Financial Audit of the Public School System

A Report to the Governor and the Legislature of the State of Hawai‘i

Report No. 96-8
March 1996

THE AUDITOR
STATE OF HAWAI‘I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai‘i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. Financial audits attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. Sunset evaluations evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. Sunrise analyses are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. Health insurance analyses examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.

7. Procurement compliance audits and other procurement-related monitoring assist the Legislature in overseeing government procurement practices.

8. Fiscal accountability reports analyze expenditures by the state Department of Education in various areas.

9. Special studies respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawai‘i’s laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

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Report No. 96-8 March 1996

OVERVIEW

THE AUDITOR
STATE OF HAWAII

Financial Audit of the Public School System

Summary

The Office of the Auditor and the certified public accounting firm of Nishihama & Kishida, CPA's, Inc. conducted a financial audit of the public school system for the fiscal year July 1, 1994 to June 30, 1995. The public school system is managed by the Department of Education. The audit examined the department's financial records and the systems of accounting and internal controls and tested these for compliance with applicable laws and regulations.

In the opinion of Nishihama & Kishida, CPA's, Inc., the financial statements present fairly the public school system's financial position and results of operations for the fiscal year ended June 30, 1995. These statements are in conformity with generally accepted accounting principles. Nishihama & Kishida, CPA's, Inc. noted no material weaknesses in the internal control structure and its operation. It also noted that, with respect to items tested, there were no material instances of noncompliance with applicable laws and regulations.

We found continuing problems with the financial management system and that improvements are needed in certain internal control practices.

With respect to the financial management system, we found that while some changes have been made to the system, limitations in system availability and response time continue to cause user dissatisfaction. To improve accountability within the public school system, we found that a comprehensive budgeting and accounting system is needed at the school level. We also found that expenditure reporting on a school-by-school basis is needed. Further, we found that improvements could be made in the timeliness of financial reporting and in educating users about report contents and how they are to be used.

With respect to internal controls, we found a number of reportable conditions that should be addressed. Most of these were at the school level and involved the lack of segregation of duties, weak controls over cash receipt books, and failure to record deposits in a timely manner. We also found that bank reconciliations were not prepared in timely fashion by the Office of Business Services. In addition, we found the department's storeroom practices circumvent state law. We found that excessive inventory kept the department from lapsing moneys to the general fund, caused obsolescence loss, and requires larger-than-necessary warehouse space.

Other weaknesses in internal controls were also noted. Cash collections by teachers and counselors are not remitted to the school business offices in a timely manner. Controls over school cafeteria collections could be improved. The A+ Program's

collection and enrollment procedures are deficient causing a shortfall in anticipated receipts. Employees' vacation and sick leave balances were not maintained on a current basis and can result in overpayments to employees. The department also needs to update its fixed assets inventory records as required by law.

Recommendations and Response

We made a number of recommendations concerning the department's planning, budgeting, and financial accounting and reporting. The department generally concurred with our recommendations and seeks legislative support for its initiatives to make improvements. To assist the Legislature in its review of requests for funding improvements to the planning, budgeting, and financial accounting and reporting systems, we provided, as an appendix, *Guidelines for Legislative Review*.

The department generally concurred with our recommendations to make improvements in its internal controls. One exception concerned deposits. We recommended that schools deposit moneys directly into the state treasury to relieve the department of the responsibility of reconciling checking accounts. The department disagreed with this recommendation. It believes the number and volume of deposits and the proximity of banking facilities makes this unfeasible. It states that the bank now provides the department with deposit information on electronic media which has greatly helped the reconciliation process and bank accounts are now being reconciled monthly. We are pleased that the department has addressed the problem through alternative measures.

On the issue of excessive storeroom inventory, the department generally defends its current practices, but states it will re-evaluate inventory levels to determine if they can be reduced.

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Financial Audit of the Public School System

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

Conducted by

The Auditor
State of Hawaii
and
Nishihama & Kishida, CPA's, Inc.

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 96-8
March 1996

Foreword

Hawaii has the only state-administered, unified, public school system in the nation. The Department of Education is responsible for the overall administration of the system. This is a report of our financial audit of the public school system for the fiscal year July 1, 1994 to June 30, 1995. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Nishihama & Kishida, CPA's, Inc.

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

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Exhibits

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Chapter 1
Introduction

This is a report of our financial audit of the State of Hawaii's public school system. The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of Nishihama & Kishida, CPA's, Inc. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct post audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawaii and its political subdivisions.

Background

Hawaii has the only state-administered, unified, public school system in the nation. Article X, Section 1 of the State Constitution provides "for the establishment, support and control of a statewide system of public schools free from sectarian control, a state university, public libraries and such other educational institutions as may be deemed desirable, including physical facilities therefor."

Section 26-12, HRS states that the public school system encompasses "programs of education and public instruction throughout the State, including education at the preschool, primary, and secondary school levels, adult education, school library services, health education and instruction (not including dental health treatment transferred to the Department of Health), and such other programs as may be established by law."

The Department of Education is responsible for the overall administration of the public school system, but it does not bear all costs. The Department of Accounting and General Services provides building repair and maintenance and student transportation services. The Department of Health provides nurses and health programs. Fringe benefits and unemployment compensation costs are paid by other state departments.

The department has 250 schools that provide education statewide to more than 183,000 students from kindergarten through the 12th grade, and to adults and special education students. Its operations annually cost more than $1 billion. The Department of Education alone employs more than 19,000 teachers and support personnel for the system.

Organization of the Department of Education

As of the last approved organization chart dated July 1, 1994, the department is structured as shown in Exhibit 1.1.

Board of Education

The Board of Education heads the department as its executive board. The board consists of 13 elected members and a public high school student who serves as a non-voting member. The board formulates policy and exercises control over the public school system. It appoints the superintendent of education.

Office of the Superintendent

The superintendent of education is accountable to the Board of Education for the administration of the public school system. The Office of the Administrative Assistant provides support staff to the superintendent. In addition, the superintendent has staff assigned to special projects such as the School and Community Based Management Project, the Office of Information and Telecommunication Services Reorganization Project and the Internal Audit Project.

The Office of the Superintendent also has four branches which are described here.

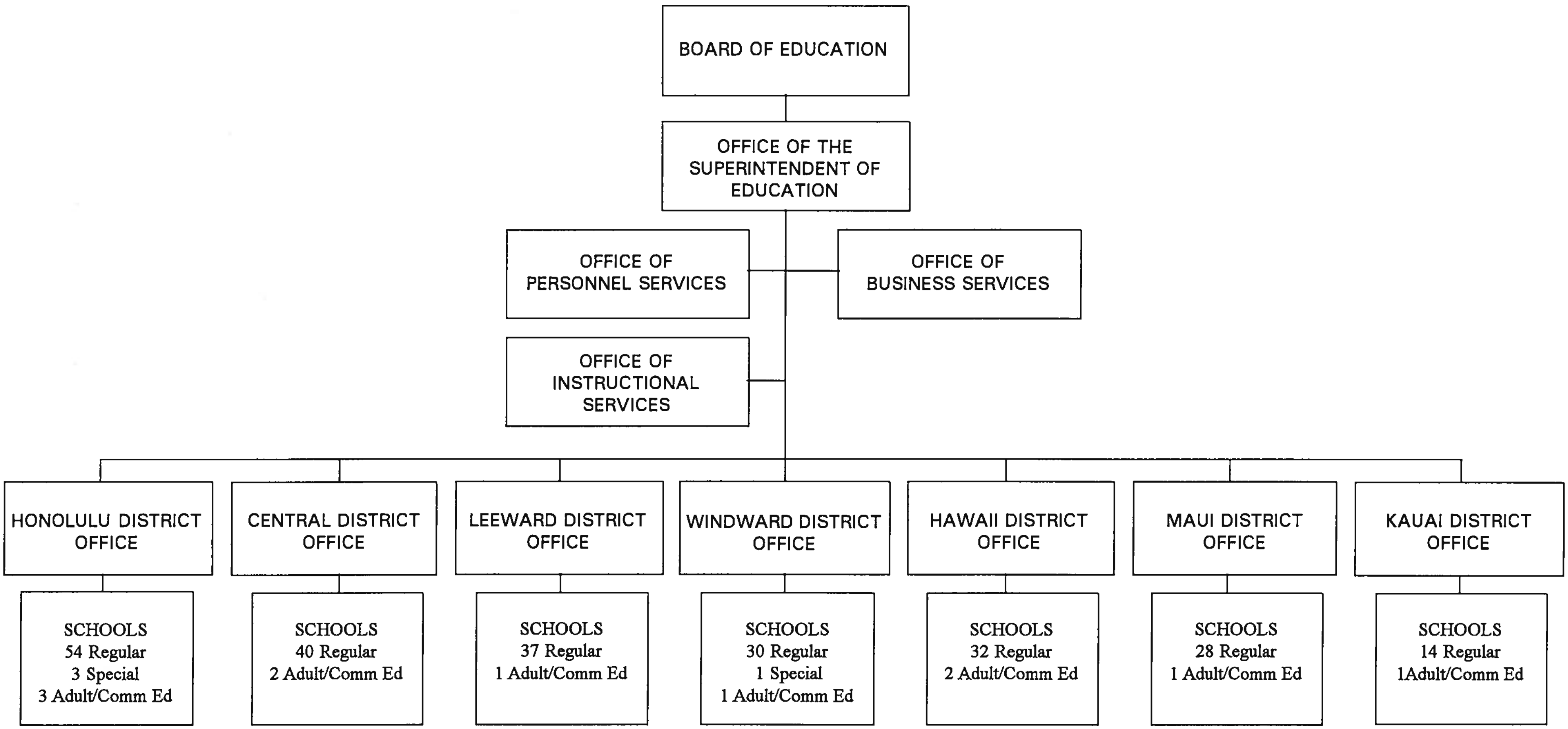
- The Communication Branch provides communication services to the Board of Education, the superintendent and all other offices and schools of the public school system as needed.

- The Budget Branch assists the superintendent in the preparation, coordination, execution, and control of the public school system's operating budget.

- The Management Analysis and Compliance Branch provides technical assistance to other units of the public school system on organization and management. It maintains the school system's official plan of organization and compiles the department's official rules in accordance with state laws. It assists with public hearings and performs other administrative functions.

- The Planning and Evaluation Branch provides services in planning, evaluation, special programs management and test development and administration.

Exhibit 1.1
STATE OF HAWAII
PUBLIC SCHOOL SYSTEM



State offices

Three division-level state offices headed by assistant superintendents provide statewide professional and technical support services and programs to the public schools.

- The Office of Business Services provides administrative, fiscal, and logistical support services and programs.
- The Office of Personnel Services provides employment and personnel management services and programs, including the certification of public and private school teachers.
- The Office of Instructional Services provides curriculum and instructional support services and programs.

District offices

Seven district offices oversee school operations and provide business, personnel, and instructional services for their respective districts. Each district office is headed by a district superintendent who reports to the superintendent. The seven districts and the islands on which they are located are listed here.

Oahu	-	Central District Honolulu District Leeward District Windward District
Hawaii	-	Hawaii District
Maui, Lanai, & Molokai	-	Maui District
Kauai & Niihau	-	Kauai District

Schools

The 250 schools are each headed by a principal. The scope of educational programs and services of the public schools encompasses grades kindergarten through twelve. Pre-school programs and community/adult education curricula may be provided as authorized.

Objectives of the Audit

1. Report on the fair presentation of the combined financial statements of the Department of Education.

2. Assess the adequacy, effectiveness, and efficiency of the systems and procedures relating to the financial accounting, internal controls, and financial reporting of the department and recommend improvements to such systems, procedures, and reports.

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

4. Ascertain the extent to which recommendations contained in Chapter 2 of the State Auditor's Report No. 93-3, *An Update on the Department of Education's Financial Management System and School Information System*, have been implemented.

Scope and Methodology

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the public school system within the Department of Education for the fiscal year July 1, 1994 to June 30, 1995. Included in our audit were all fund types and account groups except for the general fixed assets account group. We also reviewed the department's transactions, systems, and procedures for their compliance with applicable laws and regulations. Excluded from the scope of the audit were the financial accounting records of other departments providing services and resources to the public school system.

We examined the existing accounting, reporting, and internal control structure. We identified the deficiencies and weaknesses in the internal control structure and made recommendations for improvements, including, but not limited to, the forms and records, the management information system, and the accounting and operating procedures.

We reviewed the extent to which the recommendations contained in Chapter 2 of the State Auditor's Report No. 93-3 have been implemented. We evaluated the reasons for no implementation or partial implementation.

The independent auditor's opinion as to the fairness of the combined financial statements presented in Chapter 4 is that of Nishihama & Kishida, CPA's, Inc. The audit was conducted from May 1995 through January 1996. The audit work relating only to Chapter 4 was conducted from May 1995 through October 1995. The audit was conducted in accordance with generally accepted government auditing standards.

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Chapter 2

Continuing Problems with the Financial Management System

This chapter presents the findings resulting from that portion of our audit that followed up on the findings contained in Chapter 2 of our Report No. 93-3, *An Update on the Department of Education's Financial Management System and School Information System*.

Summary of Findings

In our audit, we did not find a very different state of affairs from our prior report. Instead, we found that the financial management system's response time has degenerated since our last review and system availability has not improved appreciably. We found also that the department has not incorporated school/unit-based budgeting into its financial management system and it has resisted legislative mandates to report public school system expenditures at the school level. Further, we found that financial reports are not always useful or fully understood by users.

Weaknesses Continue in System Availability and Response Time

We first reviewed the Department of Education's Financial Management System (FMS) for the public school system in 1990. At that time, we found significant problems with the FMS that were caused by major shortcomings in the system's development process.[1]

We did a follow-up review in 1992 and issued our update report in January 1993. In that report, we noted that the system was available to users for only a short period during working hours and that the computer system responded very slowly.[2] This time we found little change in the situation. Users continued to be frustrated by the limitations of the system. This condition prevailed in spite of the department's 1993 claim that we would find a very different state of affairs in 1995.

In its 1993 response to our draft report, the superintendent of education stated:

> The department found the draft report to be in general a fair assessment of both the Financial Management System (FMS) and the School Information System (SIS) as they stand today. However, in the case of the FMS analysis, I feel that the report fails to place this review in the proper context of an "interim report" on the development of an information system which is still in process. The FMS is a major

> statewide information system which was initially brought on line only last year and which is not scheduled to be fully operational until 1995. The report presents its findings as though FMS were a fully-implemented and operational system and, as a result, judges the efforts of the department in this area unfairly.
>
> We find most of the report's findings to be correct with respect to the current state of the FMS and SIS projects. There is nothing in the report that we are not already fully aware of and working to correct and/or improve. ***I believe that a similar audit at the completion of the FMS and SIS projects, perhaps in the 1995 time frame, would find a very different state of affairs.***[3] (emphasis added)

Our 1993 report of the FMS in its first year of operation found that the schools' administrative services assistants (SASAs) and account clerks were extremely frustrated by problems with system availability and slow response time. The very purpose of an automated system is to expedite workload. An automated system should be available to users during a normal workday. The efficiency of an automated system is measured, in part, by its response time—the amount of time it takes a system to process a piece of information before it "responds" and allows the user to enter another piece of information.

Some changes were made

We are pleased to note that the department responded positively to our report and has worked with the Department of Budget and Finance's Information and Communications System Division (ICSD) to improve the system availability and response time. The department provided ICSD with additional magnetic tape cartridge drives to perform "housekeeping" and back-up routines fairly smoothly. This has resulted in a slight increase in the number of hours the system is open for users.

The department has also made other efforts to improve system availability and response time. A staggered use schedule reduced the number of users on the system at any one time. Improved capabilities to process data in off-hours reduced the system's workload during peak hours. Futher, purchase order input procedures were streamlined and unnecessary data was removed from the mainframe computer to help speed up the system's response time.

The department contends that these improvements have improved operating efficiency at the schools and offices. We were not able to verify that claim. However, the department acknowledges that the changes have made virtually no impact on system availability or response time. We confirmed that there has been little improvement in availability and response time. Users continue to be dissatisfied.

Users continue to be dissatisfied

Users continue to be frustrated by the inability to access the FMS when needed and by the slow response time. We surveyed 62 users by mail and through person-to-person interviews. Most users felt that improvements were minimal, if any.

Clerical personnel continue to work overtime because of problems with the FMS. Over half of the survey respondents reported they had to work overtime during the fiscal year ended June 30, 1995 because of the FMS. Approximately one-third of the respondents reported working one to six hours in total FMS-related overtime per week. About another one-fourth of the respondents worked from seven to fifteen hours in FMS-related overtime per week.

Marginal improvement in system availability

In our 1993 report, we noted that system availability during the normal work day was approximately 7 hours but the average varied from month to month. We found that system availability did improve in 1995, primarily due to the addition of magnetic tape cartridge drives. Operating hours increased to approximately 8.75 hours per day. The average number of available hours was fairly stable from month to month.

However, with the change to a staggered use schedule, six hours per week of system availability was eliminated for each user. As a result, the average weekly hours available to users during work hours improved only marginally from approximately 35 hours to 37.75 hours.

System availability is also affected by other factors. Workstations at several schools are linked to one another and if one workstation is disconnected, workstations at several schools could be disconnected as well. We were unable to determine the extent of this problem. Also access to the system can be denied by telephone line failure. A clerk at a Windward district school observed that the telephone lines that connect her workstation to the mainframe went down on an average of once every two weeks for two to three hours at a time due to weather conditions.

Response time has degenerated

The biggest complaint from the users is the slow response time. Since our last report, response time has degenerated significantly. When the FMS was first implemented in 1991, screen response time was 60 to 110 seconds. In November 1992, we visited eleven schools and found the average response time during peak periods had improved to an average of 27 seconds. In June 1995, we visited two district offices and eight schools during a peak period to measure the average system response time. We were unable to time the rate of response at one district office and one school because the system was down during our scheduled visits. Moreover, our testing disclosed that the screen response time had degenerated—from 27 seconds to about 60 to 80 seconds.

The staggered use schedule implemented was supposed to allow each school to access the system faster on certain days. During our testing, we found no noticeable difference in response time during the scheduled "fast" or "slow" days.

Improvement plans are not written

We were informed by department personnel that improvements to the system are being considered. The department has visions of enhancing FMS, however, there are no written plans for the steps to be performed, estimated costs, and timeframe. Improvements that were verbally described include installing a new wide-area network of cables to transmit data instead of using telephone lines; completely changing the computer hardware; and continuing efforts to improve the system by working with ICSD. However, without written plans, we were unable to determine the feasibility of these verbal plans.

We caution the department about advancing plans to change the system without carefully developed written plans, detailed cost estimates, and time schedules for implementation.

A Comprehensive Budgeting and Accounting System at the School Level Is Needed

A comprehensive system that integrates the budgeting and accounting functions of the department at the school level would foster fiscal accountability. Such an integrated system would provide the means to properly plan and evaluate programs as well as control expenditures on a school-by-school basis. Without an integrated budgeting and accounting system, it is impossible to determine the operating costs of individual schools within the system and to measure costs against budget.

In recent years, the Legislature has mandated that schools be provided with greater flexibility and authority in budgeting, expenditure control and the determination of educational needs. To this end, we have recommended that: the department provide for school-level budgeting, integrate the budgeting and financial accounting systems,[4] and employ the Micro-Financial Analysis Model to the expenditures of the public school system.[5] The department has yet to implement any of these recommendations satisfactorily.

The current budgeting system limits school input

The department prepares its operating budget with little school-level input. It uses three basic categories: (1) current services, (2) workload increases, and (3) program adjustments. Current services are the resources required to provide the same quality and quantity of services of the past period for the next biennial period.[6] Workload increases reflect the delivery of the same quality and quantity of services to an increasing number of qualified recipients.[7] Program adjustments are the resources needed to improve the quality and quantity of the services, or to initiate a new program.[8]

The schools have no role in the initial budgeting process and do not have any input on the amount of resources required for their current services category. Although schools are allowed to submit budgets for workload increases or program adjustments, if any, the amounts involved do not usually represent a significant portion of planned school expenditures.

The current services portion provides for the continuation of existing positions, operating expenses and replacement of existing equipment. It accounts for approximately 93 to 97 percent[9] of the department's total operating budget request. This amount is established by the department's state level Budget Branch. The amount is based on the prior year's approved budget and is adjusted to reflect workload increases and program initiatives for the current year appropriations. Once the department budget is approved, amounts are allocated to the schools and to state and district offices based on various distribution formulas.

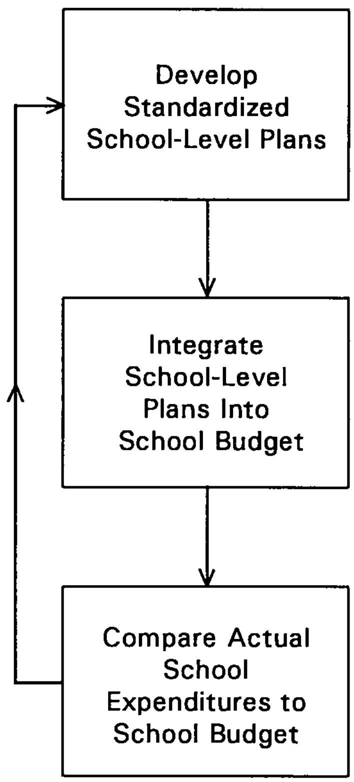
The department has implemented what is termed "lumpsum" budgeting in response to legislation requiring school-based budgeting. Under lumpsum budgeting, schools have the authority to budget and spend their share of the lumpsum funds for specific programs and expenditure categories. However, since the total amount of the funds under the schools' control is limited to a lumpsum amount established by the Budget Branch, school-level control over the budget is limited and has practically no correlation with school-level plans.

The lumpsum funds allocated to the schools are to be used for hourly-paid workers, supplies and equipment. Funds for full-time positions are not allocated to the schools. Instead, schools are allocated position counts for authorized positions. Each position has a cash value equal to the average salary of that position as specified by the superintendent. Schools are able to "buy and sell" positions with their lumpsum funds in accordance with specific department procedures and other regulations.

An integrated planning, budgeting, and accounting system is needed

To ensure that all resources received by the department are distributed and used efficiently and that accountability and responsibility are directed to the schools, the department needs to establish a system that integrates the planning, budgeting, and accounting functions at the school level. The following is a basic pattern of the entire process:

Exhibit 2.1
Planning, Budgeting, and Accounting Process



Develop standardized school-level plans

The department needs to develop a school-level planning system to ensure uniformity and consistency. This system should require schools to complete a standardized plan that considers the current needs of basic operations (i.e., staffing requirements, student count, educational materials, etc.). The plan should also consider needed improvements and other desired school activities. It should incorporate the schools' strategies to achieve these goals along with the estimated costs to carry out these endeavors. Clear and measurable goals, objectives, and outcomes should also be established for purposes of evaluation at the end of the school year.

Integrate school-level plans into school budget

The translation of the school-level plans into the dollars needed is essentially what comprises the school-level budget. The integrated planning process correlates the planned objectives and goals with the estimated costs of the plan. These estimated costs should be controllable at the school level. Costs such as personnel, water, and sewage which are currently centralized can be better monitored at the school level. Therefore, these costs should be budgeted and accounted for at the school level.

A compilation of the schools' planning budgets should be the substantial portion of the department's biennium budget request. After compiling and summarizing the school-level planning budgets, the Budget Branch should analyze the actual resources made available to the department by the Legislature and determine the amount of adjustments to be made by the individual schools. These budget adjustments should be clearly noted on the planning documents so that the effect of the adjustments is reflected on the schools' planned goals, objectives and other measurable outcomes. Exhibit 2.2 presents this budget process.

Compare actual expenditures to budget

A vital part of an integrated planning and budgeting system is the evaluation of the actual results—what was actually spent compared to what was budgeted. The department should ensure that actual expenditures can be readily compared to the budget. An integrated budgeting system needs to be designed and coordinated with the department's financial accounting and reporting system so that planned goals and objectives can be compared to actual outcomes. Comparisons determine the effectiveness of the original plan and provide a basis for future school planning and budgeting. Measurable and meaningful performance outcomes need to be clearly defined during the planning stages so that comparisons to actual results can be made.

Expenditure Reporting on A School-by-School Basis Is Needed

Act 218 of the 1995 Session Laws of Hawaii requires the department to report public school system expenditures by functions on a school-by-school basis for the fiscal biennium 1995-97. However, the department has resisted developing a school-by-school expenditure reporting system for the following reasons.

1. It believes that changing the present accounting system is unnecessary;

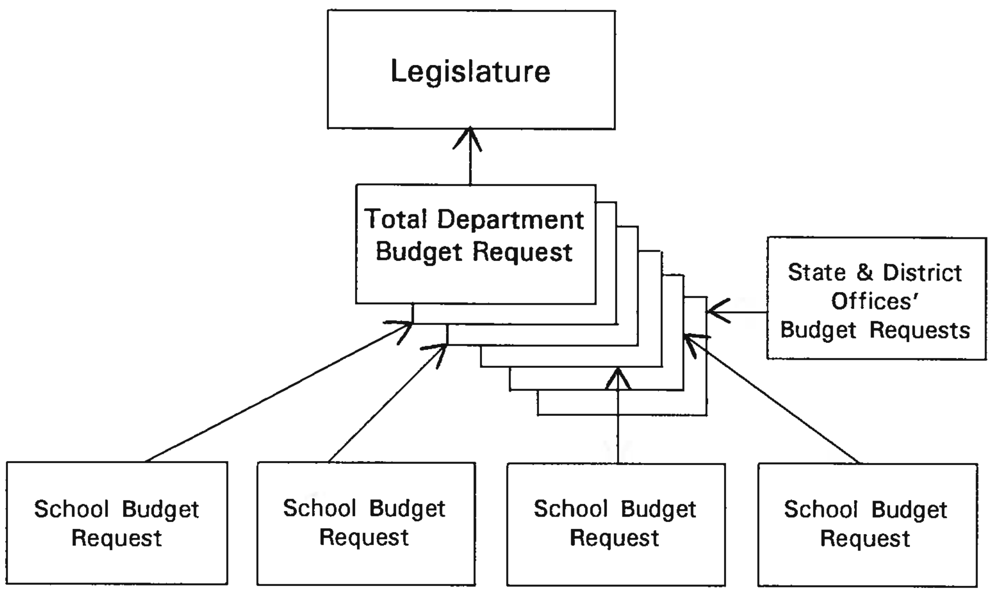
2. It fears misuse of financial information; and

3. It claims that a high initial investment is required for implementation.

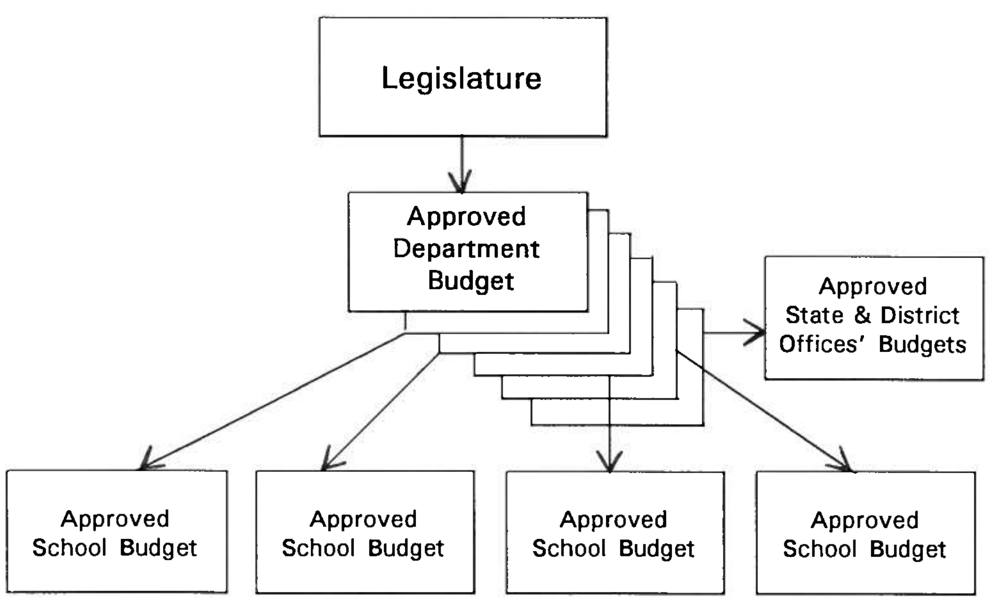
We believe that the benefits of reporting school-by-school expenditure information far outstrip the department's reservations. School-by-school expenditure information will allow for more informed decision making on funding, setting of priorities, and measurement of the effectiveness of planning decisions.

Exhibit 2.2
The Budget Process

Budget Request



Approved Budget



Legislative concerns about expenditure reporting

In fiscal year 1992-93, the Legislature expressed a need for better information on how state resources were being spent to support education in the schools and requested that the Office of the Auditor study the feasibility of applying a financial model to analyze expenditures. We recommended that the department build a Micro-Financial Analysis Model into its financial management system. That system would permit schools, districts, and the state office to track and analyze expenditures by their educational function at the location that the cost is actually incurred, rather than by the programs of the current financial accounting system.[10] The purpose of the model is to provide better information on how education dollars are actually spent and how much actually reaches the classroom.

As a result of the study, the Legislature passed Act 218, SLH 1995 which required the department to provide the Legislature with a school-by-school expenditure report in a modified form of the Micro-Financial Analysis Model. The report to the Legislature is due no later than twenty days prior to the convening of the 1996 and 1997 regular sessions, and requires that school expenditures be reported in the following six functions:

1. administration;
2. facilities and operations;
3. teacher support and development;
4. student support;
5. instructional support; and
6. classroom instruction.

In addition, expenditures for learning support centers and state and district administration are to be reported in the following two categories:

1. administration, facilities and operations, and teacher support and development; and

2. instructional and student support.

The department's accounting system does not record expenditures at the school level

Presently, the department's FMS accounting system cannot meet these legislative reporting requirements. The accounting system does not account for expenditures at the school level because the department does not prepare detailed budgets at the school level.

Many costs are budgeted for, paid for, and accounted for at the state and district level although the schools benefit directly from the purchased goods and services. These goods and services include such items as insurance, equipment maintenance services, and test booklets to take advantage of the economies of scale. Personnel costs for staff providing instructional, diagnostic, and other services to a number of schools are also budgeted and accounted for at the state and district levels.

The FMS accounts for expenditures where they are budgeted and not where purchased goods and services are delivered—that is, at the school level. In order to report expenditures at the school level, the FMS must allocate expenditures on some basis to the various schools. Apportioning expenditures to schools requires a great deal of judgment and manual allocation. Apportioning efforts could be alleviated if budgeting for costs were done at the school level.

School-level budgeting should include the costs for the goods and services that are currently being budgeted centrally. This "bottom up" approach could provide the department with a clearer idea of how many students will need these goods and services, and at which schools. More importantly, budgeting at the school level would establish accountability because actual school expenditures would be measured against the plan, or budget. The department needs to develop a system of recording school-level expenditures to compare actual school-level costs against the school-level budget.

The department has been reluctant to change

Although required by the Legislature to report expenditures by functions on a school-by-school basis, the department has not done so. The department fears that the required information may be misused or misinterpreted. It also contends that the required expenditure report would involve costly and unnecessary changes to its existing accounting system.

The department fears misuse of school-by-school expenditure information

The department fears that school-by-school expenditure comparisons may result in incorrect conclusions and perceptions about its resource allocation process. It fears that the public will not consider the variables that account for the differences in expenditures among schools and districts within the statewide system.

The fear of misuse and misinterpretation of information is one of the biggest concerns of the department and a reason for its past reluctance to move towards school-by-school expenditure reporting. Comparing schools and districts by expenditure levels and expenditures per pupil costs can be expected; however, it shouldn't be feared. It should provide the basis for clearer analysis and supporting justification for expenditure variances among schools and districts.

The reasons for expenditure variances among schools are many. They include differences in personnel pay rates, abilities of the student population, age of the school facilities, and others. For example, a school may have higher payroll costs because its teachers may have higher seniority and not because it has more teachers. Likewise, schools with more students who are mentally challenged, not fluent in English, or in some other way "disadvantaged" will have higher program costs for the additional resources that these students require.

Thus, comparisons of school-by-school costs are inevitable, but knowing the variables behind the costs leads to a better public understanding and more informed institutional analysis. School-by-school cost information also allows evaluation of student performance against related costs.

Changes to expenditure reporting are feasible

The department needs to make some changes to its accounting system to be able to account for all expenditures by function and by location. These changes to the accounting system are feasible. Changes entail adding some accounting codes at the school level for expenditures previously budgeted and accounted for at the state and district levels.

This is a one-time task, for which the FMS was designed and can accommodate. The problem is not establishing the accounting codes at the school level. The problem is the department budgeting for costs at the school level and ensuring proper classification of expenditures. The department has always been responsible in this regard. The only operational change required of the department is to train school-level personnel to develop plans, prepare school-level operating budgets, and properly record expenditures.

The department believes that changes are unnecessary

The department believes that reporting expenditures by function and location is unnecessary. It presently provides expenditure reporting in similar categories to the National Center for Education Statistics (NCES). The department argues that the NCES model meets legislative needs. This is not the case. Expenditures are not reported to NCES on a school-by-school basis as required by the Legislature. Substituting the NCES reports for those required by law does not meet the legislative requirement.

The department also argues that the required expenditure report is inconsistent with the legislative appropriations which are categorized by programs. It believes that expenditures should be reported to the Legislature only on the same basis as the appropriations. The department therefore does not feel motivated to report expenditures in a format that differs from its budget and appropriations. To the contrary, it is not necessary that funds be appropriated by function and location in order to allow expenditure analysis by function and location.

Need for school-level expenditure reporting is justified

The need for school-level expenditure reporting outweighs the department's reasons for not progressing towards reporting expenditures by function and location.

Although the misuse and misinterpretation of information is a possibility, the department should use these opportunities to educate people to better understand the report. In time, people will understand the financial information and the variables that affect the numbers. The department should not use misinterpretation as an argument for not providing necessary information to the public. To the contrary, the public needs to know and understand better how funds are spent for education.

Also, the department argues that a high initial investment will be required to implement a new expenditure coding system. This is specious. Account coding systems are designed to be flexible and can be modified as needed. Modifying the current coding system should not be shunned.

We find that the department is taking a narrow view on the model expenditure analysis. Analysis of expenditures by function is not meant to replace the current program expenditure analysis. Rather, it is meant to be an additional perspective on how the department spends its funds. Spending should be analyzed from more than one perspective to fully understand how funds are used.

Despite the anticipated difficulties and major changes in attitude and required budgeting, the need for reporting expenditures on a school-by-school basis is justified. A fully integrated planning, budgeting, accounting, and evaluation system is essential. With the department's direction towards school and community based management, there is a greater need to provide true cost information at the school level to enable school officials to make informed management decisions.

Financial Reports Are Not Timely Or Useful

Most of the users we surveyed complained that financial reports were given to them too late to be useful. Many of the users receive monthly reports more than one month after the report period. Users need reports within one to two weeks to make financial decisions and adjustments.

For example, department personnel do not receive payroll reports in a timely manner because several time-consuming steps must be performed before the reports can be generated. First, the department must enter payroll data received from DAGS into the system, review it for accuracy, and make corrections. Because of the department's payroll coding errors, the data input and corrections take from three to four weeks. Next, ICSD must print the reports, but this is delayed by the limited time available for the job. Printing is performed during the night along with the FMS "housekeeping" and batch processes. ICSD must print all other state agency requests as well.

After the reports are printed, the department's central office collates the reports by schools and offices, staples them, and inserts the reports into envelopes which are shipped to the department mailroom. The mailroom then distributes the reports to the schools and offices. The lapse time for this process involving three different agencies is over a month.

Reports should be available to users shortly after the reporting period in order to be useful for analysis, evaluation, and planning. Users want reports within one to two weeks after the report period. We feel that this expectation is reasonable. Timely and current information enables informed decision making.

Report users need training

We found that users were often not familiar with the various and multiple reports prepared by the FMS. Nor were users versed on the purpose of the reports, or how to use the information contained in the reports. The users' unfamiliarity with the FMS reports is due, in part, to the lack of complete written documentation of the reports.

FMS Reports Guide and Glossary needs to be updated

The FMS generates about 60 different reports for the department. The reports are designed for the various department levels. FMS has prepared an *FMS Reports Guide and Glossary* for the department that identifies reports, describes their purpose, and explains the report information. However, the guide does not describe all FMS reports.

The guide has not been updated since May 1992, although several reports have since been added. Some of the reports are briefly discussed at FMS training workshops but the users continue to be unfamiliar with the reports. Users seek information about these reports through the FMS hotline, user support technicians, and district business specialists. However, the number of people to answer the users' questions is not adequate to meet the demand.

An updated and complete written guide on the FMS reports would ensure that all users are aware of the purpose, availability, and frequency of reports. Users should also understand the meaning of report information. With an improved guide, the number of questions regarding FMS reports to the FMS hotline should be reduced. User technicians, district business specialists, and other support personnel could better use their time for more complex issues.

The department is in the process of updating the *FMS Reports Guide and Glossary*. However, the department has no plans to include reports that are distributed only to the Office of Business Services, a state-level office. The Guide should include all reports, including those distributed to the Office of Business Services. Other state-level offices and district-level offices may want to use these reports if their existence were known.

Conclusions

The department's attitude towards an effective and useful financial management and budgeting system needs redirection. The lack of sufficient information about expenditures at the school level hinders the progress of school/community based management (SCBM). SCBM requires school-level decision making based on fiscal accountability. This can be achieved only with improved budgeting and financial reporting at all levels—from state and districts to the school level.

The department claims that changes in its financial reporting will require vast sums of resources. This is not the case. The existing FMS is capable of providing this level of reporting and accountability. The problems caused by the FMS' system availability and response time will continue, but the system can prepare school-level financial reports required by the Legislature. It will take some modifications to the system, but it will not require a new system.

Operational problems with the FMS are due to poor management in developing the system. Any request for a new system should be acknowledged by the department to be the result of its own failure to properly manage the development and implementation of the FMS.

The Legislature should closely monitor any departmental initiatives to develop a new system. To assist the Legislature, we once again include as an appendix, our guidelines to help review requests for systems funding.

Recommendations

1. We recommend that the Legislature require the department to develop a comprehensive planning, budgeting, and financial accounting system that begins at the school level.

2. The department should develop expenditure reports by function on a school-by-school basis as required by law.

3. The department should take steps necessary to improve the timeliness and usefulness of the financial reports prepared for the public school system.

4. The department should continue its efforts to update the *FMS Reports Guide and Glossary* and include all reports prepared by the FMS.

5. The department should develop a long-range plan to make improvements to its financial management system. In doing so, the department should consider whether investing more public funds to enhance FMS is worth the expected benefits.

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Chapter 3

Internal Control Practices

Internal controls are steps instituted by management to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Department of Education.

Summary of Findings

We found three deficiencies in the financial accounting and internal control practices at the school level, and two deficiencies at the state office level. These deficiencies are serious enough that the certified public accounting firm of Nishihama & Kishida, CPA's, Inc. has reported them as four reportable conditions and one noncompliance with the law in their reports contained in Chapter 4. These findings are summarized below:

a. Segregation of duties at the schools' business offices is inadequate. As more of the daily financial activities are handled by school business offices, adequate segregation of duties is an important internal control in safeguarding assets.

b. Controls over the issuance of receipt books by the school business offices are poor. Inadequate controls over receipt books could result in collections being made but not remitted to the school business offices for deposit and proper accounting.

c. Controls over deposits are inadequate. Deposits are not recorded in a timely manner by the schools. As a result, the department's Office of Business Services is unable to record the deposit to the appropriate account, thereby delaying transfer of the funds from the non-interest bearing DOE Central Checking Account to the state treasury.

d. Bank reconciliations are not prepared in a timely manner. The Office of Business Services reconciles the DOE Central Checking Account only at year-end. Sound business practice requires monthly bank reconciliations.

e. Storeroom practices circumvent state statute. Section 296-36.5, HRS, requires that storeroom revolving funds in excess of $400,000 lapse to the state general fund at the end of the fiscal year. However, the department's excessive ordering of inventory avoids the lapsing of these funds and is wasteful.

We also found problems with the remittance of cash collections outside of the school business office, cafeteria collections, A+ Program collections, and several other aspects of the department's internal control structure and its operation.

Reportable Conditions Affect the Internal Control Structure

We noted four reportable conditions and one instance of noncompliance with state law. Although none of these findings were considered to be material weaknesses, they indicate areas in which improvements are needed.

Reportable conditions are significant deficiencies in the design or the operation of an organization's internal control structure that could adversely affect its ability to record, process, summarize and report financial data consistent with the assertions of management in the combined financial statements.

Noncompliance with state laws suggests that legislative controls are being circumvented or legislative intent is not being carried out.

In the following sections, we discuss the four reportable conditions and the noncompliance with state law.

Inadequate Segregation of Duties at the Schools

Most, if not all, of a school's cash functions are handled by a school's school administrative services assistant (SASA) or account clerk. One person receives the cash, prepares the receipts for deposit to the bank, prepares the checks, records the receipts and disbursements, and prepares the bank reconciliation. No one adequately and independently reviews these cash functions.

No one person should perform all cash functions. No one person should have access to cash, maintain the cash accounting records, and perform all duties of the receipting process. Without adequate segregation of duties, funds may be lost, unrecorded, or misused. If it is not possible to segregate these duties, other controls should be in place to compensate for the lack of segregation of duties.

For many schools, it is not possible to delegate the duties to another person. In such situations, the school principal or a designee independent of the cash accounting functions should review the work. However, there are no written procedures for reviewing cash receipts at the school level. At present, only a review of the bank reconciliation is required.

A simple review of the bank reconciliation is not sufficient to prevent the loss or misuse of funds. The department should establish written procedures and a checklist for the principal or a designee independent of the cash accounting functions to review cash receipts at the school level. The checklist should be completed monthly and include the following:

1. a review of the posting of transactions to the ledger/subledger;
2. a review of bank deposits; and
3. a review of bank reconciliations.

The checklist should be dated and signed or initialed by the reviewer.

Schools' Controls Over Receipt Books Are Weak

Schools collect cash from students and the public for such things as rent for school facilities, payment for damages to school property or lost books, and meals. The cash is collected either at the school business office or at other locations by teachers and class advisors. Books of prenumbered receipts are issued to teachers and advisors for them to acknowledge the receipt of money.

Each school business office maintains the *Inventory Record of Pre-numbered Forms* as a control over the issuance and use of the receipt books for these outside collections. Schools should maintain control over the use of receipt books to ensure that all cash received is properly accounted for and deposited into the appropriate bank accounts.

We noted poor controls over the issuance and use of receipt books. We found that teachers do not return all receipt books to the school business offices at the end of the school year and that school business offices do not always follow up on unreturned receipt books.

Receipt books returned to the school business offices were not always recorded as returned on the business offices' *Inventory Record of Pre-numbered Forms* because documentation at the time of the return simply was not done.

Without adequate controls over receipt books, the school business offices cannot ensure that all cash receipts are remitted and all deposits are properly made. Receipt books should be monitored to ensure that cash received outside of the school business office is being remitted to the school business office.

Deposits Are Not Recorded in a Timely Manner by the Schools

The 250 public schools deposit their cash collections into one central checking account maintained by the department. The schools are expected to properly record the deposits in the FMS and forward the deposit slips to the department's Office of Business Services. That office then reconciles the checking account and periodically transfers cash to the state treasury. When the Office of Business Services tried to reconcile the DOE Central Checking Account at June 30, 1995, it was unable to match all deposits shown on the bank statements to the deposits recorded on the FMS. It could not match more than $7 million as shown below.

Total deposits per bank statement unmatched with FMS	$4,311,400
Total deposits per FMS unmatched with bank statement	3,321,600
Total unmatched deposits	$7,633,800

The unmatched deposits represent deposits that are either not recorded in the FMS, or recorded improperly in the FMS by the schools. Because of the failure to properly record the deposits, the department's financial reports understate the actual revenues collected by the schools. In addition, the Office of Business Services is unable to transfer the moneys to the state treasury in a timely manner because the account information needed to make the transfer is available only when the deposits are matched. At June 30, 1995, we estimate that approximately $1.2 million held in the checking account should have been transferred to the state treasury to earn interest for the State.

To help alleviate this problem, the Office of Business Services established ***another*** checking account into which schools are to deposit only meal collections. All other collections continue to be deposited in the original checking account. However, this does not address the root problem—that schools are not recording the deposits properly. Also, the additional checking account adds one more bank reconciliation that the department must perform on a monthly basis. This may slow the transfer of cash to the state treasury even further.

A simpler solution would be to have the schools deposit the moneys directly into the state treasury. This would relieve the Office of Business Services of reconciling two checking accounts each month. It would render the transfer of cash to the state treasury as unnecessary. It also would assist the State in earning interest faster. However, the schools must first properly record all deposits.

Bank Reconciliations Are Not Prepared Timely by the Office of Business Services

The central Office of Business Services presently prepares bank reconciliations for the DOE Central Checking Account at the end of the fiscal year, rather than monthly.

It is a sound and standard business practice to prepare bank reconciliations monthly to ensure that (1) all deposits are properly recorded, (2) checks issued are properly cashed, and (3) any improper or erroneous charges to the bank account are corrected. Errors and other reconciling items are more difficult to identify when reconciliations are infrequently performed. This is confirmed by the fact that the office is unable to reconcile the checking account by about $15,500. If the department required schools to deposit all receipts directly into the state treasury, it would not have to perform even these bank reconciliations, albeit only yearly as is its current practice.

Storeroom Practices Circumvent State Statute

The department has a storeroom which functions as the public school system's central purchasing center. The storeroom purchases educational, office, and custodial supplies in bulk and sells them at cost to schools and department offices. The purchase and sale of supplies is accounted for in the Storeroom Revolving Fund, as authorized under Section 296-36.5, HRS.

Section 296-36.5 requires that "...balances in excess of $400,000 at the end of the fiscal year shall lapse into the general fund." We find that the storeroom inventory practices circumvent statutory lapsing requirements because the department ensures that the balance never exceeds $400,000 at the end of the fiscal year. We also find the inventory practices are wasteful.

Excessive orders circumvent lapsing requirement and causes waste

As of June 30, 1995, the storeroom inventory consisted of supplies on-hand costing $2.3 million, purchase commitments of $700,000, and an unreserved balance of $255,000. As a result of purchases and future commitments, the fund balance did not exceed $400,000 and no moneys lapsed to the general fund.

The purchase commitments at year-end consisted of five contracts and various purchase orders. Many of the goods on order had required delivery dates of either September 1, 1995 or October 2, 1995. One commitment to purchase office supplies of approximately $164,000 was canceled on August 28, 1995. Had this purchase order been canceled prior to June 30, 1995, the department would have been required to lapse approximately $20,000 to the general fund.

Our review of storeroom purchases disclosed that the department is circumventing Section 296-36.5 by ordering more supplies than needed. The department's procurement policies and procedures state that one of the duties of the department's purchasing section is to:

> Operate a central storeroom stocked with fast-moving, common-use educational and custodial supplies when such stockage is to the best interest of the department.[1]

We found that the storeroom has not followed this practice. It has purchased supplies which, based on prior demand, resulted in inventory balances sufficient for a period of one to three years. The department argues that this practice allows advantageous price breaks and protects the public schools from supply shortages resulting from strikes or other delivery disruptions. Price breaks alone are insufficient reason to maintain an inventory for one to three years of use. Exhibit 3.1 presents a sample of four items we tested. We used three months' usage (one third of a school year) as an estimated reasonable balance to maintain and computed the excess inventory on hand at June 30, 1995.

Exhibit 3.1
Excessive Inventory Examples

Inventory Item	June 30, 1995		Total	3 Months' Demand	June 30, 1995 Excess	
	On Hand	On Order			Units	Dollar Value
Maxell Video Tapes						
Units (each)	15,940	12,000	27,940	4,760	23,180	
Dollar Value	$30,445	$23,160	$53,605	$9,139		$44,466
Laminating Film						
Units (roll)	5,817	2,000	7,817	914	6,903	
Dollar Value	$76,028	$32,800	$108,828	$12,723		$96,105
8-1/2" x 11" Ruled Paper						
Units (carton)	12,620	7,200	19,880	3,782	16,098	
Dollar Value	$35,336	$33,120	$68,456	$13,010		$55,446
18"x24" Drawing Paper						
Units (ream)	2,533	1,500	4,033	372	3,661	
Dollar Value	$52,889	$40,500	$93,389	$8,616		$84,773
Total Dollar Value						**$280,790**

The total dollar value of the computed excess inventory for the four items tested was $280,000. If the storeroom limited its supplies on hand to a three-month supply, the department would have lapsed $280,000 to the general fund. Since our testing was limited, we do not know the extent of excess inventory for all storeroom items. We do not know how much more moneys could be lapsed to the general fund if inventory balances were better managed.

Another wasteful inventory practice deserves notice. We found that the storeroom has ordered supplies even though it had not conducted a survey to determine demand. For example, at June 30, 1995, the storeroom inventory had on hand 26,292 (2,192 dozen) 6" sharp point primary scissors costing $30,893. It also had, on order, 21,600 (1,800 dozen) 5" blunt point primary scissors costing $25,956.

No requests or shortage reports indicating a need for so many scissors were on file. No justification for demand for the 5" scissors was available. Yet the storeroom will have an inventory of almost 48,000 primary scissors—enough to supply each kindergarten, first grade, and second grade student with a free pair of scissors this year. This sizable inventory is questionable in light of the fact that schools require parents to provide their children in these grades with their own primary scissors.

Maintaining excessive inventory keeps moneys from lapsing to the general fund. It also adds avoidable inventory costs of obsolescence and unnecessary warehousing costs.

Obsolete inventory costs

The storeroom's practice of "loading up" on its inventory results in obsolescence costs. Excess inventory can lose its value the longer it sits. An example is the storeroom's supply of thermal facsimile (fax) paper. At the end of the year, the storeroom had 6,467 packages of this paper at a cost of $35,600. Storeroom personnel admit the inventory is obsolete and has reduced its price 141 percent in its attempt to get rid of it. The exact amount of the loss is not yet known as the storeroom is still trying to sell the thermal fax paper.

Warehouse costs

The department's storeroom rents a spacious warehouse in the Waipahu Industrial Park to store its inventory. The warehouse and adjoining office is leased at an annual cost of $263,500. Reducing the amount of inventory may reduce the amount of warehouse space needed and save the department money.

We do not believe it is necessary to purchase quantities at purported cost savings only to maintain excessive inventory in rented storage. The storeroom is basically converting cash into supplies that are not used for several months to more than a year. That cash could be better used by the State. The savings, through lower priced one-time large purchases, do not justify the lost interest income that could have been earned by the general fund. Further, the rental cost for a large warehouse to house excess and obsolete inventory is wasteful and an abuse of public funds.

Recommendations

1. The department should establish written procedures and a checklist for reviewing cash receipts at the school level by the principal or a designee independent of the accounting functions.

2. School business offices should monitor the issuance and use of receipt books to ensure that cash received outside of the business offices is remitted to the school business offices.

3. The department should ensure that each school properly records its deposits.

4. The department should cease using separate checking accounts for school deposits and require that schools deposit all moneys directly into the state treasury.

5. The department should reduce its storeroom inventory and maintain inventory levels sufficient to meet a few months' demand. It could then consider leasing a smaller warehouse.

Weaknesses In Internal Controls Are Found In Other Areas

In addition to the reportable conditions described above, we noted several other weaknesses involving the department's internal controls and its operations which are summarized as follows:

1. Cash collections outside of the school business office are not remitted in a timely manner to the school business office. Teachers and advisors are not complying with department procedures to remit cash to the business offices daily.

2. There are no written procedures governing the monitoring of cash shortages and overages in cafeteria collections. Three schools had cash overages or shortages in excess of $10,000 for the school year.

3. A+ Program collection procedures need improvement to ensure that all fees are collected and appropriate follow-up is made on delinquent parents. Parents have been able to avoid paying registration fees.

4. The October 31, 1994 accrued vacation and sick leave liability was reported to the State Comptroller as the June 30, 1995 balance. The department does not have current leave balance information for its employees.

5. The fixed assets inventory records are not current. Required reports are not being prepared and submitted to DAGS.

Cash Collections Outside of the School Business Offices Are Not Remitted in a Timely Manner

The Office of Business Services provides guidance on financial administration in its *Business Office Handbook*. Section VII, Part III.C.b.1 of the *Business Office Handbook* requires collections made outside of the school business offices to be remitted to the school business offices daily. However, the teachers and class advisors do not always comply with the requirement.

Cash collected by the teachers and class advisors are generally not remitted to the school business offices on a daily basis for deposit. In many instances, teachers and class advisors take from several days to several weeks after the receipt date to remit cash to the school business offices. In one instance, a teacher remitted fees for an art class to the school business office one year after the money was collected.

Moneys should be remitted to the school business offices daily to minimize theft or misplacement of moneys.

Controls Over School Cafeteria Collections Are Poor

For meal sales for the fiscal year ended June 30, 1995, 250 schools in the public school system reported a net cash shortage of $43,655 in their school cafeteria collections. Three schools had cash overages or shortages over $10,000 for the school year.

Schools periodically report their cafeteria collections to their respective district food supervisors. Once reported, however, cash overages and shortages are not monitored or followed up by the district food supervisors. The department has no written guidelines or procedures for district food supervisors to monitor cash overages and shortages at the schools.

Cash overages and shortages should be minimal. Excessive overages and shortages indicate reporting errors, inadequate controls over cash collection, or both. Without proper controls, the department cannot ensure that all cafeteria sales are correct, collected, and deposited. Proper controls also help ensure that reimbursement from the federal government is based on the proper number of meals served.

A+ Program Collection and Enrollment Procedures Are Deficient

During the year, the public school system provided after-school care to an average of more than 19,000 elementary school students in its A+ Program. Although a nominal fee of $35 per month was assessed each participating child, children qualifying for federally funded free or reduced charge meals were allowed to participate for free. The program cost the State about $16.8 million and collected about $3.8 million.

The A+ program is administered at the school level by site coordinators and by district and state coordinators at the district and state offices. Revenues and costs are accounted separately from other instructional programs. We found that procedures over cash collections and enrollment were deficient.

For the fiscal year ended June 30, 1995, deposits into the A+ Program's central bank account were approximately $123,000 short of calculated receipts based on enrollment statistics. The shortage was due to the lack of standard procedures in collecting delinquent payments and the overstatement of the enrollment count.

Collections are not pursued

Site coordinators at various schools allowed children to participate in the program although their parents did not pay the fee. In some instances, children were not charged while their applications were pending for participation in the free or reduced meal program. When children were determined ineligible for the free or reduced meal program, their parents withdrew them from the after-school program and refused to pay for the month(s) of participation.

In other instances, the site coordinators allowed children to participate based on the parents' verbal promises to pay, but payment was never received. Although the program's parent handbook states that overdue payments of more than three days may be grounds for a child's termination from the program, the site coordinators did not exercise this provision. Because specific guidance was lacking, the site coordinators did not always follow up on delinquent payments. As a result, taxpayers have subsidized program participants unnecessarily.

Improved written collection procedures for the A+ Program are needed. The collection procedures should address the free participation of children whose parents are in the process of applying for participation in the free or reduced meals program. Specific procedures should be established for following up on delinquent payments.

Enrollment statistics are not always correct

It is imperative that enrollment counts be proper to ensure proper staff levels and facilitate management review of costs and collections. At one district, the enrollment count included children who applied for the program but did not attend. Generally, the problems occurred due to inadequate review of the school-level operations. Overstating enrollment may result in overstaffing and unnecessary costs.

To improve the review of the school-level operations, the district A+ program coordinators are reviewing the bank deposit slips against the monthly enrollment log for each school beginning with the 1995-96 school year. We acknowledge that a comparison of the deposits with the enrollment records is an initial step to ensuring the accuracy of enrollment counts and to ascertain whether all revenues are being collected and deposited. However, further action such as strengthening the accuracy of enrollment counts and enforcement of collection procedures is also needed to ensure that the program is properly staffed and that all revenues are collected.

Vacation and Sick Leave Balances Are Not Current

The amount of accrued vacation and sick leave, reported to the State Comptroller as of June 30, 1995 is actually the amount of liability as of October 31, 1994. Seven months of leave liability is not reported. Accrued compensated absence balances should be accurately stated as of the end of the fiscal year, June 30, 1995. The misstatement of the accrued vacation and sick leave balances is due to the department not updating its employee leave records.

The department chooses to computerize the maintenance of employee leave records rather than maintain them manually. The department claims that manual maintenance of employee leave records is time-consuming and the department's insufficient staff could not ensure timely record maintenance. However, the department is backlogged in updating the computerized leave files for (1) name and address changes, (2) change in rate of leave credits earned, and (3) calculations for leave without pay and leave credits earned by part-time employees. Whether the department maintains employee leave records manually or on a computer is not the issue. The department simply is not doing its job of maintaining current leave records.

Without current leave information, the department is unable to determine the amount of employees' accrued vacation and sick leave at any given time. Unauthorized leave cannot be challenged without current records. Employees may be paid for leave that had not been authorized or earned. In addition, the amount of accrued vacation and sick leave used to prepare the State's annual financial report is misstated.

Fixed Assets Inventory Records Are Not Current

We tested the department's fixed asset inventory as of June 30, 1995. Six out of the fourteen equipment purchases we tested were not recorded in the fixed assets inventory. Chapter 106, HRS, requires that a detailed listing of all property belonging to the State and in the possession, custody, control, or use of the department be filed with the state comptroller on or before September 15th of each year. This requirement enables the State to account for all property acquired with public funds.

The department did not include the equipment in its inventory report to the state comptroller because the school level personnel did not update computerized inventory records properly. Updated inventory records are essential for insurance purposes, as well as for meeting the statutory reporting requirements.

Recommendations

1. The department should ensure that cash collected by the teachers are remitted to the school business office on a daily basis.

2. The department should establish written procedures for district school food supervisors to monitor cafeteria collection overages and shortages.

3. The department should improve its written enrollment and collection procedures for the A+ Program.

4. The department should improve its processes for accounting for, and maintaining, current employee leave records.

5. The department should ensure that all equipment purchases are properly recorded in the fixed assets inventory and reported to DAGS as required by law.

Chapter 4

Financial Audit

This chapter presents the results of the financial audit of the State of Hawaii's public school system of the Department of Education as of and for the fiscal year ended June 30, 1995. The audit does not include the Hawaii public library system which is part of the Department of Education. This report includes the independent auditors' report and reports on the internal control structure and tests of compliance with laws and regulations as it relates to the public school system. It also displays financial statements of all fund types and account groups included in the scope of the audit, together with explanatory notes.

Summary of Findings

In the opinion of Nishihama & Kishida, CPA's, Inc. based on their audit, except for the general fixed assets account group, the combined financial statements present fairly, in all material respects, the financial position of the public school system as of June 30, 1995, and the results of its operations for the fiscal year then ended in conformity with generally accepted accounting principles.

Nishihama & Kishida, CPA's, Inc. noted matters involving the internal control structure and its operation that they considered to be reportable conditions as defined in the report on the internal control structure. They also noted that, with respect to items tested, the public school system has complied, in all material respects, with laws and regulations applicable to the public school system.

Independent Auditors' Report

To the Auditor
State of Hawaii

We have audited the following combined financial statements of the State of Hawaii, public school system:

Combined balance sheet - all fund types and account groups, June 30, 1995 (Exhibit A);

Combined statement of revenues, expenditures and changes in fund balances - all governmental fund types and expendable trust funds, fiscal year ended June 30, 1995 (Exhibit B);

Combined statement of revenues and expenditures - budget and actual - general and special revenue fund types, fiscal year ended June 30, 1995 (Exhibit C).

These combined financial statements of the public school system are the responsibility of the management of the Department of Education. Our responsibility is to express an opinion on these combined financial statements based on our audit.

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

In accordance with the terms of our engagement, the scope of our audit did not include the audit of the general fixed assets account group. As a result, the balance sheet of the general fixed assets account group is included in the accompanying combined balance sheet of the public school system for informational purposes only. It has been prepared from the public school system's fixed asset records without audit and we express no opinion on it.

As discussed in the notes to the combined financial statements of the public school system, the combined financial statements are intended to present the financial position and results of operations of only that portion of the funds and account groups of the State of Hawaii that is attributable to the transactions of the public school system.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had the scope of our audit not excluded the general fixed assets account group as discussed in the fourth paragraph, the combined financial statements referred to above present fairly, in all material respects, the financial position of the public school system as of June 30, 1995, and the results of its operations for the fiscal year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued a report dated October 12, 1995 on our consideration of the public school system's internal control structure and a report dated October 12, 1995 on its compliance with laws and regulations.

Our audit was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining fund financial statements Schedule I through Schedule IV are presented for purposes of additional analysis and are not a required part of the combined financial statements of the public school system. Such additional information has been subjected to the auditing procedures applied in the audit of the combined financial statements and, in our opinion, is fairly presented in all material respects in relation to the combined financial statements taken as a whole.

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

Honolulu, Hawaii
October 12, 1995

Independent Auditors' Report on the Internal Control Structure Based on an Audit of the Combined Financial Statements Performed in Accordance with Government Auditing Standards

To the Auditor
State of Hawaii

We have audited the combined financial statements, except for the general fixed assets account group, of the State of Hawaii, public school system, as of and for the fiscal year ended June 30, 1995, and have issued our report thereon dated October 12, 1995.

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

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

In planning and performing our audit of the combined financial statements of the public school system, for the fiscal year ended June 30, 1995, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the Department of Education's ability to record, process, summarize, and report financial data of the public school system consistent with the assertions of management in the combined financial statements. The reportable conditions that we noted are described in Chapter 3.

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the combined financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described in Chapter 3 are material weaknesses.

We also noted other matters involving the internal control structure and its operation that we have reported to the Auditor, State of Hawaii, and the management of the Department of Education, which are described in Chapter 3.

This report is intended for the information of the Auditor, State of Hawaii and the management of the Department of Education. However, this report is a matter of public record and its distribution is not limited.

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

Honolulu, Hawaii
October 12, 1995

Independent Auditors' Report on Compliance Based on an Audit of the Combined Financial Statements Performed in Accordance with Government Auditing Standards

To the State Auditor
State of Hawaii

We have audited the combined financial statements, except for the general fixed assets account group, of the State of Hawaii, public school system, as of and for the fiscal year ended June 30, 1995, and have issued our report thereon dated October 12, 1995.

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

Compliance with laws, regulations, contracts, and grants applicable to the public school system is the responsibility of the Department of Education's management. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement, we performed tests of the public school system's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the combined financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

We noted an immaterial instance of noncompliance with HRS Section 296.36-5 related to the storeroom revolving fund that we have reported to the management of the public school system in Chapter 3.

This report is intended for the information of the Auditor, State of Hawaii and the management of the public school system. However, this report is a matter of public record and its distribution is not limited.

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

Honolulu, Hawaii
October 12, 1995

Descriptions and Definitions

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

Descriptions of financial statements and schedules

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

Combined balance sheet - all fund types and account groups (Exhibit A). This statement presents assets, liabilities, and fund equity of all fund types and account groups used by the public school system on an aggregate basis.

Combined statement of revenues, expenditures and changes in fund balances - all governmental fund types and expendable trust funds (Exhibit B). This statement presents revenues, expenditures, and changes in fund equity for all governmental fund types used by the public school system on an aggregate basis. Revenues include state appropriations mandated by various appropriations acts of the State Legislature, federal grant revenues, and others.

Combined statement of revenues and expenditures - budget and actual - general and special revenue fund types (Exhibit C). This statement summarizes revenues and expenditures by source and type on the budgetary basis and compares such amounts to the budget as adopted by the State Legislature.

Combining balance sheet - special revenue funds (Schedule I). This schedule presents assets, liabilities and fund balances of the special revenue funds of the public school system.

Combining statement of revenues, expenditures, and changes in fund balances - special revenue funds (Schedule II). This schedule presents revenues, expenditures, and changes in fund balances of the special revenue funds of the public school system.

Combining balance sheet - trust and agency funds (Schedule III). This schedule presents assets, liabilities, and fund balances of the trust and agency funds of the public school system.

Combining statement of revenues, expenditures, and changes in fund balances - expendable trust funds (Schedule IV). This schedule presents the revenues, expenditures and changes in fund balances of the expendable trust funds of the public school system.

Definition of terms

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

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

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

Encumbrance. An obligation in the form of a purchase order or contract which is chargeable to an appropriation.

Expenditure. The incurrence of a liability for goods delivered or services rendered.

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

Notes to the Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the combined financial statements and financial condition of the funds included in the scope of the audit are discussed in this section.

Note 1 - Financial reporting entity

The public school system is part of the Department of Education which is part of the executive branch of the State of Hawaii. The public school system's combined financial statements reflect only its portion of the fund type categories. It does not reflect the financial activities of the Hawaii State public library system which is also part of the Department of Education. The state comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually, which includes the public school system's financial activities.

Fund accounting. The financial transactions of the public school system are recorded in individual funds and account groups which are reported by type in the combined financial statements and are described in the following sections. Each fund and account group is considered a separate accounting entity. The financial activities of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures, as appropriate. Account groups are used to establish accounting control and accountability for the public school system's general fixed assets and general long-term obligations. Account groups are not funds as they do not reflect available financial resources and related liabilities.

Governmental fund types. The measurement focus of governmental funds (general, special revenue, capital projects funds) is on current financial resources.

The general fund is the general operating account for all financial activities except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted for.

Special revenue funds are used to account for the proceeds of specific revenue sources (other than expendable trusts) that are restricted to expenditures for specified purposes.

The capital projects fund is used to account for financial resources to be used for the acquisition or construction of major capital facilities.

Fiduciary fund type. The trust and agency funds are used to account for assets held by the public school system in a trustee or agency capacity. These include expendable trust funds which account for cash collected and expended by the public school system as trustee and agency funds which account for the receipts and disbursements of various amounts collected by the public school system in a custodial capacity.

Account groups. The general fixed assets acquired for use by the public school system are accounted for in the general fixed assets account group. Accumulated depreciation is not recorded in the general fixed assets account group. The obligation for the long-term portion of accrued vested vacation is recorded in the general long-term debt account group.

Note 2 - Summary of significant accounting policies

Basis of accounting. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds and expendable trust funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities generally are included on the combined balance sheet. Operating statements of these funds present increases (i.e., revenues and other financial sources) and decreases (i.e., expenditures and other financing uses) in net current assets.

The public school system uses the modified accrual basis of accounting for the general, special revenue, capital projects and trust and agency funds. Under the modified accrual basis of accounting, revenues and related current assets are recognized in the accounting period when they become both measurable and available to finance operations of the fiscal year or liquidate liabilities existing at year-end. Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after year-end to liquidate liabilities existing at the end of the fiscal year. Revenues susceptible to accrual include federal grants and funds appropriated by the State Legislature and allotted by the Governor.

Due from federal government. Due from federal government consists mainly of reimbursement claims from various federal agencies including reimbursement claims on behalf of outside agencies participating in U.S. Department of Agriculture (USDA) programs. It also consists of awarded revenues in which cash has not yet been received.

Accounts receivable. Accounts receivable in the special revenue funds consist primarily of amounts due from various agencies that purchase meals from the School Food Services Branch. The amounts reported as receivables were established based on cash repayments received subsequent to the balance sheet date.

Inventory. Inventory of materials and supplies is valued at cost (first-in, first-out) and consists of expendable supplies held for consumption. The reserve for inventory is equal to the amount of inventory to indicate that portion of the fund balance which is not available for funding other expenditures.

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

Deferred revenues. Deferred revenues consist of amounts received from grantor agencies which have not yet been earned by the public school system.

Due to student groups and others. In the special revenue funds, amounts owed to others are for federal funded reimbursements to various outside agencies under USDA programs. In the agency fund, these amounts are for amounts held in trust in a custodial capacity for student groups and others.

Due to State of Hawaii. This account consists primarily of the authorized balance of the vendor payment checking account in which the public school system processes its payments and the authorized petty cash fund balances.

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

Fund balances. Fund balances are reservations for encumbrances, inventory, trust funds and continuing appropriations. Encumbrances represent outstanding commitments which are generally liquidated in the subsequent year.

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

Total columns on the combined financial statements. The total columns on the combined financial statements are captioned Memorandum Only to indicate that they are presented only to facilitate financial analysis. Information in these columns does not purport to present financial position or results of operations of the public school system in conformity with generally accepted accounting principles. Such data is not comparable to a consolidation. Interfund balances and transactions have not been eliminated.

Note 3 - Budgeting and budgetary control

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated throughout the fiscal year. Amounts reflected as budgeted revenues in the combined statement of revenues and expenditures - budget and actual - general and special revenue fund types are those estimates as compiled by the public school system. Budgeted expenditures are derived primarily from acts of the State Legislature and from other authorizations contained in other specific appropriation acts in various Session Laws of Hawaii.

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

Section 37-41.5 of the Hawaii Revised Statutes allows the Department of Education to carryover up to five per cent of any appropriation for the public school system's school-based budgeting program at the end of a fiscal year. These carryover funds, to the extent not expended or encumbered, lapse at June 30 of the first fiscal year of the next fiscal biennium. As of June 30, 1995, general funds carried over amounted to approximately $7,800,000.

Summarization of the budgets adopted by the State Legislature for the "budgetary" general and special revenue funds is presented in the combined statement of revenues and expenditures - budget and actual - general and special revenue fund types. For purposes of budgeting, the public school system's budgetary fund structure and accounting principles differ from those utilized to present the combined financial statements in conformity with generally accepted accounting principles (GAAP). The public school system's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to (1) the encumbrance of purchase order and contract obligations, (2) special revenue fund program grant accruals and deferrals, and (3) revenues and expenditures of unbudgeted funds. These differences represent a departure from GAAP. The following schedule reconciles the budgetary amounts to the amounts presented in accordance with GAAP for the fiscal year ended June 30, 1995:

	General	Special Revenue
Excess of revenues and other sources over expenditures and other uses - actual on a budgetary basis	$ 12,232,195	$ 1,997,767
Reserved for encumbrances at fiscal year-end	1,185,614	3,850,345
Expenditures for liquidation of prior fiscal year encumbrances	(23,034,396)	(6,768,660)
Net adjustment for grant accruals	—	(4,218,217)
Excess revenues over expenditures for unbudgeted programs	—	1,813,420
Excess of revenues and other sources over (under) expenditures and other uses - GAAP basis	$ (9,616,587)	$ (3,325,345)

Note 4 - Changes in assets and liabilities of the agency fund

The agency fund is purely custodial (assets equal liabilities) and thus does not involve measurement of results of operations. The changes in assets and liabilities of the agency fund for the fiscal year ended June 30, 1995, were as follows:

	Balance July 1, 1994	Additions	Deductions	Balance June 30, 1995
ASSETS				
Cash and other assets held in trust	$5,574,472	$19,863,454	$19,327,387	$6,110,539
LIABILITIES				
Due to student groups and others	$5,574,472	$19,863,454	$19,327,387	$6,110,539

Note 5 - General fixed assets

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

	Land	Building and Improvements	Equipment	Total
Balance at July 1, 1994	$172,304,346	$955,887,487	$247,909,029	$1,376,100,862
Additions	455,070	72,746,690	19,406,060	92,607,820
Deductions	—	155,894	5,188,567	5,344,461
Balance at June 30, 1995	$172,759,416	$1,028,478,283	$262,126,522	$1,463,364,221

Note 6 - General long-term debt

The general long-term debt account group is used to account for the long-term portion of the obligation for accrued vested vacations. The obligation changed during the fiscal year ended June 30, 1995, as follows:

Balance at July 1, 1994	$17,465,919
Net increase	3,242,066
Balance at June 30, 1995	$20,707,985

Note 7 - Retirement benefits

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

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

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

Actuarial valuations are prepared for the entire ERS and are not separately computed for each department or agency. Information on vested and nonvested benefits and other aspects of the ERS is also not available on a departmental or agency basis. The disclosures required by Governmental Accounting Standards Board Statement No. 5 are presented in the ERS' Comprehensive Annual Financial Report (CAFR). The following data is provided as of June 30, 1994 for the entire ERS from the disclosures contained in the CAFR for the fiscal year then ended, the most recent available information.

Pension benefit obligation:		
Pensioners and beneficiaries currently receiving benefits and terminated members not yet receiving benefits		$2,842,629,300
Current members:		
Accumulated member contributions		909,987,900
Employer-financed vested		1,829,319,500
Employer-financed nonvested		1,417,364,200
Total pension benefit obligation		6,999,300,900
Net assets available for pension benefits, at cost:		
Pension Accumulation Fund	$4,499,634,536	
Annuity Savings Fund	909,988,708	5,409,623,244
Unfunded pension benefit obligation		$1,589,677,656

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

Post-retirement health care and life insurance benefits. In addition to providing pension benefits, the State provides certain health care and life insurance benefits to retired State employees. Contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued. The public school system's general fund share of the post-retirement benefits expense for the fiscal year ended June 30, 1995, has not been separately computed and is not reflected in the public school system's combined financial statements. The public school system's special revenue fund share of the post-retirement health care and life insurance benefits expense for the fiscal year ended June 30, 1995, was approximately $1,231,000 and is included in the special revenue funds' financial statements.

Note 8 - Commitments and contingencies

Accumulated sick leave pay. Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service without limit, but can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a public school system employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 1995, approximated $364,000,000.

Deferred compensation plan. In 1983, the State established a deferred compensation plan which enables state employees to defer a portion of their compensation. The State Department of Human Resource Development has the fiduciary responsibility of administering the plan. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency. All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject to the claims of the State's general creditors. Participants' rights under the plan are equal to those of the State's general creditors in an amount equal to the fair market value of the deferred account for each participant.

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

Leases. The public school system leases equipment and office facilities on a long-term basis that are reported in the general fund. The following is a schedule of minimum future rentals on noncancelable operating leases for the five years subsequent to June 30, 1995.

Fiscal Year Ending June 30	Amount
1996	$ 955,000
1997	312,000
1998	102,124
1999	—
2000 and thereafter	—
	$ 1,369,124

Total rent expense for the fiscal year ended June 30, 1995 was approximately $1,452,000.

Litigation. The public school system is a party to various legal proceedings. Although the public school system and its counsel are unable to express opinions as to the outcome of the litigation, it is their opinion that any potential liability arising therefrom will not have a material adverse effect on the financial position of the public school system because any judgments against the public school system are judgments against the State and would be paid by legislative appropriation of the State's general fund and not by the public school system.

Note 9 - Food distribution program

The public school system receives food commodities from the U.S. Department of Agriculture, Food and Nutrition Service (FNS), under the Federal Food Distribution Program. The public school system School Food Services Branch distributes the food to qualifying schools, charitable organizations, and nonprofit summer camps for children. The total value of the amount of food which the public school system is entitled to receive is determined in part by the number of meals served under the National School Lunch Program. The public school system's allocation balance is reduced as the public school system receives the food commodities. The amount charged to the public school system allocation balance is based upon the FNS's cost to purchase the commodities. In addition to this allocation, the public school system may also receive "bonus" food commodities. The bonus commodities do not reduce the public school system's allocation balance.

The following is a summary of the value of the food commodities received by the public school system during the fiscal year ended June 30, 1995. The value of the bonus commodities is based upon the estimated costs provided by the FNS in the Current Commodity File report dated June 30, 1995.

	Amount
Basic allocation	$3,058,561
Bonus commodities	630,758
	$3,689,319

Exhibit A

State of Hawaii
Public School System
COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS
June 30, 1995

	Governmental Fund Types			Fiduciary Fund Type	Account Groups		
	General	Special Revenue	Capital Projects	Trust and Agency	General Fixed Assets (Unaudited)	General Long-Term Debt	Total (Memorandum Only)
ASSETS							
Cash	$30,533,253	$16,438,958	$1,812,303	$7,551,592	$ --	$ --	$ 56,336,106
Receivables							
Due from other State Agency	--	--	6,699,924	--	--	--	6,699,924
Due from Federal Government	--	4,991,025	--	--	--	--	4,991,025
Due from other funds	--	16,643	--	--	--	--	16,643
Accounts receivable	--	350,661	--	--	--	--	350,661
Inventory of materials and supplies	--	2,276,887	--	--	--	--	2,276,887
Fixed assets	--	--	--	--	1,463,364,221	--	1,463,364,221
Amount to be provided for the retirement of general long-term debt	--	--	--	--	--	20,707,985	20,707,985
TOTAL ASSETS	$30,533,253	$24,074,174	$8,512,227	$7,551,592	$1,463,364,221	$20,707,985	$1,554,743,452
LIABILITIES AND FUND EQUITY							
LIABILITIES							
Vouchers payable	$ 5,152,489	$ 1,445,226	$ 554,544	$ 42,708	$ --	$ --	$ 7,194,967
Accrued wages and employee benefits payable	8,267,797	2,324,189	--	132,351	--	20,707,985	31,432,322
Deferred revenues	--	6,397,082	--	--	--	--	6,397,082
Due to student groups and others	--	859,372	--	6,110,539	--	--	6,969,911
Due to State of Hawaii	8,111,601	--	--	--	--	--	8,111,601
Due to other funds	--	--	--	16,643	--	--	16,643
Total liabilities	21,531,887	11,025,869	554,544	6,302,241	--	20,707,985	60,122,526
FUND EQUITY							
Investment in general fixed assets	--	--	--	--	1,463,364,221	--	1,463,364,221
Fund balances							
Reserved for encumbrances	1,185,614	3,850,345	--	324,530	--	--	5,360,489
Reserved for inventory of materials and supplies	--	2,276,887	--	--	--	--	2,276,887
Reserved for trust funds	--	--	--	924,821	--	--	924,821
Reserved for continuing appropriations	7,815,752	--	7,957,683	--	--	--	15,773,435
Unreserved	--	6,921,073	--	--	--	--	6,921,073
Total fund equity	9,001,366	13,048,305	7,957,683	1,249,351	1,463,364,221	--	1,494,620,926
TOTAL LIABILITIES AND FUND EQUITY	$30,533,253	$24,074,174	$8,512,227	$7,551,592	$1,463,364,221	$20,707,985	$1,554,743,452

See accompanying notes to the combined financial statements.

Exhibit B

State of Hawaii
Public School System
COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES - ALL GOVERNMENTAL FUND TYPES AND EXPENDABLE TRUST FUNDS
Fiscal Year Ended June 30, 1995

	Governmental Fund Types			Fiduciary Fund Type	Total (Memorandum Only)
	General	Special Revenue	Capital Projects	Expendable Trust	
REVENUES					
State allotted appropriations	$ 703,882,288	$ --	$	$ --	$ 703,882,288
Intergovernmental revenues	--	89,525,049	--	--	89,525,049
Other revenues	--	22,543,349	--	2,704,586	25,247,935
	703,882,288	112,068,398	--	2,704,586	818,655,272
EXPENDITURES					
School level instruction and support	$ 557,867,023	62,172,578	--	--	620,039,601
Instructional support	24,901,957	1,126,725	--	--	26,028,682
State and district administration	37,466,745	1,006,761	--	--	38,473,506
School support	67,858,848	48,585,992	--	--	116,444,840
School community service	25,404,302	2,450,341	--	--	27,854,643
Capital outlay	--	--	3,868,722	--	3,868,722
Other expenditures	--	--	--	2,199,021	2,199,021
	713,498,875	115,342,397	3,868,722	2,199,021	834,909,015
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	(9,616,587)	(3,273,999)	(3,868,722)	505,565	(16,253,743)
OTHER FINANCING SOURCES AND USES					
Operating transfers in	--	--	11,826,405	--	11,826,405
Operating transfers out	--	(51,346)	--	--	(51,346)
	--	(51,346)	11,826,405	--	11,775,059
EXCESS OF REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	(9,616,587)	(3,325,345)	7,957,683	505,565	(4,478,684)
OTHER CHANGES IN FUND BALANCES					
Lapsed appropriations	(5,467,647)	--	--	--	(5,467,647)
Increase in reserve for inventory of materials and supplies	--	274,169	--	--	274,169
	(5,467,647)	274,169	--	--	(5,193,478)
EXCESS OF REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES, OTHER USES, AND OTHER CHANGES IN FUND BALANCES	(15,084,234)	(3,051,176)	7,957,683	505,565	(9,672,162)
FUND BALANCES AT JULY 1, 1994	24,085,600	16,099,481	--	743,786	40,928,867
FUND BALANCES AT JUNE 30, 1995	$ 9,001,366	$ 13,048,305	$ 7,957,683	$1,249,351	$ 31,256,705

See accompanying notes to the combined financial statements.

Exhibit C

State of Hawaii
Public School System
COMBINED STATEMENT OF REVENUES AND EXPENDITURES - BUDGET AND ACTUAL - GENERAL AND SPECIAL REVENUE FUND TYPES
Fiscal Year Ended June 30, 1995

	General Fund			Special Revenue Funds		
	Actual on Budgetary Basis	Budget	Variance Favorable (Unfavorable)	Actual on Budgetary Basis	Budget	Variance Favorable (Unfavorable)
REVENUES						
State allotted appropriations	$ 703,882,288	$ 703,882,288	$ --	$ --	$ --	$ --
Intergovernmental revenues	--	--	--	80,948,417	94,547,283	(13,598,866)
Other revenues	--	--	--	20,441,066	22,400,513	(1,959,447)
	703,882,288	703,882,288	--	101,389,483	116,947,796	(15,558,313)
EXPENDITURES						
School level instruction and support	539,100,264	546,925,603	7,825,339	56,786,723	76,554,119	19,767,396
Instructional support	24,814,181	25,413,710	599,529	916,281	2,467,035	1,550,754
State and district administration	36,806,171	36,961,657	155,486	984,494	1,259,544	275,050
School support	66,039,953	68,638,772	2,598,819	38,608,790	35,037,347	(3,571,443)
School community service	24,889,524	25,942,546	1,053,022	2,044,082	1,629,751	(414,331)
	691,650,093	703,882,288	12,232,195	99,340,370	116,947,796	17,607,426
EXCESS OF REVENUES OVER EXPENDITURES	12,232,195	--	12,232,195	2,049,113	--	2,049,113
OTHER FINANCING USES						
Operating transfers out	--	--	--	(51,346)	--	(51,346)
EXCESS OF REVENUES OVER EXPENDITURES AND OTHER USES	$ 12,232,195	$ --	$12,232,195	$ 1,997,767	$ --	$ 1,997,767

See accompanying notes to the combined financial statements.

Schedule I

State of Hawaii
Public School System
COMBINING BALANCE SHEET - SPECIAL REVENUE FUNDS
June 30, 1995

	Federal Grants	Lahainaluna Boarding School	Adult Education	School Food Services	Summer School	Driver's Education	Use of School Facilities	Special School Fees	Storeroom	Hurricane Iniki Insurance	Total
ASSETS											
Cash	$ 9,478,564	$ 15,899	$ 492,161	$ 2,515,233	$ 1,623,962	$ 245,763	$ 535,774	$ 310,678	$ 1,025,781	$ 195,143	$16,438,958
Receivables											
Due from Federal Government	4,991,025	–	–	–	–	–	–	–	–	–	4,991,025
Due from other funds	16,643	–	–	–	–	–	–	–	–	–	16,643
Accounts receivable	–	–	–	350,661	–	–	–	–	–	–	350,661
Inventory of materials and supplies	–	–	–	–	–	–	–	–	2,276,887	–	2,276,887
TOTAL ASSETS	$14,486,232	$ 15,899	$ 492,161	$ 2,865,894	$ 1,623,962	$ 245,763	$ 535,774	$ 310,678	$ 3,302,668	$ 195,143	$24,074,174
LIABILITIES AND FUND BALANCES											
LIABILITIES											
Vouchers payable	$ 1,003,274	$ –	$ 9,959	$ 270,322	$ 26,936	$ 26,841	$ 10,601	$ 17,596	$ 29,896	$ 49,801	$ 1,445,226
Accrued wages and employee benefits payable	2,300,417	824	737	2,408	194	19,609	–	–	–	–	2,324,189
Deferred revenues	6,397,082	–	–	–	–	–	–	–	–	–	6,397,082
Due to others	859,372	–	–	–	–	–	–	–	–	–	859,372
Total liabilities	10,560,145	824	10,696	272,730	27,130	46,450	10,601	17,596	29,896	49,801	11,025,869
FUND BALANCES											
Reserved for encumbrances	2,616,851	63	33,356	–	45,470	191,001	41,640	49,755	739,897	132,312	3,850,345
Reserved for inventory of materials and supplies	–	–	–	–	–	–	–	–	2,276,887	–	2,276,887
Unreserved	1,309,236	15,012	448,109	2,593,164	1,551,362	8,312	483,533	243,327	255,988	13,030	6,921,073
Total fund balances	3,926,087	15,075	481,465	2,593,164	1,596,832	199,313	525,173	293,082	3,272,772	145,342	13,048,305
TOTAL LIABILITIES AND FUND BALANCES	$14,486,232	$ 15,899	$ 492,161	$ 2,865,894	$ 1,623,962	$ 245,763	$ 535,774	$ 310,678	$ 3,302,668	$ 195,143	$24,074,174

Schedule II

State of Hawaii
Public School System
COMBINING STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES - SPECIAL REVENUE FUNDS
Fiscal Year Ended June 30, 1995

	Federal Grants	Lahainaluna Boarding School	Adult Education	School Food Services	Summer School	Driver's Education	Use of School Facilities	Special School Fees	Storeroom	Hurricane Iniki Insurance	Total
REVENUES											
Intergovernmental revenues	$89,525,049	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$89,525,049
Other revenues	–	17,214	634,955	15,095,122	3,335,952	661,534	572,276	190,756	2,035,540	–	22,543,349
	89,525,049	17,214	634,955	15,095,122	3,335,952	661,534	572,276	190,756	2,035,540	–	112,068,398
EXPENDITURES											
School level instruction and support	55,830,081	15,517	–	–	3,091,628	610,533	–	217,774	1,921,980	485,065	62,172,578
Instructional support	1,126,725	–	–	–	–	–	–	–	–	–	1,126,725
State and district administration	1,006,761	–	–	–	–	–	–	–	–	–	1,006,761
School support	33,642,986	–	–	14,943,006	–	–	–	–	–	–	48,585,992
School community service	1,211,616	–	654,530	–	–	–	584,195	–	–	–	2,450,341
	92,818,169	15,517	654,530	14,943,006	3,091,628	610,533	584,195	217,774	1,921,980	485,065	115,342,397
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	(3,293,120)	1,697	(19,575)	152,116	244,324	51,001	(11,919)	(27,018)	113,560	(485,065)	(3,273,999)
OTHER FINANCING USES											
Operating transfers out	(20,000)	–	–	–	–	–	(31,346)	–	–	–	(51,346)
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES AND OTHER USES	(3,313,120)	1,697	(19,575)	152,116	244,324	51,001	(43,265)	(27,018)	113,560	(485,065)	(3,325,345)
OTHER CHANGES IN FUND BALANCES											
Increase in reserve for inventory of materials and supplies	–	–	–	–	–	–	–	–	274,169	–	274,169
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES, OTHER USES, AND OTHER CHANGES IN FUND BALANCES	(3,313,120)	1,697	(19,575)	152,116	244,324	51,001	(43,265)	(27,018)	387,729	(485,065)	(3,051,176)
FUND BALANCES AT JULY 1, 1994	7,239,207	13,378	501,040	2,441,048	1,352,508	148,312	568,438	320,100	2,885,043	630,407	16,099,481
FUND BALANCES AT JUNE 30, 1995	$ 3,926,087	$ 15,075	$ 481,465	$ 2,593,164	$ 1,596,832	$ 199,313	$ 525,173	$ 293,082	$ 3,272,772	$ 145,342	$13,048,305

Schedule III

State of Hawaii
Public School System
COMBINING BALANCE SHEET - TRUST AND AGENCY FUNDS
June 30, 1995

	Expendable Trust Funds		Agency Funds	
	Athletic Trust Fund	Other Funds	Local School Funds	Total
ASSETS				
Cash	$359,488	$1,081,565	$ 6,110,539	$ 7,551,592
LIABILITIES AND FUND BALANCES				
LIABILITIES				
Vouchers payable	$ 22,215	$ 20,493	$ --	$ 42,708
Accrued wages and employee benefits payable	--	132,351	--	132,351
Due to student groups and others	--	--	6,110,539	6,110,539
Due to other funds	--	16,643	--	16,643
Total liabilities	22,215	169,487	6,110,539	6,302,241
FUND BALANCES				
Reserved for encumbrances	41,324	283,206	--	324,530
Reserved for trust funds	295,949	628,872	--	924,821
Total fund balances	337,273	912,078	--	1,249,351
	$359,488	$1,081,565	$ 6,110,539	$ 7,551,592

State of Hawaii
Public School System
COMBINING STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES - EXPENDABLE TRUST FUNDS
Fiscal Year Ended June 30, 1995

	Athletic Trust Fund	Other Funds	Total
REVENUES			
Other revenues			
Donations and gifts	$ --	$ 368,092	$ 368,092
Foundations and other grants	--	1,173,978	1,173,978
Athletic trust fund	483,809	--	483,809
Others	--	678,707	678,707
Total revenues	483,809	2,220,777	2,704,586
EXPENDITURES	508,357	1,690,664	2,199,021
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	(24,548)	530,113	505,565
FUND BALANCES AT JULY 1, 1994	361,821	381,965	743,786
FUND BALANCES AT JUNE 30, 1995	$337,273	$ 912,078	$ 1,249,351

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Guidelines for Legislative Review

Here we propose general guidelines for the Legislature in reviewing requests for funding of major computer systems.

We believe that a legislative review should not be limited to the initial request for funds. It should be ongoing. It should span the system development process and end only when the system is fully operational and has become part of the agency's routine. Our guidelines for review are therefore twofold. They cover (1) the review of the funding request, and (2) the requirements for status reports to the Legislature during system development.

The review of the funding request has two objectives: first, to assure the Legislature that the requesting department or agency has identified its needs, evaluated alternatives, and selected the best course of action, and second, to provide assurance that the department or agency has a reasonable workplan and cost estimates for achieving the desired outcome. The objective of requiring status reports is to allow the Legislature to monitor the progress of major computer system projects.

Review of Request for a Major Computer System

The initial request for funding of a major computer system should be accompanied by a report justifying the need for the system. The report should contain a description of problems with the existing system, an analysis of alternatives, a project workplan, and cost estimates of implementation. It should be written in language a lay person can understand. In reviewing the report, the Legislature should look for the following information:

- *Overview of the existing system*. The overview describes the system currently in place at the department or agency.
- *Discussion of problems with the existing system*. This section describes the problems with the existing system and provides the rationale for a new system.
- *Analysis of alternatives*. This section should identify and evaluate alternative ways of dealing with the existing situation. It would propose the best course of action. It should justify why the proposed course is the best alternative.

- *Discussion of the goals of the new system and description of project organization.* The report should describe the goals of the new system, both long and short term. It should then set forth how the project will be organized to achieve those goals.

- *Workplan for the system development process.* This section should include a fairly detailed workplan that lays out the timeframe and resources necessary for each of the system development phases: analysis phase, design phase, construction phase, and implementation phase.

- *Cost estimate.* This section should estimate what each phase will cost. This estimates should be classified by major cost category: for example, consultants, system software, system hardware, and so forth. Cost estimates should include the recurring costs of maintaining the system that the State must incur.

Review Annual Status Reports

Because major computer systems often take several years to implement, ongoing legislative review will be aided by annual status reports. These should be mandatory until the new system is fully operational and has become part of the day-to-day routine of the department of agency. While each computer system will have different characteristics, certain basic information will hold the same and should always be part of the status reports.

Status reports should at a minimum (1) compare the implementation status of the project to the workplan and explain any variances; (2) discuss problems encountered and their actual or intended resolution; (3) describe major shifts in direction or major changes in plans; (4) break down the actual costs to date; and (5) break down the estimated costs to complete.

Notes

Chapter 2

1. Hawaii, The Auditor, *Study of the Development of the Department of Education's Financial Management System and Program Information System*, Report No. 91-2, Honolulu, January 1991.

2. Hawaii, The Auditor, *An Update on the Department of Education's Financial Management System and School Information System*, Report No. 93-3, Honolulu, January 1993.

3. Letter to Marion M. Higa, State Auditor, from Charles T. Toguchi, Superintendent of Education, February 12, 1993.

4. Hawaii, The Auditor, *An Update on the Department of Education's Financial Management System and School Information System*, p. 16.

5. Hawaii, The Auditor, *The Feasibility of Applying the Micro-Financial Analysis Model to Expenditures for Public education in Hawaii: What Reaches the Classroom?*, Report No. 96-6, Honolulu, September 1994.

6. Hawaii, Department of Education, "Budget Preparation Operating Budget Request Instruction," Fiscal Biennium 1995-97."

7. Ibid.

8. Ibid.

9. Hawaii, Department of Education, "Budget System Handout," 1995.

10. Hawaii, The Auditor, *The Feasibility of Applying the Micro-Financial Analysis to Expenditures for Public Education in Hawaii: What Reaches the Classroom?*, p. 26.

Chapter 3

1. Hawaii, Department of Education "Procurement Policies and Procedures," August 1989, p. IV-3.

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Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Department of Education on March 8, 1996. A draft of the report was also transmitted to the Board of Education. A copy of the transmittal letter to the Department of Education is included as Attachment 1. A similar letter was sent to the Board of Education. The Department of Education's response is included as Attachment 2. The Board of Education did not respond.

The department's response stated that "In general, the department accepts and concurs with your office's recommendations." The department agrees that a comprehensive planning, budgeting, and financial accounting system that focuses on the school level is highly desirable. It included as an exhibit general and specific comments about various issues and problems relating to the improved planning, budgeting, and financial accounting system. It maintains that it is exploring an expenditure reporting system on a school-by-school basis, similar to the model used by the Florida Department of Education. The department contends that it has complied with the legislatively required reporting of expenditures by function on a school-by-school basis. It believes the expenditure report contained in its data warehouse computer files meets this requirement. The department concurs that this information is not currently available on its financial management system.

The department states that these initiatives will require additional funding from the Legislature. To assist the Legislature in its assessment of the department's request, we have provided as an appendix to this report *Guidelines for Legislative Review* of requests for this type of funding.

The department states that it now has established and promulgated written procedures for schools to follow when handling cash receipts. The department does not agree with our recommendation that schools deposit their cash receipts directly into the state treasury. It believes the number and volume of deposits and the proximity of banking facilities make this unfeasible. It states that the bank now provides the department with deposit information on electronic media which has greatly helped the reconciliation process and the bank accounts are now being reconciled monthly. We are pleased that the department has addressed the problem through alternative measures.

With regard to the issue of excessive storeroom inventory, the department generally defends its current practices, but states it will re-evaluate inventory levels to determine if they can be reduced.

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

March 8, 1996

COPY

The Honorable Herman M. Aizawa
Superintendent of Education
Department of Education
Queen Liliuokalani Building
1390 Miller Street
Honolulu, Hawaii 96813

Dear Dr. Aizawa:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Financial Audit of the Public School System*. We ask that you telephone us by Tuesday, March 12, 1996, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Monday, March 18, 1996.

The Board of Education, 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

Marion M. Higa
State Auditor

Enclosures

BENJAMIN J. CAYETANO
GOVERNOR

HERMAN M. AIZAWA, PH.D.
SUPERINTENDENT

STATE OF HAWAII
DEPARTMENT OF EDUCATION
P. O. BOX 2360
HONOLULU, HAWAII 96804

OFFICE OF THE SUPERINTENDENT

RECEIVED
MAR 18 3 27 PM '96
OFC. OF THE AUDITOR
STATE OF HAWAII

DATE: March 18, 1996

MEMO TO: Ms. Marion M. Higa, State Auditor

FROM: Herman M. Aizawa, Ph.D., Superintendent

SUBJECT: **Auditor's Report titled: "Financial Audit of the Public School System"**

Thank you for the opportunity to review and comment on the Financial Audit of the Public School System.

We are pleased that the audit report contained the following conclusions:

* "With respect to the items tested, the public school system has complied, in all material respects, with laws and regulations applicable to the public school system." (Ref.: page 35)

* "We believe none of the reportable conditions described in Chapter 3 [Internal Control Practices] are material weaknesses." (Ref.: page 39)

However, the department recognizes that there are several critical recommendations in your report which deserve significant attention.

Recommendations are in two chapters of your report:
Chapter 2: Financial Management System
Chapter 3: Internal Controls

The DOE's responses to the specific recommendations of the report are provided below:

Chapter 2: Financial Management System (FMS):

Recommendation #1: We recommend that the Legislature require the department to develop a comprehensive planning, budgeting and financial accounting system that begins at the school level.

AN AFFIRMATIVE ACTION AND EQUAL OPPORTUNITY EMPLOYER

DOE Response:

The department welcomes the concept of a comprehensive system which would integrate planning, budgeting, and financial accounting needs, originating at the school level. In addition to those key areas, we feel that it would be equally important to link personnel and student information as well. This comprehensive system would provide valuable information for management judgment, decision-making, accountability and for evaluations of programs, focused at the school level.

If the Legislature supports the development of this comprehensive system, assuming that adequate resources are provided, the department is prepared and willing to work together to do what is necessary to achieve this goal.

However, the DOE does not have the resources in its current budget to develop such a comprehensive system. We ask that the Legislature support this initiative, by providing additional funds for system development. If the DOE is required to achieve this system development without additional resources, the achievement of this goal would require an inordinate length of time, well beyond several biennium budget periods.

Recommendation #2:

The department should develop expenditure reports by function on a school-by-school basis as required by law.

DOE Response:

The department has complied with Act 218, SLH 1995, which requires a school-by-school expenditure report by location and function. The report is stored in the department's data warehouse files which are accessible by the State Auditor and the Legislature. State and district level costs are allocated by functions to each school based on student enrollment.

The department concurs with the statement that expenditures by function and location are not currently available in the FMS system. However, we disagree with the report section which states that, "Charges entail adding some accounting codes at the school level for expenditures previously budgeted and accounted for at the state and district level." These codes will not be sufficient to obtain school-by-school expenditure reports by location and function. At a minimum, a methodology must be developed to allocate personnel costs for state and district personnel who serve multiple schools. Our understanding is that the existing payroll system, maintained by the Department of Accounting and General Services, does not have the capability to process cost allocations to multiple areas.

The audit report states that, "School-level budgeting should include the costs for the goods and services that are currently budgeted centrally." We recognize that this involves full allocation of state and district costs to the school level. Considering the limitations of existing systems, both within the DOE and at other related state agencies, the DOE is willing to explore alternative school-by-school systems, such as the electronic financial management system currently used by Florida's Department of Education, and the adaptability of such systems to Hawaii. The Florida system was mentioned in your office's Report No. 95-23, Case Study: Royal Elementary School.

However, in order to explore alternatives and develop a new school-by-school expenditure system, we ask that the Legislature support this initiative, by providing additional funds for system evaluation and development. The DOE currently does not have resources in its current budget to support this project.

Recommendation #3: The department should take steps necessary to improve the timeliness and usefulness of the financial reports prepared for the public school system.

DOE Response: The department's FMS system provides on-line status of all schools' and offices' account balances. The on-line reports are available on demand at each school and office to obtain daily or current information for users for analysis, evaluation and planning, to make informed decisions. The hard copy financial reports which are sent to the schools are historical information at the close of each month, which the schools can use to review the details of transactions processed during the month.

Recommendation #4: The department should continue its efforts to update the *FMS Reports Guide and Glossary* and include all reports prepared by the FMS.

DOE Response: The *FMS Reports Guide and Glossary* has been updated in draft form, and has been distributed for review by DOE staff. Consolidation of corrections and revisions will take place in April; final editing and printing in May, and distribution to users in June 1996.

Recommendation #5: The department should develop a long-range plan to make improvements to its financial management system. In doing so, the department should consider whether investing more public funds to enhance FMS is worth the expected benefits.

DOE Response: The department has completed a set of incremental FMS improvement tasks, and has an additional series of improvements scheduled and under development. We have achieved increases in FMS usability and availability; however, we acknowledge that response-time has not improved to the degree we had originally expected. The improvement tasks still in process, along with anticipated benefits from complementary efforts to upgrade the ICSD Host computer system and the DOE Wide Area Network, are intended to result in more significant response-time reductions. A long-range FMS improvement plan will be developed that incorporates current efforts as well as future alternatives.

(Please refer to Exhibit A attached for further explanatory details.)

Chapter 3: Internal Control Practices:
The department concurs with the auditor's recommendations, **except as noted below:**

Recommendation #1: The department should establish written procedures and a checklist for reviewing cash receipts at the school level by the principal or a designee independent of the accounting functions.

DOE Response: The department has established written procedures in a newly-developed FMS User Policy Flow Guide, which has now replaced the Business Office Handbook, Volume I. The written procedures are in Chapter 7 - "Accounting for Collections" and in Chapter 9 - "Non-Appropriated Local School Fund Policies on Compensating Internal Accounting Controls" on cash receipts, and an "Administrator's Check List" (Exhibit IX-I) dated August 26, 1995 and September 1, 1995. This FMS User Guide, with these written procedures and checklist, was issued to the schools on December 20, 1995.

Recommendation #4: The department should cease using separate checking accounts for school deposits and require that schools deposit all moneys directly into the state treasury.

DOE Response: The department does not agree with this recommendation for the following reasons:

a. The department has an agreement with the Department of Budget & Finance (B&F) staff to consolidate the department's deposits from over 240 schools and offices. The reasons for the request for consolidation of deposits were (1) the volume of Treasury Deposit Receipts (TDR) B-13's generated by the schools, (2) the volume of errors due to credit and debit memos and dishonored checks, and follow-up required by B&F, and (3) the difficulty in reconciliation of the bank statement.

b. The process of allowing schools to deposit their cash directly into the state treasury seems to be a simple solution. However, this process would create a tremendous burden to the school staff. The schools would be required to prepare a TDR to B&F for every deposit. Currently, for School Lunch receipts, the schools need only to prepare a bank deposit slip and deposit the receipts with our bank. This alone has reduced the workload of the school staff tremendously, and we have received positive comments on the system. Our bank supports us by providing monthly bank statements listing daily deposits by school, to aid in the reconciliation process. Additionally, the bank provides schools with deposit information on electronic media, tape, and downloads using a specific type of computer software. This process has improved the transmitting of collections on a timely basis to the state treasury. In addition, this new system has eliminated the risk of erroneous data entry, and has resolved bank reconciliation problems. Therefore, since September 1995, the inception of this new system, the bank account is being successfully reconciled on a monthly basis.

c. Schools are provided with armored car services at one bank only. If the department is required to deposit into the state treasury directly, additional armored car services costs would be incurred. Certain schools may not be banking with the same bank, or schools must transfer their accounts to where the state treasury account is domiciled. Individual bank deposit slips for each school would have to be created with the school code encrypted to identify the school's deposit, each time the state treasury changes banks. This would create more confusion for the schools.

Recommendation #5: The department should reduce its storeroom inventory and maintain inventory levels sufficient to meet a few months' demand. It could then consider leasing a smaller warehouse.

DOE Response: The department's storeroom procedures are directed toward ensuring appropriate inventory levels. In the determination of inventory levels, the storeroom takes into account the significant lead time required to complete the procurement process for large purchases. The procurement process for contracting large purchases takes at least sixty (60) days to get the contract executed (signed/approved). This includes researching the goods or services to be bid; writing of the minimum specifications; advertising; bid preparation by bidders; bid opening and evaluation; fund certification; proper execution of forms; and review and approval as to form by the Office of the Attorney General. The time is further extended by ensuring satisfactory delivery by the contractor; stocking; filling of orders; packaging; and delivery to locations on Oahu or the neighbor islands. Due to these time delays, if the storeroom stocks at relatively low levels, we run a significant risk of not being able to supply our schools with critically needed items.

With regard to year-end inventory, the storeroom maintains inventory levels to accommodate the significant demands of school opening orders, which normally occur between May through August. Orders are minimized in June due to annual inventory and audit, and levels are replenished when they are depleted, beginning on or about September. The particular purchase order for $164,000 mentioned in the report (Ref.:page 27) was for copy paper purchased when the price of paper was doubling. It was issued based on a DAGS price list. When a shortage occurred, the purchase order was cancelled in August 1995 because the vendor could not fill the order.

However, with due attention given to the auditor's recommendation, we will re-evaluate our storeroom inventory levels to determine if they could be reduced. We will explore the need for a computerized inventory management system, which would track consumption rates, movement of goods, and provide calculations of optimum inventory levels. In addition, we will review the operations to determine if further efficiencies can be achieved, including warehouse capacity considerations and other alternatives. We expect that this evaluation will be completed by early 1997.

Internal Controls in Other Areas: (Report reference: page 34)
The department concurs with the auditor's recommendations, with the following additional comments on certain items:

Recommendation #2: The department should establish written procedures for district school food service supervisors to monitor cafeteria collection overages and shortages.

DOE Response: The department acknowledges that there are no written procedures governing the monitoring of cash shortages and overages in the cafeteria collections. We will establish written procedures to monitor cash shortages and overages at the appropriate levels.

Recommendation #3: The department should improve its written enrollment and collection procedures for the A+ Program.

DOE Response: Closer monitoring of A+ fee collections by district A+ coordinators is now possible, due to guidelines developed since April 1995. These guidelines require the A+ site coordinators to provide monthly collection reports to the district. Discrepancies between enrollment and fees collected can now be readily addressed by the district coordinators. It is expected that district staff will follow-up with site coordinators, to ensure that all fees are collected and appropriate follow-up is made on delinquent parents. Informal reports by district staff indicate that there are fewer delinquent problems since the implementation of the collection and reporting guidelines.

In addition, in May 1996, A+ district staff will evaluate its written enrollment and collection procedures. It is expected that procedures on fee collection, enrollment counts, and delinquent payments will be clarified and further strengthened. There also will be discussion on enforcement of these procedures.

Concluding Remarks:

We appreciate the opportunity to comment on your report. In general, the department accepts and concurs with your office's recommendations. We have provided comments in areas of disagreement, or where we felt that more information could be of value in understanding the department's views.

We agree that it is highly desirable to develop of a comprehensive planning, budgeting and financial accounting system that focuses on the school level. We also are open to exploring the development of a full-cost-allocated expenditure reporting system on a school-by-school basis, similar to the model used by the Florida Department of Education.

Our request is that the Legislature support these initiatives by providing additional funding to adequately establish a means of achieving the objectives. The department currently does not have resources in its current budget to support these initiatives.

Attachment

EXHIBIT A

Response to Auditor's Report

Summary

We do not disagree with the auditor's conclusion that response time is the major limitation of FMS. We do believe, however, that we have made cumulative improvements to the overall usability of FMS, to system availability (up-time), and have provided more local, workstation-based capabilities to reduce dependence on the central host. We have not, unfortunately, been able to address either of the two biggest contributors to response-time: the Host computer capacity and capabilities, and the Workstation capacity and capabilities.

The survey that we sent to all users in 1995 indicated that although response time was still a problem, users were better able to get their work accomplished. As a result of various small improvements, the off-line alternatives, the access scheduling (to keep the system from saturating), and increased hours of availability, the "bottom-line" sense we got from the surveys was this: "Users are not happy that the system is still much slower than they would like it to be, but they were better able to get their work done than in previous years." We also get this sense from discussions we have with schools, and from the types of calls we get during the peak period of May - August, when the on-line load is so high that the system used to almost lock up. In this period in 1995, there were far fewer "problem" calls related to response-time.

There is no magic bullet that will significantly improve FMS response time other than a major increase in the performance and capacity of the host computer it runs on, and this has not been a practical alternative (see section below on this subject). We believe that the "solution" lies in the combined effect of multiple improvement areas. Some of these are discussed below, along with specific comments relating to the Audit report.

1. Response Time Measurement

   Although we certainly don't want to defend FMS response-time as being acceptable, any measurement of it should be done on a consistent basis. All of the internal parameters that we monitor, which indicate the load level of the system, have shown that the system operates a little better than it used to. Our user survey results and qualitative observations seem to indicate this also. We thus take issue with the auditor's measurement that seems to show it worse than in 1993. The most likely explanation for the discrepancy is that the FMS workload varies by about a factor of two, depending on the time of year. The 1995 measurements were taken on June 26, 27, 29 and July 11. These are the last days in the fiscal year, and the first days of the new fiscal year (FMS is closed to users during the first week of July for year-end processing). This time period represents, without question, the most heavily loaded, worst case conditions possible. Unless the 1993 measurements referred to in the Audit report were also taken in the similar year-end time period, the year-to-year comparison is not valid, and the 1995 measurements should be described as having been taken under the heaviest possible, worst case load.

2. Host Computer Resources

It has been evident for several years that there is a mismatch between the original sizing of the FMS system (the processing power, memory, and disk capacities needed to run this particular application) and the typical workload generated by the Schools and DOE offices (number of users and transaction volumes). The computer hardware resources available are clearly undersized for the application workload. This is not uncommon when large applications are developed and deployed, since it is impossible to accurately model and analyze the full scope of complex application logic, along with realistic workload scenarios, before a system is built. More often than not, systems come out undersized, since everyone involved, including and especially the hardware vendors, cannot afford to put a safety factor in the system sizing estimates, or the resulting cost may kill the project before it even starts.

If this undersizing is evident, why hasn't something been done about it ?
The Information & Computer Services Division (ICSD) of the Department of Budget & Finance, which operates the State's mainframe computer complex, has not had the funds to add more mainframe capacity for FMS use. DOE has not had the funds available to pay for additional FMS computer capacity to be installed at ICSD, without taking away from other school programs. Consequently, all FMS improvement efforts related to response time have had to nibble around the edges of the major problem, an undersized host computer, without directly addressing the major problem itself.

Although we are hesitant to count on it yet, there is currently a possibility of a host upgrade in 1996. This is being pursued by ICSD for environmental cost savings, but will also provide somewhat more CPU and memory capacity, which is likely to benefit FMS processing.

3. Wide Area Network

The current network being utilized by the FMS is a utility network that provides a cost effective way of handling different network protocols for different applications. Most of the communications lines to the schools are connected through dedicated analog lines leased by Hawaiian Telephone Company. The leased lines are subject to failure and DOE has to rely on the telephone company's ability to provide the continuity of services.

Most of the current network links have a redundant backup link to connect to the host in case of line failure.

DOE is in the process of upgrading its wide area network to a router-based network, and FMS together with other applications will be utilizing the upgraded network. The new network is based on Ethernet on CATV on Oahu and public Frame Relay service offered by Hawaiian Tel on the neighbor islands. The new network will provide wider bandwidth and token ring interface to the host, which should provide improved network response time. However, it should be noted that the new network will be shared by users of Internet for instruction, and may affect the FMS response time.

4. FMS Workstation PC's

We estimate that 10 to 25% of the FMS response-time can be attributed to the throughput of the workstation itself. The vast majority of FMS PC's are PS2 Model 55SX, which are 386 CPU's running at 16 Mhz, with 60 MB disk drives. These are over five years old, and obsolete by almost any standard.

In addition, a key part of our FMS software strategy is to move data and processing functions, where practical, to the workstation instead of the host. This creates a more balanced client-server architecture and reduces the host transaction load. However, there is no capacity left on the current workstations to accommodate these distributed functions.

Thus, upgrading the workstations will help response time in two ways: (1) by running the workstation software faster, and (2) by allowing more off-loading of functions from the host. Since there have been no funds available for a technology "refreshment" or replacement of these PC's, we are working on an interim plan to upgrade at least some of these with a new motherboard, CPU and disk drive combination as part of an integrated maintenance/upgrade plan.

5. System Availability

FMS is a much more stable system than it used to be. Periods of down time or non-availability are infrequent, and most often due to communication or hardware failures rather than software failures. The statistics clearly bear this out. Furthermore, we have optimized the software code and made significant reductions in running times of the nightly batch jobs, which also helps preserve a full daily on-line schedule.

6. Why Haven't Improvement Efforts Paid Off Yet?

Although it cannot be quantified accurately, we believe that the incremental gains resulting from improvement efforts have been offset by increased workload, leaving only a small net gain. In addition, some of the alternative capabilities we have developed, which free the user from FMS response-time (and also help reduce the load on the FMS host), are not yet being used widely enough by schools. Specifically:

A. Steady growth in the number of FMS workstations at schools. Some of this increase has been due to growth in school size and the establishment of new schools. Some growth, however, has been due to schools getting additional workstations in order to have more "pipes" into FMS because of the response time problem. Unfortunately, more FMS workstations make the problem worse for everyone, so this is a self-defeating strategy, but difficult to police and prevent.

B. New functions which have been added to FMS, including those needed by DOE Accounting to meet external agency requirements, those mandated by legislative actions, as well as those requested by users to simplify their input, perform additional verification of their input, and other user-interface improvements. These added requirements and their associated processing logic are not individually significant, but cumulatively comprise a moderate net increase in processing load.

C. Alternative capabilities not being fully used. We have developed alternative ways for schools to get some of their work done without being limited by FMS response time. The Off-line Purchase Order capability is a good example. However, so far only about 20% of the FMS PO volume is generated this way. Since generating PO's this way is at least three or four times faster than doing it on-line, why aren't more schools using it? (Training, support and encouragement have been provided.) The audit report states that users continue to be dissatisfied. However, when alternatives are provided, schools are slow to utilize them. We intend to put more effort into channeling users to the alternative capabilities.

7. Written Improvement Plans

The Audit report contains criticism (report paragraph entitled "Improvement Plans not Written") that some of the potential improvements to FMS are not in a written plan with cost estimates and schedules. The improvements referred to, however, are all improvements to computer hardware and network infrastructure that are the result of other developments being taken by the State or by DOE, for reasons and objectives that only incidentally benefit FMS.

The DOE Wide Area Network (WAN) upgrade is being implemented to provide Internet access to the schools, school access to instructional applications, and higher bandwidth for all administrative applications. FMS is only a small part of this. The effort is being funded incrementally by DOE. We discussed the WAN upgrade with audit team because it is a complementary effort that has potential future benefit for FMS. There is not, however, a firm timetable and deployment schedule that we can plan on for FMS purposes.

Similarly, the host computer upgrade we referred to in discussions with the Audit team is a plan that ICSD is hoping to be able to implement. As of this writing it is not yet out to bid, and may not happen. In any case, the motivation for such an upgrade is almost entirely a projected major cost saving in environmental costs (power, air conditioning, floor space, etc.), not performance improvement. The anticipated replacement models use far less power, require far less cooling, and take up far less floor space. It is anticipated (but not certain at this time since the bid process has not begun) that they also will have somewhat more CPU capacity and more memory. If they do, ICSD is still the final arbiter of how this is allocated among agencies and applications. We brought this up in the Audit team discussions because it can potentially make a difference to FMS, and we will continue our discussions with ICSD to request more CPU capacity and memory allocation.