
Examination of Selected Aspects of Capital Projects Funds

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

Conducted by

The Auditor
State of Hawaii
and
KPMG Peat Marwick,
Certified Public
Accountants

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 93-20
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Foreword

State capital improvement projects constitute a large part of the overall state budget. These projects are paid for with proceeds from the sale of general obligation and revenue bonds, special funds, federal funds, and recently, appropriations of general fund revenues. Capital projects funds are accounting entities used for recording appropriations and expenditures for capital improvement projects.

An examination of selected aspects of the capital projects funds was conducted by our office and the independent certified public accounting firm of KPMG Peat Marwick. The examination was performed 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 and its political subdivisions.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Departments of Accounting and General Services, Budget and Finance, and of the other expending agencies responsible for capital improvement projects.

Marion M. Higa
State Auditor

Table of Contents

Chapter 1 Introduction

Background	1
Objectives of the Examination	3
Scope and Methodology	3

Chapter 2 Oversight and Control of the Capital Projects Fund

Summary of Findings	5
Executive Budget Request and Appropriations Are Not Based on a Realistic CIP Program	5
Agencies Circumvent Constitutional Lapsing Provisions	8
Continuing Appropriations are Unnecessary	14
Agencies Are Keeping Excess CIP Funds	16
Recommendations	17

Notes	19
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Responses of the Affected Agencies	21
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Exhibits

Exhibit 1.1: Annual Capital Improvement Appropriations FY1981-82 - FY1991-92	1
Exhibit 1.2: Sources of Funding in Capital Improvement Appropriations 1981-1991	2
Exhibit 2.1: Capital Improvement Appropriations and Expenditures Fiscal Years ended June 30, 1985 to 1992	7
Exhibit 2.2: CIP Appropriations and Encumbrances by Acts as of June 30, 1992	9
Exhibit 2.3: Schedule of Capital Improvement Encumbrances Requiring Re-evaluation	13
Exhibit 2.4: Schedule of Contracts Placed on Hold	13
Exhibit 2.5: Schedule of Continuing Appropriations By Year of Appropriation and Funding Source.....	15

Chapter 1

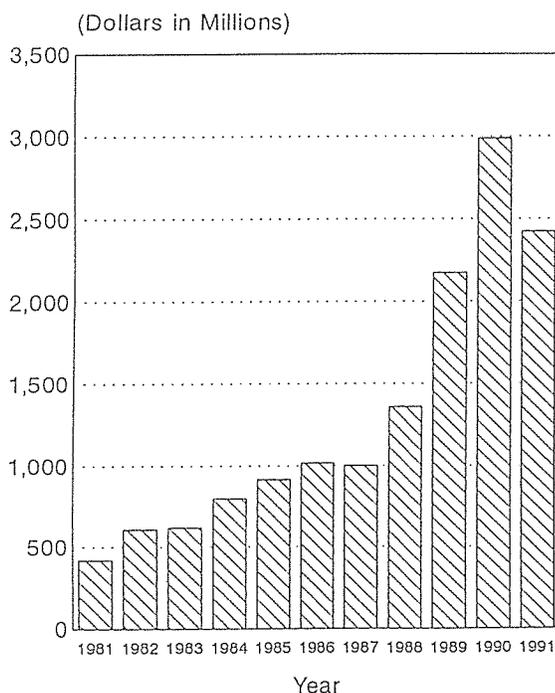
Introduction

This is a report on our examination of selected aspects of capital projects funds of the State of Hawaii that was conducted by the Office of the Auditor and the certified public accounting firm of KPMG Peat Marwick. The examination was performed 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 and its political subdivisions.

Background

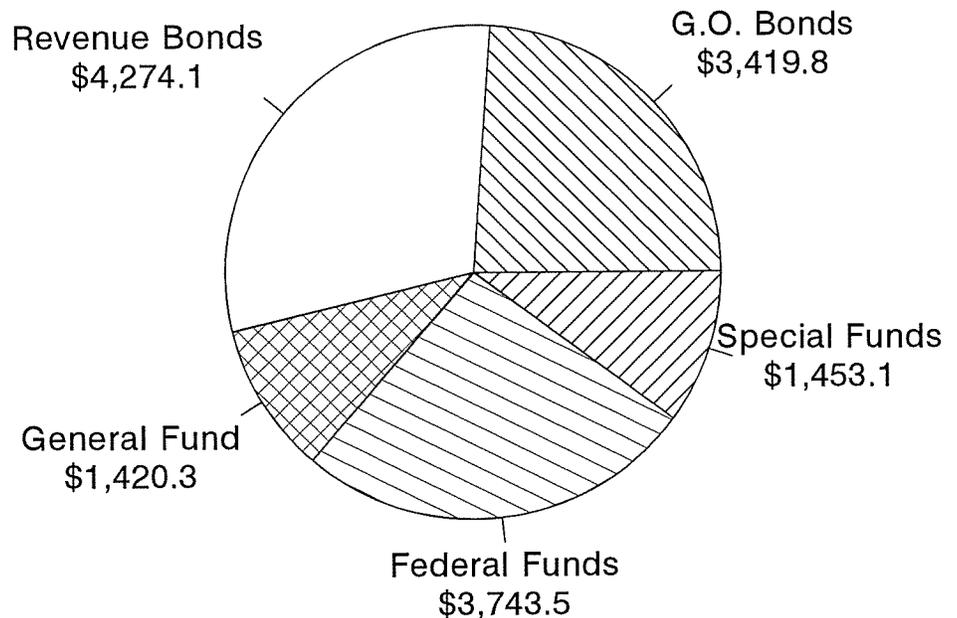
Capital improvement projects (CIPs) of the State constitute one of its more significant and costly programs. These projects range from construction of schools, hospitals, and highways to asbestos removal and reroofing. In 1981, the Legislature appropriated about \$419 million for the CIP program. Ten years later, CIP appropriations had increased almost sixfold to more than \$2.4 billion. Over a three-year period (1989, 1990, 1991) the Legislature appropriated a total of \$7.58 billion for CIPs. Exhibit 1.1 shows the annual growth in the State's CIP appropriations between 1981 and 1991.

Exhibit 1.1
Annual Capital Improvement Appropriations
FY1981-82 - FY1991-92



CIPs are funded through sales of general obligation bonds and revenue bonds, as well as moneys from special funds, the general fund, and federal funds. Exhibit 1.2 presents the initial funding sources approved by the Legislature for projects authorized between 1981 and 1991. Long-term debt in the form of bonds is the major source of funds—54 percent—followed by federal funds. Cash financing through the general fund and special funds supply about 10 percent each. These funds are deposited in a capital projects fund that accounts for all of the financial resources to be used for the State’s capital improvements program.

Exhibit 1.2
Sources of Funding in Capital Improvement Appropriations
1981-1991



(Dollars in Millions)

Source: Department of Budget and Finance, State of Hawaii

Objectives of the Examination

1. Determine whether adequate accounting and financial controls are exercised over the capital projects fund.
2. Determine whether encumbrances of the capital projects fund are appropriate as legal commitments and are properly documented.
3. Ascertain the extent to which applicable recommendations contained in Chapters 3, 4, and 5 of the State Auditor's Report No. 82-3, *Examination of Selected Aspects of the State General Obligation Bond Fund*, have been implemented.
4. Make appropriate recommendations for improved management and operational controls over the capital projects fund.

Scope and Methodology

We examined the system of accounting and the internal and operational controls of the capital projects fund as maintained by the Department of Accounting and General Services. To the extent applicable, we also examined the activities of the Department of Budget and Finance and the expending agencies. In addition, we reviewed the encumbrance practices and continuing appropriations of the capital projects fund. Specifically, we:

- Identified projects and the related appropriations and encumbrances at the end of June 30, 1990, 1991, and 1992 that showed little or no expenditures for an inordinate length of time and determined whether there was a reasonable expectation that the projects will be undertaken.
- Identified the appropriations continued in effect beyond the ordinary lapse date because they were necessary to qualify for federal aid financing and reimbursement (hereinafter referred to as continuing appropriations) and reviewed them for compliance with applicable provisions and intent of the State Constitution.
- Reviewed the extent to which the recommendations made in Chapters 3, 4, and 5 of the State Auditor's Report No. 82-3 have been implemented.

Our work was performed from July 1991 through September 1993 in accordance with generally accepted government auditing standards.

Chapter 2

Oversight and Control of the Capital Projects Fund

The capital projects fund is used to account for the financial resources to be used in acquiring or constructing major capital facilities. Our review finds that the Legislature could strengthen its control of the State's capital improvement projects (CIPs) and make better use of the financial resources in the fund if certain practices were changed.

Summary of Findings

1. The executive budget request for CIPs and the Legislature's appropriations do not result in a realistic spending program. This weakens the Legislature's control over the CIP program.
2. The executive branch has circumvented constitutional lapsing provisions through questionable encumbrance practices.
3. Continuing appropriations for projects receiving federal aid are unnecessary.
4. Executive agencies are still not transferring surplus appropriations to the project adjustment fund as required by the general appropriations acts.

Executive Budget Request and Appropriations Are Not Based on a Realistic CIP Program

The executive branch has a long-standing practice of including in its CIP budget request the full estimated cost for the CIPs it requests, including all costs for planning, design, and construction. In turn, the Legislature appropriates the full estimated cost of all projects it authorizes. However, the number and duration of authorized CIPs exceed what can realistically be built within the three year time limit on appropriations set under the State Constitution. The State Constitution requires appropriations that are unencumbered to lapse in three years.

The result is an unrealistic CIP spending plan and program. In 1990 and 1991, the Legislature approved \$5.41 billion for CIPs. We found that the executive branch is able to spend less than half of the appropriations it receives, but it protects these funds from lapsing through questionable encumbrance practices.

There is an increasing pool of authorized CIP projects from which the executive branch can choose. In addition, the practice of fully funding all estimated costs for CIPs limits the Legislature to a one-time review of

projects at the time of the initial budget request. The Legislature foregoes any subsequent evaluation and redetermination of CIP priorities, regardless of changes in the State's fiscal condition or changes in legislative priorities.

Appropriations not spent

We found that historically, about 5 percent of CIP appropriations are expended in the first year, 13 percent in the second year, and about 20 percent in the third year. This means that less than 40 percent of CIP appropriations are expended by the statutory lapse date. The remaining 60 percent are carried forward through various encumbrance practices. Of appropriations made during 1989-1991 totalling almost \$6 billion, only about \$2.4 billion is expected to be expended during the first three years following the appropriation. The remaining \$3.6 billion is carried forward via encumbrances.

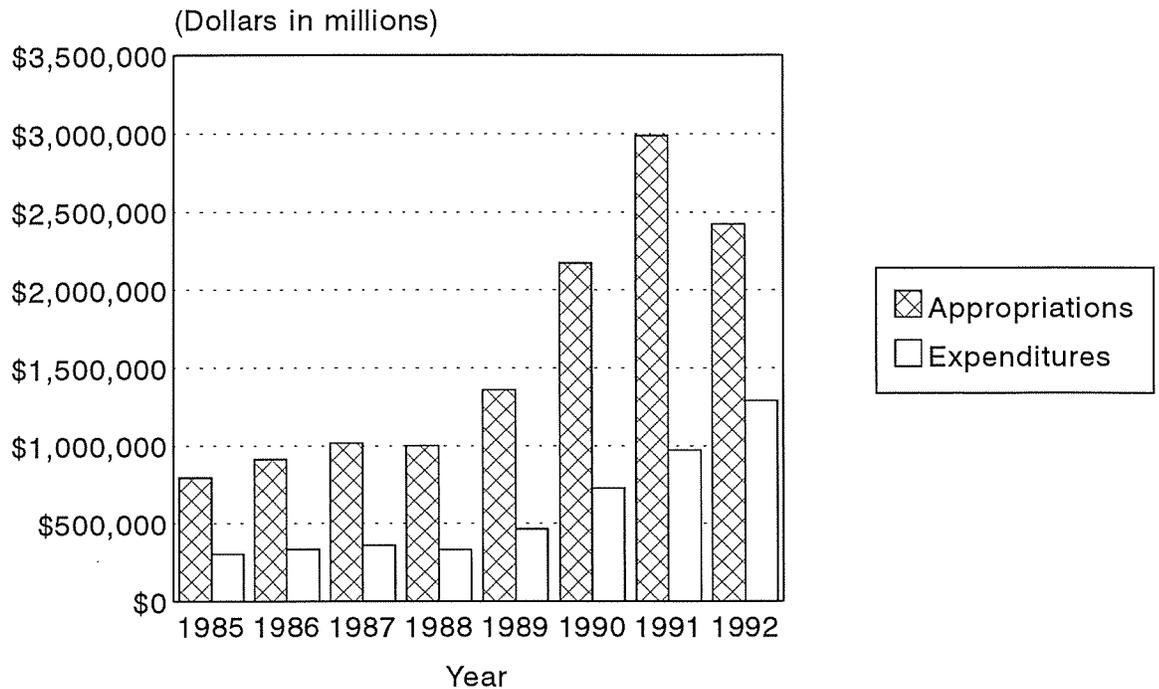
Projects generally have three cost categories: (1) planning, (2) design, and (3) construction. During the first three years, the executive branch usually begins planning and design of projects it selects and then encumbers or ties up the balance of the appropriations. The executive branch frequently requests, and the Legislature approves, funding for all cost categories in the initial appropriation for projects. This practice, called "front loading," diminishes legislative authority.

For fiscal years ending June 30, 1985 through 1992, annual CIP appropriations have far exceeded the CIP expenditures actually made (see exhibit 2.1). During this period CIP appropriations totalled \$12.67 billion, CIP expenditures totalled \$4.79 billion, and CIP appropriation lapses amounted to \$0.89 billion. The net result is that, at the end of this eight-year period, unspent appropriations amounted to \$6.99 billion. Yet the executive branch continues to request, and the Legislature continues to approve, new CIP appropriations.

Section 37-69(d)(K), Hawaii Revised Statutes, establishes the framework for submission of the executive capital improvement projects budget. It requires fairly detailed information on estimated costs for each project, including costs actually incurred in the current fiscal year and estimated costs for the remainder of the current fiscal year and the following six years.

The Legislature could achieve a more realistic CIP program by authorizing funds for planning and design first and then requiring the executive branch to return to the Legislature for appropriations for construction costs. The Legislature should tie appropriations to expected expenditures for the three-year period. Construction costs occurring far into the future should be approved only when needed.

Exhibit 2.1
Capital Improvement Appropriations and Expenditures
Fiscal years ended June 30, 1985 to 1992



Fiscal Year	Appropriations(1)	Expenditures(2)
1985	\$ 795,763	\$ 305,117
1986	913,773	335,296
1987	1,016,898	360,238
1988	1,000,864	332,131
1989	1,359,240	465,802
1990	2,172,704	726,810
1991	2,985,987	973,283
1992	2,422,272	1,290,367
Total	\$12,667,501	\$ 4,789,044

Source: (1) Department of Budget and Finance, State of Hawaii (dollars in thousands).
 (2) State of Hawaii Financial Accounting and Management Information System, "Status of Appropriation Account Balances," Report MBP 430 (dollars in thousands).

The Legislature would then have the opportunity to reconsider specific projects in light of changing economic conditions and priorities.

Agencies Circumvent Constitutional Lapsing Provisions

Article VII, Section 11, of the State Constitution states that appropriations shall not exceed three years. Any appropriations or any portion of an appropriation that is unencumbered at the close of the three-year period shall lapse. Lapsing could be an important legislative tool that would require executive branch agencies to submit incomplete projects to the Legislature for reconsideration. The Legislature could then decide whether projects are still necessary.

We found that the executive branch has circumvented these lapsing provisions through contradictory encumbrance policies, the use of interagency contracts, and a failure to strictly monitor encumbrances. Exhibit 2.2 presents outstanding encumbrances as of June 30, 1992. It shows that \$905,000 from appropriations made in 1981 still has not lapsed because the funds have been encumbered. Over \$23 million has not lapsed from appropriations made in 1984, almost ten years ago. The total amount of funds encumbered and not lapsed exceeds \$1.5 billion.

Unclear encumbrance definition and policies

Appropriations must lapse unless they are encumbered. But the term “encumbrance” has no clear definition in statute or in practice. This has allowed agencies to protect their CIP funds by encumbering them at will. Section 40-66, HRS, on Audits and Accounting, refers indirectly to encumbrances as contracts of engagement. It states:

Unless otherwise provided by law all sums of money which are appropriated to the public service for any fiscal period, and which are not expended during the period, shall lapse...unless a contract of engagement has been made and entered into...and a certified copy of which contract or engagement has been deposited with the comptroller.

In its annual financial report for the State, the Department of Accounting and General Services (DAGS) defines encumbrances similarly as “recorded obligations in the form of purchase orders or contracts” and further states that “The State records encumbrances at the time purchase orders or contracts are awarded and executed.”¹ DAGS *Accounting Manual* defines purchase order encumbrances as obligations incurred through issuance of a purchase order authorizing the delivery of goods or the rendering of services for a stated payment.²

However, DAGS’ *Accounting Manual* also states that for incomplete capital improvement projects, “encumbrances of estimated project costs

Exhibit 2.2

**CIP Appropriations and Encumbrances Outstanding by Acts
As of June 30, 1992
(Dollars in thousands)**

Acts	Original Appropriation Amounts	Encumbrances Outstanding June 30, 1992
SLH 1981, Acts 1 and 2	\$ 418,694	\$ 905
SLH 1982, Acts 263, 264, and 267	606,371	676
SLH 1983, Acts 283, 291, and 301	618,266	1,557
SLH 1984, Acts 285, 286, and 287	795,763	23,255
SLH 1985, Acts 169 and 300	913,773	10,362
SLH 1986, Acts 345, 347 and 348	1,016,898	47,090
SLH 1987, Acts 216, 217, and 375	1,000,864	38,982
SLH 1988, Acts 2, 318, and 390	1,359,240	79,701
SLH 1989, Acts 314, 315, and 316	2,172,704	453,272
SLH 1990, Acts 299, 300, and 301	2,985,987	512,135
SLH 1991, Acts 296, 299, and 317	2,422,272	319,780
Outstanding encubrances for CIPs prior to 1981		10,183
Outstanding encumbrances for other CIP projects not specifically identified	<u> </u>	<u>23,722</u>
Totals	<u>\$ 14,301,832</u>	<u>\$ 1,521,620</u>

may be recorded without executing a written agreement or issuing a purchase order.”²³ Expending agencies have used this definition to encumber unused CIP appropriations through memoranda and other informal and non-binding communications. This practice also contradicts DAGS’ statement in its annual report that the State records encumbrances at the time purchase orders or contracts are awarded and executed.

Expending agencies have argued that incomplete project encumbrances are necessary to reserve funds for legitimate anticipated costs. Further, we were informed that the amount of time required for the planning and design phase of projects, especially for larger projects, coupled by unexpected delays (i.e., delays in obtaining necessary environmental impact statements and permits, etc.) make it impossible for certain projects to be completed within the constitutionally mandated lapsing period.

Another argument commonly heard from expending agencies is that it is cumbersome and time-consuming to resubmit an appropriation for legislative reconsideration. While agencies may feel that legislative review and approval of appropriations is cumbersome and time-consuming, the review and approval nonetheless is required by the Constitution.

Agencies also argue that they need to encumber funds for administrative costs to complete projects. These incomplete project encumbrances are used to reserve funds for in-house planning, design, project management, and inspection necessary to complete projects. For larger, more complex CIP projects, a good portion of these costs will be incurred several years after the original lapse date. The costs are also quite difficult to estimate due to uncertainties involved in any large project. In these instances, it is reasonable that the funds will not be expended before the mandated lapsing period.

The problem of incomplete project encumbrances could be resolved by absorbing such costs through operating funds rather than bond proceeds. These are primarily for in-house personnel costs that would be more appropriately budgeted for as part of the agencies’ operating budget.

We had criticized this practice of incomplete project encumbrances in our Report No. 82-3, *Examination of Selected Aspects of the State General Obligation Bond Fund*, February, 1982. We recommended the *State Accounting Manual* be revised to disallow encumbrances except to fund existing legal commitments. At that time, the comptroller responded that he felt flexibility was necessary in interpreting “encumbrances.” Since no substantive change has been made to the executive branch’s questionable encumbrance practices, the Legislature

should consider a statutory definition for an encumbrance. An encumbrance should be defined as funds obligated only under a purchase order or contract — that is, a legally binding commitment. In-house contract costs should be financed through operating appropriations.

Inappropriate interagency contracts

To keep their CIP appropriations from lapsing, executive agencies enter into contracts with each other. This practice is not illegal, but it violates the constitutional intent of requiring unused appropriations to be lapsed. We cite several examples of this.

- The Department of Business, Economic Development, and Tourism (DBEDT) received an appropriation in 1987 to build a filming facility. The appropriation would have lapsed in June 1990. To prevent this from happening, in April 1990 DBEDT contracted with DAGS to select the construction contractor(s) and to oversee the construction of a filming facility — DBEDT’s own responsibilities as the expending agency.
- Act 391, SLH 1988, appropriated \$3 million to the University of Hawaii for a master plan and construction of improvements to the Waikiki Aquarium. The appropriation was for one year and was to have lapsed June 30, 1989. The university could not complete the project by that date, and contracted with DAGS for DAGS to subcontract for the design and construction of the Waikiki Aquarium improvements. The funds were thus protected from lapsing although no expenditures were made for the next two years and only \$160,000 was expended in 1992.
- DBEDT contracted with the university to construct a Hyperbaric Treatment Center for \$1,750,000, the amount of the appropriation. With the appropriation due to lapse on June 30, 1989, the university, with DBEDT’s approval, subcontracted with the Research Corporation of the University of Hawaii. As of June 1992, no expenditures were incurred.

The Department of the Attorney General (AG) believes interagency contracts to be legal. In reviewing one such contract, the 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 legality of encumbering 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 they are not a sound practice for capital improvements projects. The Legislature should clarify the responsibilities of expending agencies for their CIP

requests. It should prohibit agencies from contracting with other state agencies when they cannot fulfill their responsibilities. Unused appropriations should lapse. Agencies should resubmit requests for previously authorized CIPs for legislative review and reconsideration.

Encumbrances not strictly monitored

We find that the comptroller has not adequately complied with Section 40-66, HRS, which makes the comptroller responsible for monitoring outstanding encumbrances for continued validity or for lapsing as appropriate. Various agencies are responsible for their CIP projects and maintain project records for literally thousands of CIP projects. Supporting documentation for encumbrances is kept in project files. DAGS personnel do not periodically review supporting documentation for outstanding encumbrances. Instead, we find that DAGS relies primarily on the expending agencies to monitor and evaluate their own encumbrances.

DAGS sends out memoranda to expending agencies requesting them to identify and explain which outstanding encumbrances should be continued. DAGS does little follow-up on the departments' explanations and support for their encumbrances.

A random sample of CIP encumbrances at the close of June 30, 1990, 1991, and 1992 disclosed numerous discrepancies as to the validity of recorded encumbrances. We found encumbrances for projects that (1) have never been implemented, (2) have already been completed, (3) have been on the books for numerous years while the State was settling disputes or deciding whether to complete the project, and (4) have continued for more than five years after the projects were authorized. We also noted deficiencies in monitoring the works of art program.

Exhibit 2.3 gives some examples of outstanding encumbrances that show the need for more active monitoring by DAGS.

The two Department of Transportation projects were completed long ago with no payments made since 1985. The third project by DAGS shows an encumbered balance of \$866,975 for a contract that was completed in 1988 but was not closed because DAGS had not received the statutorily required tax clearance. The fourth project has an encumbrance that has been outstanding for more than 15 years.

Exhibit 2.4 presents several projects that have been placed on hold for many years for various reasons including: (1) no decision to proceed with the project, (2) legal disputes, and (3) delays in planning, design, and construction. Two have been assigned lapse dates of February 31, 1999 by DAGS to identify them as appropriations that will not be subject to normal lapsing procedures.

Exhibit 2.3
Schedule of Capital Improvement Encumbrances
Requiring Re-evaluation

Expending Agency	Project Description	Appropriation Year	Lapse Date	Encumbrance Balance June 30, 1992
1. Department of Transportation	RH1 - East of Halawa Interchange/Middle Street	1969	02-31-99 *	\$ 303,193
2. Department of Transportation	Airport Planning Statewide Plans	1983	06-30-86	140,488
3. Department of Accounting and General Services	Hawaii Ocean Awareness Center - Design	1985	06-30-88	866,975
4. Department of Accounting and General Services	Bilger Hall Alterations and Additions	1966	12-31-72	5,157

Source: State of Hawaii Financial Accounting & Management Information System, "Status of Appropriation Account Balances," Report MBP 430-B.

* 02-31-99 per Report MBP 430-B

Exhibit 2.4
Schedule of Contracts Placed on Hold

Expending Agency	Project Description	Appropriation Year	Lapse Date	Encumbrance Balance June 30, 1992
1. Department of Transportation	Piilani Highway, Kihei to Ulupalakua	1981	2-31-99 *	\$ 166,121
2. Department of Land and Natural Resources	Pump and Controls for Waialae Nui Well	1982	6-30-84	420,000
3. Department of Land and Natural Resources	Drilling of the Kapakahi Well	1981	6-30-84	334,000
4. Department of Transportation	Boat Harbor/Ka'ulana Launch Ramp	1982	2-31-99 *	249,456
5. Department of Accounting and General Services	Wailuku Court Building Renovation	1985	6-30-88	770,352

Source: State of Hawaii Financial Accounting & Management Information System, "Status of Appropriation Account Balances," Report MBP 430-B.

* 02-31-99 per Report MBP 430-B

The age of the appropriations—1981, 1982, and 1985—indicates the need for more effective monitoring. DAGS should evaluate these types of encumbrances and document whether they continue to be justified. Without this justification, the money should lapse.

**Works of art projects
a special problem**

One percent of all CIP appropriations is set aside for works of art to be commissioned for state capital improvement projects. We found serious deficiencies in the monitoring of funds for the works of art projects. Encumbrances for these remain outstanding for extended periods of time because DAGS and the State Foundation on Culture and the Arts do not require artists to abide by contractual time commitments. In addition, we found that moneys were encumbered via memoranda and carried forward for as long as ten years before contracts were awarded. We found no adequate explanation or justification for encumbrances on appropriations dating back to 1980.

Monitoring of CIP funds for the works of art program has been further circumvented by statute. Act 389, SLH 1989, established the Works of Art Special Fund into which CIP appropriations for works of art are transferred. Since balances of special funds do not automatically lapse, transfers to this special fund are not subject to normal CIP lapsing procedures. Further, balances accumulating in this fund are generally from proceeds of bonds issued. This is an extremely expensive way to accumulate funds. We reviewed this fund in our Report No. 91-10, *Review of Special and Revolving Funds of the Departments of Accounting and General Services, Agriculture, and Budget and Finance*, and recommended it be repealed. We recommend again that the special fund be repealed. Works of art for CIP projects should be subject to the same laws that govern the expenditure of CIP funds.

**Continuing
Appropriations are
Unnecessary**

The Legislature allows expending agencies to exempt certain CIP appropriations from the three-year lapsing requirement if the agencies determine that the appropriations are necessary to qualify for federal aid financing and reimbursement. These appropriations are called continuing appropriations because of their nonlapsing status. At June 30, 1992, the state's portion of unallotted and unencumbered continuing appropriations amounted to \$2.8 billion. These appropriations go back more than 10 years. Exhibit 2.5 presents a breakdown by year and source of state funding.

Each appropriations act has a section stating: "the Legislature hereby determines (that continuing appropriations) are necessary to qualify for federal aid financing and reimbursement." Agencies then identify appropriations for projects that qualify for federal financing and DAGS designates them as continuing appropriations.

Exhibit 2.5
Schedule of Continuing Appropriations
By Year of Appropriation and Funding Source

As of June 30, 1992
(Dollars in thousands)

<u>Year of Appropriation</u>	<u>Bond funds</u>	<u>Special Funds</u>	<u>Total State Funds</u>
1981 and prior	\$ 451,437	\$ 187,410	\$ 638,847
1982	17,026	3,844	20,870
1983	78,550	1,075	79,625
1984	24,769	74,267	99,036
1985	52,230	39,169	91,399
1986	25,975	23,166	49,141
1987	441,318	57,566	498,884
1988	105,680	98,261	203,941
1989	38,361	148,408	186,769
1990	117,299	88,115	205,414
1991	391,724	300,701	692,425
	\$ 1,744,369	\$ 1,021,982	\$ 2,766,351
	\$ 1,744,369	\$ 1,021,982	\$ 2,766,351

Source: State of Hawaii "Schedule of Nonlapsing CIP Accounts"

Expending agencies say these appropriations should be afforded nonlapsing status because they will not undertake these projects unless the federal government provides financing. Some projects may never receive federal funding or funding may be held up for years. Agencies want continuing appropriations so that they already have state funding for a project once the federal funds are authorized.

We find little reason to generally authorize nonlapsing, continuing appropriations. The federal government does not require this for federal funding. The practice only serves to undermine legislative oversight.

The State Constitution allows the Legislature to designate appropriations as nonlapsing for specific projects. This provision resulted from the Constitutional Convention of 1978. The Committee of the Whole reported:

The intent of this amendment is to require the Legislature to positively determine that a particular federal aid project or program is deserving of not being lapsed. Your Committee wishes to emphasize that such a determination should not be made before the regular session of the Legislature preceding the date of lapsing.⁴

The intent was for the Legislature to determine which projects should continue to be authorized in the legislative session just preceding the scheduled lapse date. Allowing agencies to determine which appropriations should lapse defeats the legislative intent of the law. The Legislature should cease the practice of pre-determining that appropriations necessary for federal funding should be non-lapsing.

Agencies Are Keeping Excess CIP Funds

Appropriations are based on estimated project costs. Some projects cost less than expected, some cost more. Projects that cost less than expected result in a surplus of appropriations over the project cost. Agencies are keeping surplus appropriations instead of transferring them to the project adjustment fund as required by law. Every appropriations act provides for the establishment of a project adjustment fund. Appropriations in excess of individual project needs are to be transferred to this fund to create a pool of funds for projects that cost more than was appropriated.

For example, Section 218 of the General Appropriations Act of 1991 (Act 296, SLH 1991) states that,

“After the objectives of appropriations made in the Act...for capital investment purposes have been met, unrequired balances *shall be transferred to the project adjustment fund* appropriated in Part II and described in Part IV of this Act and shall be considered a supplementary appropriation thereto...”

We found that agencies still do not make transfers to the project adjustment fund until they have another project that needs supplemental funding. We reported this in 1982 in our *Examination of Selected Aspects of the State General Obligation Bond Fund*. The project adjustment fund does not, therefore, provide a pool of funds, but instead acts as an account through which agencies transfer appropriations among projects. Since these transfers do not occur until funds are needed for the receiving projects, the availability of the excess funds is known only to the agency.

The reluctance of agencies to make transfers is understandable. It is not in their interests to release surplus appropriations to a fund over which they have no control. By keeping unrequired balances, the expending agencies have access to their own "pool" of surplus appropriations that they can draw upon for their other projects.

As the central budget control agency, the Department of Budget and Finance should make sure that departments transfer surplus appropriations to the project adjustment fund. And the Legislature should be kept apprised of the status of the project adjustment fund as was done at one time. The 1979 general appropriations act required an annual report on the activity of the project adjustment fund. Such an annual report would enable the Legislature to monitor the use of the project adjustment fund. The Legislature should again require DAGS to submit such an annual report.

Recommendations

1. To strengthen the State's capital improvements program, the Legislature should consider:
 - a. Requiring the executive branch to submit a realistic budget for a three-year CIP program showing the schedule of spending by the cost categories of planning, design, and construction;
 - b. Appropriating funds for capital improvements projects in increments based on a three-year spending schedule and cost categories;
 - c. Requiring that in-house personnel costs of CIP be included in the executive operating budget request instead of the CIP budget requests;
 - d. Providing a statutory definition of an encumbrance that restricts encumbrances to obligations in the form of purchase orders and executed contracts;

- e. Designating the responsibilities of expending agencies for CIPs so that they may no longer engage in interagency contracting to circumvent constitutional lapsing requirements;
 - f. Repealing the Works of Art Special Fund and requiring works of art to be treated as a part of each CIP project;
 - g. Ceasing the practice of generally allowing appropriations needed for federal funding to be non-lapsing. Instead, the Legislature should follow the intent of the constitution and positively determine that particular federal aid projects are deserving of not being lapsed in the legislative session just preceding the lapse date; and
 - h. Requiring the Department of Accounting and General Services to submit an annual report on activity in the project adjustment fund.
2. The Department of Accounting and General Services should monitor more strictly the encumbrance practices of expending agencies to make sure the encumbrances continue to be justified.
 3. The Department of Budget and Finance should ensure that surplus appropriations are transferred to the project adjustment fund.

Notes

Chapter 2

1. Hawaii, the Comptroller, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 1992*, p. 48
2. *State of Hawaii Accounting Manual*, Section 470, paragraph 5(a).
3. *State of Hawaii Accounting Manual*, Section 470, paragraph 8(a).
4. State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii of 1978*, Volume I, p. 1022

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Department of Accounting and General Services (DAGS) and the Department of Budget and Finance (B&F) on November 18, 1993. A copy of the transmittal letter to DAGS is included as Attachment 1. A similar letter was sent to B&F. The response from DAGS is included as Attachment 2; the response from B&F is included as attachment 3.

The Department of Accounting and General Services agrees with our recommendations that in-house personnel costs of CIP should be included in the operating budget instead of the CIP budget and that a statutory definition of an encumbrance is necessary. It does not object to our recommendation that the Legislature cease allowing appropriations needed for federal projects to be non-lapsing.

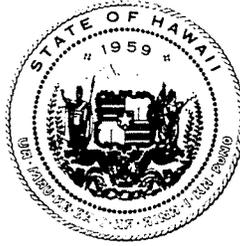
DAGS has strong reservations about our recommendation for the executive branch to submit a realistic CIP budget based on a three-year spending cycle. It says that it is not cost effective to separate requests for design and construction funds. We believe that the practice of appropriating funds far in advance of the time when they are expected to be spent has created an unrealistic CIP program that gives the executive branch too much flexibility.

DAGS also has reservations about our recommendation to monitor the encumbrance practices of agencies because the term “encumbrance” has no formal definition and DAGS has no statutory authority to require agencies to justify their encumbrances. In addition, the department opposes the abolishment of interagency contracts—if they meet constitutional mandates and legal parameters outlined in an Attorney General opinion of 1988. It did not address the problem of interagency contracts being entered into solely to avoid lapsing of appropriations. It also has reservations about our recommendation that it prepare an annual report on the activity of the project adjustment fund—it believes that it is more appropriate for B&F to prepare such a report.

DAGS reports that it is working with the Department of Taxation to resolve problems encountered in closing out encumbrances because of the need for tax clearances. The department also believes the Works of Art Special Fund is needed to allow the State Foundation on Culture and the Arts to obtain meaningful art works. We stand by our recommendation that this fund be repealed and works of art included in CIP appropriations be subject to the same lapsing provisions as other CIP appropriations.

The Department of Budget and Finance concurs with our recommendation that it should ensure that surplus appropriations are transferred to the project adjustment fund.

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



ATTACHMENT 1

MARION M. HIGA
State Auditor

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

November 18, 1993

C O P Y

The Honorable Robert P. Takushi, Comptroller
Department of Accounting and General Services
Kalanimoku Building
1151 Punchbowl Street
Honolulu, Hawaii 96813

Dear Mr. Takushi:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Examination of Selected Aspects of Capital Projects Funds*. We ask that you telephone us by Monday, November 22, 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 Thursday, December 2, 1993.

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



JOHN WAIHEE
GOVERNOR

ROBERT P. TAKUSHI
COMPTROLLER

LLOYD I. UNEBASAMI
DEPUTY COMPTROLLER

STATE OF HAWAII
DEPARTMENT OF ACCOUNTING AND GENERAL SERVICES
P. O. BOX 119, HONOLULU, HAWAII 96810

LETTER NO. S-1734.3

DEC 2 1993

Honorable Marion M. Higa
State Auditor
Office of the Auditor
State of Hawaii
Honolulu, Hawaii

RECEIVED
DEC 2 3 35 PM '93
OFFICE OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

Subject: Draft Report - Examination of Selected Aspects of
Capital Projects Funds

Thank you for the opportunity to review your draft report. Since DAGS is only one of several expending agencies, we feel that the report's recommendations should be reconciled with the other agencies, statewide. For example, the Department of Transportation (DOT) is responsible for their own CIP process with a large proportion of Federal-Aid projects. Accordingly, we are providing comments on concerns that affect our operations and not necessarily those of other departments, as follows:

1. Chapter 1 - Background.

Delete "maintenance" from the second sentence. Since the report is specifically about the capital improvement project (CIP) program of the State, it should be noted that schools and hospitals are maintained via the R&M/R&A programs of DAGS and other departments.

2. Chapter 2.

a. Executive budget request and appropriations are not based on a realistic CIP program.

Delete "unexpended" from the last sentence of the first paragraph. The State Constitution (Article VII - Section 11) cites requirements to lapse unencumbered appropriations. The provisions do not extend to unexpended funds.

b. Appropriations not spent.

The current practice to fund all cost categories in the initial appropriation assures construction and minimizes obsolescence of the projects. This is consistent with the general practice of the Department of Budget and Finance (B&F) to release design funds only if construction funds are appropriated or are a high priority in the next budget request.

One of the consequences of "incomplete" funding is the failure to obtain construction funds in a timely manner after the completion of the design. If construction funds are not obtained expeditiously, the design could become obsolete because of new laws, county requirements, codes, etc. Thus, additional appropriations and time for redesign would be needed, further delaying completion of the project. For Department of Education (DOE) classroom projects, such delays would be an undue hardship for the schools.

c. Inappropriate interagency contracts.

Your concern that the executive branch circumvented lapsing provisions through the use of interagency contracts was addressed in DAGS's April 28, 1992 response to your draft report Financial Audit of the Department of Business, Economic Development, and Tourism. Specifically, that an interagency contract is a legal basis for encumbering funds. Secondly, that the contract may be used as a viable means of encumbering funds provided that an assessment was made to determine if the contract met the constitutional mandate and the parameters set by a 1988 AG opinion.

d. Encumbrances not strictly monitored.

We do not see Section 40-66, HRS, as a mandate for DAGS to monitor outstanding encumbrances for continued validity or for lapsing as appropriate. Section 40-66, HRS, is an edict to lapse funds unexpended during the fiscal period of the

appropriation, unless a contract of engagement has been made and entered before the expiration of the fiscal period. This is not a directive for DAGS to monitor the validity of encumbrances.

Section 40-67, HRS, alludes to the authority of the comptroller to close accounts after the purposes of the appropriation have been accomplished. However, the comptroller can act only after the expending agency notifies him that everything has been accomplished. Therefore, we do not agree that the comptroller is responsible for monitoring outstanding encumbrances for continued validity.

Regarding the DAGS projects that have not been closed because of various problems, we agree that the statutory requirement for a tax clearance certificate is a problem. Accordingly, we are working with the Tax Department on a resolution and will continue the collaboration until the problem is resolved.

e. Works of art projects a special problem.

The Legislature established the Works of Art Special Fund as a repository for the assessments from the various appropriations. This accumulation of funds allows the State Foundation on Culture and the Arts (SFCA) to obtain quality and meaningful art works that otherwise could not have been obtainable due to high acquisition costs including initial acquisition, consultant or staff services, site modifications, display work, upkeep services, storage, and transportation.

If the special fund is abolished, the SFCA would not have a means to obtain the above services. Thus, the Works of Art program would be reduced to the acquisition of individual works per project. The 1% assessment on minor projects would result in minor acquisitions. One of the consequences of this scenario would be the lack of planned acquisitions and the accumulation of hodgepodge art.

Additionally, since the assessments are released for expenditure after bids are opened and awarded, the SFCA would not be able to utilize funds from

projects opening bids late in the fiscal year. Those funds would probably lapse because there would not be enough time for encumbrance.

3. Recommendations.

- a. DAGS has strong reservations about the two sub-recommendations regarding a realistic budget and appropriations for a three-year CIP program.

Our previous comments on Chapter 2 - Appropriations not spent address concerns on obsolescence and delays of projects. Additionally, we feel that it is not cost-effective to separate requests for design and construction funds. It is noted that expenditures for the cost categories of planning, design and construction of many projects exceed three years in time.

- b. DAGS agrees that in-house personnel costs of CIP should be included in the executive operating budget request instead of the CIP budget requests. However, the expending agencies that deal with CIPs need flexibility to cope with the demands of a fluctuating workload. We foresee the need for CIP funds for staff overtime costs and for 12 % to 15% of the personnel to be CIP-funded to provide the capability to expand and contract the work force.

The in-house personnel costs of CIP for DAGS in fiscal year 93 was \$5.7 million, which includes all required fringe benefits.

- c. DAGS agrees that a statutory definition of an encumbrance is necessary. However, we feel that it should also include a mechanism for saving construction and administration funds on projects that open bids up to and including June 30 of the lapse year. Additionally, the definition must provide for the encumbrance of funds for staff services to administer construction contracts in progress after the funding lapse date.

The need for such encumbrances would be alleviated upon the conversion of in-house personnel costs to the executive operating budget. However, since CIP-funded personnel would still be required to maintain the flexibility of expending agencies, such encumbrances would still be necessary.

- d. DAGS opposes the abolishment of interagency contracts. As stated previously, the process is legal and as long as the agencies determine that the contract will meet constitutional mandates and the parameters of the 1988 AG opinion, the Legislature's objective should be intact.
- e. DAGS opposes the repeal of the Works of Art Special Fund. The Legislature's intent to provide for quality works of art is sound and effective.
- f. DAGS does not have any objections to ceasing the practice of generally allowing appropriations needed for federal funding to be non-lapsing. However, we recommend that the Legislature confer with other expending agencies, such as the DOT, to ascertain the ramifications of implementing the recommendation.
- g. DAGS has reservations about the requirement for an annual report to be prepared by DAGS on activity in the project adjustment fund. Since DAGS would only be able to produce a financial report on amounts transferred in and out of the project adjustment fund, it would not be meaningful to the Legislature without details on the projects.

We recommend that B&F prepare a report that would be more appropriate for the Legislature's needs. Since transfers into and from the project adjustment fund require the review and approval of B&F and the Governor, the details and documentation on the specific projects are maintained by B&F.

- h. DAGS has reservations about the effectiveness of requiring DAGS to monitor the encumbrance practices of expending agencies to make sure the encumbrances continue to be justified. The task seems to be formidable because there is no formal definition of "encumbrance" nor the statutory authority to request expending agencies to report on the justification of encumbrances.

DAGS monitors the CIP encumbrances annually. It is important to note that it is the expending agency that decides the status and current need for the encumbrance. In accordance with §40-67, HRS, the comptroller may close out an account "...upon

Honorable Marion M. Higa
Letter No. S-1734.3
Page Six

receipt of a certificate from the head of the department or other public officer who is charged with the duty of expending the appropriation...". Therefore, DAGS is empowered to close accounts only after authorization by the expending agency.

If there are any questions on this matter, please have your staff call Mr. Gordon Matsuoka of the Public Works Division at 586-0526.

Very truly yours,



ROBERT P. TAKUSHI
State Comptroller

cc: Admin. Services

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

December 2, 1993

RECEIVED

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

DEC 2 3 56 PM '93

OFF. OF THE AUDITOR
STATE OF HAWAII

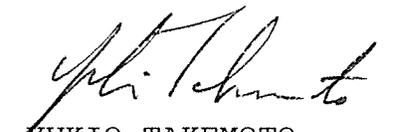
Dear Ms. Higa:

We have reviewed your draft report regarding the "Examination of Selected Aspects of Capital Projects Funds," which is a follow up to the State Auditor's Report No. 82-3, "Examination of Selected Aspects of the State General Obligation Bond Fund."

Our response is limited to your recommendation that the "Department of Budget and Finance should ensure that surplus appropriations are transferred to the project adjustment fund." In concurring with the recommendation, we note that an expenditure tracking system will need to be established to effectively identify unrequired balances. Further, administrative guidelines or legislative policy will need to define the point at which funding for a project is unrequired.

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

Sincerely,


YUKIO TAKEMOTO
Director of Finance