
Audit of the Research Corporation of the University of Hawaii

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

Submitted by

THE AUDITOR
STATE OF HAWAII

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Foreword

The Legislature created the Research Corporation of the University of Hawaii to make the university more competitive in obtaining research grants. The corporation has played a vital role in administering and expediting university research projects. In fiscal year 1991-1992, RCUH administered more than \$84 million in research grants for the university.

Because of the importance of the corporation to the State and the university, the State Auditor initiated this audit of the corporation. We examined the corporation's operations, external relationships, and financial management. We also studied the corporation's administration of contracts with agencies in the executive branch.

We wish to express our appreciation for the cooperation extended to us by the board and staff of the Research Corporation of the University of Hawaii. We would also like to acknowledge the cooperation provided by staff of the University of Hawaii and state agencies who assisted us in this review.

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State Auditor

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Chapter 1

Introduction

In the early 1960s, the Hawaii Legislature sought to promote research to enhance the reputation of the University of Hawaii (UH) and to advance the state's economic growth and development. To support UH's efforts to be a leader in research, the Legislature created the Research Corporation of the University of Hawaii (RCUH). The corporation was designed to make UH more competitive in obtaining research grants through expeditious administrative and financial services. Today, the UH is among the leading research institutions in the United States. In 1991-92, the university received about \$120 million in research contracts and grants.

In enacting Act 209 of 1965 that created RCUH as a non-profit, public agency, the Legislature stated:

The rapid and extensive entry of the University of Hawaii into basic and applied research programs...requires a much more flexible and streamlined method of operation than is permitted the usual operations of state agencies. In short, the University must be able to function in research activities more like a business, with...highly flexible financial capability, and ease of operations both in- and out-of-state.¹

To give RCUH the needed flexibility from state regulations, the Legislature exempted RCUH from state civil service and procurement laws. The RCUH may enter into contracts with the federal government, UH, and state agencies to carry out such research projects more effectively and efficiently.

The RCUH receives no appropriations from the State. Rather, it is supported entirely by management fees charged to contracts and grants. It is governed by a nine-member Board of Directors, which includes representatives from the UH, State, and community. The community members are appointed by the governor and confirmed by the State Senate. Exhibit 1.1 shows the organizational structure of RCUH.

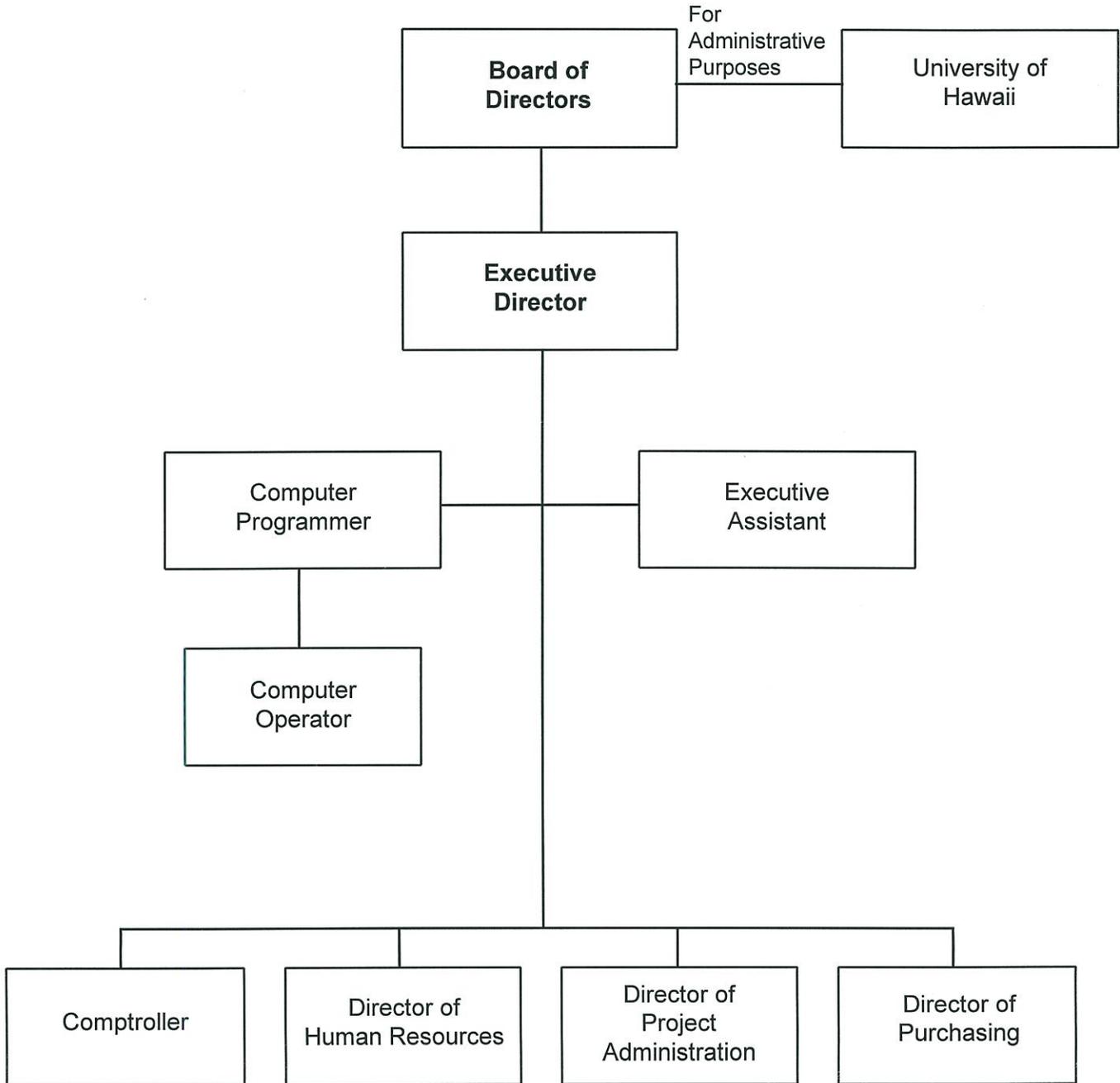
Impetus for the Audit

This audit was performed pursuant to Section 23-4, Hawaii Revised Statutes, which requires our office to conduct post audits of the transactions, accounts, programs, and performance of all state agencies.

The State Auditor initiated this audit of RCUH because of recent deficiencies uncovered by federal auditors about the university's management of federal contracts and grants. The federal auditors found

Exhibit 1.1
Research Corporation of the University of Hawaii

Organization Chart



many instances where UH was not in compliance with federal requirements. The RCUH, as a partner with UH in managing these projects, was found similarly deficient. The federal audit findings were sufficiently serious that in August 1991, the U.S. Defense Contract Audit Agency threatened to suspend all federal funding to UH. These funds exceeded \$75 million in fiscal year 1991-92. The initial federal letter of suspension cited 27 areas of concern with 25 of these relating to RCUH.

Additional problems in RCUH's management controls and compliance were found by a consultant hired by the university to resolve issues raised by the federal auditors.² A 1992 task force established by the UH president to review operating relationships, policies, and procedures between UH and RCUH identified weaknesses in staff training, the use of purchase orders to establish positions, management fee shortfalls, and personnel policies. Finally, the Legislature has been concerned about abuse because RCUH is not subject to state personnel and purchasing laws.

Objectives of the Audit

This audit sought to:

1. Determine whether RCUH operations appropriately reflect its mission, functions, and responsibilities.
2. Determine whether RCUH fee assessments are appropriate, reasonable, and accurately reflect costs.
3. Evaluate whether RCUH controls over contracts related to state projects are prudent and proper.

Scope and Methodology

We reviewed the legislative intent, mission, organization, operations, and management of RCUH. We also reviewed coordination and agency relationships between RCUH, the university, and state agencies. Our work focused on RCUH activities from 1990 to the present.

We interviewed officials at RCUH, the UH, and state agencies, as well as officials from economic development organizations. We reviewed and analyzed RCUH agreements, policy and procedure manuals, program files, previous audit studies, and annual reports. In addition, we sampled and reviewed 27 on-going state contracts (26 percent of the total number of state contracts) to assess compliance with applicable laws and adherence to internal controls and to compare RCUH's management of UH contracts with its management of state contracts.

To assess the validity of fees charged to users, we reviewed funding sources, internal agreements, contract requirements, and financial statements.

We obtained information from corporations affiliated with other mainland universities that are similar to RCUH.

Our work was performed from January 1993 through September 1993 in accordance with generally accepted government auditing standards.

Chapter 2

RCUH Contracts and Relationship With the University of Hawaii

Since the 1960s, the University of Hawaii (UH) has become a leading research center. But this progress has been accompanied by questions about the university's management of federally sponsored research contracts and grants. Many of its weaknesses have been attributed to the Research Corporation of the University of Hawaii (RCUH). In this chapter, we review RCUH's mission, operations, and working relationship with the university.

Summary of Findings

1. The RCUH operates as an independent entity with little accountability and oversight by either the university or its board.
2. Federal funds have been jeopardized and significant deficiencies found in RCUH's financial management because the university and RCUH have not defined clearly their respective responsibilities.
3. The RCUH's financial reports are misleading and do not adhere to generally accepted accounting principles for treatment of assets.

RCUH Operates With Little Oversight and Accountability

RCUH handled more than \$84 million in research grants in fiscal year 1991-92. Despite the substantial moneys involved, RCUH operates with little accountability. Ambiguities in the statute establishing RCUH and insufficient oversight by the university and the RCUH board are contributing factors.

Under the statute, RCUH is attached administratively to the university and is part of the university. At the same time, the statute places RCUH under a board—the majority of whose members are not part of the university.

The RCUH functions like a separate, private corporation. Its executive director and administrative staff have a status separate from that of university employees. RCUH has its own financial and personnel system. It also has its own computers and handles its own purchasing, contracting, accounting, and financial services. Furthermore, its budget is approved by the RCUH board and is not submitted to the UH or the State for approval.

Because RCUH is exempt from personnel and procurement requirements imposed on other state agencies, the issues of oversight and accountability are particularly important. In view of its considerable freedom from state controls, RCUH must be able to demonstrate that it receives the oversight necessary to ensure its integrity and accountability.

No oversight by the university

The university exercises virtually no oversight or control over RCUH operations despite the extent and importance of the work RCUH performs for UH. The university assigns a significant portion of its grants and contracts to RCUH. In 1991-92, for example, it expended more than \$64 million through RCUH or slightly more than half of the outside funding the university received.

By law, the university does have some authority over RCUH. RCUH was established as a private, non-profit agency that is attached to the university for administrative purposes as provided for in Section 26-35, HRS. Section 26-35 defines administrative supervision by any department to mean, among other things that the attached agency would be represented by the head of the department when communicating with the governor and the Legislature and would get approval from the department on personnel and purchasing matters.

The university president, as head of UH, has the authority to impose these requirements on RCUH, but has not done so. For example, the president could approve RCUH personnel actions and purchases but does not. A consultant to UH has observed that the growth of UH's research activity has been accompanied by the "increasing independence of RCUH."¹ The consultant found that UH has the authority to exercise control over RCUH and to hold RCUH accountable for its actions.

The federal government also considers RCUH to be part of UH as determined by a recent opinion from the federal Office of Naval Research. The federal government considers UH and RCUH to be one entity in the handling of federal grants and contracts and will hold UH accountable for actions RCUH takes on federal grants.

Limited oversight by board

The Legislature also intended RCUH to be a vehicle for promoting the state's economic development. To accomplish this, the Legislature established a nine-member Board of Directors, the majority of whose members are in private industry. The intent to create a business orientation for the board has weakened the necessary oversight of RCUH.

Inappropriate economic development mission

In 1973, the Legislature reduced the number of UH members on the board from four to two. The Legislature believed that maximum use of practical business expertise in the community was not being made. Changing the board composition was intended to “have a very powerful economic impact on the State of Hawaii in terms of achieving greater economic diversification and expanding our economic horizons into new areas.”²

Currently, the UH president and vice president of research and the state director of business, economic development and tourism serve as ex-officio voting members of the board. The six other members appointed by the governor include two attorneys, two businessmen, a union official, and a public citizen.

The economic development role of the board is inappropriate for RCUH’s main mission which is to facilitate and administer research contracts and grants for the university. Furthermore, since 1965, several other agencies have been established specifically to promote economic development. Besides the Department of Business, Economic Development, and Tourism, they include the:

High Technology Development Corporation,
Hawaii Software Service Center,
Pacific International Center for High Technology Research,
Natural Energy Laboratory of Hawaii Authority,
Hawaii Strategic Development Corporation, and the
Hawaii Information Network Corporation.

The board is responsible for establishing policy, approving budgets, appointing the executive director, and carrying out other activities to enable RCUH to meet its duties and responsibilities. These duties and responsibilities should be directed primarily at supporting the university’s research mission. We found little evidence that the board actively governs RCUH towards this end. Board members receive little information from the executive director on problems facing the corporation and allow him to administer RCUH relatively autonomously.

Limited board activity

Board members have limited involvement in RCUH. They did not see themselves governing the operations of the corporation. One member stated that they see themselves as lay members who exercise general oversight of the corporation. Another member said that the board lacks the expertise or time to closely oversee RCUH operations.

In addition to its limited expertise in the field of research, the board is not active. The board meets quarterly but the board's committees generally do not meet regularly. Our review of board minutes from 1990 to 1992 showed that only the finance and personnel committee meets and reports to the board on a regular basis.

This committee addresses issues such as budget expenditures, revenues, salary adjustments, and personnel actions. Other committees meet infrequently on an as-needed basis. For example, in 1992 RCUH created oversight and audit committees to monitor the serious federal audit issues affecting RCUH. The oversight committee met only once and the audit committee met twice. The committees did not discuss significant issues nor take actions at the meetings.

Limited information received

In addition, the board receives little information on problems or significant issues affecting the corporation. We found that the executive director has not supplied board members with information on important issues facing the agency. For example, several board members told us that they were not aware of the serious deficiencies that were uncovered by federal auditors. One said that he found out about the problems through the newspaper.

Division of Responsibility Between RCUH and UH Is Unclear

The university and RCUH have not reached a clear understanding of their respective responsibilities despite the \$64 million in research contracts RCUH currently manages for UH. The university—as the recipient of a grant—is ultimately the responsible agency but UH officials acknowledge that they have not held RCUH accountable.

The relationship between the UH and RCUH is based on an internal agreement established in 1973. The internal agreement, however, does not specify how RCUH will be held responsible or accountable to UH, and it does not require RCUH to report to UH. Rather, the agreement describes mainly the financial transactions between the two parties and the conditions under which UH can contract with RCUH to manage a project (called a service order).

Currently, both UH and RCUH are involved in managing projects that are service ordered to RCUH. Typically, RCUH manages the fiscal and personnel aspects of a project. A UH researcher, referred to as a principal investigator, oversees the day-to-day operations of the project. This division of responsibility makes it essential for both UH and RCUH to have a clear understanding of their respective responsibilities for internal controls and for ensuring compliance with federal contracts.

Internal controls would include effective policies and procedures and accounting systems to ensure proper management of contracts. Unfortunately, these controls are not in place.

Federal funding jeopardized

In audits conducted in both 1991 and 1992, the U.S. Defense Contract Audit Agency (DCAA) found significant deficiencies in internal controls and compliance with the university's handling of federal contracts and grants. DCAA also found numerous cost accounting deficiencies and questionable charges to federal contracts and grants. It questioned the veracity of the university's billings. Because of the seriousness of the 1991 audit findings, the federal government threatened to suspend all funds to UH. These federal funds exceeded \$80 million in 1992.

DCAA identified 27 weaknesses, 25 of which related to RCUH. Among the weaknesses, it noted that RCUH could not account for approximately \$3 million in equipment it had purchased and that cost overruns were routinely transferred from one contract to another. To avoid suspension of funds, UH and RCUH, with the help of a private auditing firm, developed a corrective action plan to address the 27 deficiencies.

RCUH acknowledges the weaknesses identified by the federal audits and the divided responsibility and duplication of effort between UH and RCUH. Currently, the university's research projects operate under two governing boards; two senior management structures; and duplicate administrative offices, accounting systems, personnel, and other services to administer research projects.

With the help of a private auditing firm, UH and RCUH have initiated a number of corrective actions. For example, RCUH hired a purchasing specialist to monitor and ensure compliance with federal and state purchasing policies. The consultant monitoring the corrective actions noted that most of the problems are caused by the separation of responsibility and authority between both parties. For corrective actions to succeed, the consultant concluded that the UH president must assume more authority over RCUH. The consultant also concluded that RCUH has gone beyond the Legislature's intent by becoming an independent organization that is accountable to no one.³

Continuing deficiencies in financial management

Despite their efforts, the UH and RCUH continue to experience problems in managing research projects. An independent auditor's report issued in June 1993 found a number of "reportable conditions" and "material weaknesses" in RCUH's financial management or internal controls. Financial auditors use the phrase "reportable conditions" to describe a significant deficiency that could adversely affect an organization's ability to record, process, and report financial data. A "material weakness" is the worst possible condition—a situation where significant errors or thefts could occur and not be detected.

The audit report disclosed 50 deficiencies in internal controls, 29 pertaining to RCUH. The auditors found that in one instance RCUH had billed the university for \$500,000 of equipment that had not been received and in a second instance, it had billed the university for \$338,740 when reports showed expenditures of \$139,355.⁴

It should be noted that in auditing UH financial statements and internal controls, the auditors see UH as having two separate financial and administrative management systems for federal research funds. One system is within UH and the second is administered by RCUH. Both systems are part of UH.

RCUH Should Be Restructured

The basic problem of the unclear relationship between UH and RCUH will only be remedied by changing the structure of RCUH. We believe that RCUH must be made clearly subordinate to the University of Hawaii and central to supporting its research mission.

UH control needed

The UH should clearly make RCUH a subordinate unit. In exercising virtually no control over the operations of RCUH, the university departs significantly from the prevailing practice of mainland universities with similar organizations.

Mainland universities control their research organizations through a variety of means such as (1) the corporate charter and bylaws, (2) university control over the board of directors, (3) a formal agreement between the university and the research corporation, (4) staffing the research corporation with university personnel, and (5) subjecting the research organization to some of the university's administrative procedures.

For example, the Ohio State University Research Foundation, established in 1936 by Ohio State University and administering about \$140 million in sponsored projects, has a board of directors dominated by university representatives with a university vice-president as president of the board. The foundation's budget is reviewed by the university before it is submitted to the foundation's board of directors for approval. The president of the San Diego State University serves as president of the university's research foundation. The president also nominates members of the board of the foundation.

Constructive proposal by RCUH

In May 1992, the executive director of RCUH proposed a reorganization to meet changing conditions and requirements. The executive director noted three areas of concern:

- The growth in the volume of projects service ordered to RCUH by the university and problems with working capital and cash flow;
- A number of challenges by a labor union on the use of RCUH services; and
- The weaknesses identified by the federal audits.

The executive director stated that the central focus must be the university's research mission and the effectiveness with which RCUH could assist the university. To eliminate the division of responsibility and duplication of services, he proposed that RCUH be integrated into the UH. This could be done by:

- Designating RCUH as a subsidiary corporation of UH and making it clearly subordinate to UH;
- Changing the composition of the RCUH board of directors—to three UH regents and six public members appointed by the governor;
- Converting the senior RCUH management and administrative staff to university employees. The UH vice-president for sponsored research could be the executive director of RCUH and the UH vice-president for finance would be the chief financial officer of RCUH; and
- Administering all sponsored projects through RCUH and consolidating various operations at RCUH and UH, including accounting, information systems, financial operations, contracting, procurement, and property management.

We believe that some of these changes could address weaknesses in accountability and coordination between UH and RCUH. However, we do have some concerns about consolidating administrative operations at UH and RCUH. The combined operations would be large and complex and would require strong management.

Officials from the university and RCUH are currently in the process of developing ways to better coordinate and improve the relationship between the two organizations. We believe the restructuring should make clear the subordinate function of RCUH to serve the university and its research needs. The RCUH Board of Directors should also be made aware of its responsibility for oversight of RCUH programs to ensure that university needs are met.

We believe that the UH with its new president should be given the opportunity to address and resolve this issue internally. To ensure progress in this area, the Legislature should require UH to report during the 1994 legislative session on its plans and actions for restructuring RCUH and to submit a final report to the 1995 Legislature.

Financial Statements Are Misleading

RCUH's audited financial statements mislead the public in several respects. We find that (1) revenues and expenses are not clearly identified to allow a clear understanding of RCUH financial activities, and (2) property and equipment that should be accounted for as assets are omitted from RCUH's balance sheet and are classified improperly as operating expenses. They are not properly stated on RCUH's statement of revenues and expenses.

Revenues and expenses not clearly identified

RCUH lists an "endowment fund" under the assets section of its balance sheet. This is not actually an endowment fund but investments at UH Foundation. Revenues from the investments and expenditures of investment moneys are misstated.

RCUH should properly identify the fund as investments at UH Foundation. Calling it an endowment fund suggests that moneys in the fund may only be used for certain purposes. In reality, RCUH uses income from the investments as it chooses.

RCUH's statement of revenues and expenses for FY1991-92 shows an endowment fund expense of \$6,188. This is not an expense but actually the difference between the expenditures and the income from its investment account at UH Foundation. Only by carefully studying the notes to the financial statements can it be determined that RCUH actually received an investment income of \$49,366. RCUH spent \$55,554 for research assistantships from this account, thereby arriving at the net loss, or "expense" of \$6,188. Thus, investment income on the statement of revenues and expenses is understated by the \$49,366. Expenses for research assistantships are understated by the \$55,554 paid from the investment account. Moreover, the statement of revenues and expenses does not accurately reflect what RCUH actually spent for research assistantships. The true amount was \$88,238. The \$32,684 shown on the statement of revenues and expenses represents the difference after \$55,554 was paid from the investment account at UH foundation.

Treatment of assets contrary to policy

In its treatment of fixed assets, such as equipment, RCUH departs from its own policy as well as generally accepted accounting principles (GAAP). This results in a misstatement of the management fee it charges the university.

RCUH's practice, as stated in the notes to its financial statements, is to account for property and equipment as expenses when acquired and not to depreciate them.⁵ This means that RCUH treats the entire cost of equipment as an expense in the year it is purchased. This is contrary to its written policy which states that equipment with a unit value of \$500 and an expected useful life of two years shall be capitalized. Capitalized means that assets are listed on the balance sheet and depreciated over their useful life.

We found no fixed assets listed on RCUH's balance sheet and no depreciation expense on its statement of revenues and expenses. In our opinion, expensing property and equipment in the year it is purchased is an inappropriate accounting practice which violates generally accepted accounting principles.

Treatment contrary to generally accepted accounting principles (GAAP)

RCUH's practice of expensing the entire cost of property and equipment in the year purchased is contrary to GAAP which defines depreciable assets as "assets that (a) are expected to be used during more than one accounting period, (b) have a limited useful life, and (c) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes."⁶

For example, the office equipment RCUH considers an expense in calculating the management fee meets GAAP's definition of a depreciable asset. GAAP defines depreciation accounting as "a system of accounting which aims to distribute the costs or other basic value of tangible capital assets over the estimated useful life of the asset in a systematic and rational manner."⁷

Management fee also misstated

By not applying GAAP definitions and depreciation accounting, administrative costs for the year are inflated. Administrative costs are a major component of the management fee RCUH charges the university. When the entire cost of equipment is treated as an expense in the year it is purchased, administrative costs are inflated as well as the related fee that UH is charged. Administrative costs in subsequent years are understated by the amount of the equipment costs that should have been allocated to those years in the form of depreciation.

Recommendations

1. We recommend that the Legislature require the University of Hawaii to report to the 1994 Legislature on its plans and intention to restructure the RCUH and UH relationship. The report should include how the university intends to hold RCUH accountable; the

role and function of the Board of Directors; and the RCUH relationship to other university research activities. A final report on the implementation of the reorganization should be presented to the 1995 Legislature.

2. We recommend that the Research Corporation of the University of Hawaii report accurately on its revenues and expenses in its financial statements. We also recommend that it adhere to its written policy and generally accepted accounting principles in its treatment of fixed assets.

Chapter 3

RCUH Contracts With State Agencies

In this chapter we review the relationship between the Research Corporation of the University of Hawaii (RCUH) and state agencies. In fiscal year 1991-92, the total volume of RCUH contracts with state agencies was \$8.2 million—a significant sum. We assessed the appropriateness of these contracts and the adequacy with which they are administered.

Summary of Findings

1. RCUH lacks clear policies, criteria, and management controls for contracting with state agencies. It has allowed abuses to occur.
2. Executive departments use contracts with RCUH to evade state requirements.
3. RCUH charges an arbitrary fee for its services to state agencies.

RCUH Lacks Policies and Management Controls To Safeguard Its Integrity

As does the university, state agencies contract with RCUH for project management and administrative services such as accounting, procurement, and hiring of personnel.

In view of the considerable flexibility RCUH enjoys and its exemption from state personnel and purchasing requirements, RCUH should have clear policies and strong management controls over its contracts. Without these, RCUH is vulnerable to abuse by those with whom it contracts. We found RCUH to be weak both in its policies and management controls. Its policies lack criteria that would ensure acceptance of appropriate research projects only. Without clear policies and guidelines some agencies have used RCUH to avoid state laws and regulations. RCUH lacks the appropriate management controls to prevent these abuses.

Weak project acceptance policy

The RCUH policies and procedures manual states it will accept state projects that need flexibility and that are in accord with the purposes for which RCUH was established. The policy, however, has no criteria for determining what might be in accord with RCUH's established purposes. This contrasts with the specific criteria used for UH projects.

The RCUH agreement with UH deals specifically with the potential of contracts to evade state laws by identifying a number of conditions that must be met before the university may contract (or service order) with RCUH for project management. A project must meet at least one of the following conditions before RCUH will accept the contract:

- Involve private organizations;
- Have unusual procurement problems such as major items of special equipment, or complex equipment construction;
- Have operations that lie largely outside the state;
- Have personnel problems that might be handled more effectively outside the state or UH personnel system;
- Have a substantial amount of shop operations, technical shop-type operations, computer services, etc.;
- Involve research facility management where any combination of the above-mentioned problems exist; and
- Have other special problems that may be better resolved through the services of the RCUH.

In addition, the internal agreement states specifically that in no event will the university use RCUH services to avoid bidding and other statutory requirements not intended to be exempted by the Legislature in creating RCUH.¹ RCUH should have similar policies for accepting contracts from state agencies.

Ready acceptance of state contracts

In the absence of criteria, RCUH officials have considerable discretion in deciding what projects they will accept. They say that they look for either a research or training component when considering a project for acceptance. Yet, in reviewing a sample of state contracts, we found projects that did not meet research or training criteria. For example, the then Department of Planning and Economic Development used a contract with RCUH to hire staff to implement an electronic bulletin board.

In theory, state departments may also use RCUH when they cannot perform the work themselves. We found four projects in our sample in which a state agency justified the request to contract with RCUH by saying it lacked full-time staff and internal support to implement the project. Subsequently, however, the agency hired its own staff to implement the project. The staff left the agency, but were re-hired for the project through RCUH.

It appears that RCUH seldom refuses any state agency request for project management. It has little incentive to turn down projects since it receives a fee for these services.

Poor management controls

Once contracts are executed, RCUH does not closely monitor them. In sampling state agency contracts, we found significant weaknesses in management controls similar to those identified by federal and private auditors in their review of contracts between RCUH and UH.

RCUH has taken steps to improve its management controls for university projects, but it has not initiated any improvements for state contracts. Its policy and procedures manual is silent on its contract monitoring responsibilities and accountability for state projects. According to an RCUH official, it functions more as a bookkeeper for projects. RCUH believes that responsibility for monitoring projects should rest with the sponsoring agency and relies on the sponsoring agency to monitor itself. This has resulted in problems such as contracts not being in compliance and inactive contracts not being terminated.

Noncompliance with contracts

RCUH contracts require principal investigators, or those who are responsible for overseeing the project, to be state employees. We found three projects in our sample where the principal investigators were not state employees. The contracts, therefore, were not in compliance. The contract states that:

The State shall designate a Principal Investigator (PI) who shall be an employee of the State. Supervision of the project and any contractors or employees hired by the Consultant for the project shall be the responsibility of the PI. The PI shall initiate purchase requisitions and authorize the Consultant to make payments on invoices received from vendors from funds received for the project, all in accordance with Consultant policies and procedures.²

The purpose of this provision is to ensure that public funds are spent only for legitimate purposes authorized by a state employee. RCUH does not check to make sure that principal investigators are state employees. It makes payments on project expenditures without ensuring that the payment authorizations comply with the contract agreement.

No termination of inactive contracts

RCUH does not monitor the status of projects to terminate those that are inactive. We found projects initiated in 1987, 1988, and 1992 that have not been active nor spent any funds. According to a state agency official, the 1992 project plans to request a no-cost extension from

RCUH. By not terminating inactive projects, RCUH allows agencies to avoid the State's requirement that unused funds be returned to the general fund.

RCUH says it has no follow-up procedures for inactive state projects. RCUH does not question why contracts are extended and assumes state agencies have their reasons for not spending the moneys.

Departments Use RCUH to Evade State Requirements

Departments appear to have contracted with RCUH to evade state laws and legislative authority, such as circumventing position ceilings, changing programs, and making purchases not otherwise permitted. The executive branch has allowed these abuses by not developing criteria for contracting with RCUH and by having no systematic review of requests to contract with RCUH.

No executive branch criteria for use of RCUH

The state executive branch is at fault for having no policies on when agencies may contract with RCUH. The Department of Budget and Finance (B&F) treats RCUH as a consultant and state departments contract with RCUH as they would a consultant.

Other than the annual governor's budget execution instructions that say that agencies must have the governor's approval for consultants, the B&F has no written guidelines for departments that wish to contract with RCUH. According to a B&F official, the only written guidelines are those in Chapter 307, HRS, which outlines RCUH's duties and functions. If the request falls within these guidelines and is one that the department cannot perform, B&F will recommend approval.

The individual departments contracting with RCUH also lack internal written criteria for when they may use RCUH. Principal investigators or state personnel who are responsible for overseeing projects with RCUH said they were not aware of any departmental policies on RCUH. Several principal investigators stated that an applicable criterion used in their department is whether projects contain research and developmental aspects or are large, multi-disciplinary projects involving multiple parties. However, research or developmental aspects are not defined and the principal investigator uses broad discretion in deciding when a project should be handled by RCUH.

No executive branch policies for reviewing requests

The individual departments and B&F also lack written policies for reviewing requests to contract with RCUH. We found little systematic review of requests. Branch level managers who decide to use RCUH submit their recommendations to department management; the

department director gives final approval. All of the principal investigators we interviewed said their branches did not have a formal review process for RCUH projects.

B&F's process is similarly informal. No standard format or procedure is prescribed for requests. Departments submit a request to B&F describing the scope of work to be performed. They usually supply information on the scope of work, purpose of the final product, and the cost and duration of the contract. B&F then reviews the request and makes a recommendation to the governor, who either approves or disapproves the request.

Avoiding lapsing requirements

We found several projects that appear to use contracting with RCUH to avoid state lapsing provisions. State law requires that funds not expended by the end of the fiscal year must be returned or lapse to the general fund. But funds encumbered by contract do not lapse. By contracting with RCUH, departments can encumber the entire contract amount and keep it from lapsing. For example, we found two projects in our sample that have had no activity since 1987 and 1988—over five and six years respectively. Nevertheless, the projects had encumbered \$55,000 and these funds have not lapsed to the general fund. This practice denies the Legislature the opportunity to reappropriate the unused funds for other purposes.

Circumventing position ceilings

Departments also contract with RCUH to obtain personnel when positions have not been appropriated by the Legislature and to avoid state personnel policies and procedures. For example, the Department of Business, Economic Development, and Tourism (DBEDT) requested the governor's approval for an interim 14-month contract with RCUH for personnel services. To justify the request, DBEDT noted the long lead time required for legislative approval of positions and state procedures for establishing the positions. DBEDT sought technical and professional personnel services from RCUH until it could obtain legislative authorization for two permanent positions.

Amending contracts and changing programs

Departments that contract with RCUH sometimes are unclear about the intended scope of work and amend the contracts at will. We found several contracts that were amended continuously with accompanying increases in contract cost. This practice allows departments to change programs without being held accountable for them.

One example is the Office of State Planning's contract with RCUH for a project on the Hawaii State Plan. The original request approved by the governor described the project as a research and analysis contract to establish a mechanism and process to promote the Hawaii State Plan.

The project also sought to review the overall monitoring and reporting system that supports state policy analysis. The 1986 contract was not to exceed \$65,000. However, 11 days after the contract was executed, the agency requested approval from the governor to amend the scope to include preparation of public media materials highlighting the Hawaii Coastal Zone Management Program. The amendment increased the cost for the project by \$36,000. The contract continued to be amended and extended six times from May 1987 to the present. Each extension added an additional year to the contract as well as program changes and budget increases.

Today, seven years later, the project has yet to be completed even though \$56,000 has been added to the contract amount, bringing the total to \$121,000. We believe the office took advantage of RCUH's statutory flexibility to use funds for various purposes.

Inappropriate purchasing

Because RCUH is exempt from state procurement laws, departments have used RCUH to make purchases that are questionable and not directly linked to project needs. For example, in 1987 the Governor's Cable Advisory Board entered into a contract with RCUH to obtain ideas on the use of geothermal energy and its distribution to other islands. The contract was used to obtain furnishings and equipment not authorized by the Legislature, giving the appearance of avoiding state purchasing requirements. Purchase orders charged under the contract included furnishings such as executive and secretarial desks and chairs, lateral files, credenza, bookcase, and a fax machine purchased two years after the start of the contract. In addition, food items such as meat, relish, cheese platters, and a buffet luncheon were also purchased for the project.

We note that the Governor's Cable Advisory Board is not a research project and the purchases of furnishings and food appear unrelated to research. In addition, equipment purchased by RCUH for a project reverts to the sponsoring agency at the completion of the project. Therefore, the purchases made on behalf of the Governor's Cable Advisory Board later became the property of the sponsoring agency.

RCUH Management Fee For State Contracts Is Arbitrary

RCUH is required by law to be self-sustaining. It derives most of its revenues from fees it charges under its contracts. The RCUH management fee charged the university is based on administrative expenses that are attributable to UH. The fee is designed to recover RCUH's administrative expenses proportionate to the volume of UH business with RCUH. The formula for determining the amount of the fee is found in the internal agreement between UH and RCUH.

In contrast, the management fees charged state agencies are based on an arbitrary rate not directly linked to RCUH's administrative costs or based on any policies for these fees. Unlike its agreement with the university, RCUH charges state departments a 5 percent rate that is not based on an agreed upon formula nor linked to administrative costs. An RCUH official informed us that the 5 percent rate has been used for years.

The 5 percent fee has given RCUH some excess funds and allowed it to build a pool of working capital. As of June 30, 1992, working capital was over \$2.2 million. This is unlike the management fee RCUH charges UH which is really a reimbursement of actual costs and does not result in any excess funds. RCUH says it needs working capital because funding for some projects may be delayed and other projects are on a cost reimbursement basis. We found no written policies, however, that would allow RCUH to generate excess funds.

In restructuring RCUH, the UH should exercise the same oversight over RCUH's contracts with state agencies that it intends to exercise over RCUH's university research contracts. The UH should ensure that RCUH has written policies and procedures for state contracts. These policies should cover RCUH's fee for state contracts and the use of revenues derived from the fee. The fee should be based on RCUH's administrative costs for managing state contracts.

Recommendations

1. We recommend that the University of Hawaii should ensure that RCUH does the following:
 - a. develops clear policies, criteria, and guidelines for the types of projects it will accept from state agencies.
 - b. develops management controls and a monitoring program that would ensure that state projects are not inappropriately circumventing state laws and the contracts.
 - c. formalizes policies for a management fee for RCUH contracts with state agencies that is based on its administrative costs and defines the use of revenues derived from the fee.
2. We also recommend that the governor develop policies for the executive branch that identify the conditions and criteria under which the state agencies may contract with RCUH and establish a system for reviewing requests for contracting with RCUH.

Notes

Chapter 1

1. Senate Standing Committee Report No. 836 on House Bill No. 1227, Regular Session of 1965.
2. KPMG Peat Marwick, Management Consultants, *University of Hawaii and Research Corporation of the University of Hawaii Grants and Contracts Management Review, Final Report*, November 1992, p. 12.

Chapter 2

1. KPMG Peat Marwick, Management Consultants, *University of Hawaii and Research Corporation of the University of Hawaii Grants and Contracts Management Review, Final Report*, November 1992, p. 12.
2. Senate Standing Committee Report No. 390 on Senate Bill No. 270, Regular Session of 1973.
3. *Ibid.*, pp. 10, 11.
4. KPMG Peat Marwick, *University of Hawaii, State of Hawaii, Financial Statements and Schedule of Federal Awards, June 30, 1992 and 1991*, June 30, 1993.
5. Gerald Y. Ushijima, C.P.A., *The Research Corporation of the University of Hawaii Financial Statements and Independent Auditor's Report June 30, 1992 and 1991*, p. 13.
6. D.R. Carmichael, Steven B. Lilien, Martin Mellman, *Accountant's Handbook*, 7th ed., New York, John Wiley & Sons, 1991, p. 14.14.
7. *Ibid.*, p. 14.18.

Chapter 3

1. Internal agreement between the University of Hawaii and the Research Corporation of the University of Hawaii, June 12, 1973, p. 2.
2. State of Hawaii, Standard Consultant Agreement, Form AG-1(11-91), Attachment 6.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the University of Hawaii, the Research Corporation of the University of Hawaii, and the Department of Budget and Finance on September 17, 1993. A copy of the transmittal letter to the University of Hawaii is included as Attachment 1. A similar letter was sent to the Research Corporation of the University of Hawaii and the Department of Budget and Finance. The university's response is included as Attachment 2. The responses from the corporation and the Department of Budget and Finance are included respectively as Attachments 3 and 4.

The University of Hawaii generally agreed with our recommendations to clarify its oversight relationship with the corporation. The university has formed a committee to review its relationship and oversight responsibility over the corporation. With respect to state contracts, the Department of Budget and Finance agreed that the corporation needs to develop policies and guidelines for the projects it will accept from state agencies.

The Research Corporation of the University of Hawaii says it disagreed to a large extent with the findings and recommendations. The corporation took exception to our policy of keeping our working papers confidential until the report is published. The corporation generally agreed that restructuring its relationship with the university could provide an opportunity for increased effectiveness. However, the corporation did not comment specifically on the recommendations in the report. Instead, it presented a detailed justification of its current operations.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

September 17, 1993

C O P Y

The Honorable Kenneth P. Mortimer
President
University of Hawaii
2444 Dole Street
Honolulu, Hawaii 96822

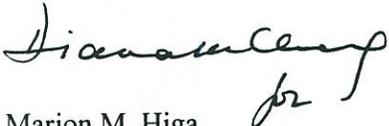
Dear President Mortimer:

Enclosed for your information is copy number 9 of our draft report, *Audit of the Research Corporation of the University of Hawaii*. We ask that you telephone us by Tuesday, September 21, 1993, 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 Friday, October 1, 1993.

The Research Corporation of the University of Hawaii, the Department of Budget and Finance, 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
State Auditor

Enclosures



UNIVERSITY OF HAWAII

PRESIDENT, UNIVERSITY OF HAWAII
AND CHANCELLOR, UNIVERSITY OF HAWAII AT MANOA

September 23, 1993

Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

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OFF. OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

Thank you for the opportunity to comment on your audit of the Research Corporation of the University of Hawaii. The University has one general comment that deals with the issue of the Corporation's relationship with the University of Hawaii. The need to review and revise the relationship between the two organizations has been acknowledged and recommended in your report. Recommendations to review the relationship have also been articulated by other concerned parties. However, input from perhaps the most important group, namely the research users of the Corporation's services, has been largely missing. For this reason, I have formed a committee comprised of University research and financial personnel and have charged the committee with coming up with recommendations which address the issues of responsibility, oversight and accountability, with the intent of maintaining the primary purpose of the Research Corporation -- that of supporting the University's research mission.

Based on my review of the recommendations, appropriate changes will be made to ensure the continued viability of the Research Corporation in its support of the University.

Sincerely,

Kenneth P. Mortimer
President, University of Hawaii and
Chancellor, University of Hawaii at Manoa

c: H. Howard Stephenson
Chairperson, Board of Regents

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STATE OF HAWAII

**Response
to the
Legislative Auditor Report
on the
Research Corporation
of the University of Hawaii**

October 8, 1993

The Research Corporation of the University of Hawaii



October 8, 1993

Ms. Marion M. Higa
State Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813

Dear Ms. Higa:

We appreciate the opportunity to respond to the findings and recommendations in your draft audit report of the Research Corporation of the University of Hawaii (RCUH), dated September 17, 1993.

We have prepared comments and a response on these findings and recommendations. These are attached and we understand are to be submitted to the Governor and Legislature of the State of Hawaii together with your report.

We disagree to a large extent with the findings and recommendations of the Office of the Auditor (the Auditor). We also take exception to the Auditor's policy of confidentiality that results in nonavailability of additional information on the findings, and thus our inability to validate the findings reported. This policy precludes our responding to the findings in a specific factual manner and from taking appropriate action if needed.

The Auditor describes findings that have been previously disclosed in other audit reports, but fails to recognize that corrective action plans have been developed and corrective action has been implemented.

As a part of its business and by the nature of its function, RCUH is under scrutiny by its federal sponsors and auditors, the University and State departments and agencies. We have addressed and will continue to address deficiencies and areas that need improvement. We are also proactively addressing the nature and structure of our relationship with the University and plan to strengthen our capabilities.

We believe that the RCUH plays a vital role in supporting the University of Hawaii's goal of becoming a premier research institution in the Pacific. RCUH core administration strives to provide quick, responsible service to its projects at a reasonable cost while meeting applicable reporting requirements and compliance regulations. RCUH project staff contribute directly to the performance and advancement of study in areas key to the State's research, education, development and reputation.

We look forward to continuing to serve the University of Hawaii and the State of Hawaii.

Very truly yours,

Gary W. Rodrigues
Chairman, Board of Directors

Fujio Matsuda
Executive Director

**RESPONSE TO
THE LEGISLATIVE AUDITOR REPORT ON
THE RESEARCH CORPORATION OF THE UNIVERSITY OF HAWAII**

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**RESPONSE TO
THE LEGISLATIVE AUDITOR REPORT ON
THE RESEARCH CORPORATION OF THE UNIVERSITY OF HAWAII**

OCTOBER 8, 1993

An audit by the Office of the Auditor (Auditor) of the Research Corporation of the University of Hawaii (RCUH) was conducted during the eight month period from January 1993 to September 1993. The draft audit report was received by RCUH on September 17, 1993.

The stated objectives of the audit were to:

1. Determine whether RCUH operations appropriately reflect its mission, functions, and responsibilities.
2. Determine whether RCUH fee assessments are appropriate, reasonable, and accurately reflect costs.
3. Evaluate whether RCUH controls over contracts related to state projects are prudent and proper.

Having read the Auditor's report, RCUH must take strong exception to most of its conclusions.

In its report, the Auditor alludes to instances of improper handling but fails to identify the specific facts of its allegations. RCUH requested that the Auditor provide additional information so that the findings could be verified. This request for information was declined by the Auditor based on its policy of confidentiality. It is difficult to respond factually to the findings and to take appropriate corrective action unless the specific situation is known.

RCUH has compiled detailed comments and response on those items where the Auditor has provided sufficient information to identify a project or incident. We are prepared to provide a complete response on the findings when specific information is made available.

Before responding to the audit findings, the purpose, organization and function of RCUH are described to provide a context for understanding and interpreting the audit findings.

1. RCUH SERVES A UNIQUE FUNCTION IN GOVERNMENT.

RCUH was established to enhance the State's, primarily the University's, ability to attract research grants and to complete research in an efficient and cost effective manner.

The 1965 Legislature recognized that usual bureaucratic red-tape in procurement of equipment and support and in hiring of personnel hindered the attraction and performance of externally funded research programs. These basic and applied research programs sponsored primarily by the Federal Government and coupled with private industry were seen as vital to the growth and reputation of the University of Hawaii and the State. The vision for RCUH was bold and innovative: provide an effective, efficient means to respond to the demands of creative, highly competitive and dynamic research.

Accordingly, RCUH was established to enhance the State's, primarily the University's, ability to attract research grants and to complete research in an efficient and cost effective manner. The Legislature created RCUH as a public instrumentality and a body corporate with a broad mission. Understanding the scope of RCUH's capabilities and its organization and relationship to the University and the State are key in the evaluation of the effectiveness of the RCUH. Excerpts from Hawaii Revised Statutes (HRS) Section 307-1 describe its purpose:

"The objects ... are to promote all educational, scientific, and literary pursuits

by encouraging, initiating, aiding, developing, and conducting scientific investigations and research ...

by encouraging and aiding in the education and training of persons for the conduct of such investigations, research, and study,

by the furnishing of means, methods, and agencies by which the investigation, research, and study may be conducted,

by assisting in the dissemination of knowledge by establishing, aiding, and maintaining ... means to make the benefits of investigations, research and study available to the public;

and by any and all other acts reasonably designed to promote the above purposes in the interest of promoting the general welfare of the people of the State."

RCUH is exempt from certain State laws relating to procurement and personnel. To provide the needed flexibility and rapid response, certain exceptions to State law are granted to RCUH, as described in HRS Section 307-4:

"... the research corporation shall be granted flexibility in hiring its personnel and in handling and disbursing moneys by being excepted from the following state laws:

- (1) Sections 36-27 and 36-30, relating to special fund reimbursements to the state general fund;
- (2) Sections 103-22 and 103-42, relating to advertising for bids and purchases to be made in Hawaii whenever public moneys are expended;
- (3) Chapter 76, relating to civil service;
- (4) Chapter 77, relating to compensation; and
- (5) Section 78-1, relating to public employment."

To provide the meaningful working relationship with its parent university and the State government, RCUH is a part of the University for administrative purposes, as provided for in HRS Section 26-35. In September 1984, the University delegated certain responsibilities to RCUH, in recognition of RCUH's statutory purpose.

RCUH receives no appropriations from the State. It was intended that the RCUH operate entirely on income from contracts and grants from external sources.

RCUH performs two primary functions: contract and grant administration and projects support.

RCUH performs two primary functions: contract and grant administration and projects support. Core staff perform contract and grant administration, providing quick, responsive service to its projects while meeting applicable reporting requirements and compliance regulations. Project staff, hired for the duration of a project, contribute directly to the performance and advancement of research and study.

The principal investigator (PI), who is an employee of the University or a State agency, is responsible for the conduct and performance of the technical aspects of the project, including technical report preparation and submittal. RCUH core administration acts as a fiscal officer, doing day-to-day administration including hiring of project personnel and obtaining goods and services as requested by the PI, periodic payroll and billing, and project closeout with final financial report preparation and final billing.

2. THE RCUH BOARD PLAYS A KEY ROLE IN THE GOVERNANCE OF RCUH.

The Board has focused on policy issues.

Historically, the RCUH Board has focused on policy issues, and requires prior approval on matters it wishes to control, such as bank loans for equipment purchase and working capital, advance project funding above a specified threshold amount, personnel and fiscal policies, the operating budget for the Corporation, etc. The Board requires quarterly financial and operational reports to monitor the performance of the Corporation. This mode of operation has been in place for at least the past twenty years.

Notwithstanding the Auditor's failure to corroborate or document alleged shortcomings, the Board will take the

Auditor's findings under advisement, and intends to reassess its role and responsibilities. The Board is prepared to take appropriate steps to redefine its responsibilities and duties.

The Board will not allow, condone, perpetuate, or administer programs that are known to evade State requirements.

The Auditor alleges that "... some agencies have used RCUH to avoid state law and regulations ..." and "[d]epartments appear to contract with RCUH to evade state laws and legislative authority ..."

The Board will not allow, condone, perpetuate or administer programs that are known to evade State requirements. RCUH and the departments in question should be notified with specific information so that corrections can be made, if there are improper uses of RCUH.

3. ACCOUNTABILITY IS INTEGRAL TO OUR BUSINESS.

RCUH is accountable to and held responsible by many parties.

RCUH is accountable to and held responsible by many parties, at the operational, policy and regulatory levels:

- the PI and his project
- its Executive Director
- its Board
- the University of Hawaii
- its federal sponsors
- its State sponsors
- through its Board and the University, the Governor and the Legislature

Policies and procedures are established in the RCUH.

Policies and procedures are established in the RCUH. Policies and procedures are defined for the entire RCUH operation, and apply to both University projects and State contracts.

These rules are somewhat different in structure, compared to most models of government. The operation of an entity like the RCUH in the State requires "flexibility" so that projects can proceed in a timely manner and projects are able to meet deadlines and commitments in the "real world". Such flexibility does not imply that there are no rules or that rules change to fit a situation. It is a set of rules designed for streamlined, responsible action.

Internal Agreement specifies how RCUH is held accountable.

Contrary to the Auditor's statement, **the Internal Agreement specifies how RCUH is held accountable to the University.** Article V, Section 5 of the Internal Agreement states:

- "5. In the event that an expenditure made or authorized by the CORPORATION under the contract/grant is ruled subsequently by the Sponsor to be improper, the CORPORATION shall be liable to the UNIVERSITY for any loss in reimbursement resulting therefrom, unless the authority for such expenditure had been granted to the UNIVERSITY."

Accountability is inherent in Federal award administration.

A large portion of RCUH projects involve Federal sponsors. Federal award administration is subject to Federal regulations which include cost principles that define allowable, allocable and reasonable costs, administrative requirements that describe fair labor practices, and audit requirements. Due to the large volume of federal awards, the University and RCUH have an assigned cognizant federal agency for its research activities, with a federal auditor who provides oversight and monitoring of federally funded programs at the University.

RCUH has strengthened its system of internal control and compliance measures.

RCUH cooperated fully with the University, Defense Contract Audit Agency (DCAA), and KPMG Peat Marwick in resolving audit issues identified by the DCAA in 1991. We examined each issue, investigated the facts in each finding with the project, and where appropriate, took immediate corrective action, including addition of four new positions to core administration to provide compliance monitoring.

RCUH has strengthened its system of internal control and compliance measures. In its efforts to strengthen and implement corrective policy and procedures, RCUH has expended over \$300,000 in audit and consultant fees.

An overall corrective action plan was developed by KPMG Peat Marwick for the University and RCUH. The first phase of the plan was implemented by the University and RCUH in July 1993. Such action included: changes to policies and procedures, new and revised forms and documentation requirements; and the development of an electronic interface between the University and RCUH financial accounting systems. While we continue to adjust the system, we believe that the major compliance issues have been addressed.

The appearance of continuing deficiencies at RCUH is because the various audit reports cover the same period in time. The independent auditor's report issued in June 1993 covered the fiscal years ending in 1991 and 1992 and included many of the findings from the prior DCAA and consultant reports that covered the years 1989 - 1992. Corrective actions taken by RCUH during 1991 - 1993 were not disclosed in the independent auditor's report. Similarly, the Auditor's report covers the period from 1990 to the present and discloses findings previously reported, without acknowledging the corrective actions taken by RCUH. The repetition of the same deficiencies for a given time period in multiple audit reports has given an appearance of continuing deficiencies since the corresponding corrective actions taken subsequently were not disclosed.

Project overruns and disallowances average 0.02%, or \$200 per \$1 million, of project expenditures.

Federal auditors are taking a hard, close look at federally sponsored research programs at universities across the nation. The University and RCUH are subject to such increased scrutiny which included the DCAA audits of 1989 - 1991 and the extensive review of all systems in conjunction with the DCAA audits by KPMG Peat Marwick in 1991 - 1992.

The results to-date show: (1) There are no allegations of willful misfeasance. (2) Over the past ten years, project overruns and disallowances including interest charges

averaged 0.02% of expenditure volume, as shown in the following table:

<u>Year</u>	<u>Volume of Expenses</u>	<u>Project Overruns/ Disallowances</u>	<u>%</u>
1984	\$34,546,845	\$545	0.002
1985	38,647,142	21,349	0.055
1986	40,594,124	2,639	0.006
1987	41,898,500	1,680	0.004
1988	49,509,845	10,674	0.022
1989	59,703,430	973	0.002
1990	70,347,859	563	0.001
1991	74,318,233	12,898	0.017
1992	84,834,263	44,162	0.052
1993	71,050,820	26,227	0.037
Average for 10-year period:			0.022

4. REALIGNING RCUH OPERATIONS MAY PROVIDE A BETTER FIT FOR THE UNIVERSITY'S RESEARCH MISSION.

The Internal Agreement clearly defines the respective responsibilities of the University and RCUH.

Contrary to the Auditor's view, the Internal Agreement clearly defines the respective responsibilities of the University and RCUH regarding award administration:

- The University PI is responsible for fulfilling the terms and conditions of the contract/grant between the University and the sponsor, supervision of research, and has the authority to request RCUH to make payments.
- RCUH is responsible as the fiscal officer to authorize only commitments and disbursements allowed by the contract/grant, to maintain books of original entry, to keep official records of commitments and disbursements, and to be responsible for business, fiscal, legal and other matters. RCUH is liable to the University for any loss in reimbursement due to its fault.

Restructuring the UH/RCUH relationship provides opportunity for increased effectiveness.

The current relationship between the University and RCUH is clear with regard to sponsored project administration and operation.

The system of internal control is in place. It is complicated and made more difficult and complex by the current structural relationship between the University and RCUH.

The current arrangement involves two parallel organizations for research administration: one within the University that uses University and State procedures, and the second, RCUH, that operates on a different, more flexible system as authorized by Chapter 307, and designed to meet the needs of externally funded projects. There are problems of redundancy, timing, reconciliation and resulting inefficiency that are common to maintaining and synchronizing two separate parallel systems.

The University and RCUH have an opportunity to review the current arrangement and determine whether an integration of the University's and RCUH's research administration is needed. Having all aspects of all projects processed through

one organization could simplify the system of policies, procedures, and internal control. It will also define the locus of responsibility and accountability without ambiguity.

5. RCUH'S FINANCIAL STATEMENTS ARE AUDITED ANNUALLY BY INDEPENDENT EXTERNAL AUDITORS.

RCUH financial statements are audited annually by an independent external auditor. RCUH's external auditors have concluded that RCUH's financial statements have fairly presented in all material respects the financial condition of RCUH in conformity with generally accepted accounting principles.

6. RCUH MANAGEMENT FEE ON STATE CONTRACTS IS REASONABLE AND APPROPRIATE.

The management fee for State projects involving federal funds is set in accordance with federal regulations.

The management fee for State projects involving federal funds is set in accordance with federal regulations, and are audited and negotiated on an annual basis with the Federal Government.

RCUH needs to generate sufficient revenues to fund its operations.

Several factors influence the management fee rate for non-federally funded State projects:

- RCUH is by law self-supporting and must generate sufficient revenues to fund its operations.
- Almost all RCUH projects are cost-reimbursable, i.e., RCUH must first expend its own funds, then collect reimbursements later. Current working capital requirements are estimated to be \$6 million to \$7 million per month.
- In 1987, the Board of RCUH authorized a working capital reserve of \$2.5 million. Over the years RCUH was able to accumulate \$1.8 million in working capital through its operations. In 1991, the Board of RCUH authorized an increase in our bank line of credit to \$3 million to meet working capital needs.

The management fee for State projects involving non-federal funds has been set, unchanged, at 5% of total direct costs for the past 20 years. For fiscal year 1994, the rate was raised to 6% of total direct costs.

Is the present rate reasonable? We use two measures in evaluation. First, fiscal year 1993 ended in a deficit financial position; State projects were not over-charged, based on our financial needs.

A second measure is: is the rate reasonable compared to other options available to the State agencies? Is it cost-effective to use RCUH? RCUH provides: complete accounting services, purchasing, billing and payments; complete personnel services for project personnel; complete payroll, payroll taxes, and fringe benefit packages, workers compensation, health and retirement plan administration. The University charges a 10% rate on its State contracts.

7. CONCLUSION.

The principal source of the Auditor's criticism appears to be a fundamental lack of understanding of the RCUH's charter, its purpose and operations, as defined by its enabling legislation.

Misconceptions of RCUH's structure, mission and function will hamper the evaluation of RCUH's operation and effectiveness.

RCUH would be pleased to engage in fair informed discussion of its operations, efficiency and effectiveness as they relate to its mission and support of the University of Hawaii and the State of Hawaii.

RCUH plays a vital role in supporting the University of Hawaii's goal of becoming a premier research institution in the Pacific. RCUH provides quick responsible service to its projects at a reasonable cost while meeting applicable reporting requirements and compliance regulations. RCUH contributes directly to the advancement of study in areas key to the State's research, education, development and reputation.

We look forward to continuing to serve the University of Hawaii and the State of Hawaii.

JOHN WAIHEE
GOVERNOR



YUKIO TAKEMOTO
DIRECTOR

EUGENE S. IMAI
DEPUTY DIRECTOR

Barbara Kim Stanton
Deputy Director

EMPLOYEES' RETIREMENT SYSTEM
HAWAII INC
HAWAII PUBLIC EMPLOYEES HEALTH FUND
HOUSING FINANCE AND DEVELOPMENT
CORPORATION
OFFICE OF THE PUBLIC DEFENDER
PUBLIC UTILITIES COMMISSION

STATE OF HAWAII
DEPARTMENT OF BUDGET AND FINANCE

STATE CAPITOL

P.O. BOX 150

HONOLULU, HAWAII 96810-0150

BUDGET, PROGRAM PLANNING AND
MANAGEMENT DIVISION
FINANCIAL PLANNING AND POLICY
DEVELOPMENT DIVISION
INFORMATION AND COMMUNICATION
SERVICES DIVISION
TREASURY OPERATIONS DIVISION

October 4, 1993

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OFFICE OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King St., Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

We have reviewed your draft report, "Audit of the Research Corporation of the University of Hawaii," and believe that some clarification may be required relating to the Executive Branch approval process for consultant contracts.

Our clarification relates to the statement on page 18 of the report, "the only written guidelines are those in Chapter 307, HRS, which outlines RCUH's duties and functions. If the request falls within these guidelines and is one that the department cannot perform, the B&F will recommend approval." We believe that this criteria has been utilized by the RCUH for acceptance of a service contract.

It should be clarified that an agency intending to contract with the RCUH is handled in the same manner as for all consultant contract requests.

Requests for consultant services are generally routed through the Department of Budget and Finance for review and recommendation prior to the Governor's action on the consultant request. In our review of the request, our primary focus is on:

1. The purpose or reason for requiring the services.
2. Nature and description of the services to be provided.
3. The outcome/benefit/product to be realized from the services.
4. The relationship of the outcome/benefit/product on the program's activities and objectives.
5. Whether or not the services can be performed internally.

6. The availability of funds to support the contract and future cost implications.

It must be clarified that our review of requests for consultant services is intended to focus on the need for such consultant services, and not on any specific consultant. As such, our process does not require that the name of the consultant be provided, or even that one has been selected. We do not make recommendations as to the method of procuring the consultant services.

In approving consultant contracts, the Governor's response to the department acknowledges the need for services and approves the department's request to engage a consultant. The Governor does not approve the hire of a specific consultant. In addition, the Governor's response to the requesting agency concludes with, "Please take all necessary steps to ensure conformity with appropriate procurement processes and other applicable statutory requirements."

Additional guidelines to departments providing information or requirements relating to consultant contracts have been transmitted through memoranda from the Attorney General, the Comptroller, and the Department of Personnel Services and are included in the State of Hawaii Accounting Manual.

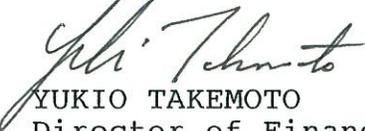
With regard to the Auditor's findings that State departments appear to have contracted with RCUH to evade State laws and legislative authority, it should be noted that this department has, in the past, raised concerns about the appropriate role of the RCUH as a consultant for non-research type activities. This matter has also been brought to the attention of the agencies and the Executive Director of the RCUH.

With respect to your statement that the B&F has no written guidelines for departments that wish to contract with the RCUH, it should be made clear that our role in the review of consultant contracts is from a budget perspective and as such, we are following the guidelines/criteria that we noted above.

Therefore, we concur with your recommendation that the RCUH develop policies, criteria, and guidelines for the types of projects it will accept from State agencies (consistent with Chapter 307, HRS). If such policies were developed to govern the allowable RCUH contracts, it is believed that much of the past problems and concerns regarding the use of RCUH may be avoided. Should it be determined that procurement policies for obtaining services from consultants such as the RCUH are still necessary, then the DAGS may be the more appropriate agency to develop such policies as part of its procurement functions.

Thank you for the opportunity to review and comment on the draft report.

Sincerely,


YUKIO TAKEMOTO
Director of Finance