the accounting records. These security deposits were in the form of a savings passbook and money market certificates and were stored in a locked vault at the FTZ.

Inadequate controls over petty cash

During our audit we found an overage in the FTZ petty cash fund that had not been returned to the state treasury. The overage was due to checks drawn on the petty cash fund that were long outstanding and had never been cashed. They had been voided and returned to the petty cash balance. FTZ did not see the need to return the funds to the state treasury.

We also noted poor controls over the petty cash fund. The FTZ petty cash custodian prepared the vouchers; controlled, prepared, signed and distributed the checks; received the replenishments; recorded all transactions in the accounting records; and reconciled the books. Except for voucher approval by another individual, no one reviewed the work.

All checks written from the petty cash account should be payable to an individual or to a business or organization. Identifying the payee on checks serves as a control that the payment is being made to the proper person or organization. During our audit, we found that the FTZ wrote checks payable to cash.

Recommendations

The FTZ should include all charges in the tariff booklet and adhere to those charges.

All forms of security deposits received should be recorded in the accounting records of the State as required by statute.

Controls over petty cash should be improved to:

- return overages to the State treasury.
- separate the petty cash duties so that they are performed by different individuals.
- make all checks payable to an individual or organization.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Department of Business, Economic Development, and Tourism for the fiscal year ended June 30, 1991. It displays financial statements of all fund types and account groups administered by the department, together with explanatory notes. It also includes reports on the internal control structure and tests of compliance with laws and regulations.

Summary of Findings

In the opinion of Nishihama & Kishida, CPA's, Inc., based on their audit, except for the reporting of the financial position and the revenue, expenditures and changes in fund balance of the Foreign Trade Zone in a special revenue fund and the general fixed assets account group, the financial statements present fairly, in all material respects, the combined financial position of the department as of June 30, 1991, and the combined results of its operations for the fiscal year then ended in conformity with generally accepted accounting principles.

Nishihama & Kishida, CPA's, Inc. noted no matters involving the internal control structure and its operation that they considered to be material weaknesses as defined in the report on the internal control structure. They also noted, with respect to items tested, that the department has complied, in all material respects, with laws and regulations applicable to the department.

Independent Auditors' Report

Nishihama & Kishida, CPA's, Inc.'s report filed with the Auditor is as follows:

Independent Auditors' Report

To the Auditor
State of Hawaii

We have audited the following financial statements of the State of Hawaii, Department of Business, Economic Development, and Tourism:

Combined balance sheet—all fund types and account groups—June 30, 1991 (Exhibit A);

Combined statement of revenues, expenditures, and changes in fund balances—all governmental fund types and expendable trust funds—fiscal year ended June 30, 1991 (Exhibit B); and

Combined statement of revenues and expenditures—budget and actual (budgetary basis)—general and special revenue fund types—fiscal year ended June 30, 1991 (Exhibit C).

These combined financial statements are the responsibility of the management of the State of Hawaii, Department of Business, Economic Development, and Tourism. Our responsibility is to express an opinion on these combined financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall combined financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In accordance with the terms of our engagement, the scope of our audit did not include the audit of the general fixed assets account group. The balance sheet of the general fixed assets account group is included in the accompanying combined balance sheet of the State of Hawaii, Department of Business, Economic Development, and Tourism for informational purposes only, and has been prepared from the books without audit and we express no opinion on it.

As discussed in the notes to the combined financial statements, the State of Hawaii, Department of Business, Economic Development, and Tourism has reported the financial position and the revenues, expenditures, and changes in fund balance of the Foreign Trade Zone in a special revenue fund. In our opinion, generally accepted accounting principles require operations of this type to be reported in an enterprise fund.

As discussed in the notes, the combined financial statements of the Department of Business, Economic Development, and Tourism are intended to present the financial position and results of operations

of only that portion of the funds and account groups of the State of Hawaii that is attributable to the transactions of the Department of Business, Economic Development, and Tourism.

In our opinion, except for the matters described in the third and fourth paragraphs and the effects of the change in presentation which would be required to resolve the matter discussed in the fourth paragraph, the combined financial statements referred to above present fairly, in all material respects, the financial position of the State of Hawaii, Department of Business, Economic Development, and Tourism as of June 30, 1991, and the results of its operations for the fiscal year then ended in conformity with generally accepted accounting principles.

/s/ Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawaii
October 18, 1991

Descriptions and Definitions

This section provides descriptions of the financial statements audited and definitions of technical terms used in this chapter.

Descriptions of financial statements and schedules

The following is a brief description of the financial statements audited by Nishihama & Kishida, CPA's, Inc. The financial statements are attached at the end of this chapter.

Combined balance sheet—all fund types and account groups (Exhibit A). This statement presents assets, liabilities, and fund balances of all fund types and account groups used by the department on an aggregate basis.

Combined statement of revenues, expenditures, and changes in fund balances—all governmental fund types and expendable trust funds (Exhibit B). This statement presents revenues, expenditures, other financing sources (uses) and changes in fund balances for all governmental fund types, and expendable trust funds of the department on an aggregate basis. Revenues include state appropriations mandated by the General Appropriations Act of 1989 (Act 316, Session Laws of Hawaii 1989), as amended by the Supplemental Appropriations Act of 1990 (Act 299, Session Laws of Hawaii 1990) and other specific appropriations acts.

Combined statement of revenues and expenditures—budget and actual (budgetary basis)—general and special revenue fund types (Exhibit C). This statement presents a comparison of budgeted and actual revenues, expenditures, and other financing sources for the general fund accounts and special revenue funds used by the department.

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:

Appropriation. An authorization granted by the State Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures.

Allotment. An authorization by the director of finance to a state agency to incur obligations and to make expenditures pursuant to the appropriation made by the State Legislature.

Encumbrance. An obligation in the form of a purchase order or contract which is chargeable to an appropriation, the incurring of which sets aside the appropriation for the amount of the obligation.

Expenditure. The actual disbursement of funds for the payment of goods delivered or services rendered, and the obligation to pay for such goods or services having been incurred against authorized funds.

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

Transfers. The transaction between funds, departments, and/or programs which is approved by the appropriate authority.

Notes to the Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the combined financial statements and financial condition of the funds administered by the department are discussed in this section.

Financial statement presentation

General. The accompanying combined financial statements of the Department of Business, Economic Development, and Tourism present the financial position of various fund types and account groups, and the results of operations of the various fund types for the fiscal year ended June 30, 1991.

Reporting entity. The Department of Business, Economic Development, and Tourism is a department of the State of Hawaii.

Fund accounting. The financial activities are recorded in individual funds classified by type and described in the following sections, each of which is deemed to be a separate accounting entity. The financial position and operations of each fund are accounted for in separate self-balancing accounts which represent the fund's assets, liabilities, equity, revenues and expenditures or expenses.

Account groups are used to establish accounting control and accountability for the department's general fixed assets and general long-term obligations. Account groups are not funds as they do not reflect available financial resources and related liabilities.

Governmental fund types. Financial resources which are not accounted for in other funds are accounted for in the general fund. The measurement focus of governmental funds is on determination of financial position and changes in financial position rather than upon net income determination. The budget adopted by the Legislature provides the basic framework within which the resources and obligations of the general fund are accounted. The general fund of the department is a part of the state's general fund and the accompanying general fund financial statements are limited to and reflect only the appropriations, expenditures, and obligations of the general fund accounts used by the department, and the general fund allotments received by the department.

Financial resources obtained from specific revenue sources and used for restricted purposes are accounted for in the special revenue funds.

Substantially all financial resources obtained and used for the acquisition or construction of the department's general fixed assets and facilities are reflected in the capital projects fund. Such resources are derived principally from proceeds of general obligation bond issues and operating transfers from the special revenue funds.

Fiduciary fund types. Expendable trust funds account for transactions related to assets held by the department in a trustee capacity to be expended for designated purposes. Agency funds are accounts for funds held by the department as agent.

Account groups. The general fixed assets account group is used to account for all fixed assets of the department other than those accounted for in the proprietary fund types. The general long-term obligations account group is used to account for the accrued vacation payable for governmental fund types.

Summary of significant accounting policies

Total columns on combined financial statements. Total columns on the accompanying combined financial statements are captioned “memorandum only” to indicate that they are presented only to facilitate financial analysis. Data in these columns do not purport to present financial position, results of operations, or changes in financial position or fund equity of the department in conformity with generally accepted accounting principles. Such data is not comparable to a consolidation.

Basis of accounting. The accounts of the governmental fund and fiduciary fund types are reported using the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized when they become measurable and available to finance operations of the current fiscal year. *Measurable* means that the amount of the transaction can be determined. *Available* means that the amount is collected in the current fiscal year or soon enough after year-end to liquidate liabilities existing at the end of the fiscal year. Expenditures are generally recognized when the related liability is incurred, except for accumulated unpaid vacation and accrued workers’ compensation claims which are recognized as expenditures when payable from expendable available financial resources. Encumbrances are recorded obligations in the form of purchase orders or contracts. The department records encumbrances at the time purchase orders or contracts are awarded and executed. Encumbrances outstanding at fiscal year-end are reported as reservations of fund equity since they do not constitute expenditures or liabilities.

Accumulated vacation and sick leave. Employees’ vested annual vacation and sick leave are recorded as expenditures when actually taken. The employees of the department are entitled to receive cash payment for accumulated vacation leave upon termination. The liability for such accumulated vacation leave pay is not reflected in the governmental funds but is reflected in the general long-term debt account group.

Intrafund and interfund transactions. Significant transfers of financial resources between activities included within the same fund are offset within that fund. Transfers of revenues from funds authorized to receive them to funds authorized to expend them have been recorded as operating transfers in the combined financial statements.

Inventory. Inventory of materials and supplies is recorded as expenditures when purchased.

Investments. Investments are stated at cost, which approximates market.

Grants. Federal grants and assistance awards made on the basis of entitlement periods are recorded as intergovernmental receivables and revenues when entitlement occurs. All other Federal reimbursement type grants are recorded as intergovernmental receivables and revenues when the related expenditures or expenses are incurred.

Reserved for housing projects. Portions of fund balance are restricted to expenditures for affordable housing projects.

Reserved for relocation loan program. Fund balance is restricted for the funding of loans to assist in the reestablishment and continuance of displaced small businesses in Kakaako.

Reserved for future debt service. Portions of fund balance are restricted for payment of special assessment bond debt service should delinquent installment assessments produce a debt service deficiency in future periods.

Infrastructure fixed assets. Funds disbursed for the cost of infrastructure fixed assets are expended in the capital projects funds and are not capitalized or reported in the department's combined balance sheet.

Budgeting and budgetary control

The budget of the department is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes (1) the program, services and activities to be provided during the fiscal year, (2) the estimated revenues available to finance the operating plan and (3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented, and controlled. Revenue estimates are provided to the Legislature at the time of budget consideration and are revised and updated throughout the fiscal year. Amounts reflected as budgeted revenues in Exhibit C are those estimates as compiled by the department. Budgeted expenditures are derived primarily from the General Appropriations Act of 1989 (Act 316, SLH 1989) and other specific appropriations acts.

All expenditures of these appropriated funds are made pursuant to the appropriation in the 1989-1991 biennial budget as amended by subsequent supplemental appropriations. The final legally adopted budget in Exhibit C represents the original appropriations, supplemental appropriations, transfers, and other legally authorized legislative and executive changes.

Budgetary control is maintained at the appropriation line item as established in the appropriations acts. The governor is authorized to transfer appropriations within a state agency; however, transfers of appropriations between state agencies generally require legislative

authorization. Records and reports reflecting the detail level of control are maintained by and are available at the department. During the fiscal year ended June 30, 1991, there were no expenditures in excess of appropriations at the legal level of budgetary control.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year in which the appropriations were made. The Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations.

Budgets adopted by the Legislature for the general and special revenue funds are presented in Exhibit C. The department's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to the encumbrances of purchase order and contract obligations. These differences represent departures from generally accepted accounting principles (GAAP). A reconciliation between non-GAAP budgetary actual and GAAP actual is as follows:

	General Fund	Special Revenue Funds
Excess of revenues and other sources over expenditures and other uses - actual on a budgetary basis	\$ 1,093,137	\$ 7,411,005
Reserved for encumbrances at fiscal year-end	9,029,458	4,202,028
Expenditures for liquidation of prior fiscal year encumbrances	(5,382,900)	(2,099,534)
Reclassification of expenditures to other agencies as operating transfers	---	(8,310)
Excess of revenues and other sources over expenditures and other uses - GAAP basis	<u>\$ 4,739,695</u>	<u>\$ 9,505,189</u>

Accounts and loans receivable

At June 30, 1991, the special revenue fund receivables consisted of the following:

	Accounts Receivable	Loans Receivable
Foreign Trade Zone	\$ 114,486	\$ ---
Hawaii Community Development Authority	456,328	50,000
Financial Assistance Branch Hawaii Disaster Commercial Loan Program	---	56,997
Large Fishing Vessels Loan Program	---	3,378,395
Small Fishing Vessels Loan Program	---	310,435
Hawaii Capital Loan Program	---	10,136,063
Molokai Notes Receivable	---	82,216
Hawaii Innovation Development Loan Program	---	170,000
	<u>570,814</u>	<u>14,184,106</u>
Less allowance for doubtful accounts	<u>22,620</u>	<u>3,402,772</u>
	<u>\$ 548,194</u>	<u>\$ 10,781,334</u>

Unallotted appropriations

Unallotted appropriations for capital improvement projects at June 30, 1991, were comprised of the following:

	General	Capital Projects
Act 285, 1984 Regular Session	\$ ---	\$ 21,872
Act 300, 1985 Regular Session	---	281,993
Act 299, 1989 Regular Session	5,167,110	---
Act 316, 1989 Regular Session	395,270	---
Act 299, 1990 Regular Session	2,000,000	3,892,000
Act 300, 1990 Regular Session	<u>100,000</u>	<u>---</u>
	<u>\$ 7,662,380</u>	<u>\$ 4,195,865</u>

General fixed assets

The changes in the general fixed assets (unaudited) were as follows:

	Land	Building and Improvements	Equipment	Total
Balance at July 1, 1990	\$ 5,879,800	\$ 1,893,166	\$ 2,422,676	\$ 10,195,642
Additions	---	---	811,071	811,071
Deductions	---	---	(73,547)	(73,547)
Balance at June 30, 1991	<u>\$ 5,879,800</u>	<u>\$ 1,893,166</u>	<u>\$ 3,160,200</u>	<u>\$ 10,933,166</u>

The Hawaii Community Development Authority (HCDA), which is administratively attached to the department, acquired real property for future redevelopment projects. These projects will be administered by the HCDA until the projects' completion. For financial statement purposes, such acquisitions have been included as capital expenditures of the current period and are reflected as additions to the general fixed assets account group.

The HCDA may also acquire real property through condemnation proceedings. In such proceedings, the Circuit Court of the State of Hawaii determines the fair value of the property being condemned. As part of the condemnation proceedings, the HCDA submits cash deposits to the Circuit Court. At June 30, 1991, such deposits totalled \$11,043,386.

**General long-term
debt account group**

The changes in the general long-term debt were as follows:

	Accrued Vacation Payable	General Obligation Bonds Payable	Installment Contracts Payable	Total
Balance at July 1, 1990	\$ 1,252,014	\$ 466,308	\$ 64,323	\$ 1,782,645
Retirements and extinguishment	---	(26,928)	---	(26,928)
Net increase in accrued vacation payable	83,924	---	---	83,924
Net additions and payments	---	---	(20,967)	(20,967)
Balance at June 30, 1991	<u>\$ 1,335,938</u>	<u>\$ 439,380</u>	<u>\$ 43,356</u>	<u>\$ 1,818,674</u>

The details of the general long-term debt are as follows:

Accrued Vacation Payable:

Vested and accumulated vacation pay benefits.	<u>\$ 1,335,938</u>
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General Obligation Bonds Payable:

General obligation bonds are serial bonds backed by the full faith and credit of the State of Hawaii.

\$304,524 economic development bonds, series BK, dated April 1, 1988; due in annual installments of \$16,920 from April 1, 1991 through April 1, 2006 and \$16,901 on April 1, 2007 and April 1, 2008; interest varies from 6.125% to 7.50%; payable semi-annually.	287,604
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\$151,776 refunding bonds, series BI, dated March 1, 1987; due in annual installments of \$11,676 from March 1, 1992 through March 1, 2003 and \$11,669 on March 1, 2004; interest varies from 5.40% to 6%; payable semi-annually.	<u>151,776</u>
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	<u><u>\$ 439,380</u></u>
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The annual requirements to amortize the general obligation bond and general obligation refunding bond debt and related interest are as follows:

Fiscal Year Ending June 30,	Principal	Interest	Total
1992	\$ 28,596	\$ 28,009	\$ 56,605
1993	28,596	26,342	54,938
1994	28,596	24,675	53,271
1995	28,596	23,008	51,604
1996	28,596	21,330	49,926
Thereafter	<u>296,400</u>	<u>119,630</u>	<u>416,030</u>
Total	<u><u>\$ 439,380</u></u>	<u><u>\$ 242,994</u></u>	<u><u>\$ 682,374</u></u>

The department purchased various office equipment under installment purchase contracts. The following is a schedule of future minimum lease payments on installment contracts.

Fiscal Year Ending June 30,	Amount
1992	\$ 21,637
1993	17,048
1994	6,724
1995	<u>4,739</u>
Total future minimum lease payments	50,148
Less amount representing interest	<u>6,792</u>
Present value of future minimum lease payments	<u>\$ 43,356</u>

Changes in assets and liabilities of the agency fund

The agency fund is purely custodial (assets equal liabilities) and thus does not involve measurement of results of operations. The changes in assets and liabilities of the agency fund for the fiscal year ended June 30, 1991, were as follows:

	Balance July 1, 1990	Additions	Deductions	Balance June 30, 1991
ASSETS				
Due from other funds	<u>\$ 6,957</u>	<u>\$ 1,387,215</u>	<u>\$ 1,380,310</u>	<u>\$ 13,862</u>
LIABILITIES				
Due to bond trustee	<u>\$ 6,957</u>	<u>\$ 1,387,215</u>	<u>\$ 1,380,310</u>	<u>\$ 13,862</u>

Special assessment bonds

In order to obtain funding for infrastructure improvements, the HCDA has issued \$12,755,000 of Improvement District bonds. These bonds are not a general obligation of the HCDA but are a limited obligation of the HCDA payable solely from monies derived from installment payments received from the affected property owners and monies held in reserve in the special revenue funds as required in the bond resolutions. The HCDA is also responsible for initiating foreclosure proceedings against delinquent property owners, if any.

The following is a summary of the outstanding Improvement District bonds and the required reserves as of June 30, 1991:

Year of Issue June 30,	Final Maturity Date	Interest Rates	Original Amount of Issue	Principal Outstanding	Required Reserve
1986	07/01/2006	5.7-8.85%	\$ 3,600,000	\$ 2,980,000	\$ 223,500
1989	07/01/2008	6.0-8.00%	5,275,000	4,795,000	359,625
1991	07/01/2010	6.0-7.00%	<u>3,880,000</u>	<u>3,745,000</u>	<u>187,250</u>
			<u>\$ 12,755,000</u>	<u>\$ 11,520,000</u>	<u>\$ 770,375</u>

Retirement plan

All eligible employees of the department are required by Chapter 88 of the Hawaii Revised Statutes to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under social security. Persons employed in positions not covered by social security are excluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service for the contributory and noncontributory options, respectively.

The ERS's funding policy provides for employer contributions at actuarially determined rates that should provide sufficient resources to pay member pension benefits when due. The funding method used to calculate the total employer contribution required is the frozen initial liability method.

Under this method, the total employer contribution is comprised of the "normal cost" plus the level annual payment required to amortize the frozen unfunded accrued liability. The employer normal cost is the level percentage of payroll contribution to pay all future benefits, after subtracting expected future member contributions, the unfunded accrued liability, and the assets accumulated as of the valuation date. Actuarial gains and losses resulting from differences between actual and assumed experience are reflected in the employer normal cost rates.

Actuarial valuations are prepared for the entire ERS and are not separately computed for each department or agency. Information on

vested and nonvested benefits and other aspects of the ERS is also not available on a departmental or agency basis.

The amount shown as “pension benefit obligation” is a standardized disclosure measure of the present value of credited projected pension benefits, adjusted for effects of projected salary increases, estimated to be payable in the future as a result of member service to date. The measure is the actuarial present value of credited projected benefits and is intended to help users assess the funding status of the ERS on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among public employee retirement systems. The measure is independent of the actuarial funding method used to determine contributions to the ERS described previously.

The pension benefit obligation was determined as of June 30, 1990. Significant assumptions underlying the actuarial computations include:

- In accordance with the provisions of Act 184 of the 1989 Regular Session of the State legislature, the long-term rate of investment yield on the assets of the ERS is assumed to be 8% per year.
- An assumed annual salary increase of 6-1/2% per year for all members.
- The assumed rates of retirement, turnover and disability were based upon the ERS’s experience.
- The assumed mortality rates were based on published statistical data as determined by the ERS’s experience.
- The unused sick leave credit accumulated by members is assumed at 12 days per year.

At June 30, 1990, the total and unfunded pension benefit obligation for all members of the ERS was as follows:

Pension benefit obligation:

Pensioners and beneficiaries currently receiving benefits and terminated members not yet receiving benefits	\$ 1,964,477,200
Current members:	
Accumulated member contributions	845,653,400
Employer-financed vested	1,273,795,900
Employer-financed nonvested	<u>1,118,933,500</u>
Total pension benefit obligation	5,202,860,000
Net assets available for pension benefits, at cost	<u>3,846,337,900</u>
Unfunded pension benefit obligation	<u>\$ 1,356,522,100</u>

Ten-year historical trend information designed to provide information about the ERS's progress in accumulating sufficient assets to pay benefits when due is included in the separately issued audited financial statements of the ERS.

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to retired State employees. Contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued. The department's general fund share of the expense for post-retirement benefits for the fiscal year ended June 30, 1991, has not been separately computed and is not reflected in the department's general fund financial statements. The department's special revenue funds' share of post-retirement health care and life insurance benefits expense for the fiscal year ended June 30, 1991, was approximately \$40,800, and is included in the funds' financial statements.

Operating leases

The department leases various office facilities and equipment on long-term bases through 1996. The following is a schedule of minimum future rentals on noncancelable operating leases at June 30, 1991:

Fiscal Year Ending June 30,	Amount
1992	\$ 241,700
1993	207,500
1994	178,200
1995	159,100
1996	<u>143,438</u>
	<u><u>\$ 929,938</u></u>

Commitments and contingencies

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 and other insurance claims are appropriated annually from the State General Fund.

Accumulated sick pay. Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit. It may be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a state employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the Employees' Retirement System. Accumulated sick leave at June 30, 1991, aggregated approximately \$3,517,000.

Deferred compensation plan. In 1983, the State established a deferred compensation plan which enables state employees to defer a portion of their compensation. The State of Hawaii, Department of Personnel Services, has the fiduciary responsibility of administering the plan. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency.

All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject to the claims of the state's general creditors. Participants' rights under the plan are equal to those of the general creditors of the state in an amount equal to the fair market value of the deferred account for each participant.

Condemnation proceedings. As discussed in the Note for General Fixed Assets, the HCDA may acquire real property through condemnation proceedings. The Circuit Court of the State of Hawaii is

responsible for determining the fair value of real property acquired through condemnation. As of June 30, 1991, the fair value of eight properties to be acquired through condemnation proceedings has not been determined by the Circuit Court. Cash deposits with the Circuit Court made by the HCDA for these properties amounted to approximately \$11 million. Upon resolution of the fair value by the Circuit Court, the HCDA may be required to pay an additional amount in order to acquire these properties.

Declaratory action. The HCDA also has a pending Declaratory Action with Hawaiian Electric Company, Inc., Gasco, Inc., and GTE Hawaiian Telephone Co., regarding cost to relocate underground utility facilities. A verbal agreement has been reached where the HCDA will be responsible for approximately \$62,500.

Revenue bonds. The State legislature has authorized the issuance of revenue bonds for the Kakaako Community Development District project. At June 30, 1991, a total of \$52,245,000 was authorized and unissued.

Effect on financial statement presentation of variance from generally accepted accounting principles

The Foreign Trade Zone (FTZ) operates a warehouse facility. The space is subdivided and rental income is collected from various tenants. The operation has characteristics more similar to a business concern than a governmental entity. Such activity is generally accounted for as an enterprise fund (proprietary fund type).

The FTZ maintains a separate general ledger on an enterprise fund basis. However, the FTZ is accounted for by the department and the Department of Accounting and General Services of the State of Hawaii as a special revenue fund.

The preceding combined financial statements of the department would be presented differently had the FTZ been reported as an enterprise fund. All of the balances and activities of the FTZ would be removed from the special revenue funds. A separate fund would appear in the combined balance sheet and combined statement of revenues, expenditures and changes in fund balances. The separate fund would appear under the primary heading "Proprietary Fund Type" with a subsidiary heading of "Enterprise Fund." In addition, a statement of changes in financial position would be presented for the enterprise fund.

The only significant effect on the amounts reported for the FTZ would be the computation of depreciation expense and the inclusion of accumulated depreciation on the combined balance sheet.

Financial highlights of the FTZ as of June 30, 1991 are as follows:

Current assets	\$ 3,472,708
Other assets	199,411
Fixed assets	2,751,822
Less accumulated depreciation	<u>(1,144,666)</u>
TOTAL ASSETS	<u>\$ 5,279,275</u>
Current liabilities	\$ 195,376
Bonds payable	439,380
Equity contributed by the State of Hawaii	2,172,147
Retained earnings	<u>2,472,372</u>
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 5,279,275</u>

Results of operations are summarized as follows for the fiscal year ended June 30, 1991:

Revenues	\$ 1,820,944
Expenses	<u>1,256,577</u>
NET INCOME	<u>\$ 564,367</u>

Depreciation expense for the fiscal year ended June 30, 1991 was \$137,142.

Independent Auditors' Report on the Internal Control Structure

To the Auditor
State of Hawaii

We have audited the combined financial statements, except for the general fixed assets account group, of the State of Hawaii, Department of Business, Economic Development, and Tourism as of and for the fiscal year ended June 30, 1991, and have issued our report thereon dated October 18, 1991.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

In planning and performing our audit of the combined financial statements of the State of Hawaii, Department of Business, Economic Development, and Tourism for the fiscal year ended June 30, 1991, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control structure.

The management of the State of Hawaii, Department of Business, Economic Development, and Tourism is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of combined financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- Revenues/receipts cycle
- Purchases/disbursements cycle
- Payroll cycle

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the

combined financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the Auditor, State of Hawaii, in Chapter 2.

This report is intended for the information of the Auditor, State of Hawaii and management of the State of Hawaii, Department of Business, Economic Development, and Tourism. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

/s/ Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawaii
October 18, 1991

Independent Auditors' Report on Compliance Based on an Audit of the Combined Financial Statements

To the Auditor
State of Hawaii

We have audited the combined financial statements, except for the general fixed assets account group, of the State of Hawaii, Department of Business, Economic Development, and Tourism as of and for the fiscal year ended June 30, 1991, and have issued our report thereon dated October 18, 1991.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the State of Hawaii, Department of Business, Economic Development, and Tourism is the responsibility of the State of Hawaii, Department of Business, Economic Development, and Tourism's management. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement,

we performed tests of the State of Hawaii, Department of Business, Economic Development, and Tourism's compliance with certain provisions of laws and regulations. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, the State of Hawaii, Department of Business, Economic Development, and Tourism complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the State of Hawaii, Department of Business, Economic Development, and Tourism had not complied, in all material respects, with those provisions.

This report is intended for the information of the Auditor, State of Hawaii and management of the State of Hawaii, Department of Business, Economic Development, and Tourism. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

/s/ Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawaii
October 18, 1991

State of Hawaii
Department of Business, Economic Development & Tourism
COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS
June 30, 1991

(EXHIBIT A)

	Governmental Fund Types			Fiduciary Fund Types		Account Groups		
	General	Special Revenue	Capital Projects	Expendable Trust	Agency	General Fixed Assets (Unaudited)	General Long-Term Debt	Total (Memorandum Only)
ASSETS								
Cash	\$11,714,824	\$54,663,077	\$59,062,861	\$328,916	\$ -	\$ -	\$ -	\$125,769,678
Investments	-	200,028	-	-	-	-	-	200,028
Receivables	-	-	-	-	-	-	-	-
Accounts receivable, net	-	548,194	-	-	-	-	-	548,194
Loans receivable, net	-	10,781,334	-	-	-	-	-	10,781,334
Interest	-	362,570	3,372	-	-	-	-	365,942
Deposits	-	-	11,043,386	-	-	-	-	11,043,386
Due from other funds	-	-	5,459,421	-	13,862	-	-	5,473,283
Fixed assets	-	-	-	-	-	10,933,166	-	10,933,166
Amount to be provided for retirement of general long-term debt	-	-	-	-	-	-	1,818,674	1,818,674
TOTAL ASSETS	\$11,714,824	\$66,555,203	\$75,569,040	\$328,916	\$13,862	\$10,933,166	\$1,818,674	\$166,933,685
LIABILITIES AND FUND EQUITY								
LIABILITIES								
Vouchers payable	\$ 2,646,866	\$ 350,350	\$ 2,844,458	\$ -	\$ -	\$ -	\$ -	\$ 5,841,674
Deposits payable	-	-	-	92,269	-	-	-	92,269
Accrued vacation payable	-	-	-	-	-	-	1,335,938	1,335,938
Due to bond trustee	-	-	-	-	13,862	-	-	13,862
Due to others	-	2,002,000	-	-	-	-	-	2,002,000
Due to other funds	-	5,473,283	-	-	-	-	-	5,473,283
Due to State General Fund	38,500	-	-	-	-	-	-	38,500
Due to Federal government	-	118,481	-	-	-	-	-	118,481
General obligation bonds payable	-	-	-	-	-	-	439,380	439,380
Installment contracts payable	-	-	-	-	-	-	43,356	43,356
Total liabilities	2,685,366	7,944,114	2,844,458	92,269	13,862	-	1,818,674	15,398,743
FUND EQUITY								
Investment in general fixed assets	-	-	-	-	-	10,933,166	-	10,933,166
Fund balances								
Reserved for encumbrances	9,029,458	4,202,028	47,607,017	-	-	-	-	60,838,503
Reserved for investments	-	200,028	-	-	-	-	-	200,028
Reserved for loans	-	23,060,958	-	-	-	-	-	23,060,958
Reserved for housing projects	-	193,821	-	-	-	-	-	193,821
Reserved for future debt service	-	770,375	-	-	-	-	-	770,375
Reserved for amounts held in trust	-	-	-	236,647	-	-	-	236,647
Reserved for continuing appropriations	-	-	25,117,565	-	-	-	-	25,117,565
Unreserved	-	30,183,879	-	-	-	-	-	30,183,879
Total fund equity	9,029,458	58,611,089	72,724,582	236,647	-	10,933,166	-	151,534,942
TOTAL LIABILITIES AND FUND EQUITY	\$11,714,824	\$66,555,203	\$75,569,040	\$328,916	\$13,862	\$10,933,166	\$1,818,674	\$166,933,685

See accompanying notes to the combined financial statements.

State of Hawaii
Department of Business, Economic Development & Tourism
COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES - ALL GOVERNMENTAL
FUND TYPES AND EXPENDABLE TRUST FUNDS
Fiscal year ended June 30, 1991

	Governmental Fund Types			Fiduciary Fund Type	Total (Memorandum Only)
	General	Special Revenue	Capital Projects	Expendable Trust	
REVENUES					
State allotted appropriations	\$94,078,197	\$ -	\$20,273,050	\$ -	\$114,351,247
Intergovernmental revenues	-	1,099,272	-	-	1,099,272
Charges for current services	-	2,673,245	-	-	2,673,245
Assessments and other	-	2,131,327	-	-	2,131,327
Reimbursement for capital outlays	-	-	1,963,861	-	1,963,861
Housing reserves	-	1,018,850	-	-	1,018,850
Proceeds from settlement of Federal lawsuits	-	950,053	-	-	950,053
Contributions from other private sources	-	54,035	-	275,036	329,071
Loan repayments	-	1,606,769	-	-	1,606,769
Interest	-	4,085,617	3,372	-	4,088,989
Return of capital	-	99,634	-	-	99,634
	<u>94,078,197</u>	<u>13,718,802</u>	<u>22,240,283</u>	<u>275,036</u>	<u>130,312,318</u>
EXPENDITURES					
Commerce and industry	13,836,485	5,125,227	-	-	18,961,712
Land use and coastal management	371,855	-	-	-	371,855
Hawaii Community Development Authority	245,262	4,910,763	20,630,524	-	25,786,549
Foreign Trade Zone	-	1,484,004	-	-	1,484,004
State Tourism Office	25,620,503	426,703	-	-	26,047,206
Energy development and management	2,909,397	4,507,254	-	-	7,416,651
Economic planning and research for economic development	776,096	-	-	-	776,096
General support for economic development	2,226,814	23,095	-	-	2,249,909
Private housing development and ownership	-	-	-	-	-
Other	-	-	-	271,393	271,393
Capital outlays	-	-	4,102,699	-	4,102,699
	<u>45,986,412</u>	<u>16,477,046</u>	<u>24,733,223</u>	<u>271,393</u>	<u>87,468,074</u>
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	<u>\$48,091,785</u>	<u>\$(2,758,244)</u>	<u>\$(2,492,940)</u>	<u>\$ 3,643</u>	<u>\$ 42,844,244</u>

(Continued)

State of Hawaii
Department of Business, Economic Development & Tourism
COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES - ALL GOVERNMENTAL
FUND TYPES AND EXPENDABLE TRUST FUNDS (Continued)
Fiscal year ended June 30, 1991

	Governmental Fund Types			Fiduciary Fund Type	Total (Memorandum Only)
	General	Special Revenue	Capital Projects	Expendable Trust	
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	\$ 48,091,785	\$ (2,758,244)	\$ (2,492,940)	\$ 3,643	\$ 42,844,244
OTHER FINANCING SOURCES (USES)					
Operating transfers in	19,327	12,263,433	31,000,421	-	43,283,181
Operating transfers out	(43,371,417)	-	(625,050)	-	(43,996,467)
	(43,352,090)	12,263,433	30,375,371	-	(713,286)
EXCESS OF REVENUES AND OTHER SOURCES OVER EXPENDITURES AND OTHER USES	4,739,695	9,505,189	27,882,431	3,643	42,130,958
OTHER CHANGES IN FUND BALANCES					
Lapsed appropriations	(1,285,555)	-	(1,443)	-	(1,286,998)
Increase in reserve for loans receivable	1,241,924	1,241,924	-	-	1,241,924
	(1,285,555)	1,241,924	(1,443)	-	(45,074)
EXCESS OF REVENUES AND OTHER SOURCES OVER EXPENDITURES, OTHER USES AND OTHER CHANGES IN FUND BALANCES	3,454,140	10,747,113	27,880,988	3,643	42,085,884
Fund balances at July 1, 1990	5,575,318	47,863,976	44,843,594	233,004	98,515,892
Fund balances at June 30, 1991	\$ 9,029,458	\$58,611,089	\$ 72,724,582	\$236,647	\$140,601,776

See accompanying notes to the combined financial statements.

State of Hawaii
Department of Business, Economic Development & Tourism
COMBINED STATEMENT OF REVENUES AND EXPENDITURES - BUDGET AND ACTUAL (BUDGETARY BASIS) - GENERAL AND SPECIAL REVENUE FUND TYPES
Fiscal year ended June 30, 1991

	General Fund		Special Revenue Funds	
	Actual on Budgetary Basis	Budget	Actual on Budgetary Basis	Budget
			Variance Favorable (Unfavorable)	Variance Favorable (Unfavorable)
REVENUES				
State allotted appropriations	\$ 94,078,197	\$ 94,078,197	\$ -	\$ -
Intergovernmental revenues	-	-	253,303	319,000
Other revenues	-	-	1,837,323	2,969,500
Non-budgeted revenues	-	-	11,628,176	-
	<u>94,078,197</u>	<u>94,078,197</u>	<u>13,718,802</u>	<u>3,288,500</u>
				<u>10,430,302</u>
EXPENDITURES				
Commerce and industry	17,224,235	18,673,319	1,449,084	-
Land use and coastal management	393,994	403,662	9,668	-
Hawaii Community Development Authority	245,263	247,670	2,407	-
Foreign Trade Zone	-	-	-	-
State Tourism Office	25,807,768	25,957,917	1,388,571	1,530,252
Energy development and management	2,943,448	2,952,296	-	1,800,000
Economic planning and research for economic development	786,539	789,175	2,636	726,408
General support for economic development	2,231,723	2,310,737	-	-
Non-budgeted expenditures	<u>49,632,970</u>	<u>51,334,776</u>	<u>16,929,357</u>	<u>4,309,962</u>
			<u>18,571,230</u>	<u>(16,929,357)</u>
				<u>(14,251,268)</u>
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	<u>44,445,227</u>	<u>42,743,421</u>	<u>(4,852,428)</u>	<u>(3,830,966)</u>
OTHER FINANCING SOURCES (USES)				
Operating transfers in	19,327	-	19,327	520,433
Operating transfers out	<u>(43,371,417)</u>	<u>(42,743,421)</u>	<u>(627,996)</u>	<u>-</u>
	<u>(43,352,090)</u>	<u>(42,743,421)</u>	<u>12,263,433</u>	<u>520,433</u>
EXCESS OF REVENUES AND OTHER SOURCES OVER EXPENDITURES AND OTHER USES	<u>\$ 1,093,137</u>	<u>\$ -</u>	<u>\$ 7,411,005</u>	<u>\$ (3,310,533)</u>

See accompanying notes to the combined financial statements.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Department of Business, Economic Development, and Tourism (DBEDT) and to the Department of Accounting and General Services (DAGS) on April 21, 1992. A copy of the transmittal letter to DBEDT is included as Attachment 1. A similar letter was sent to DAGS. The responses of DBEDT and DAGS are included as Attachments 2 and 3, respectively.

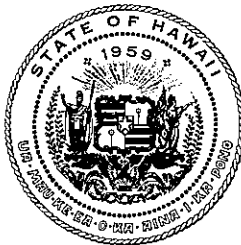
The Department of Business, Economic Development, and Tourism generally concurs with our recommendations. The department states it contracted with DAGS in order to carry out the legislative intent of the appropriation in an expedient and efficient manner. It deferred to DAGS to comment on our recommendation on interdepartmental contracts. The department disagrees with our recommendations about contracting the use of consultants through master contracts with RCUH. It states it has complied with the State Accounting Manual and the governor's budget execution instructions because this practice of contracting for consultant services through RCUH was approved by the Governor in 1986. We believe that the State Accounting Manual applies on a contract-by-contract basis and blanket authorization received some four years in the past is insufficient for its purposes.

Two of our recommendations concerning the Foreign Trade Zone seem to have been misunderstood by the department. The department does not agree that security deposits should be recorded in DAGS' accounting records because they have not been cashed and recorded as revenues. This is not the point. DAGS maintains the official accounting records of the State and the requirement that security deposits and the related liability be recorded on those accounting records has nothing to do with cashing them and recording the cash as revenues. We also recommended that the overage in petty cash be returned to the state treasury. The department interpreted state treasury to mean the general fund and therefore does not agree with our recommendation. The state treasury is comprised of all cash of the State, to include special fund cash as well as general fund cash. We made no recommendation to return the cash to the general fund, but that the cash be returned to the state treasury.

The Department of Accounting and General Services does not disagree with our finding concerning interdepartmental contracts being used to avoid constitutional lapsing of appropriations. It believes that any attempt to prohibit an otherwise legal contracting process should be debated and decided through the legislative process. Attached to its response was a copy of a June 24, 1988 letter from the Attorney General supporting the legality of encumbering funds through these types of contracts.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813



(808) 548-2450
FAX: (808) 548-2693

New numbers as of 12-01-91
(808) 587-0800
FAX: (808) 587-0830

April 21, 1992

C O P Y

The Honorable Murray E. Towill, Director
Department of Business, Economic Development,
and Tourism
Central Pacific Plaza, 11th Floor
220 S. King Street
Honolulu, Hawaii 96813

Dear Mr. Towill:

Enclosed are three copies, numbered 6 through 8, of our draft report, *Financial Audit of the Department of Business, Economic Development, and Tourism*. We ask that you telephone us by Thursday, April 23, 1992, on whether you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Tuesday, April 28, 1992.

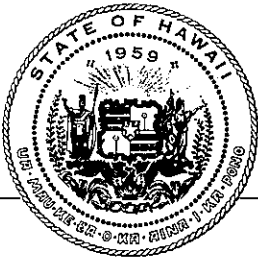
The Comptroller of the Department of Accounting and General Services, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
Acting Auditor

Enclosures

JOHN WAIHEE
GovernorMURRAY E. TOWILL
DirectorBARBARA KIM STANTON
Deputy DirectorRICK EGGED
Deputy DirectorTAKESHI YOSHIHARA
Deputy Director

DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

Central Pacific Plaza, 220 South King Street, 4th Floor, Honolulu, Hawaii
Mailing Address: P.O. Box 2359, Honolulu, Hawaii 96804 Telephone: (808) 586-2406 Fax: (808) 586-2452

April 28, 1992

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa, Acting Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, HI 96813

Dear Ms. Higa,

The Department of Business, Economic Development & Tourism appreciates the opportunity to respond to the draft report, Financial Audit of the Department of Business, Economic Development, & Tourism. We are pleased that the report, in the financial audit, finds no material weaknesses in the internal control structure. Further, we are gratified with the finding that the department has complied with the laws and regulations applicable to the department. We disagree with criticisms of department practices that are said to violate the intent of state law and the requirements of state financial administration. The auditors also alluded to presumed weaknesses in the department's financial management. We are able to provide clarification on some of these points and on the others, we can benefit from the suggestions made by the auditors.

The following are our comments regarding specific areas of concern:

1. "The department entered into an interdepartmental contract to avoid constitutional provisions on lapsing of funds," regarding the construction of the film studio facility.

The legality of an interdepartmental contract between DAGS and DBED is undisputed, as the Auditor recognizes. Instead, the Auditor questions whether this contract was "sound practice" and done to avoid the "intent of the State Constitution" and to "negate the Legislature's authority to exercise the oversight responsibility intended by the Constitution."

Ms. Marion M. Higa
April 28, 1992
Page 2

DBED strongly disagrees. To the contrary, in this case, DBED contracted with DAGS in order to carry out the legislative intent in an expedient and efficient manner.

The Department kept the Legislature well informed of the status of the film studio throughout. There was no avoidance of legislative oversight. Legislative oversight was accomplished through Annual CIP status reports and the departmental budgetary review at the onset of each session. Further, at the time of the 1990 biennium budgetary session, the funds were not encumbered and the Legislature, as the appropriating body, had the opportunity to redirect funds from the project if it so desired.

The intention of the department was to persevere with the project to continue progress. Clearly, DAGS, as the contractor, has the ability to carry out the terms of the contract and in fact has been successful with the ground breaking of the film facility.

Moreover, both DBED and DAGS are sanctioned to engage in the terms of the contract. The project required construction engineering capability and DBED contracted appropriately for the services of DAGS for help in the endeavor.

The State Comptroller has addressed the above issue in separate correspondence. He refers to an AG opinion of June 28, 1988, confirming that the law does not preclude interagency contracts encumbering funds, but that each case must be examined to determine that all elements of a valid government contract are met, as was the case here.

2. "It (the department) executed contracts with the Research Corporation of the University of Hawaii (RCUH) to avoid requisite state approvals."

The report incorrectly concludes the department was "circumventing the State Accounting Manual and the Governor's budget execution instructions," and that the department "avoided going through the required approval process" and avoided obtaining the required approval for consultant services by contracting with RCUH..."

DBED has not attempted to circumvent nor avoid the state approval process. The approval process requires that agencies solicit the Governor's approval for consultant services and expenditure of the funds required for these services. It is DBED's practice to obtain the Governor's approval to contract for services.

Ms. Marion M. Higa
April 28, 1992
Page 3

The department requested authority from the Governor to enter into contracts (with Exxon oil overcharge funds) on November 20, 1986 for the purpose of carrying out State Energy programs. Authorization was approved by the Governor on November 25, 1986, allowing DBED to implement its programs through contracts with RCUH and accompanying subcontracts for consultant and other services on behalf of DBED.

Following state contracting statutes, selection of the contractor for these services is left to the department in accordance with written departmental procedures. Contracting with RCUH is not improper. Indeed, the Governor's office may even direct that the department contract with RCUH.

The process of contracting for consultant services through RCUH is supported in a letter from Governor Waihee dated March 6, 1992 which reads in part:

"While I concur with your request to fund this project, in order to maintain consistency in the administration of the HES (Hawaii Energy Strategy) project, please contract for the administration of this project through the RCUH."

The Auditor also erroneously states that the department "does not obtain that (the Governor's) approval for... the 'sub-contractor' consultants." The state approval process does not require the departments to obtain the Governor's approval for subcontracts. Therefore, the department has not attempted to "avoid(ed) obtaining the required approvals for consultant services." Furthermore, the statement that "The department obtains the governor's approval only for its contracts with RCUH" is a correct statement which incorrectly intimates additional Governor's approvals are required.

The report continues with a description of DBED's contracting practices with RCUH. These are desirable contract management and monitoring practices which, in the context of the report, appear to have been disregarded by the department. DBED holds that it has complied with the requirements of the State Accounting Manual and the Governor's budget execution instructions. DBED will continue to monitor compliance with state fiscal and accounting policy closely.

3. "The department has administered contracts inconsistently because it lacks written procedures."

The DBED Contracts Manual contains instructions on administration and monitoring of contracts. In the absence of specific examples of inconsistency in contract administration, the seriousness of the situation is difficult to assess.

Ms. Marion M. Higa
April 28, 1992
Page 4

The Attorney General in AG Interdepartmental Memorandum No. 1991-7 of December 4, 1991, Re: New standard form of consultant contract has provided information on developing scopes of services, time schedules, and Compensation and Payment schedules. The manual and the AG memo cited address some of the Auditor's concerns.

The Department does agree with the Auditor that department personnel should document contract monitoring to a greater degree. Admittedly much contract monitoring is done by meetings and review of drafts and preliminary reports. These may not be formally recorded. Reviewing and approving the deliverables is observed and considered to be "monitoring". DBED will take steps to enforce closer compliance with the Contracts Manual and will take steps to document contract compliance in a more complete manner.

4. "The department has not developed written guidelines for loan administration, and there is no assurance that loans are being evaluated fairly and administered properly. In addition, the processing of loan payment receipts needs to be improved."

All loans made by the Financial Assistance Branch are presented to the three loan officers in a prescribed standard format so all evaluation factors are presented. Loans are not evaluated solely on an objective monetary basis, but are often tied to the economic vigor of an economic sector or geographic area. Although written guidelines are not used in evaluating loans, each of the three loan officers has extensive experience in commercial lending and all factors are fairly considered.

The Department will establish a standard format for recording the existing process of follow-up with loan applicants to monitor their progress after the loan is approved. Site visits and evaluation of written reports and financial data provided by the applicants will be recorded on a standard form and placed in the applicant's file.

Improvements in loan payment receipt processing will be implemented by separating the loan receipt and recording duties. DBED will also deposit loan receipts to the state treasury on as timely a basis as possible.

5. "Procedures at the Foreign Trade Zone Division with respect to tariffs charged, security deposits, and petty cash need to be improved."

The Foreign Trade Zone (FTZ) agrees that all of its charges, as much as practical, should be included in Tariff No. 1. The Audit found that some charges for electricity, administrative fees and equipment rental did not conform to rates published in the tariff booklet. Because no debriefing meeting was held with the FTZ management by the Auditor, FTZ management does not know which specific charges are referred to in the report. The FTZ would appreciate any specific information regarding this matter and will endeavor to correct any discrepancies in the Tariff.

Security Deposits - Section 40-81, HRS, applies only to agencies that are authorized to have monies outside the state treasury. Such agencies must report all receipts and disbursements on those accounts quarterly to the comptroller. The FTZ is not authorized under Section 40-81, HRS, so the cited section does not apply.

The rental security deposits held by FTZ in the form of savings passbooks and money market certificates require two signatures to cash and are only endorsed by the tenants. They are not negotiable instruments unless and until they are also endorsed by the FTZ and are not "monies" which have to be recorded in the state accounting records until they are cashed and become revenues. In this manner, these instruments are like security bonds.

The FTZ does believe, however, that it would be appropriate to reflect these non-cash security deposits on its internal financial statements.

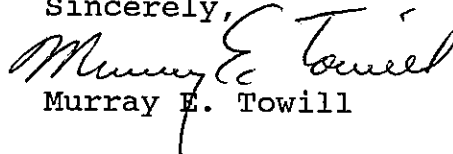
Petty Cash - The FTZ agrees that the petty cash fund should be reduced by the amount of the overage found in the fund during the audit. The FTZ does not agree that the funds should be returned to the state treasury (general fund). Because all replenishment of the petty cash fund have come from the FTZ special fund, the overage should go back to the special fund.

The FTZ agrees that it is preferable to have petty cash duties performed by more individuals than just the petty cash custodian. The staffing of the FTZ Business Office, however, consists of only four individuals, and the work loads of the other three staff are already very high. The FTZ will try to provide more checks and balances in the petty cash system in additional review of the custodian's work.

The audit report points out that all petty cash checks should be payable to an individual or an organization, but that some

Ms. Marion M. Higa
April 28, 1992
Page 6

FTZ petty cash checks were made payable to cash. The only checks made out to cash have been those used to replenish the cash on hand kept in the FTZ office safe. The FTZ agrees that checks should not be made out to cash, and these replenishment checks will henceforth be made out to the petty cash custodian and signed by another authorized staff.

Sincerely,

Murray E. Towill

MET;JEN;lck/Audit2.wp

JOHN WAIHEE
GOVERNOR



ATTACHMENT 3

RUSSEL S. NAGATA
COMPTROLLER

ROBERT P. TAKUSHI
DEPUTY COMPTROLLER

STATE OF HAWAII
DEPARTMENT OF ACCOUNTING
AND GENERAL SERVICES

P. O. BOX 119
HONOLULU, HAWAII 96810-0119

April 28, 1992

The Honorable Marion M. Higa
Acting Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813

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OFFICE OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

Thank you for the opportunity to comment on your draft report, Financial Audit of the Department of Business, Economic Development, and Tourism.

Specifically we would like to address your concerns about the interdepartmental contract between DBEDT and the Department of Accounting and General Services (DAGS). Although not illegal you stated that this practice violated the "intent" of the State Constitution which limits appropriations for capital improvement projects to a specified period. You stated that in a 1988 opinion that the Department of the Attorney General (AG) advised DAGS that contracts between state agencies are a legal basis for encumbering funds. You further stated that the AG's opinion limited its findings only to that particular case and should not be applied to other circumstances.

We believe that you have left out an essential element of the AG's opinion. Attached for your review is a copy of the June 24, 1988 opinion. The last sentence of the last paragraph of the opinion that "analyses similar to that made in our 2/16/88 memorandum would have to be made to assess whether a particular inter-agency agreement were capable of encumbering funds."

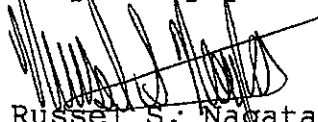
The film facility contract between DBEDT and DAGS was entered into with exactly that analysis in mind. First, the contract was legal. Second both DBEDT and DAGS were authorized to do what the contract required. DAGS as the contracted agency is in the business of providing the types of services being contracted. The Public Works Division of DAGS is in the business of providing centralized engineering services, and contracting the services of outside architects, engineers, construction contractors, and related type services. Although

The Honorable Marion M. Higa
April 22, 1992
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not in any written memorandum DAGS and DBEDT conferred with the AG to determine if this contract met the constitutional mandate and the parameters set by the 1988 AG opinion.

Your concern with interdepartmental contracts does not question the legality of the act but the effect it has on the spirit of the constitutionally mandated lapsing period. This concern rightly belongs within the legislative arena. Administrative action can be taken to scrutinize and minimize these interdepartmental contracts. However, any attempt to prohibit an otherwise legal contracting process should be debated and decided through the legislative process.

Very truly yours,



Russel S. Nagata
Comptroller

RSN:rn

Attachment

JOHN WAINES
GOVERNOR



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WARREN PRICE, III
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CORINNE K. A. WATANABE
FIRST DEPUTY ATTORNEY GENERAL

June 24, 1988

The Honorable Russel S. Nagata
Comptroller
Department of Accounting
and General Services
Kalanimoku Building
1151 Punchbowl Street, Room 412
Honolulu, Hawaii 96813

Dear Mr. Nagata:

Re: Ability to Encumber Funds Through Inter-Agency
Contracts

This is written in response to your request for our opinion concerning a certain agreement between the Governor's Agricultural Coordinating Committee ("GACC"), and the Department of Agriculture ("DOA"). Through conversations with Mr. Wayne Horie of the Uniform Accounting and Reporting Branch, we determined the questions to be as follows. First, whether the agreement for consultant services between GACC and DOA amounts to a valid encumbrance, and second, whether general funds which are "transferred" as advance payments to DOA, pursuant to said agreement, and held by DOA, lapse at the end of the fiscal year.

We answer both questions in the affirmative with the following considerations.

We understand the facts to be as follows. GACC entered into an "Agreement for Consultant Services" with DOA, to be funded by a GACC general fund appropriation which lapses on June 30, 1988. The agreement provides that the entire contracted-for amount be transferred to DOA as an advance payment upon execution of its Agreement with GACC.

Section 37-41, Hawaii Revised Statutes, provides that funds will lapse unless a specific law provides otherwise, or

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the funds are encumbered or expended. Section 40-66, Hawaii Revised Statutes, states that unless a contract to encumber funds is entered into before the end of a fiscal year, the funds will lapse. The funds will not lapse if the contract were entered into before the end of a fiscal year and a copy of it is served on the comptroller.

In order to be a valid encumbrance, the contract must be legal, and GACC and DOA must be authorized to do what the contract requires them to do. The facts which give rise to your questions are the same facts which were the basis of our prior Attorney General Legal Memorandum 2/16/88, which concluded that the GACC and DOA are authorized to enter that specific contract. Thus, the contract is legal and serves as a valid encumbrance, as though it were between GACC and a private sector organization. It is important to note, however, that the encumbrance will prevent the funds for the contract from lapsing only if the funds remain with GACC, since, as we have been told by your staff, the DOA does not have an appropriate pre-existing, statutorily established special, revolving, or trust fund into which the advanced sums could be deposited. It should be noted also that even if the advance could be deposited into a pre-existing special fund, they could be subsequently withdrawn only by appropriation. See sections 37-31 to 37-40, Hawaii Revised Statutes.

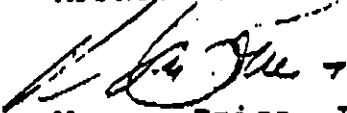
Please understand that the conclusions arrived at in this memorandum are confined to the actual situation presented, and should not be applied to other circumstances. Separate analyses similar to that made in our 2/16/88 memorandum would have to be made to assess whether a particular inter-agency agreement were capable of encumbering funds.

Very truly yours,



Patricia Ohara
Deputy Attorney General

APPROVED:



Warren Price, III
Attorney General

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