

Report of independent certified public accountants in accordance with
Government Auditing Standards

State of Hawaii, Department of Transportation, Harbors Division

June 30, 2005

**Submitted by
The Auditor
State of Hawaii**

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Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an
Audit of Financial Statements Performed in
Accordance with *Government Auditing Standards*

The Auditor
State of Hawaii

We have audited the financial statements of the Harbors Division, Department of Transportation of the State of Hawaii relating to the Public Undertaking (Harbors Division), as of and for the years ended June 30, 2005 and 2004, and have issued our report thereon dated November 15, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audits, we considered the Harbors 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 an opinion on the internal control over financial reporting. Accordingly, we express no such opinion. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. 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 Harbors Division's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and responses as items 05-01 to 05-03.

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 none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Harbors Division's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, including applicable provisions of the Hawaii Public Procurement Code

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(Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars, 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 audits, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Auditor, the Department of Transportation's management, the Harbors Division's management and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink, reading "Grant Stewart" in a cursive script.

Honolulu, Hawaii
November 15, 2005

State of Hawaii
Department of Transportation
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SCHEDULE OF FINDINGS AND RESPONSES

Year ended June 30, 2005

Ref.
No. **Internal Control Findings**

05-01 Improve Management of Financial Records

The fiscal office continues to address issues encountered with the implementation of the financial management package of the Comprehensive Information Database System (CIDS) effective July 1, 2002 and the lack of sufficient staff resources. See Internal Control Findings 04-01, Prior Year Audit Findings. Although many improvements were again noted during the current year, continued efforts in implementing additional improvements are still needed in the Harbors Division fiscal office.

Periodic account reconciliations, including the thoroughness of subsequent review and approval of such reconciliations, help to ensure the accuracy of financial information provided to management and aide the decisions made, based on such information. The lack of these controls could affect the accuracy of such information. Furthermore, the probability that additional errors will occur and go undetected is greatly increased. Finally, when accounts have not been reviewed and reconciled during the year, attempts to perform year-end account analyses can become a time-consuming and costly process. During our audit, we noted instances where the lack of these controls led to certain of the Harbors Division's subledgers not reconciling to the general ledger at year end. In addition, we noted that there continues to be some unresolved credits within the account receivable subledger in CIDS.

The Harbors Division maintains various CIP schedules between the Accounting Department and the Project Engineers. While the Accounting Department prepares their schedules from the Project Engineer's schedules, the Project Engineers should also review what the Accounting Department is recording. Lack of communication and review between these two departments could lead to errors.

Recommendation

We continue to recommend that significant accounts on the statement of net assets be reconciled in a more timely manner. Timely reconciliations should be assured by establishing a realistic schedule and having completion monitored by a designated individual. A staff accounting person (rather than a supervisor) should be assigned to reconcile account balances on a routine basis. This would allow supervisors to perform review activities, thereby improving the control system in the fiscal office. In addition, all reconciliations should be reviewed by a designated individual to ensure accuracy and completeness, and to verify that reconciled items have been properly handled. This should be evidenced by having the reviewer initial the reconciliation. Although this reconciliation procedure is currently in place, greater care needs to be exercised in preparing and reviewing such reconciliations to ensure the effectiveness of such controls.

We also recommend that the communication between the Accounting Department and the Project Engineers continue to ensure that completed projects are transferred out of CIP and into the appropriate fixed asset classification, including items to be classified as capital versus repairs and maintenance expenses. The

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SCHEDULE FINDINGS AND RESPONSES (continued)

Year ended June 30, 2005

project engineers should continue to review the Accounting Department's final CIP schedule as of year end to ensure that these amounts are reported correctly.

05-02 Improve Monitoring of Self-Reporting Revenue

Significant portions of the Harbors Division revenues are of a self-reporting nature. The Harbors Division has formal comprehensive policies and procedures to ensure the completeness of revenues. Due to the self-reporting nature of the Harbors Division's revenues the completeness of recorded revenues should be monitored closely. The Harbors Division has policies and procedures to perform audits of self-reported wharfage revenue, as both a detective and preventative control measure to ensure accuracy and completeness of the reported amounts. Audit of shipping lines and agents are based on errors noted on filed reports, type of commodities reported and the dollar amount of the wharfage reported. Due to the lack of sufficient resources in the financial management office, the Harbor Division's auditors have been assisting with various accounting functions and did not perform the number of audits usually conducted.

Recommendation

We continue to recommend that since wharfage is the Harbors Division's largest source of revenue, this area should be closely monitored. We recommend that the Harbors Division schedule audits on a more frequent basis. We also recommend that the auditors adjust their audit selection criteria to include larger revenue shipping lines and shipping agents such as Matson, Young Brothers, and Horizon Lines. If staff resources are limited, we recommend that the Harbors Division consider hiring independent contractors to perform such tasks.

05-03 Preparation of Vacation and Sick Leave Accrual

The Harbors Division prepared a summary leave schedule to determine the amount of its accrued compensated absence liability and reported the liability to the State Comptroller. The liability was based on the balance of earned hours per individual leave records (Form DPS-7) multiplied by each employee's hourly rate. We noted the following conditions:

During our testing of accrued vacation, we noted that some of the formulas on the supporting schedules were incorrect, resulting in the initial recording of incorrect amounts, which were subsequently revised by Harbors Division personnel.

Recommendation

We recommend that Harbors Division personnel implement spreadsheet controls to protect the formulas used in computing the accrued vacation liability to ensure accuracy and completeness before reporting the balances to the State Comptroller.

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SUMMARY SCHEDULE OF PRIOR-YEAR AUDIT FINDINGS

Year ended June 30, 2005

Ref.
No. Internal Control Findings

04-01 Improve Management of Financial Records

The fiscal office has been challenged over the past two years mainly due to the significant issues encountered with the implementation of the financial management package of the Comprehensive Information Database System (CIDS) effective July 1, 2002 and the lack of sufficient staff resources. Although many improvements were noted during the current year, continued efforts in implementing additional improvements are still needed in the Harbors Division fiscal office.

The primary focus of the Fiscal Office was to stabilize CIDS and to develop and implement compensating accounting procedures in order to produce meaningful financial reports. This major task contributed to the delay in performing timely periodic reconciliation of the Harbors Divisions accounts. As a result the Harbors Division recorded numerous adjustments after the books were closed at year-end. The lack of periodic account reconciliations, including the thoroughness of subsequent review and approval of such reconciliations, could affect the accuracy of financial information provided to management and may jeopardize decisions based on such information. Furthermore, the probability that additional errors will occur and go undetected is greatly increased. Finally, when accounts have not been reviewed and reconciled during the year, attempts to perform year-end account analyses can become a time-consuming and costly process.

The statement of net assets of the public undertaking at June 30, 2003 and the statement of revenues, expenses and changes in net assets of the public undertaking for the fiscal year ended June 30, 2003 were restated to reflect the correction of certain assets, liabilities, revenues and expenses. The correction of these errors were the result of system implementation issues, lack of periodic reconciliation of the Harbors Divisions accounts in a timely manner as well as the lack of established policies and procedures to ensure proper cutoff of transactions

Recommendation

We recommend that the Harbors Division assess its control processes, procedures and resources and consider undertaking a restructuring of functions in the accounting and financial management area. The objective of the assessment will be for management to determine whether its resources are adequate to maintain proper controls weighing its risks in connection with costs and benefits. The following are important factors to consider in the assessment:

- Proper segregation of duties
- Proper authorization and monitoring of accounting functions
- Backup systems and levels of redundancy

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SUMMARY SCHEDULE OF PRIOR-YEAR AUDIT FINDINGS (continued)

Year ended June 30, 2005

The function of the fiscal office should be one of financial management as well as maintaining the internal control of the Harbors Division. Management should determine whether this function and objectives could be achieved with the capabilities of its current resources.

To ensure that appropriate actions steps are taken, we suggest that the Fiscal Officer direct the efforts in implementing improvements in the financial reporting process. To facilitate this process, a work plan and implementation schedule should be prepared that would detail the requirements, persons responsible for implementation and timetable. The Fiscal Officer should submit periodic assessments to management on the implementation progress of the proposed plan. This will enable management to monitor the progress of the Fiscal Office's progress and provide for greater accountability.

As part of the implementation plan, the Harbors Division should continue to improve the management of its financial records by strengthening its monitoring process to ensure that there are adequate resources and training, appropriate assignment of responsibilities, appropriate prioritization of accounting duties, establishment of appropriate fiscal procedures, and follow-through in executing fiscal procedures.

The Harbors Division should continue to update its accounting policy and procedures manual so that employees have a reference source on how they should perform any assigned tasks.

We recommend significant accounts on the statement of net assets be reconciled in a more timely manner. Timely reconciliations should be assured by establishing a realistic schedule and having completion monitored by a designated individual. A staff accounting person (rather than a supervisor) should be assigned to reconcile account balances on a routine basis. This would allow supervisors to perform review activities, thereby improving the control system in the fiscal office. In addition, all reconciliations should be reviewed by a designated individual to ensure accuracy and completeness, and to verify that reconciled items have been properly handled. This should be evidenced by having the reviewer initial the reconciliation. Although this reconciliation procedure is currently in place, greater care needs to be exercised in preparing and reviewing such reconciliations to ensure the effectiveness of such controls.

In addition, we recommend that the Harbors Division develop policies and procedures to ensure that analytical procedures are performed on the statement of revenues, expenses and changes in net assets to identify large or unusual fluctuations for investigation. These analytical review procedures could include the comparison of current year to prior year results, budget to actual results and the review of statistical reports.

Status

Similar instances noted in the current year. See Finding 05-01.

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SUMMARY SCHEDULE OF PRIOR-YEAR AUDIT FINDINGS (continued)

Year ended June 30, 2005

04-02 Improve Monitoring of Self-Reporting Revenue

Significant portions of the Harbors Division revenues are of a self-reporting nature. The Harbors Division has formal comprehensive policies and procedures to ensure the completeness of revenues. Due to the self-reporting nature of the Harbors Division's revenues the completeness of recorded revenues should be monitored closely.

The Harbors Division has policies and procedures to perform audits of self-reported wharfage revenue, as both a detective and preventative control measure to ensure accuracy and completeness of the reported amounts. Audit of shipping lines and agents are based on errors noted on filed reports, type of commodities reported and the dollar amount of the wharfage reported. Due to the lack of sufficient resources in the financial management office, the Harbor Division's auditors have been assisting with various accounting functions and did not perform the number of audits usually conducted.

Recommendation

We recommend that the Harbors Division continue to develop formal comprehensive policies and procedures to ensure that all revenues earned be recorded in a timely manner. Also since wharfage is the Harbors Division's largest source of revenue, we recommend that this should be closely monitored. We recommend that the Harbors Division schedule audits on a more frequent basis. We also recommend that the auditors adjust their audit selection criteria to include larger revenue shipping lines and shipping agents such as Matson, Young Brothers, and Horizon Lines. If staff resources are limited, we recommended the Harbors Division should consider hiring independent contractors to perform such tasks.

Status

The Harbors Division has requested additional funding to enable them to perform audits on larger revenue shipping lines and shipping agents. However, no such audits have been performed to date. See Finding 05-02.

04-03 Allowance for Doubtful Accounts

The Harbors Division has not established a written policy for maintaining an allowance for receivables where management anticipates collectibility problems. The accrual basis of accounting requires the Harbors Division to record an allowance for probable losses on any receivables that might not be collected. Generally accepted accounting principles require that a provision for bad debt expense be estimated each year in order to properly match such expenses with related revenue and reported net of related revenues.

Recommendation

We recommend the Harbors Division establish written policies and procedures to maintain an allowance for doubtful accounts to provide for potential losses, giving due consideration to the composition and character of its receivables. The allowance should include amounts for specifically identified potentially uncollectible

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SUMMARY SCHEDULE OF PRIOR-YEAR AUDIT FINDINGS (continued)

Year ended June 30, 2005

accounts as well as estimated amounts of the potential losses, not specifically identified, and based upon the Harbors Division's past loss experience.

Status

No similar instances noted in current year.

04-04 Preparation of Vacation and Sick Leave Accrual

The Harbors Division prepared a summary leave schedule to determine the amount of its accrued compensated absence liability and reported the liability to the State Comptroller. The liability was based on the balance of earned hours per individual leave records (Form DPS-7) multiplied by each employee's hourly rate. We noted the following conditions:

There were a few occurrences on the accrued vacation and sick leave summary schedule where the employee's actual hourly rates did not agree to the DPS Form 5.

Recommendation

We recommend that the summary leave schedule be reviewed and validated against personnel and payroll records to ensure accuracy and completeness before reporting the balances to the State Comptroller.

Status

Similar instances noted in the current year. See Finding 05-03.

RESPONSE OF THE AFFECTED AGENCY

LINDA LINGLE
GOVERNOR



RODNEY K. HARAGA
DIRECTOR

Deputy Directors
BRUCE Y. MATSUI
BARRY FUKUNAGA
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STATE OF HAWAII
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January 18, 2006

IN REPLY REFER TO:
HAR-S
8307.06

Grant Thornton LLP
1132 Bishop Street, Suite 1000
Honolulu, Hawaii 96813

Gentlemen:

We appreciate the opportunity to provide comments on the findings and recommendations contained in the schedule of findings relating to the audit of the financial statements and schedules of the Harbors Division for the fiscal year ended June 30, 2005.

We have no disagreements with the findings and concur with the recommendations. Although significant improvements were noted in the current year, we acknowledge that further corrective actions are needed to ensure accuracy and efficiency in our financial operations.

The division is working to complete its reorganization of the Fiscal Office which will restructure functions and responsibilities for greater accountability. Funds were also approved in our fiscal year 2006 operating budget to contract for independent audits of self-reported wharfage revenue and procurement of such services will begin in the very near future.

The division continues to work on establishing compensating accounting procedures to perform fundamental accounting tasks in light of the serious deficiencies of the Comprehensive Information Database System (CIDS) project. The Attorney General's Office is also engaged in negotiations with the contractor on the release of the CIDS source codes.

Thank you for the opportunity to provide our comments.

Very truly yours,

A handwritten signature in black ink, appearing to read "Barry", written over the typed name.

BARRY FUKUNAGA
Deputy Director-Harbors