
Financial Audit of the Highways Division of the Department of Transportation

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

Report No. 98-9
March 1998



THE AUDITOR
STATE OF HAWAII

The Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii 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 and 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.

Hawaii'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.



THE AUDITOR STATE OF HAWAII

Kekuanao'a Building
465 South King Street, Room 500
Honolulu, Hawaii 96813

OVERVIEW

THE AUDITOR
STATE OF HAWAII

Financial Audit of the Highways Division of the Department of Transportation

Summary

The Office of the Auditor and the certified public accounting firm of Deloitte & Touche LLP conducted a financial audit of the Highways Division of the Department of Transportation for the fiscal year July 1, 1996 to June 30, 1997. The audit examined the financial records and systems of accounting and internal controls and tested these for compliance with applicable laws and regulations. Because of the serious problems noted, Deloitte & Touche LLP was unable to express an opinion on the division's financial statements.

The division manages 2,300 lane miles of highways, employs 850 people, and generates volumes of \$325 to \$400 million annually.

We found that the financial records of the division were too incomplete to be audited in a timely manner. The division failed to 1) determine the proper amounts for all accounts, 2) reconcile the division's accounting records with the State's accounting records, and 3) prepare its financial statements in accordance with generally accepted accounting principles. Deloitte & Touche LLP considered the division's failure to perform these accounting procedures to be a reportable condition and a material weakness in the internal control system.

Specifically, we found that the fiscal staff failed to maintain its accounting records in a proper manner and to prepare its financial statements on a timely basis, resulting in a material weakness in internal controls. Many of the internal financial reports are not being used, as they are considered to be irrelevant or untimely. Projects have to be monitored using non-financial information and the annual fixed asset inventory was not performed by a district office as required by law.

We also found that cash management activities require improvement. The division is not maximizing its investment income because no formal analysis is prepared to determine the availability and need for cash by month. Furthermore, a significant portion of moneys collected from the public for highway purposes is being transferred to the State's general fund for general operating purposes.

Finally, we found that the division failed to comply fully with the Hawaii Public Procurement Code and the administrative rules relating to a sole source contract.

Recommendations and Response

We recommend that the division take steps necessary to ensure that the division's accounting records are properly maintained and financial statements are prepared on a timely basis. We also recommend that the fiscal staff generate more relevant and useful financial reports, ensure the accuracy of those reports and render them on a more timely basis. Further, we recommend that the division implement procedures to monitor its projects more effectively and ensure that all district offices complete their annual inventory of fixed assets within the time period required.

We also recommend that the division improve its cash management activities by preparing necessary analyses and that the Legislature, governor, Department of Transportation and Highways Division consider the negative long-term effect of transferring highway fund revenues to the general fund. We also recommend that the director of the department ensure compliance with the provisions of the Hawaii Public Procurement Code.

The department generally concurs with our findings and recommendations. It states that the division is currently working on a new performance accounting system to maintain accounting records in an accurate manner, prepare financial statements on a timely basis and improve internal financial reporting. Further, the department recognizes that monitoring of projects is a key factor to complete projects in a timely manner and within budget. The department also acknowledges its failure to complete the annual fixed asset inventory, stating that the Oahu District Office is currently trying to complete the \$300,000 fixed asset inventory by March 31, 1998. Although the department concurred with our finding that earmarked funds are being used for general operating purposes, it contends that this was mandated by Act 270, Session Laws of Hawaii 1997.

The department does not agree with our finding that the Highways Division failed to comply fully with the Hawaii Public Procurement Code and the administrative rules relating to a sole source contract. It contends that since the original sole source contract fell under the old procurement law, the amendment to the sole source contract was "grandfathered" in and therefore, did not require the division to follow the sole source procedures of the new procurement law. We generally disagree. The current procurement code and administrative rules are unclear on the treatment of amendments to contracts "grandfathered" in under the old procurement law. In addition, the scope requirements of phase II do not qualify the contract as a sole source contract under the new procurement law. And since the contract amount increased significantly with this amendment (\$1.5 million or over 150 percent), the department should have considered awarding phase II through a bidding process under the new procurement code. The spirit of open competition was violated and the State has no assurance it received the best value for the price.

Marion M. Higa
State Auditor
State of Hawaii

Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813
(808) 587-0800
FAX (808) 587-0830

Financial Audit of the Highways Division of the Department of Transportation

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

Conducted by

The Auditor
State of Hawaii
and
Deloitte & Touche
LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 98-9
March 1998

Foreword

This is a report of the financial audit of the Highways Division of the Department of Transportation for the fiscal year July 1, 1996 to June 30, 1997. 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 and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Deloitte & Touche LLP.

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

Marion M. Higa
State Auditor

Table of Contents

Chapter 1 Introduction

Background	1
Organization of the Highways Division	1
Objectives of the Audit	4
Scope and Methodology	4

Chapter 2 Internal Control Practices

Summary of Findings	5
Accounting Procedures Should Be Improved	6
Internal Financial Reporting Should Be Improved	7
Monitoring of Projects Should Be Improved	8
Fixed Asset Inventory Was Not Performed	9
Cash Management Activities Should Be Improved	10
Earmarked Funds Are Being Used for General Operating Purposes	11
Noncompliance with the Hawaii Public Procurement Code Was Noted	12

Chapter 3 Financial Audit

Summary of Findings	15
Independent Auditors' Report	15
Independent Auditors' Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	17
Description of Financial Statements	18
Notes to the Combined Financial Statements	18

Response of the Affected Agency	35
---------------------------------------	----

Exhibits

Exhibit A	Combined Balance Sheet-All Fund Types and Account Groups	31
Exhibit B	Combined Statement of Revenues, Expenditures and Changes in Fund Balances-All Governmental Types Year Ended June 30, 1997	33

Chapter 1

Introduction

This is a report of our financial audit of the Highways Division of the Department of Transportation of the State of Hawaii (Highways Division). The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of Deloitte & Touche LLP.

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

Background

Chapter 26, Hawaii Revised Statutes, empowers the Department of Transportation to establish, maintain, and operate the transportation facilities of the State, including highways, airports, and harbors. The department's Highways Division is responsible for the management and maintenance of the State Highway System and the location, design and construction of new highways and facilities. The Highways Division supervises the completion of state highway contracts in accordance with plans and specifications.

The Highways Division generates revenues of between \$325 to \$400 million annually. The major sources of the revenues are: federal grants-in-aid, fuel taxes, vehicle weight taxes, rental motor and tour vehicle surcharge taxes, and vehicle registration fees. In addition, the Highways Division issues revenue bonds and the State issues general obligation bonds to finance capital improvement projects.

The Highways Division expends between \$300 to \$390 million annually. The major classifications of expenditures are: operations and maintenance, administration, capital projects, debt service, Motor Vehicle Safety Office, and operating transfers to other state agencies.

The Highways Division manages approximately 2,300 lane miles of highways in the State Highway System on six islands, and employs approximately 850 people.

Organization of the Highways Division

The Highways Division is managed by the highways division chief. Each district in the State Highway System is managed by a district manager (Oahu, Hawaii, Kauai, and Maui, which includes the islands of Molokai and Lanai). Besides the four districts, the Highways Division is functionally divided into four offices and six branches.

- Oahu, Maui, Hawaii and Kauai Districts - Each island district is responsible for providing engineering services and field inspections of construction projects; and maintaining, altering, and repairing state roads, highways, and related structures. Practically all of the actual construction work is performed by outside contractors. The districts' project engineers and other personnel principally monitor the progress of the construction projects. At June 30, 1997, the four districts employed 553 personnel.
- Staff Services Office - The Staff Services Office is responsible for developing and maintaining program planning and control systems; providing coordination and liaison services for federal aid and legislative matters; preparing the Highways Division's budget; providing project management, management, fiscal, personnel and clerical support services; providing public information services; and coordinating data processing services. At June 30, 1997, the office employed 37 personnel.
- Landscape Services Office - The Landscape Services Office is responsible for developing a landscape master plan for the State Highway System, establishing landscape guidelines and procedures, and providing landscaping technical assistance to the branches and district offices. At June 30, 1997, the office employed one person.
- Management Information Systems Office - The Management Information Systems Office is responsible for planning and directing the development, implementation, operation and maintenance of computer-based information systems; serving as the on-site technical advisor to management; and acting as the division liaison with other state information systems agencies. At June 30, 1997, the office employed two personnel.
- Motor Vehicle Safety Office - The Motor Vehicle Safety Office is responsible for directing and administering the state's motor carrier and highway safety programs, establishing and updating motor carrier and highway safety standards and regulations, and reviewing all non-engineering highway safety projects and programs. At June 30, 1997, the office employed 39 personnel.
- Planning Branch - The Planning Branch is responsible for developing conceptual highway project plans and coordinating route adoption, conducting field surveys of traffic volumes and traffic characteristics, and directing the division's portion of the urban and rural transportation planning processes and other planning efforts by state and county agencies. At June 30, 1997, the branch employed 34 personnel.

- Design Branch - The Design Branch is responsible for preparing construction plans, specifications, and estimates for highway projects; conducting location and right-of-way surveys; negotiating project agreements with governmental agencies and public and private utilities; and providing technical services to other branches and district offices. At June 30, 1997, the branch employed 86 personnel.
- Right-of-Way Branch - The Right-of-Way Branch is responsible for acquiring and managing lands, right-of-ways, easements and other real property interests required for the construction of highways; providing advisory relocation assistance; and monitoring right-of-way activities by political subdivisions. At June 30, 1997, the branch employed 27 personnel.
- Materials Testing & Research Branch - The Materials Testing & Research Branch is responsible for managing all testing, quality assurance, research and development, soil engineering, and pavement design and special engineering studies; providing technical and consultative services relating to materials, foundations, pavements and environment quality; testing and certifying all test equipment and materials incorporated into all transportation facilities; conducting soil engineering studies; managing applied engineering research and development programs; and conducting technical services inspections and tests in all aspects of transportation systems. At June 30, 1997, the branch employed 40 personnel.
- Construction & Maintenance Branch - The Construction & Maintenance Branch is responsible for providing review and management services on statewide highway construction and maintenance programs; reviewing and consolidating district construction and maintenance budgets; reviewing policies and procedures for the purchase of materials; and estimating requirements of personnel, material, and equipment budgets. At June 30, 1997, the branch employed 9 personnel.
- Traffic Branch - The Traffic Branch is responsible for planning and designing roadway pavement markings and signs, traffic signals, highway lighting, and operational and safety improvements; and analyzing and monitoring operating characteristics, accident records, and statistical reports. At June 30, 1997, the branch employed 25 personnel.

Objectives of the Audit

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the Highways Division; to recommend improvements to such systems, procedures, and reports; and to report on the financial statements of the Highways Division.
2. To ascertain whether expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.
3. To make recommendations as appropriate.

Scope and Methodology

The contract with Deloitte & Touche LLP requires an audit of the financial records and transactions and a review of the related systems of accounting and internal controls of the Highways Division for the fiscal year July 1, 1996 to June 30, 1997. Included in the scope of work were all fund types and account groups. The contract also provides for review of the Highways Division's transactions, systems, and procedures for their compliance with applicable laws and regulations.

To the extent possible, we examined the existing accounting, reporting and internal control structure. We identified deficiencies and weaknesses in the internal control structure and made recommendations for improvement.

The independent auditors' report on the combined financial statements presented in Chapter 3 is that of Deloitte & Touche LLP. The work was conducted from July 1997 through October 1997 in accordance with *Government Auditing Standards*. Because of the severity of the problems noted in Chapter 3, Deloitte & Touche LLP was unable to complete its audit, and accordingly was unable to express an opinion on the Highways Division's financial statements.

Chapter 2

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 Highways Division of the Department of Transportation of the State of Hawaii (Highways Division).

Summary of Findings

We found serious deficiencies in the Highways Division's fiscal operations. These deficiencies are so serious that the certified public accounting firm of Deloitte & Touche LLP was not able to complete its audit of the Highways Division's financial statements and has reported one of the deficiencies as a material weakness. These findings are summarized below:

1. The financial reporting system is weak. The fiscal staff has failed to maintain its accounting records in a proper manner and to prepare its financial statements on a timely basis, resulting in a material weakness in internal controls. Many of the internal financial reports are not being used, as they are considered to be irrelevant or untimely. Projects have to be monitored using non-financial information. In addition, the required annual fixed asset inventory was not performed by a district office.
2. Cash management activities should be improved. Investment income is not being maximized, due to the Highways Division's inability to forecast on a monthly basis either its requirements for, or the availability of, excess cash.
3. Funds collected from the public that are earmarked for highway purposes are being transferred to the State's general fund to be used for general operating purposes. This may imply that the rates being charged to the public are higher than necessary to pay for the on-going costs of the State Highway System. Also, more costly funds, such as revenue bonds, may have to be used to pay for future costs.
4. A provision of the Hawaii Public Procurement Code relating to sole source contracts was violated. This may have prevented other qualified vendors from submitting proposals.

Accounting Procedures Should Be Improved

The Highways Division's management is responsible for establishing and maintaining effective controls to ensure that appropriate goals and objectives are met; resources are safeguarded; laws and regulations are followed; and reliable data are obtained, maintained, and fairly disclosed. An important aspect of these controls is the need for the Highways Division to maintain its accounting records in an accurate manner and to prepare its financial statements on a timely basis. We found that the fiscal staff in the Staff Services Office has not done so.

As of October 27, 1997, the fiscal staff had not yet done the following: (1) determine the proper amounts for all of the accounts, (2) reconcile the Highways Division's accounting records with the State's accounting records, and (3) prepare the Highways Division's financial statements in accordance with generally accepted accounting principles. The failure to complete these tasks within four months after the end of the fiscal year is symptomatic of a weak accounting system.

The failure of the fiscal staff to maintain the accounting records in a proper manner and to prepare the Highways Division's financial statements on a timely basis is not unique to the 1997 fiscal year. Based on a review of the past several years' audit reports and from discussions with highways division management, we found that the fiscal staff has historically been late in performing the required year-end accounting procedures. In fact, the fiscal staff even required the assistance of an outside CPA firm to help it with such procedures during the 1996 and 1997 fiscal years. The CPA firm was paid \$30,000 in each fiscal year to provide assistance in financial record reconciliation and schedule preparation, duties which should have been performed by the fiscal staff. Even with such outside assistance, the fiscal staff was still unable to complete the required 1997 fiscal year-end accounting procedures within four months after the end of the fiscal year.

It is unclear whether the fiscal staff's failure to maintain its accounting records in a proper manner and to perform the required year-end accounting procedures results from a lack of technical skills, shortage of staff, or indifference. The fiscal staff did not seem to be concerned that it was taking more than four months to perform the required year-end accounting procedures. In fact, during our entry conference in June 1997, the chief accountant informed us that it was normal for the fiscal staff to take at least six months after the end of a fiscal year to complete such procedures. Moreover, he did not indicate any intentions to change or improve the timeliness of such procedures. The division's senior management has not taken steps to correct the situation but seems to have accepted the fiscal staff's tardiness as a matter of course. Clearly, management should not tolerate such a practice.

The aforementioned matters result in a reportable condition that is considered to be a material weakness in the Highways Division's internal control system.

Recommendations

The Highways Division's management should determine the causes of the fiscal staff's failure to properly maintain the division's accounting records and to prepare financial statements on a timely basis. The division should take the steps necessary to correct this problem.

Internal Financial Reporting Should Be Improved

The Highways Division's operations consist mainly of constructing, improving, repairing, and maintaining highways, roads, bridges, lighting, and traffic signs and signals. In carrying out their operating activities, the Highways Division personnel must rely on financial information that is relevant, useful, timely, accurate, and complete. This information is provided through financial reports produced by the fiscal staff. We found that the Highways Division fiscal staff prepares a significant number of internal financial reports that are not used by many division managers.

The fiscal staff in the Highways Division Staff Services Office is responsible for providing the division personnel with financial information. The fiscal staff routinely prepares 59 financial reports on a monthly or annual basis. These reports generally include information such as summaries of expenditures according to various categories, status of appropriations, summaries of payroll and labor charges, listings of encumbrances, summaries of cash receipts, trial balances, and federal-aid information. Out of these 59 reports, only 13 are used by the Highways Division offices and branches on a regular basis. The majority of the reports are used only by the fiscal staff, and 19 reports are not used by anyone at all. The fiscal staff indicated that these 19 reports are still prepared because someone in the division requested them many years ago.

Managers in the division's offices and branches indicated that they use the internal financial reports mainly for historical reference but not for daily decision making purposes, because many reports are not useful, accurate, or timely. Management complained that the reports often lacked relevant information, are often two months late, are in formats that are difficult to understand, and sometimes include errors such as posting to the wrong accounts. As a result, managers must either prepare their own informal reports in a format that they can understand, or go without information that could assist them in carrying out their responsibilities. For example, budgetary information is usually not

included in the monthly report of revenues and expenditures. Therefore, the reports cannot assist managers to determine if division's projects are over- or under-budget at any given time.

In addition, the director and deputy directors do not usually use financial information prepared by the Highways Division's fiscal staff. Instead, they obtain the necessary financial information primarily from the Program, Planning, Budget Management and Analytical Office, a staff unit at the department level. This office is responsible for compiling information received from the Highways, Airports, and Harbors Divisions.

It appears that the majority of the financial reports prepared by the fiscal staff are not considered to be relevant, useful, or timely by most of the management of the Highways Division.

Recommendation

The fiscal staff should revise the types and numbers of financial reports being generated in order to be more relevant and useful to management personnel. The staff should ensure the accuracy of their reports and render them on a more timely basis.

**Monitoring of
Projects Should Be
Improved**

The Highways Division is responsible for ensuring that its projects are completed within budget and on time. A key factor in achieving this is its ability to monitor the progress of the projects on an on-going basis. We found that division personnel have difficulty in monitoring the projects due to a lack of necessary financial information and the division's organizational structure.

The monitoring of individual projects is performed primarily by project engineers. Most of the project engineers we interviewed indicated that they monitor the projects using non-fiscal information (e.g., quantity of materials used, length of pavement covered, days elapsed, etc.) or reports they prepared for themselves. They do so because the financial reports prepared by the fiscal staff do not always contain the required information (e.g., variance between budgeted and actual amounts) or are received too late. As a result, project engineers have difficulty forecasting possible budget overruns.

In addition, the division's organizational structure segregates responsibilities so that no one person is responsible for a particular highway project from its inception to its completion. For example, the Planning Branch is responsible for preparing conceptual plans; the Design Branch for preparing construction plans, specifications, and

estimates; and the Construction and Maintenance Branch for providing review and management services. Project engineers on each island are responsible for field inspections and monitoring the progress of the projects. So while many individuals have input into a project, no one individual is responsible for its outcome.

One indication of the division's lack of effectiveness in monitoring projects is the number and cost of amendments to on-going contracts processed during the 1997 fiscal year. A total of 35 amendments amounting to \$51.6 million were processed. While amendments to contracts are normal in any construction activity, a more effective monitoring process could have decreased the number and cost of amendments.

Another indication of the division's lack of effectiveness in monitoring projects is the amount of overtime the division incurred in the 1997 fiscal year—approximately 86,900 hours of overtime, amounting to \$2.1 million. This amount is equivalent to about 44 full-time staff. Adherence to the budgeted hours in the contracts could result in decreased overtime.

Recommendation

The Highways Division should implement procedures to monitor its projects more effectively. More relevant information should be provided to the project engineers on a more timely basis. Possibly consolidating responsibilities among division personnel should be considered.

Fixed Asset Inventory Was Not Performed

In order to ensure that the State's fixed assets are properly stated, Section 103D-1206, Hawaii Revised Statutes, requires that an annual inventory of fixed assets be taken before September 16th of each fiscal year. The annual inventory of fixed assets is considered to be a serious matter. Thefts or unauthorized disposals of fixed assets would not be detected if an inventory of fixed assets is not performed. The statutes provide that if an annual inventory is not filed within the time prescribed, the responsible individual's salary can be withheld, and the individual can be fined up to \$500 and imprisoned up to six months.

We found that the Oahu District did not perform such an inventory, in spite of repeated reminders by the Staff Services Office. Personnel at the Oahu District Office indicated that they were not able to conduct the annual inventory because other tasks of higher priority took precedence.

In the absence of an annual inventory, over \$300,000 of the Oahu District's fixed asset additions were not reported to the Department of

Accounting and General Services. This resulted in a misstatement of the fixed asset accounts in both the Highways Division's and the State's financial statements.

Recommendation

The Highways Division should ensure that all district offices complete their annual inventory of fixed assets within the time period required. Division managers should help establish work priorities for any district office that has difficulty complying with this requirement.

**Cash Management
Activities Should
Be Improved**

The Highways Division's cash balances normally remain at a consistently high level throughout the year. For example, the total cash with the director of finance was \$373.2 million at June 30, 1997 and \$396.6 million at June 30, 1996, and averaged \$378.9 million throughout the 1997 fiscal year. With such large amounts on hand, the division should be increasing its revenues even more by investing the maximum amount of excess funds throughout the year. However, we found that the division's cash management activities need improvement.

The division's policy is to invest up to 80 percent of excess cash. However, no formal analysis, such as a forecast of sources and uses of cash by project, is prepared to determine the amount of excess cash. Instead, the chief accountant uses his previous experience and knowledge to determine how much excess cash is available to be invested. In addition, since the projected cash that is available and needed for future months is not determined, the excess amounts are invested only in financial instruments with a 90-day maturity period, thereby limiting the rate of return that could be realized.

During the 1997 fiscal year, no excess cash at all was invested from July 1, 1996 to September 2, 1996. Nor were any of the amounts received from the federal government as reimbursements for grant expenditures invested. The fiscal office explains this non investment as due to the lack of staff to compute the amounts available to be invested.

As a result of these practices, the division does not maximize its investment income. During the 1997 fiscal year, investment income totaled \$11.0 million. Using the average cash balance of \$378.9 million, this income equates to a return on investment of only 2.9 percent. Assuming that 80 percent of the average cash balance could have been invested at an average return of 5 percent (the approximate rate of return in the last quarter of fiscal year 1997), the division could have earned \$15.2 million or \$4.2 million more than it actually earned.

Recommendation

The Highways Division should improve its cash management activities by preparing analyses to determine the availability and need for cash by month and investing excess cash for those periods in relation to the availability and need for cash.

**Earmarked Funds
Are Being Used for
General Operating
Purposes**

A significant portion of moneys collected from the public for highway purposes are being transferred to the State's general fund to be used for general operating purposes. In the fiscal year 1997, \$22.6 million was transferred, with another \$23.4 million intended to be transferred in the 1998 fiscal year and \$24.3 million in the 1999 fiscal year. These transfers were authorized by the 1997 Legislature.

Much of the Highways Division's revenues come from users of motor vehicles on the state's highways in the form of taxes, fees and charges. A state fuel tax is imposed at the rate of 16 cents per gallon of gasoline and diesel fuel. A vehicle weight tax is imposed at rates varying between .75 to 1.25 cents per pound of net vehicle weight. A rental motor vehicle surcharge tax is imposed at a rate of \$2 a day. A vehicle registration fee is imposed at a rate of \$20 per vehicle. A tour vehicle surcharge tax is imposed at a rate of either \$15 per month or \$65 per month, depending on the size of the vehicle. Lastly, a motor carrier safety inspection fee is imposed at the rate of \$1.50 per vehicle every six months. These revenues totaled approximately \$145 million in the 1997 fiscal year.

These revenues are accounted for in a special revenue fund called the State Highway Fund established by Section 248-8, Hawaii Revised Statutes. The moneys in the fund are supposed to be expended for the following purposes: (1) to pay the costs of operation, maintenance, and repair of the State Highway System; (2) to pay the costs of acquiring, planning, designing, constructing, and reconstructing the State Highway System; and (3) to reimburse the general fund for principal and interest on general obligation bonds, where the proceeds were used for State Highway Fund projects.

In the 1997 fiscal year, approximately \$146 million was budgeted for operation, maintenance, and administrative expenditures of the State Highway Fund. In addition, the Legislature appropriated \$359.9 million of capital improvement projects for the State Highway System in Act 218, SLH 1995, as amended by Act 287, SLH 1996. These appropriations funded a portion of the total capital improvement projects for the State Highway System by \$2.98 billion for the next six years, as estimated by the Department of Transportation in 1996.

The effects of transferring highway fund revenues to the general fund are two-fold. First, the taxes, fees and charges collected from motor vehicle users are being used for purposes other than highway construction, improvement, maintenance, and reimbursement of general obligation bond debt service for highway projects. This may imply that the rates for these taxes and fees are higher than necessary to pay for the on-going costs of the State Highway System. Second, more costly sources of funds, such as revenue bonds, may be needed in the future to pay for the costs of the State Highway System since the cash balance in the special revenue fund has been reduced. For example, the Highways Division is planning to issue another \$40 million of revenue bonds in the 1998 fiscal year. The interest payable on the bonds will most likely total in the millions over the term of the bonds. The overall effect of these transfers from the State Highway Fund is that the cost of operating the Highway Division may increase over the long term in order that the immediate fiscal needs of other state departments can be met.

Recommendation

The Legislature, governor, Department of Transportation and Highways Division should consider the negative long-term impact that the transfer from the State Highway Fund to the general fund may cause. It would be more cost effective to use the Highways Division's operating funds for its operating and capital improvement purposes than it would be to issue revenue bonds.

**Noncompliance
with the Hawaii
Public Procurement
Code Was Noted**

The Hawaii Public Procurement Code and the administrative rules adopted by the Procurement Policy Office establish the compliance requirements that state agencies must follow when purchasing goods and services. We noted that the Highways Division failed to comply fully with the code and the administrative rules relating to a sole source contract.

In 1990, the director of transportation entered into a sole source contract with a CPA firm to develop and install a comprehensive system of accounting, reporting and internal control for the Highways Division. The contract was divided into two phases: Phase I related to the requirements validation and system design alternatives, and Phase II related to the design, development, and implementation of the approved system design alternative. Phase I was to be completed within 90 days, and Phase II was to be performed only after receiving authorization from the director. The fees for Phases I and II were \$247,500 and \$750,000, respectively, or a total of \$997,500.

Although Phase I was to have been completed within 90 days, it actually took more than six years to complete. At the beginning of the 1997 fiscal year, Phase II had yet to be implemented. Since the total fees of \$997,500 for both phases were used to pay for Phase I, the original sole source contract was amended to add an additional fee of \$1,500,000 for Phase II.

The administrative rules relating to amending a sole source contract require that a "Notice of Amendment to Sole Source Contract" be completed and submitted to the chief procurement officer and posted in a public area at least seven days prior to any approval action. This posting requirement allows other vendors the chance to determine if they are also qualified to provide the desired services, and if so, to object to the sole source contract amendment. The chief procurement officer would then be alerted to other vendors who might be better qualified to perform the requested service.

We were informed by the Highways Division's contract management section that the notice was neither prepared nor posted in a public area.

In addition, because the scope of Phase II (implementation of the approved design alternative) was completely independent from Phase I (defining system requirements and proposing design alternatives), it would appear that both phases should have been awarded under separate contracts, thus necessitating that Phase II undergo a separate bidding process from Phase I.

Recommendation

We recommend that the director ensure compliance with the provisions of the Hawaii Public Procurement Code.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Highways Division of the Department of Transportation of the State of Hawaii (Highways Division) as of and for the fiscal year ended June 30, 1997. This chapter includes the independent auditors' report and the report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays financial statements together with explanatory notes.

Summary of Findings

Because of the Highways Division's failure to (1) determine the proper amounts for all of the accounts, (2) reconcile the Highways Division's accounting records with the State's accounting records, and (3) prepare its financial statements in accordance with generally accepted accounting principles, Deloitte & Touche LLP was unable to complete its audit of the financial statements. Accordingly, the scope of their work was not sufficient for them to express, and they did not express, an opinion on the Highways Division's financial statements.

Deloitte & Touche LLP considered the Highways Division's failure to perform the aforementioned procedures to be a reportable condition and a material weakness in the internal control system. But, they did not note, with respect to the items tested, any instance of noncompliance with laws and regulations applicable to the Department of Transportation of the State of Hawaii that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

To the Auditor
State of Hawaii

We were engaged to audit the following financial statements of the Highways Division of the Department of Transportation of the State of Hawaii (Highways Division):

- Combined Balance Sheet - All Fund Types and Account Groups, June 30, 1997 (Exhibit A).
- Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types, Year Ended June 30, 1997 (Exhibit B).

These financial statements are the responsibility of the management of the Highways Division.

As of the date of this report, management had not been able to (1) determine the proper amounts for all of the accounts, (2) reconcile the Highways Division's accounting records with the State's accounting records, and (3) prepare the Highways Division's financial statements as of June 30, 1997 in accordance with generally accepted accounting principles. Consequently, we were not able to complete our audit of the Highways Division's financial statements. In addition, the accompanying financial statements do not include (a) a combined statement of revenues and expenditures - budget and actual, (b) detail categories of revenues and expenditures in the combined statement of revenues, expenditures and changes in fund balances - all governmental fund types, and (c) footnote information relating to budgetary accounting and details of other financing sources and uses. We believe that such financial statement and financial information are required in order for the basic financial statements to be prepared in accordance with generally accepted accounting principles.

Because of the limitations on the scope of our audit discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 27, 1997 on our consideration of the Highways Division's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
October 27, 1997

**Independent
Auditors' Report
on Compliance and
on Internal Control
over Financial
Reporting Based on
an Audit of
Financial
Statements
Performed in
Accordance with
Government
Auditing Standards**

To the Auditor
State of Hawaii

We were engaged to audit the financial statements of the Highways Division of the Department of Transportation of the State of Hawaii (Highways Division) as of and for the year ended June 30, 1997, and have issued a disclaimer of opinion dated October 27, 1997.

Compliance

As part of attempting to obtain reasonable assurance about whether the Highways Division's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal control over financial reporting

In planning and performing our audit, we considered the Highways Division's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Highways Division's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described as follows:

As of the date of this report, management had not been able to (1) determine the proper amounts for all of the accounts, (2) reconcile the Highways Division's accounting records with the State's accounting records, and (3) prepare the Highways Division's financial statements as of June 30, 1997 in accordance with generally accepted accounting principles.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the 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 over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition described above is a material weakness.

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

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
October 27, 1997

Descriptions of Financial Statements

The following is a brief description of the financial statements which are attached to 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 the Highways Division at June 30, 1997.

Combined Statement of Revenues, Expenditures and Changes in Fund Balance - All Governmental Fund Types (Exhibit B). This statement presents the revenues, expenditures and changes in fund balances for the Highways Division for the year ended June 30, 1997.

Notes to the Combined Financial Statements

Explanatory notes, which are pertinent to an understanding of the 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

Act 1, Session Laws of Hawaii (SLH), Second Special Session 1959, the Hawaii State Government Reorganization Act of 1959 (Act), established the Department of Transportation (Department) whose function is to

establish, maintain and operate transportation facilities of the State of Hawaii (State), including highways, airports, harbors and such other transportation facilities and activities as may be authorized by law. The Department's activities are carried out through three primary operating divisions: Airports, Harbors and Highways. Through the Highways Division (Highways Division), the Department has general supervision of the management and maintenance of the State Highway System and the location, design and construction of new highways and facilities. The Highways Division provides supervision to assure completion of State highway contracts in accordance with plans and specifications.

Taxes, fees and charges authorized and collected relating to the operation and use of motor vehicles on public highways of the State are deposited into the State Highway Fund, and expenditures for purposes of the Act are made from the State Highway Fund.

The State Highway Fund also includes the Motor Vehicle Safety Office (MVSO). MVSO was originally established as the Highway Safety Coordinator's Office to implement the 1967 Hawaii Highway Safety Act. It was reorganized by the 1977 State Legislature to encompass the additional duty of the safety of operations of heavy motor vehicles. The MVSO is assigned as a staff office under the Highways Division.

***Note 2 - Summary of
Significant Accounting
Policies***

Basis of presentation. The accounts of the Highways Division are organized on the basis of funds and account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures. Governmental resources are allocated to and accounted for in individual funds based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

Amounts in the "Total (Memorandum Only)" columns in the combined financial statements represent summations of the financial statement line items of the fund types and account groups included in those statements, and are presented only for analytical purposes. Those summations may include fund types and account groups that use different bases of accounting. Consequently, amounts shown in the "Total (Memorandum Only)" columns are not comparable to a consolidation and do not represent the total resources available or total revenues and expenditures of the Highways Division.

For financial reporting purposes, the Highways Division includes all funds and account groups that are controlled by or dependent on the Highways Division's administrative head. Control by or dependence on

the Highways Division was determined on the basis of statutory authority and moneys flowing through the Highways Division to each fund or account.

The Highways Division uses the following fund types and account groups:

Governmental fund types

State Highway Fund: The State Highway Fund generally accounts for revenues and expenditures for highway operations and maintenance and administration.

The State Highway Fund is a special revenue fund of the State established by Section 248-8, Hawaii Revised Statutes (HRS). All fuel taxes collected under Section 243-4, HRS except county fuel taxes, aviation fuel taxes, and taxes on fuel sold for use in small boats are deposited in the State Highway Fund.

Section 248-9, HRS provides that moneys in the State Highway Fund shall be expendable by the Department for the design, construction, reconstruction, repair and maintenance, and for acquisition of rights-of-way for public highways included in the State Highway System established under Section 264-41, HRS.

Debt Service Fund: The Debt Service Fund accounts for the Highways Division's financial resources obtained and used for the payment of principal and interest on State of Hawaii Highway Revenue Bonds.

Capital Projects Fund: The Capital Projects Fund accounts for the Highways Division's highway construction projects and the related sources of financing.

The accompanying financial statements include highway projects authorized by legislative acts (Session Laws of Hawaii) through June 30, 1997.

General Fixed Asset Account Group

The General Fixed Asset Account Group is used to account for property and equipment used in the operations of the Highways Division.

Buildings and Improvements, Vehicles and Equipment: Property and equipment used in operations, other than land, are valued at cost or estimated cost in the General Fixed Asset Account Group. Depreciation is not recorded on the Highways Division's assets.

Highway Construction Expenditure: Acquisition costs of land remnants (comprised of land areas acquired in excess of rights-of-way needs which were purchased in connection with the construction of highway projects) and land for highways, related bridges, landscaping, drainage, lighting systems, curbs and gutters, and sidewalks have been excluded from property and equipment. These costs are recorded as expenditures as incurred.

At June 30, 1996, the latest date that information is available, the Highways Division had 847 parcels remaining with an aggregate acquisition cost of approximately \$1,254,000, which is not included in the combined balance sheet. Upon sale of a parcel to a private party, the proceeds are accounted for as a recovery of expenditures of the applicable Capital Projects Fund if the project has not been closed; otherwise, the proceeds are accounted for as revenues of the State Highway Fund.

General Long-Term Debt Account Group

The General Long-Term Debt Account Group accounts for liabilities associated with State of Hawaii Revenue Bonds, workers' compensation and compensated absence programs which are not expected to be liquidated with expendable available resources.

Basis of Accounting - The accompanying financial statements are prepared on the modified accrual basis of accounting. Under the modified accrual basis:

Revenues are recognized when received in cash except for those accruable, which are recorded as receivables when measurable and available. For financial statement purposes, unbilled reimbursable costs at year-end are accrued and recorded as revenue and receivable from the U.S. Government for federal grants-in-aid.

Expenditures are recorded on the accrual basis except that (1) disbursements for inventory are considered expenditures at the time of purchase, (2) prepaid expenses are not normally recognized, and (3) sick pay is not normally accrued.

Encumbrances - The Highways Division's accounting procedures provide for the recording of commitments as encumbrances at the time contracts are awarded and executed. For federal-aid highway projects, only that portion of the contract which is payable out of state and local moneys is encumbered. Purchase orders issued for materials, supplies and services chargeable to annual appropriations for operating costs which are outstanding at the end of the year are also encumbered. Encumbrances are recorded as a reservation of fund balance. Future

contractual amounts payable out of federal funds are approximately \$36,064,000 and \$165,052,000 at June 30, 1997 for State Highway Fund and Capital Projects Fund, respectively. Such amounts have not been encumbered as of June 30, 1997.

Cash - Cash reported in the combined balance sheet includes cash in the State Treasury, including repurchase agreements with maturities of three months or less, and deposits received and held for others in the amount of \$3,334,000 at June 30, 1997. The deposits were received on the Highways Division's contracts with third parties.

The State of Hawaii maintains a cash pool that is available for all funds. Each fund type's portion of this pool is displayed on the combined balance sheet as Cash with Director of Finance. Those funds are pooled with funds from other State of Hawaii agencies and departments and deposited in approved financial institutions by the Director of Finance.

Deposits not covered by federal deposit insurance are fully collateralized by government securities held in the name of the State of Hawaii by third-party custodians.

The HRS authorize the Director of Finance to invest in obligations of or guaranteed by the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

Departmental Administration - The departmental administration expenditures represent the Highways Division's share of the operating costs incurred by the administrative functions of the Department. The departmental costs, which are funded by the operating divisions of the Department, have been allocated to the State Highway Fund on a consistent basis from year to year.

Note 3 - Budgets and Budgetary Accounting

State Highway Fund. A statement of revenues and expenditures - budget and actual, which is required under generally accepted accounting principles, has not been included in the accompanying financial statements. In such a statement, amounts reflected as budgeted revenues would be the official estimates as compiled by the State Department of Budget and Finance at the time of budget consideration and adoption by the State Legislature. Revenue received from federal grants-in-aid would not be included in the statement since such grants are normally reimbursements of costs incurred on projects.

In the case of expenditures, the budgeted amounts to be reflected on a statement of revenues and expenditures - budget and actual would be

derived from: the General Appropriations Act of 1995 (Act 218, SLH 1995) and the Supplemental Appropriations Act of 1996 (Act 287, SLH 1996) - authorizations for expenditures for operating purposes for the Highways Division and the Motor Vehicle Safety Office; and the allocation portion of authorization for expenditures for departmental administration.

With reference to a statement of revenues and expenditures - budget and actual, budget and actual amounts for expenditures would include encumbrances and would exclude expenditures charged to prior years' appropriations and unbudgeted federally funded expenditures.

Capital Projects Fund. Excess Capital Projects Fund appropriations lapse after completion of the project which is generally two or three years subsequent to appropriation. Funds appropriated as part of a qualified federal financial assistance program do not lapse.

Note 4 - Tax and Fee Revenues

State fuel tax. The primary source of revenue for the State Highway Fund is the state tax on liquid (motor vehicle) fuel. For the year ended June 30, 1997, the tax imposed on each gallon of fuel is as follows:

Gasoline	16 cents
Diesel fuel:	
Non-highway use	1 cent
Highway use	16 cents
Liquefied petroleum gas:	
Non-highway use	1 cent
Highway use	11 cents

Vehicle weight tax and penalties. The vehicle weight tax is .75 to 1.25 cents per pound of net vehicle weight (depending upon the weight of the vehicle) to a maximum of \$150.

Delinquent penalties, determined by counties, are assessed at 10% - 20% of the tax imposed or are a flat charge of \$8 or \$20, depending on the type of vehicle.

Rental motor vehicle surcharge tax. The rental motor vehicle surcharge tax is \$2 a day or any portion of a day that a rental motor vehicle is rented or leased.

Vehicle registration fee. The vehicle registration fee is \$20 per vehicle.

Tour vehicle surcharge tax. The tour vehicle surcharge tax is \$65 a month for tour vehicles categorized by the public utilities commission as a twenty-five or over passenger carrier vehicle and \$15 a month for tour vehicles categorized as an eight to twenty-four passenger carrier vehicle.

Other taxes and fee. The motor carrier safety inspection fee is \$1.50 per vehicle every six months.

Note 5 - Federal Grants-in-Aid

The Highways Division has projects in progress in which part of the funding is being provided by the Federal Highway Administration (FHWA) through grants-in-aid. Such projects are generally accounted for in the Capital Projects Fund. At June 30, 1997, the receivable from the U.S. Government is comprised of unbilled costs which are eligible for reimbursement. At June 30, 1997, costs of approximately \$9,343,000 were not reflected as receivables and as federal grants-in-aid revenue, pending qualification for reimbursement by the Highways Division. In addition, the MVSO has projects in progress in which part of the funding is being provided through federal grants-in-aid. The grants contain various compliance requirements which must be met by the MVSO, including a matching of the grant amounts with state and local highway safety expenditures as defined in a formula. MVSO's matching requirement is met through the expenditures of the Division of Driver Education, The Judiciary, State of Hawaii. Costs reimbursement by the FHWA and National Highway Traffic Safety Administration (NHTSA) are subject to final audit by federal agencies. In addition, FHWA and NHTSA reserve the right to examine the Highways Division for economy, efficiency and program results. The Highways Division's management believes that any federal aid received through or receivable at June 30, 1997 which might be required to be repaid to the FHWA or NHTSA based on federal audits would not be material to the financial position of the various funds and account groups of the Highways Division at June 30, 1997, or the results of operations of such funds for the year then ended.

Note 6 - Retirement Benefits

Employees' Retirement System. Substantially all eligible employees of the Highways Division are members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under Social Security. Persons employed in positions not covered by Social Security are 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 contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

The ERS' funding policy provides for employer contributions at actuarially determined rates that should provide sufficient resources to pay member pension benefits when due. Prior to 1997, the funding method used to calculate the total employer contribution required was 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 State's policy is to fund its required contribution annually.

Act 327 of 1997 changed the actuarial cost method used to calculate employer contributions from the frozen initial liability method to the entry age normal method. Such change will result in a decrease in required employer contributions for several years.

The Highways Division's payroll for employees covered by the plan for the year ended June 30, 1997 was approximately \$28,407,000. The payroll for all the Highways Division's employees for the year was \$28,831,000. Contributions made to the ERS by the Highways Division and employees for the year ended June 30, 1997 were \$3,707,000 and \$363,000, respectively. The contributions represented 13% and 2% of covered payroll, respectively.

Measurement of assets and actuarial valuations are made for the entire ERS and are not separately computed for individual participating employers such as the Highways Division. 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, 1996 for the entire ERS from the disclosures contained in the CAFR for the year then ended, the most recent available:

Pension benefit obligation	\$7,292,592,400
Net assets available for benefits, at cost (fair value \$6,657,378,000)	<u>6,063,074,600</u>
Unfunded pension benefit obligation	<u>\$1,229,517,800</u>

Ten-year historical trend information showing the ERS' progress in accumulating sufficient assets to pay benefits when due is presented in the ERS annual report.

The pension benefit obligation is a standardized measure of the present value of credited projected pension benefits, adjusted for the effects of projected salary increases, estimated to be payable in the future as a result of employee service to date.

The entire ERS actuarially determined employer contribution requirements were met as of June 30, 1997.

Post-retirement health care and life insurance benefits. In addition to providing pension benefits, the State provides certain health care and life insurance benefits for retired state employees. Contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued.

Note 7 - Changes in Property and Equipment

Changes in property and equipment during the year are as follows:

	Balance July 1, 1996	Additions	Deductions	Balance June 30, 1997
Buildings and improvements	\$6,905,498			\$6,905,498
Vehicles and Equipment	<u>32,394,814</u>	<u>\$2,623,070</u>	<u>\$1,190,481</u>	<u>33,827,403</u>
Total	<u>\$39,300,312</u>	<u>\$2,623,070</u>	<u>\$1,190,481</u>	<u>\$40,732,901</u>

Note 8 - Changes in General Long-Term Debt

Changes in general long-term debt during the year are as follows:

	Workers' Compensation Payable	Accrued Vacation Payable	Revenue Bonds Payable	Total
Balance at July 1, 1996	\$3,033,000	\$6,397,513	\$66,820,000	\$76,250,513
Net decrease in workers' compensation payable	(1,135,000)			(1,135,000)
Net decrease in accrued vacation		(444,703)		(444,703)
Net increase in revenue bonds payable			<u>50,580,000</u>	<u>50,580,000</u>
Balance at June 30, 1997	<u>\$1,898,000</u>	<u>\$5,952,810</u>	<u>\$117,400,000</u>	<u>\$125,250,810</u>

**Note 9 - Other
Financing Sources and
Uses**

Other financing sources and uses relate to the following items:

Funding of highway capital projects. Funding of highway capital projects by the State Highway Fund is recognized when received by the Capital Projects Fund. Funding by the State is recognized as "Operating transfers in" when authorized expenditures are incurred.

In fiscal 1991, \$250,000,000 was transferred to the State Highway Fund from the Department's Airports Division pursuant to Act 309, SLH 1989 as amended in 1991. These funds can be used only for certain highway projects within 10 miles by road of an airport. At June 30, 1997, approximately \$105,264,000 is uncommitted and is included in the State Highway Fund unreserved fund balance.

Reimbursement to State of Hawaii for debt service. Allocated portions of the State's general obligation bonds have been designated to be reimbursed from the State Highway Fund by the Director of Finance, State of Hawaii. The proceeds from these bonds are related to the above funds transferred from the State to the Highways Division for highway capital projects. These bonds are the obligations of the State and are not included in these financial statements.

The annual amounts required to amortize the designated portions of general obligation bonds as of June 30, 1997, including interest payments of \$77,682,000, are as follows:

Year ending June 30,	
1998	\$33,701,000
1999	31,584,000
2000	30,353,000
2001	27,562,000
2002	26,077,000
Thereafter	<u>143,542,000</u>
	<u>\$292,819,000</u>

Debt service reimbursements are accounted for as "Operating transfers out" of the State Highway Fund on the combined statement of revenues, expenditures, and changes in fund balances - all governmental fund types.

Transfer of funds to State of Hawaii General Fund. Section 248-9, HRS authorizes the Director of Transportation to transfer from the State Highway Fund moneys in excess of 135% of the requirements for the ensuing 12 months for the Fund to the State of Hawaii General Fund. For the 1997 fiscal year, \$22,559,000 was transferred to the General Fund. In addition, \$23,414,000 is planned to be transferred in the 1998 fiscal year, and \$24,268,000 is planned to be transferred in the 1999 fiscal year.

Note 10 - Commitments and Contingencies

Litigation. The State is the defendant in lawsuits seeking damages allegedly related to State highways and highway construction contracts. No provision for any liability which may result from these lawsuits has been made in the Highways Division's financial statements since any such liabilities are normally paid from the State's General Fund, should the State of Hawaii be found liable.

Condemnation proceedings. The Highways Division occasionally finds it necessary to condemn property for construction of highways. These proceedings require the Highways Division to compensate the existing property owner for the fair market value of the real property. Prior to the determination of the fair market value, the Highways Division is required to deposit funds in State courts for these proceedings. Such funds deposited may not be sufficient to cover the full amount required for compensation purposes. Management, however, believes any additional compensation in excess of amounts deposited with State courts will not be material to the financial statements of the Highways Division.

Deferred compensation plan. The State established a deferred compensation plan (plan) in accordance with Section 457 of the Internal Revenue Code which enables State employees to defer a portion of their compensation. The State of Hawaii, Department of Human Resources 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 (until paid or made available to the employee or other beneficiary) are solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject to the claims of the State's general creditors. Participants' rights under the plan are equal to those of the general creditors of the State in an amount equal to the fair market value of the deferred account for each participant. The assets of the plan and the deferred compensation payable are recorded in the State of Hawaii's Employee Benefits Agency Fund.

Insurance. The State maintains certain insurance coverages to satisfy bond indenture agreements as well as for other purposes, but is substantially self-insured for all other perils including workers' compensation. The State records a liability for risk financing and insurance related losses, including incurred but not reported, if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. At June 30, 1997,

the State recorded an estimated liability for workers' compensation, automobile and general liability claims in the General Long-Term Debt Account Group. The estimated losses will be paid from legislative appropriations of the State's general fund.

As the Highways Division is responsible for funding certain workers' compensation benefit payments, the Highways Division recorded an estimated liability of \$1,898,000 for workers' compensation in the General Long-Term Debt Account Group at June 30, 1997, as these losses will not be liquidated with currently expendable available financial resources. Workers' compensation expense for the year ended June 30, 1997 was approximately \$171,000.

Accumulated sick pay. Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit. It may be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a state employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credits in the ERS. Accumulated sick leave at June 30, 1997 aggregated approximately \$16,977,000.

Vacation. Employees are credited with vacation at a rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year-end and is convertible to pay upon termination of employment.

Note 11 - Lease Commitments

The State, through the Highways Division, leases certain offices from four landlords. The leases, which expire at various dates through 2000, provide space primarily for administrative employees of the Highways Division. The approximate future minimum rent at June 30, 1997 is as follows:

Year ending June 30,	
1998	\$404,000
1999	132,000
2000	<u>76,000</u>
	<u>\$612,000</u>

Note 12 - Revenue Bonds

On September 1, 1993, the Highways Division issued \$75,000,000 in State of Hawaii Highway Revenue Bonds, Series of 1993 (1993 Bonds). The 1993 Bonds bear interest at rates ranging from 2.6% to 5.0% and mature in increasing annual installments through 2013. The proceeds from the 1993 Bonds are used to finance certain highway improvements

and other related projects for the State Highway System. The 1993 Bonds are payable solely from and collateralized by the revenues consisting primarily of highway fuel taxes, vehicle registration fees, vehicle weight taxes and rental motor vehicle and tour vehicle surcharge taxes.

On September 1, 1996, the Highways Division issued \$55,000,000 in State of Hawaii Highway Revenue Bonds, Series of 1996 (1996 Bonds). The 1996 Bonds bear interest at rates ranging from 3.8% to 6.0% and mature in increasing annual installments through 2016. The proceeds from the 1996 Bonds will be used to finance certain highway improvements and other related projects for the State Highway System. The 1996 Bonds are payable solely from and collateralized by the revenues consisting primarily of highway fuel taxes, vehicle registration fees, vehicle weight taxes and rental motor vehicle and tour vehicle surcharge taxes.

The approximate maturities for revenue bonds, including interest of \$67,266,000 (Debt Service Fund of \$4,006,000 and general long-term debt of \$63,260,000) in each of the next five years and thereafter are as follows:

Year ending June 30,	
1998	\$11,376,000
1999	10,343,000
2000	10,336,000
2001	10,330,000
2002	10,323,000
Thereafter	<u>136,378,000</u>
	189,086,000
Less Debt Service Fund portion	<u>8,426,000</u>
General long-term debt portion	<u>\$180,660,000</u>

The 1993 Bonds maturing on and after July 1, 2004, are subject to redemption at the option of the State during specific years ranging from 102 to 100 percent of face amount plus any accrued interest.

The 1996 Bonds maturing on and after July 1, 2006 are subject to redemption at the option of the State during specific years ranging from 102 to 100 percent of face amount plus any accrued interest.

In 1997, \$10,003,142 was transferred from the State Highway Fund to the Debt Service Fund for repayment of Revenue Bond principal of \$4,420,000 and interest of \$5,583,142.

STATE OF HAWAII, DEPARTMENT OF TRANSPORTATION, HIGHWAYS DIVISION

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS
 JUNE 30, 1997

	Governmental Fund Types			Account Groups			Total (Memorandum Only)
	State Highway Fund	Debt Service Fund	Capital Projects Fund	General Fixed Assets	General Long-Term Debt		
ASSETS							
Cash with Director of Finance	\$254,837,100	\$8,426,021	\$109,996,974				\$373,260,095
Receivables:							
Due from U.S. Government	3,118,459		10,373,198				13,491,657
Due from County	21,761						21,761
Due from others	5,503,031						5,503,031
Property and equipment:							
Buildings and improvements				\$6,905,498			6,905,498
Vehicles and equipment				33,827,403			33,827,403
Amount to be provided for payment of long-term debt					\$125,250,810		125,250,810
TOTAL	<u>\$263,480,351</u>	<u>\$8,426,021</u>	<u>\$120,370,172</u>	<u>\$40,732,901</u>	<u>\$125,250,810</u>		<u>\$558,260,255</u>

STATE OF HAWAII, DEPARTMENT OF TRANSPORTATION, HIGHWAYS DIVISION

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS (Continued)
JUNE 30, 1997

LIABILITIES AND FUND EQUITY	Governmental Fund Types			Account Groups		Total (Memorandum Only)
	State Highway Fund	Debt Service Fund	Capital Projects Fund	General Fixed Assets	General Long-Term Debt	
LIABILITIES:						
Accounts payable	\$ 886,229		\$ 156,788			\$ 1,043,017
Contracts payable	3,249,747		10,011,996			13,261,743
Contracts payable - retainages	2,885,863		5,153,165			8,039,028
Deposits	3,334,000					3,334,000
Other liabilities	15,300					15,300
Workers compensation payable					\$ 1,898,000	1,898,000
Accrued vacation					5,952,810	5,952,810
Revenue bonds payable					117,400,000	117,400,000
Matured bonds and interest payable		\$ 8,426,021				8,426,021
Total liabilities	10,371,139	8,426,021	15,321,949		125,250,810	159,369,919
CONTINGENT LIABILITIES AND COMMITMENTS						
FUND EQUITY:						
Investment in general fixed assets				\$ 40,732,901		40,732,901
Fund balances - unreserved	253,109,212		105,048,223			358,157,435
Total fund equity	253,109,212		105,048,223	40,732,901		398,890,336
TOTAL	\$ 263,480,351	\$ 8,426,021	\$ 120,370,172	\$ 40,732,901	\$ 125,250,810	\$ 558,260,255

See accompanying notes to combined financial statements.

**STATE OF HAWAII, DEPARTMENT OF TRANSPORTATION,
HIGHWAYS DIVISION**

**COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND
BALANCES - ALL GOVERNMENTAL FUND TYPES
YEAR ENDED JUNE 30, 1997**

	Governmental Fund Types			Total (Memorandum Only)
	State Highway Fund	Debt Service Fund	Capital Projects Fund	
REVENUES	\$182,076,955		\$216,909,230	\$398,986,185
EXPENDITURES:				
Operations and maintenance	144,347,272			144,347,272
Motor Vehicle Safety Office	5,231,357			5,231,357
Capital projects			227,635,771	227,635,771
Debt service		\$10,003,142		10,003,142
Total expenditures	<u>149,578,629</u>	<u>10,003,142</u>	<u>227,635,771</u>	<u>387,217,542</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	32,498,326	(10,003,142)	(10,726,541)	11,768,643
OTHER FINANCING SOURCES (USES):				
Operating transfers in		10,003,142	12,455,614	22,458,756
Operating transfers out	<u>(64,162,490)</u>			<u>(64,162,490)</u>
Total other financing sources (uses)	<u>(64,162,490)</u>	<u>10,003,142</u>	<u>12,455,614</u>	<u>(41,703,734)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER FINANCING USES	(31,664,164)		1,729,073	(29,935,091)
FUND BALANCES, BEGINNING OF YEAR	<u>284,773,376</u>		<u>103,319,150</u>	<u>388,092,526</u>
FUND BALANCES, END OF YEAR	<u>\$253,109,212</u>	<u>\$ -</u>	<u>\$105,048,223</u>	<u>\$358,157,435</u>

See accompanying notes to combined financial statements.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Transportation on February 18, 1998. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2.

The department generally concurs with our findings and recommendations. It states that the division is currently working with outside consultants on a new performance accounting system that will maintain accounting records in an accurate manner and prepare relevant and timely financial reports and statements. This system conversion is presently being designed and will be completed by June 1999. The department further recognizes that monitoring of projects is important to the timely completion of projects within budget. It states that the division is presently undergoing a reorganization to improve on efficiency and is considering the establishment of a project management office to coordinate projects from inception to completion.

The department acknowledges its failure to complete the annual inventory of fixed assets as required by law. It states that the Oahu District Office is presently working on completing the \$300,000 fixed asset inventory by March 31, 1998. The department also agrees with our finding related to its cash management practices and will conduct formal analysis, such as forecasting of sources and use of cash by projects, to determine the amounts of excess cash available for investment. While the department concurs with our finding that earmarked funds are being used for general operating purposes, it contends that this was mandated by Act 270, Session Laws of Hawaii 1997 and was beyond the department's control.

The department disagrees with our finding that the Highways Division failed to comply fully with the Hawaii Public Procurement Code and the administrative rules relating to a sole source contract. It states that the original sole source contract was "grandfathered" in under the old procurement law; any amendments to this contract did not require the division to follow the new procurement rules of approval and posting of the notice of amendment. It also contends that the original contract was designed to be cost effective by having one consultant provide all services for both phases rather than undergoing a separate bidding process for phase II. We generally disagree. The current procurement administrative rules are unclear on the treatment of amendments to contracts "grandfathered" in under the old procurement law. In addition,

the scope requirements of phase II do not qualify the contract as a sole source contract under the new procurement law—they were not so unique that only one vendor could have provided the service. And since the contract amount increased significantly with this amendment (\$1.5 million or over 150 percent), the department should have considered awarding phase II through a bidding process within the requirements of the new procurement code. The spirit of open competition was violated and the State has no assurance it received the best value for the price.

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



ATTACHMENT 1

MARION M. HIGA
State Auditor

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

February 18, 1998

COPY

The Honorable Kazu Hayashida
Director
Department of Transportation
AliiAIMoku Hale
869 Punchbowl Street
Honolulu, Hawaii 96813

Dear Mr. Hayashida:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Financial Audit of the Highways Division of the Department of Transportation*. We ask that you telephone us by Friday, February 20, 1998, 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 Friday, February 27, 1998.

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

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

Sincerely,

Marion M. Higa
State Auditor

Enclosures



ATTACHMENT 2

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
869 PUNCHBOWL STREET
HONOLULU, HAWAII 96813-5097

IN REPLY REFER TO:

HWY-S
2.8256

FEB 27 1998

Ms. Marion Higa
State Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813-2917

RECEIVED

FEB 27 8 47 AM '98

OFF. OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

Thank you for this opportunity to respond to the draft report, *Financial Audit of the Highways Division of the Department of Transportation*. We have the following comments on the report.

Accounting Procedures Should Be Improved

We agree that the required year-end accounting procedures and financial statements should be completed on a timely basis. However, the inability to complete the process in a timely manner is due to the Division's complex current accounting system which does not suitably meet the Division's needs. The system requires numerous reconciliations to the State's accounting system and therefore, additional time and personnel hours are required. The Highways Division receives a substantial amount of federal funds, which adds additional accounting requirements.

The Division is in the process of implementing a new performance accounting system which will significantly improve this process, will be tailored to specifically meet the Division's needs and will provide relevant and timely management reports. We are currently working with our outside consultants and are excited about this system conversion which is presently being designed and will be in-service by June 1999. This will make the completion of the audit timely.

Highway revenue bond covenants require that the financial audit be completed by a certain date. Meeting these covenants has always been a priority for the Highways Division.

Internal Financial Reporting Should Be Improved

We agree that our internal financial reporting should be improved as these reports are critical management tools relied on by the Division. With the implementation of the new performance accounting system, we will obtain input from the managers to ensure the reports provide relevant information to meet the Division's needs and will assist management in properly monitoring the projects. Therefore, the Division's financial reporting will be revised with the new system, the reports generated will be streamlined and the reports will be generated on a timely basis. In addition, the new system will have controls in place to ensure the accuracy of the reports.

Monitoring of Projects Should Be Improved

We agree that monitoring the progress of projects is a key factor to complete projects within budget and in timely manner. The Highways Division's financial data and accounting is kept on a project basis by a unique charge code for each project. Each project has a document called the "*Job Authorization*," which has the budgeted and allotted funding and is the official document authorizing charges to a project. This document is distributed to all project engineers.

Also, the Fiscal Office generates a report titled "*Status of Charge Codes*" that shows the funds allocated, expended, encumbered and the available balance for each charge code. This report is distributed to all Branches, District Offices and Staff Offices of the Highways Division. However, due to the current accounting system, the financial information in the report is about one month late when the offices receive them. The new performance accounting system that is presently being developed will be an on-line and interactive system that will give the project engineers current up to date financial information.

The Division also publishes a "*Department of Transportation, Highways Division Status Report*" on a monthly basis. This report is a listing of all current Highways Division projects, including Capital Improvement, Federal-Aid, and Special Maintenance projects in the planning, design and construction phases. The report also has a listing of all the current County Federal-Aid projects. The reports shows non-financial information such as project title, project number, project description, schedules, percent completion, completion dates, project managers, office doing the work, and remarks on the project. The information is updated by the Project Managers on a monthly basis.

FEB 27 1998

The Highways Division is presently reorganizing the Division and has a consultant engaged to review our operations and processes and to recommend organizational changes to make a more efficient and effective organization. One of the offices being considered to be established will be a Project Management Office. This office will be responsible for coordinating the project from inception to completion assuring it is completed on schedule and within budget.

We agree a more effective monitoring process of contract amendments could decrease some of the contract amendments, however, most of the changes to contract amendments are due to unanticipated field conditions, especially underground conditions, such as utilities not at the location shown on the plans or large rocks in the areas to be excavated; missing requirements in the original design; and field changes to accommodate requests made by the public.

The Highways Division is continually monitoring the overtime that is being charged and will continue to do so to minimize the overtime. In fact, over the past three years, we have worked to reduce overtime by 30 percent.

Fixed Asset Inventory Was Not Performed

The Oahu District office is presently working on the \$300,000 fixed asset inventory and will complete the inventory by March 31, 1998.

Cash Management Activities Should Be Improved

We agree with the audit finding. The Highways Division will conduct formal analysis, such as forecasting of sources and use of cash by projects to determine the amounts of excess cash available for investment.

Earmarked Funds Are Being Used for General Operating Purposes

We agree with the State Auditor, however, this was mandated by the Nineteenth State Legislature, Session Laws of Hawaii, Regular Session of 1997, Act 270, Sections 2, 3, and 4, to help with the State's budget shortfall and is beyond the control of the Highways Division.

Noncompliance With The Hawaii Procurement Code Was Noted

We disagree with this comment. Since the original contract dated June 29, 1990, fell under the old procurement law, the amendment to the sole source contract

Ms. Marion Higa
Page 4

HWY-S
2.8256

FEB 27 1998

dated April 18, 1996, was "grandfathered" in. Therefore, the "Notice of Amendment to Sole Source Contract" was not required to be completed, submitted to the chief procurement officer and posted. This is in accordance with 3-120-3 of the Hawaii Administrative Rules regarding applicability.

In addition, the original contract was designed to be cost effective by having one consultant provide all services from defining the system requirements to the implementation and training stages, as the consultant would be very familiar with the particular system design and the Division's operational and financial needs and capabilities. Therefore, the contract included both phases rather than undergoing a separate bidding process for Phase II.

I appreciate the opportunity to comment on the above matter.

Very truly yours,



KAZU HAYASHIDA
Director of Transportation

