

STATE OF HAWAII
Office of the Auditor

2010 ANNUAL REPORT

MARION M. HIGA
State Auditor

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STATE OF HAWAII
Office of the Auditor

The Honorable Members of the Legislature
The Honorable Neil Abercrombie, Governor

March 30, 2011

Ladies and Gentlemen:



Mission of the
Office of the Auditor

The Office strives to ensure government accountability for policies, programs, and use of public funds through postaudits of accounts, programs, and performance.

This office reports its findings and recommendations to policy makers to provide timely, accurate, and objective information for decision making.

I am pleased to present this Annual Report, which highlights the efforts of the Office of the Auditor in work year 2010. The report, and the audits and special studies that it summarizes, address many important issues and challenges facing state government.

Looking back, it seems quaint and naïve that we would think of the Internet as something as tangible and orderly as an “Information Superhighway.” Today, interacting with the digital world doesn’t seem to be a matter a choice anymore. It’s more like the air we breathe.

In 2010, we reported on several agencies that adopted new technologies in the hopes of speeding up and enhancing their operations. However, we found that these efforts were undertaken without considering and preparing for the impacts on the organizations’ processes and people. While it is impossible to accurately predict how technology will determine our future, it isn’t nearly as difficult to establish its appropriate role in your present organization—that is if you have a clear understanding of the job you’re doing and why you’re doing it. Our work in 2010 made clear that many department leaders and staff lost sight of those basics as they adopted technologies that they didn’t fully understand. As we look ahead, I can assure you that we at the Office of the Auditor will continue to stick with “the basics” of our job. Because some things will always be elemental and essential—kind of like the air we breathe.

Sincerely,

Marion M. Higa
State Auditor

A Friend in Deed

Marion M. Higa, State Auditor

While Facebook, WikiLeaks, and other social media have made information gathering and sharing easier than ever, uncovering the truth will always be a careful, painstaking process.

I recently surprised one of my staff when I told him that I couldn't be his "friend." Actually, I had explained to him that as long as I am the State Auditor I won't be creating a personal Facebook page, nor would I be participating in other forms of social media at home. While I know that Facebook can put me in contact with long-lost friends, or a blog will enable me to exchange recipes and gardening tips with the wider world, my postings might lead to unnecessary confusion. For instance, could a blog post on a visit to a local farmers' market be interpreted as an endorsement for the State's agricultural policies? Would a tweet about lost baggage at the Honolulu International Airport be viewed as a criticism of the state Department of Transportation?

It's clear to me where my personal life ends and professional life begins, but it's not so easy for others to make those distinctions. This is because we live in an age in which a smartphone literally puts the world and the sum of human knowledge in the palm of your hand. Not only are we connected and informed 24/7, but we can also respond to that wide world using texts, tweets, emails, photos, videos, and, of course, our voices. Not surprisingly, this limitless ability to collect, alter, and pass along information has been transformative.

Information is the raw material that flows through and powers our office. We collect and independently verify and evaluate it. We come to conclusions and offer recommendations based on objectively analyzing it. Therefore, the veracity of information and the integrity of our sources and how we compile and scrutinize it are integral to what we do and who we are. So you can understand that despite all the excitement swirling around social media, our office is carefully and cautiously considering how we can use it or even if we should use it at all. As we do with any new procedure or development, we stick to the basics and ask some hard

questions about how the proposed change will affect our process and people.

Not losing sight of the basics is at the core of how well any organization or individual meets the challenge of the future. Unfortunately, this understanding is not universally understood across state government. In 2010, we saw numerous instances of agencies adopting new technologies without considering and preparing for the short- and long-term impacts.

A Debit Card?

In *Program and Management Audit of the State's Purchasing Card Program*, Report No. 10-05, we examined the procurement of goods and services by executive agencies using what are known as "pCards." A pCard is a charge card used by government agencies in place of cash or purchase orders for the acquisition of goods, services, or construction. Since they have a fixed limit and purchases are recorded electronically, pCards can simplify and streamline an agency's small purchase operations by eliminating the need to issue purchase orders and process invoices for payment. As of April 1, 2005, executive branch agencies were required to use pCards to pay for goods and services under \$2,500.

When we examined pCard operations of agencies in three different departments, we found that they implemented programs without carefully considering the original intent of the effort—simplifying and streamlining operations. Instead, the agencies continued to process purchase orders and invoices even though this information is collected electronically. As a result, pCard programs had more steps than the processes that they were supposed to replace.

Too Big a Byte

In *Management and Financial Audit of Taxation Contracts*, Report No. 10-11, we found a department that “bit off” more technology than it could “chew.” In 1999, the Department of Taxation began a five-year, \$51 million effort to replace its aging computer systems. Over the next decade, working with a vendor, the department undertook dozens of additional projects, enhancements, and new collection initiatives. These significant, multi-million dollar efforts were initiated with little or no long-term planning, and were overseen by managers with no formal project management or information technology (IT) backgrounds.

The result was an IT infrastructure in continuous project development mode. Staff were tasked with developing, testing, and implementing the enhancements, fixes, and tax law changes to the growing system. While duties and responsibilities grew, staffing levels didn't. As a result, not only was the department unable to sustain its system expansion, it struggled to maintain daily IT operations. In addition to not planning for the system's long-range development, the department also neglected to account for how it would continue to fund its IT expansion when the trust account created for that purpose closes on June 30, 2011. The department also failed to prepare for the transition away from vendor support, when it has to operate independently, also on June 30, 2011.

The Color of Money

The Department of Budget and Finance is responsible for managing the State's \$3.8 billion treasury. One of the department's responsibilities is investment of the State's excess cash; a key component in carrying out this duty is staying informed of how much cash is available for investment every day. Tracking this activity can be complicated, since not only is there a wide variety of investments, but many of them mature daily. To ensure there are no cash shortages, the department typically keeps a “cushion” of \$20 million to \$30 million in demand deposits in the state treasury each day.

In *Financial Examination of the Department of Budget and Finance*, Report No. 10-03, our office and a certified public accounting firm found eye-opening examples of misuse and underuse of information technology in the department's management of the State's multi-billion dollar investment pool. In one instance, instead of taking advantage of available technology, department personnel recorded maturities of securities and large recurring payments in a handwritten monthly investment calendar. The calendar, with its notations written with colored pencils and highlighters, was then used to determine how much cash was available for investment.

How many errors were made? It's impossible to say. What was clear was that department officials had little confidence in the accuracy of these calculations. Instead of the \$20 million to \$30 million reserve in department accounts, we found that since about May 2009, the department retained approximately \$50 million to \$80 million per day. That amount reached as high as \$126 million in FY2009. This is cash that sat idle and earned no investment income for the State.

I will admit to a few note-filled, color-coded calendars in our office. But I assure you there are only a few of them, and their information can also be found on other automated and reliable resources. In fact, when it comes to information technology, our office is considered somewhat cutting edge in the auditing world, and we are continuously considering ways to improve and enhance office operations. However, I promise that regardless of the high-tech application or innovation that we use, we never lose sight of the basics—collecting information methodically, analyzing and evaluating our data independently, and protecting the confidentiality of our sources fiercely. In an age in which information is increasingly valued by how fast it can be acquired and how widely it can be disseminated, our processes may sound hopelessly cautious and old school. Maybe, maybe not. But we do know a basic fact: Information without objective analysis and scrutiny is just gossip.

Staff of the Office of the Auditor

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Marion M. Higa

**Deputy Auditor and
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**Administrative Deputy
Auditor**
Calvin Hangai

**Human Resources Manager
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Sarah Akinaka
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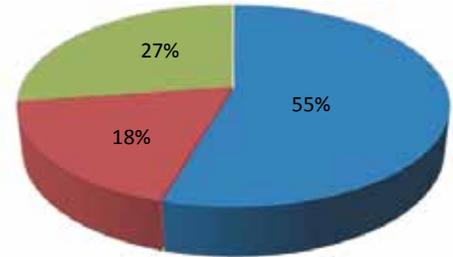
Assistant Analysts
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Analyst**
Jayna Oshiro

Office Services
Rachel Ray
Debbie M.A. Higa
Pat Mukai

Types of Reports

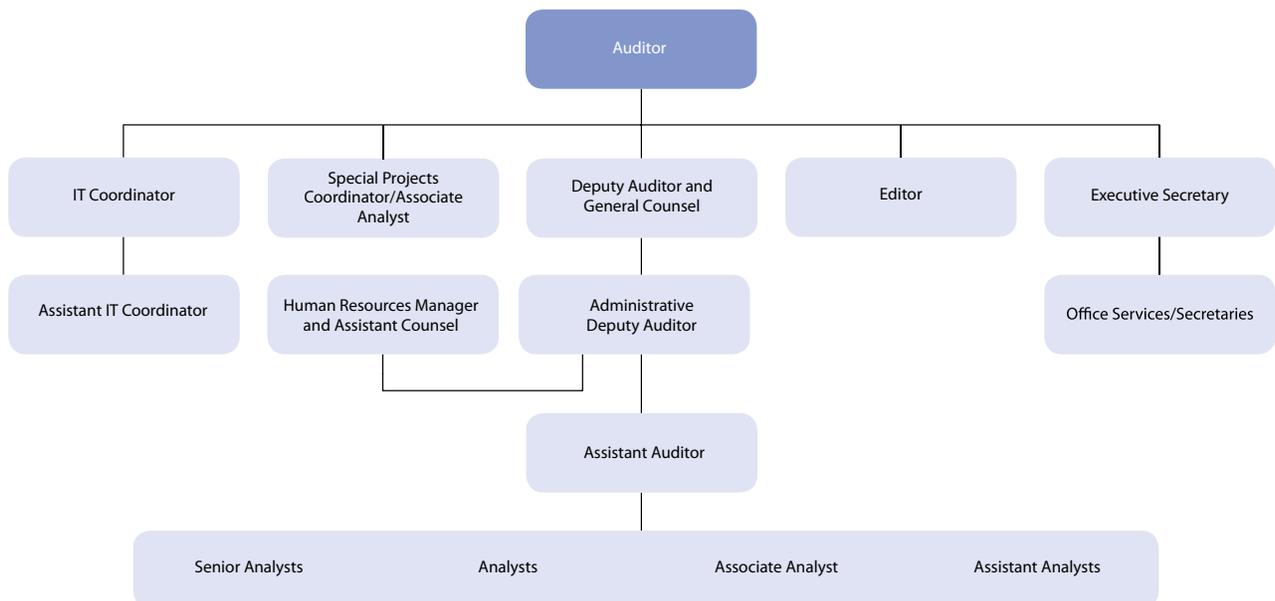
- Performance Audits (6)
- Financial Audits (2)
- Special Studies (3)



The office also performed 47 quick reviews of proposed special and revolving funds.

The office also administered 29 financial statement audits, including the Comprehensive Annual Financial Report

Organization of the Office of the Auditor



2010 Summary of Reports

Investigation of Specific Issues of the Department of Business, Economic Development & Tourism

Report No. 10-01, January 2010

Prompted by concerns over the management of federal grant funds and the State's 2005 trade mission to China and Korea, the Legislature requested that the Auditor investigate the Department of Business, Economic Development & Tourism, including the department's Out-of-State Offices.

During 2003-2004, the department requested approval from the director of finance, the governor, and the Legislature to spend funds from a \$399,500 award it received from the Federal Market Development Cooperator Program (MDCP). Our investigation found that the department failed to fully disclose to the director of finance and to lawmakers that the MDCP was a reimbursement program. The department did not make clear that it would use general funds to obtain the reimbursement moneys and that reimbursements would be under no federal spending requirements or restrictions. In essence, the department would keep and spend the reimbursement funds at its discretion.

Our investigation found the department spent tens of thousands of dollars in reimbursement funds to support its Beijing office's operations and cover overseas office's budget cuts. This non-disclosure to decisionmakers of the impact the reimbursements would have on the department's general fund expenditures tainted the approval process and allowed the department to essentially pad its general fund appropriation. We found no documentation showing the department provided lawmakers with a clear and accurate characterization of the program, thus enabling the department to spend the reimbursement funds as it saw fit.

In addition, our review of financial records from the Out-of-State Offices also found a deposit of \$35,000 of private funds into the Taipei office's bank account. The transfer of private funds directly into the office's account jeopardized its non-profit status and threatened its ability to function as a government office. Moreover, our investigation found that the funds were solicited by the department from private companies to sponsor the 2005 mission and that the transfer was requested by the department. We also found that the department provided incomplete or misleading information to the State

Procurement Office which enabled the department to expend mission funds outside the state's procurement code, without any restrictions or effective internal controls. We found the department withheld from state lawmakers fiscal records associated with the mission and provided incomplete and misleading information to state agencies about the mission's model. Finally, we found that ineffective oversight of expenditures and reporting requirements of the Out-of-State Offices created opportunities for fraud and abuse.

We recommended that the department halt all activity regarding its MDCP reimbursement funds and consult with the Legislature and the Department of Budget and Finance as to the appropriate course of action. We also recommended the State Procurement Office request records from the Pacific and Asian Affairs Council related to the 2005 mission and contact key stakeholders involved in the mission's planning and implementation to determine whether the Council's prior opinions regarding the mission were tainted and procurement laws were circumvented.

In its written response to the report, the department asserted the issues regarding the 2005 mission had been thoroughly reviewed by the Legislature and that two state agencies ruled no procurement or criminal law violations had occurred. However, as noted in our report, the conclusions reached by the Legislature and state agencies that reviewed the 2005 mission were based on incomplete, misleading, or erroneous information provided by the department. Therefore, the issues merited further review. The department added that our report provided no substantiated finding of actual abuse or impropriety regarding its Out-of-State Offices. However, we note that our report did address the lack of effective internal controls regarding the Out-of-State Offices and the need to mitigate that risk.

Study of Proposed Mandatory Health Insurance Coverage for Colorectal Cancer Screening

Report No. 10-02, February 2010

In House Concurrent Resolution No. 109, the 2009 Legislature asked the Auditor to assess the social and financial impacts of House Bill No. 823 (HB 823), which would require health insurers to provide coverage for colorectal cancer screening for asymptomatic adults 50 years and older.

This study assessed the impacts of mandating coverage for each of the colorectal screening procedures (colonoscopy, flexible sigmoidoscopy, computed tomographic colonography) and fecal tests (fecal occult blood test, fecal immunochemical test, and stool DNA) defined as the standard of care in HB 823, by applying the criteria set forth in Sections 23-51 and 23-52, Hawai'i Revised Statutes.

Colorectal cancer is a “disease in which cells in the colon or rectum become abnormal and divide without control, forming a mass called a tumor.” As of 2008, it was the third most common cancer among men and women and the second leading cause of death in the United States. Nationwide for 2009, the National Cancer Institute estimated 106,100 new cases of colon cancer, 40,870 new cases of rectal cancer, and 49,920 deaths due to colon and rectal cancer. From 2002 through 2006, the median age at colon cancer diagnosis was 71 years of age; the median age at death was 75 years of age.

The purpose of HB 823 was to encourage all asymptomatic adults aged 50 and above to obtain a colorectal cancer screening using the full range of screening options, including colonoscopy, every ten years. Colonoscopy is considered the reference standard against which the sensitivity of other tests is compared. We found that while there is some insurance coverage available, colonoscopy is not a screening method covered by the second largest health insurer we surveyed, and until January 2010 had not been a covered benefit in the preferred provider plan of the largest health insurer in Hawai'i, Kaiser Permanente Hawai'i (Kaiser). For example, Kaiser provides routine colorectal screening using flexible sigmoidoscopy and two fecal tests but screening colonoscopy is not available to 77,368 asymptomatic adults age 50 and

over. Moreover, because there is no consensus among prevention and primary care experts as to the effectiveness of extending life using other screening methods such as CT colonography and sDNA, only one health insurer in Hawai'i provides coverage for all the screening options based on the American Cancer Society's 2008 guideline. The other four health insurers we surveyed follow the 2008 recommendations of the U.S. Preventive Services Task Force to exclude screening coverage for CT colonography and sDNA.

We concluded that House Bill No. 823 would be beneficial for a majority of Hawai'i's insured population of average risk or asymptomatic adults between the ages of 50 to 75 years who are currently unable to select colonoscopy every ten years as a screening option. Insurance coverage can be expected to increase the use of screening colonoscopy, but the cost of this increase should not bar the implementation of such coverage.

We recommended enactment of an amended House Bill No. 823. The departments of Health and of Commerce and Consumer Affairs opted not to respond to our report. On June 1, 2010, Governor Linda Lingle signed Act 157, mandates health insurance coverage for colorectal-cancer screening based on the recommendations of the U.S. Preventive Services Task Force.

Financial Examination of the Department of Budget and Finance

Report No. 10-03, March 2010

The Office of the Auditor and the certified public accounting firm of Accuity LLP conducted a financial examination of the Department of Budget and Finance for the fiscal year July 1, 2008 to June 30, 2009.

Our examination evaluated the financial processes and related systems of internal controls of the department and conducted an inquiry and review of relevant policies, procedures, systems, transactions, and records. The firm also assessed the design and operating effectiveness of internal controls over the department's financial accounting and reporting process for the fiscal year ending June 30, 2009.

Our examination found the department had failed to fulfill even the most basic responsibilities. For instance, the Treasury Management Branch's process for assessing the State's cash requirements and determining allowable amounts to be invested involved the use of handwritten investment calendars and worksheets. Such antiquated cash and investment management processes are highly susceptible to errors such as misread handwritten amounts, transcription mistakes between spreadsheets, and incorrect calculations where automated formulas are not used. In addition to the risks inherent in a manual process, internal policies and procedures were not formalized. As a result, large amounts of cash went un-invested and therefore earned minimal interest. In FY2009, the amount of un-invested funds reached \$126 million.

In addition, we found the department seriously mismanaged a significant portion of the State's investment portfolio by increasing its holdings of student loan-backed auction-rate securities from \$322 million in FY2006 to more than \$1 billion in FY2008. Auction-rate securities (ARS) are debt instruments and were experiencing relatively high return yields at the time. While the securities could be bought or sold at auctions held every seven to 49 days, they typically had underlying long-term maturity dates. When these auctions began to fail in 2008, many of the securities were no longer liquid, thus reverting to the

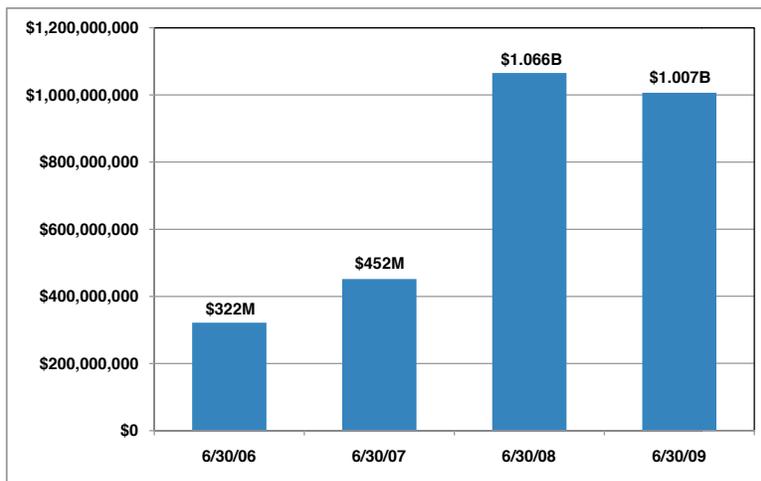
maturity dates of their underlying student loans. The director contended that holding \$1 billion of illiquid ARS posed no harm to the treasury, claiming that the State would eventually realize gains. However, the bottom line is that the State's ARS investments lost approximately \$255 million in value as of June 30, 2009. Moreover, having a large portion of the treasury tied up in ARS investments for seven to 35 years may hinder the State's ability to cover anticipated cash disbursements.

The decision to increase the number of auction rate securities holdings during FY2008 was made by personnel who did not request, obtain, or review copies of the offering documents prior to purchasing, nor inquire about possible risks associated with the securities; they focused instead on the higher yields anticipated, contrary to state policy. The director of finance was not consulted prior to purchase, nor was she involved in any decision to purchase or increase the holdings in auction-rate securities. The department claims it could not have known or understood the risks in FY2008. However, those risks are clearly laid out on the cover page of an offering document for ARS held by the department, which states, "you may have difficulty selling your notes."

On November 23, 2010, Citigroup Inc., agreed to buy back \$869 million of auction-rate securities it had sold to the State of Hawai'i and repay the State for losses on securities it had previously liquidated. In June 2015, the State will have the option to require the bank to purchase some or all of the remaining auction-rate securities. At the same time, the State released potential claims against Citi and any affiliated entities or individuals in connection with its investments in auction-rate securities, and Citi admitted no wrongdoing.

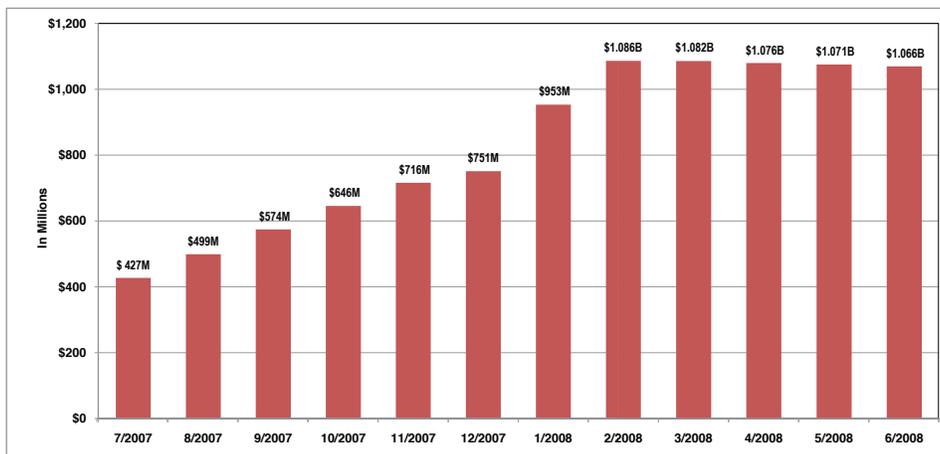
State Investments in Auction-Rate Securities – June 30 2006 through June 30, 2009

Source: Compiled by Accuity LLP from information provided by the Department of Budget and Finance



State Investments in Auction-Rate Securities – Fiscal Year 2008 by Month

Source: Compiled from information provided by the Department of Budget and Finance



Management Audit of the Aloha Tower Development Corporation

Report No. 10-04, April 2010

This was our first performance audit of the Aloha Tower Development Corporation (ATDC). Previously, we published Special Study 79-4, Evaluation of the Proposed Hawai'i World Trade Center (1979) and Report No. 87-13, Review and Analysis of the Aloha Tower Redevelopment Project (1987). Our 1987 review recommended that Chapter 206J, Hawai'i Revised Statutes, which established the corporation, be repealed.

We found that the Aloha Tower Development Corporation had made little progress in 30 years of existence. Problems identified by the Auditor in 1987, including an inherent conflict between redevelopment of the project area and maritime uses, and the corporation's pursuit of unrealistic financing strategies, remained unaddressed. In addition, the corporation has known since 1999 that its master plan and administrative rules are outdated. Yet the corporation has shirked its responsibility to update its plan and rules by ignoring professional advice from two credible consultants. Moreover, with the passage of time, the events of September 11, 2001, and their resulting increased harbor security measures and restrictions, development of the project area may no longer be viable. Because of these fundamental constraints, nearly every development undertaken by the corporation has resulted in costly litigation.

Little has changed since we delivered our 1987 report. Then, as now, redevelopment of the Aloha Tower Project Area, conflicts and may be incompatible, with the Department of Transportation (DOT)'s maritime use of the project area. In addition, a 2009 legislative conference committee found the corporation was unable to effectively lead the harbors modernization program. The corporation's one development attempt at the site culminated with only a fraction of the work completed and a struggling retail enterprise, the Aloha Tower Marketplace. Originally projected to earn more than \$4 billion over 65 years, the corporation and its marketplace have fallen far short of their financial expectations. During the period from FY1996 to FY2001, the marketplace paid ATDC about \$4.8 million—only 22 percent of the forecasted revenues of \$17 million projected for this timeframe. According to the corporation's CEO,

and based on our review of documents, the marketplace has never paid more than the minimum \$1 million in standard annual base rent.

We recommended that the Aloha Tower Development Corporation be abolished and responsibility for harbors infrastructure improvements be transferred to DOT—Harbors Division. We also recommended that responsibility for the Aloha Tower Project Area be shifted to the Hawai'i Community Development Authority.

The corporation agreed with some of our findings but disagreed with our recommendations. The corporation responded that the audit condemned “the current board and staff who have tenures of five years or less for actions long past” and pointed out that solutions to development constraints “will require political will and funding resources.” However, the corporation failed to recognize that effectively addressing redevelopment constraints—no matter how old—is one of its core responsibilities. In addition, the corporation also did not acknowledge its own failure to muster the support needed for redevelopment.

Program and Management Audit of the State's Purchasing Card Program

Report No. 10-05, June 2010

In 2001, the State Procurement Office (SPO) established its Procurement Card Program (pCard program). As defined by law, a procurement card, commonly referred to as a purchasing card, pCard, or charge card, is a limited credit card to be used by government agencies in place of cash or purchase orders for the acquisition of goods, services, or construction.

The pCard program was meant to simplify the State's small purchase operations and reduce the administrative burden associated with issuing purchase orders and processing invoices for payment without sacrificing financial controls over expenditures. As of April 1, 2005, executive branch agencies were required to use pCards to pay for goods and services under \$2,500.

Our program and management audit of the SPO's Purchasing Card Program focused on the procurement of goods and services by executive branch agencies using pCards from July 2008 to October 2009. We focused on the three executive branch agencies with the highest number of pCard transactions and largest dollar volume of pCard expenditures for the period audited: the departments of Health (DOH), Human Services (DHS), and Transportation (DOT). In the case of DOT, we focused on two of its four divisions — Administration and Highways.

We found that the pCard program has had some benefits: vendors are paid sooner, cardholders (purchasers) receive goods and services faster, and the State receives a rebate from its bank. However, other benefits, including a more efficient and streamlined government procurement system, have not been achieved. Although the procurement office is ultimately responsible for the program, it has taken a hands-off approach to its administration by delegating significant responsibilities to the executive departments. We also found that the procurement office has failed to adequately establish or evaluate the pCard program's goals, objectives, and meaningful performance measures.

We also found that without guidance from the procurement office, the DOH, DHS, and DOT structured their pCard processes to closely mirror that of the traditional and cumbersome purchase order process. As a result, the pCard process had more steps than the existing process it was designed to streamline. In addition, the SPO could not identify where, nor quantify how much, savings the program had achieved. Finally, staff from the three executive departments could not say that the benefits of the program outweighed its administrative burdens.

We recommended the procurement office play a stronger administrative role by ensuring the intent of the pCard program is met. We also made specific recommendations for the procurement office to establish clear guidelines to help executive branch agencies achieve consistency and efficiency with the pCard program.

In its response to our draft report, the State Procurement Office claimed that we made many misstatements and failed to take into account the limited resources available. Although it provided extensive comments to refute our findings, the SPO also acknowledged that there may be more that the pCard program can do for the State and counties. The SPO also stated that it has focused more on internal controls, which supports our findings that it had lost sight of the original intent of the program, streamlining processes. The SPO acknowledged our recommendations but stated that they have either already been accomplished or are not implementing. We stood by our findings and conclusions.

Audit of the Department of Public Safety, Sheriff Division

Report No. 10-06, June 2010

The audit, our first of the Department of Public Safety, Sheriff Division, was requested by the 2009 Legislature in Act 162 and House Concurrent Resolution No. 92, House Draft 1.

We found that since the department's creation in 1989, the Sheriff Division has been saddled with an ill-defined role and a lack of mission clarity and has struggled to uphold its expanded law enforcement responsibilities. As the State's law enforcement needs have expanded, confusion over the extent of the Sheriff's responsibilities has grown. This uncertainty is the result of vague constitutional language, a broad interpretation of statutory authority, and the consolidation of functions previously deemed incompatible. As a result, the Sheriff's responsibilities have grown beyond the service of process and the security of state buildings to include drug enforcement, illegal immigration, homeland security, fugitive arrests, criminal investigations, eviction proceedings, and traffic enforcement.

The Sheriff Division has been further hampered by ineffective leadership, resulting in a law enforcement agency that lacks guidance and direction. Since the Department of Public Safety (PSD) was created in 1989 there has never been a fully developed state law enforcement program or strategic plan defining the Sheriff Division's mission and setting boundaries based upon its capabilities.

In addition, inadequate law enforcement training, issues pertaining to equipment, and an absence of procedures related to staffing and service of the courts have raised questions regarding the safety of courts, the public, and deputy sheriffs themselves. For example, the department began issuing ballistic protective vests to deputy sheriffs in 2004. Based on the five-year manufacturer's warranty, 69 vests needed to be replaced by the end of 2009, and ten had already expired by May 2009. As of March 2010, none of the 69 vests has been replaced. In addition, PSD acknowledged there are not enough deputy sheriffs to carry out the Sheriff Division's functions at many of

the courts. Lacking a formal agreement with the courts, the Sheriff Division is without staffing standards for the safety of the public, deputy sheriffs, persons in custody, or court personnel.

We recommended that the Department of Public Safety perform a risk assessment of each section of the Sheriff Division in the course of developing a comprehensive strategic plan for the division that, at a minimum, meets the requirements of Act 100, SLH 1999. We also recommended that the department consider proposing statutory amendments to align with the division's duties and functions as indicated by the risk assessment. We also suggested that the department pursue accreditation for the Sheriff Division from the Commission on Accreditation for Law Enforcement Agencies, Inc., to ensure that proper law enforcement policies and procedures are enacted and followed.

In its response, the department noted that it would address and/or implement solutions to some of the specific problem areas noted, acknowledging that some deficiencies are long standing. The department indicated that it had concerns regarding the presentation of the findings; however, it did not provide any details to dispute our findings.

Deputy sheriff wearing a ballistic protection vest

Source: Office of the Auditor



The Sheriff Division reported that 70 percent of its vehicles had 50,000 or more miles and 23 percent had more than 100,000 miles on their odometers.

Source: Office of the Auditor

Sunrise Analysis: Real Estate Appraisal Management Companies

Report No. 10-07, September 2010

In Senate Concurrent Resolution No. 53, Senate Draft 1, the 2009 Legislature asked the Auditor to conduct a “sunrise” analysis of Senate Bill No. 1606 (SB No. 1606). The bill proposed to require real estate appraisal management companies (AMCs) to register with the Real Estate Commission of the Department of Commerce and Consumer Affairs (DCCA).

An appraisal management company is a business entity that, for a fee, administers a network of independent appraisers to fulfill real estate appraisal assignments on behalf of mortgage lending institutions (lenders). There are 200 to 350 AMCs nationwide, but none are physically located in the state. In Hawai‘i, individual appraisers are regulated under the Real Estate Appraiser Program, Chapter 466K, HRS, administered by the DCCA. As of July 2010, there were 602 credentialed appraisers (41 licensed and 561 certified), of which 539 were qualified to perform residential appraisals.

SB No. 1606 did not meet the statutory criteria in Chapter 26H, HRS, for several reasons. Chief among them, we found the purpose to protect consumers is not clearly articulated; instead, the bill was primarily designed to protect appraisers. In addition, the regulatory program outlined in SB No. 1606 would not be self-sustaining.

While we found that regulation as proposed in SB No. 1606 was not warranted, the federal Wall Street financial reform bill enacted into law in July 2010 now requires all states to register and supervise AMCs. States have 36 months *after* federal regulators promulgate final rules to comply with amendments to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 3331 et seq. The act requires that AMC registration programs be under a state appraiser certifying and licensing agency. In Hawai‘i, this means the Real Estate Appraiser Program administered by the DCCA director in accordance with Chapter 466K, HRS. The DCCA must establish an AMC regulatory program within three years after the federal regulations are adopted that set the minimum qualifications for states to apply relating to the registration, supervision,

and reporting of AMC activities. Unless registered, AMCs may not do business in the state. We concluded that SB No. 1606 was not an appropriate vehicle for regulating AMCs, since it placed their regulation under the Real Estate Commission, a regulatory entity within DCCA’s Real Estate Branch that oversees real estate licensees statewide. Given that states must now regulate AMCs, we recommended that the federal requirements be examined and that DCCA work with appraiser and AMC interests to arrive at an appropriate vehicle for complying with the federal law.

We recommended that SB No. 1606 of the 2009 legislative session not be enacted. We also recommended that after federal rules are adopted, the Legislature ask the DCCA to submit, a written analysis to accompany suggested language for a new bill to comply with applicable provisions of FIRREA. The Legislature should then pass conforming legislation.

The DCCA agreed in part, and disagreed in part, with our recommendations. The department did not believe a study comparing SB No. 1606 to the federal requirements was relevant or necessary. DCCA proposed the Legislature need merely mirror language that regulates real estate appraisers in Section 466K-1, HRS. Given DCCA’s response, we modified our recommendation No. 2, but maintained the Legislature needs supporting analysis from the department on the impact of expanding regulation to include AMCs, the cost of implementation, and means of financing.

SB No. 1606 was not enacted by the 2010 Legislature.

Sunrise Analysis: Athletic Trainers

Report No. 10-08, October 2010

In Act 108, Session Laws of Hawai'i 2010, the Legislature asked the Auditor to conduct a "sunrise" analysis of Senate Bill No. 2601, Senate Draft 1 (SB No. 2601, S.D. 1), which proposed to regulate athletic trainers.

Athletic trainers specialize in recognizing, preventing, managing, and rehabilitating athletic-related illnesses and injuries. Usually the first at the scene to provide immediate care when athletes are injured, athletic trainers apply protective or preventive devices such as tape, bandages and braces, and teach athletes how to prevent injuries, reduce risk, use proper equipment, and exercise to improve balance and strength. The American Medical Association recognizes athletic trainers as "allied" health professionals who work under the direction of licensed physicians and in cooperation with other health care professionals such as physical therapists. They should not be confused with personal or fitness trainers, who are not healthcare professionals. Currently, about 170 certified athletic trainers work in Hawai'i, primarily at secondary schools in the Department of Education, as well as in private secondary schools, universities, and colleges in the state. A few are employed in private physical therapy clinics and in the military.

Our analysis showed that SB No. 2601, S.D. 1 did not warrant regulation. We found no evidence of harm to the public or the athletes served by athletic trainers. Flaws in the bill would create a confusing regulatory program that fails to meet the objectives of ensuring specialized emergency and appropriate treatment and rehabilitation and providing a mechanism to report and remedy malpractice and ethical violations.

Instead, the bill's primary purpose appears aimed at enhancing the profession and gaining reimbursement from insurers. The National Athletic Trainers' Association is aggressively pursuing efforts to gain licensure and to amend regulatory laws nationwide since most third party payers reimburse only licensed

health care providers. The bill merely restricts use of the title "athletic trainer" to those who are Board of Certification, Inc. (BOC) certified, but does not restrict the practice of being an athletic trainer to those who are certified. No grounds for discipline and no mechanism for taking disciplinary action were contained in the bill. The Department of Commerce and Consumer Affairs (DCCA) would not have the power to sanction or remove an athletic trainer's registration should their submission prove false, nor to investigate complaints or pursue other enforcement actions. The public would not be protected from incompetent, unscrupulous, or unethical athletic trainers. Finally, the bill was further flawed by language in Section -6 creating licensure for an athletic trainer who is registered even though the bill is entitled the "Athletic Trainer Registration Act." The addition of this section seems related only to enabling reimbursement from third party insurance payers.

Many other protections are in place to ensure that athletes receive appropriate care. In Hawai'i, employers already require athletic trainers to be certified, or pursuing certification, from the BOC. Employers can easily check BOC's online database to verify whether an athletic trainer is active, in good standing, under investigation, inactive, delinquent, under disciplinary suspension, or has had certification permanently revoked.

We recommended that SB No. 2601, Senate Draft 1 of the 2010 legislative session not be enacted. DCCA agreed with our report findings.

Review of Revolving Funds, Trust Funds, and Trust Accounts of the Judiciary and the Departments of Commerce and Consumer Affairs, Hawaiian Home Lands, Health, and Human Services

Report No. 10-09, November 2010

Section 23-12, Hawai'i Revised Statutes, requires the Auditor to review all existing revolving and trust funds every five years.

The review is to include, for each fund or account, a five-year financial summary, an evaluation of its original intent and purpose, and a determination of the degree to which it achieves its claimed purpose. Reviews are scheduled so that funds administered by each state department are reviewed once every five years. This is our fourth review of the revolving funds, trust funds, and trust accounts of the Judiciary and the departments of Commerce and Consumer Affairs (DCCA), Hawaiian Home Lands (DHHL), Health (DOD), and Human Services (DHS).

Revolving funds are often established with an appropriation of seed money from the state's general fund. Revolving funds must demonstrate a capacity to be self-sustaining. Activities financed by revolving funds include loan programs initially established by general fund seed moneys and replenished through repayment of loans. Trust funds invoke a fiduciary responsibility of state government to care for and use the assets for the benefit of those with a vested interest in them. A pension fund is an example of a trust fund. Trust accounts are typically separate holding or clearing accounts for state agencies. A trust account is often used as an accounting device to credit or charge agencies or projects for payroll or other costs.

Of the 121 funds and accounts we reviewed this year, 27 were revolving funds, 59 were trust funds, and 35 were trust accounts. We used criteria developed by the

Legislature and by review of public finance and accounting literature. Funds must continue to serve the purpose for which they were created and not require continuing general fund appropriations. A revolving fund must reflect a link between benefits sought and charges made upon users, and also be an appropriate financial mechanism for the program or operation. A trust fund must also meet the statutory definition of a trust fund. For each fund, we presented a five-year financial summary, the purpose of the fund, and conclusions about its use. We did not present any conclusions about the effectiveness of the program, its management, or whether the program should be continued. However, we did find that 17 of 121 funds and accounts reviewed did not meet applicable criteria and/or may not be properly classified.

We transmitted a draft of this review to the Judiciary and the departments of Commerce and Consumer Affairs, Hawaiian Home Lands, Health, and Human Services. The Judiciary was in general agreement with our review of its funds. DCCA also agreed with our review of its funds; however, it disagreed with the proposed disposition of remaining moneys in a fund recommended for closure. The DHHL and DOH both in generally agreed with our findings but added points of clarification regarding some of their funds and accounts. DHS provided a point of clarification regarding the Randolph-Sheppard Revolving Fund but in general agreed with our overall conclusion regarding the fund.

Management Audit of the Department of Public Safety's Contracting for Prison Beds and Services

Report No. 10-10, December 2010

In an effort to address persistent prison overcrowding, in December 1995, the Department of Public Safety (PSD) began transferring inmates to out-of-state facilities. The transfer was viewed as a stop-gap measure that would give prison officials time to increase in-state capacity. Today, about 2,000 male inmates—approximately one-third of Hawai'i's inmate population—are held at facilities in Arizona.

We found that management did not understand the necessity of providing detailed and accurate financial information regarding the costs of such a measure to policymakers and the public, which is a key component in solving the crisis. For instance, PSD has reported it spends about twice as much to maintain an inmate in-state as out-of-state. However, we found that these cost estimates are based on a flawed methodology designed around what is easiest for the department to report. The department ignores a major component for calculating these costs—capacity versus use. In addition, PSD underutilizes the capabilities of its inmate tracking management system Offendertrak, which can collect and compute inmate days and other information that would assist managers. Moreover, the inmate tracking system is often used incorrectly. In one analysis, we found errors in 28.4 percent of the tracking system's reports.

The interim director contends that PSD provided a simple cost estimate because it could not articulate the complexity of calculating the myriad expenses incurred by individual inmates at differing facilities on a specific day. The department missed the point: Offendertrak, if used accurately and to its capabilities, would enable prison managers and policymakers to make decisions with reliable information.

In 2006, the previous department director signed an inter-governmental agreement (IGA) with the City of Eloy, Arizona, to consolidate housing for Hawai'i inmates to three prisons owned and operated by Corrections Corporation of America (CCA), a for-profit provider of correctional facilities. At the time, the corporation was building a \$95 million prison in Saguaro, Arizona, specifically for Hawai'i inmates.

As the name indicates, IGAs are agreements that involve government-to-government transactions. These agreements are exempt from competitive procurement methods, which state agencies must generally employ when soliciting proposals as required by the Hawai'i Public Procurement Code. However, in the department's IGA with Eloy, the department actually conducts all transactions directly with CCA. We found no evidence that Eloy sub-contracted inmate services to CCA, nor is the city compensated for its role in the agreement. In the State chief procurement officer's opinion, such a contract inappropriately used the IGA exemption and is circumventing Hawai'i law. In addition, we found that the IGA does not contain safeguards to protect the State's interests in the event of a dispute or if funds are not appropriated or available to pay CCA.

We found that the department had no written policies or procedures for contract administration, and the administrator and staff readily accepted CCA's representations and conclusions of its performance without verifying statements against documented evidence. The interim director reported that the department was working with the City of Eloy and CCA to establish a separate agreement that will specify and document the working relationship between the two parties. However, we recommended that the fundamentally flawed agreement not be revisited. Instead, the department undertake and accept guidance and training from the State Procurement Office, which so would help appropriately address the need for private prison beds beyond 2011 by helping to ensure that procurement occurs properly in the first place.

Management and Financial Audit of Department of Taxation Contracts

Report No. 10-11, December 2010

In 1999, the Department of Taxation (DoTAX) began a five-year, \$51 million effort to replace its aging computer systems. By October 2004, the department and its vendor completed six major system implementations.

Over the next four years the effort continued with an additional 13 projects and enhancements to the system. This was followed in January 2008 by yet another system enhancement—a \$25 million delinquent tax collections project, which called for an additional 22 new collection initiatives. Long-term planning for these projects was minimal to non-existent, and oversight was left to managers who had no formal project management or information technology (IT) backgrounds.

Throughout this period, staff were also tasked with developing, testing, and implementing enhancements, fixes, and tax law changes to the growing system. Despite the increased workload, staffing levels remained relatively constant since 2003. To compensate for the shortfall, DoTAX allowed its vendor to become an essential component in its IT infrastructure. This apparent preference for the vendor's staff over DoTAX IT staff led to management conflicts so corrosive that the Governor's Office intervened. In 2008, an email from a vendor's manager, which used inflammatory language to characterize many DoTAX managers and the work environment, led to further acrimony and a six-month work stoppage that delayed contract deliverables.

In this environment of discord, the department modified the Delinquent Tax Collections Initiatives contract. We found that a 2009 modification to the contract was crafted independently by a former deputy director who had no formal IT background or training. It removed both the obligation of the vendor to complete the 2008 contract's 22 initiatives and a constraint limiting the vendor's payment to \$9.8 million for work on the 2008 contract. The 2009 modification also allowed the vendor to receive a remaining \$15.2 million in compensation for the new collections initiative without

first completing deliverables from the 2008 contract. In addition, the modification deleted the department's ability to hold the vendor accountable for defects and system integration problems.

We also found that not only was the department unable to sustain the current rate of system enhancements, it would also struggle to maintain current levels of activity without assistance. For instance, the department's funding for the system expansion, which is delivered via a trust account that was not established through the legislative appropriations process, will close on June 30, 2011. We found internal staff were stretched thin and frustrated with spending the majority of their time testing the system at the expense of other responsibilities. In spite of these problems, the department had not adequately planned for June 30, 2011, when it will lose vendor support and must operate independently.

According to the interim director, the department had initiated corrective actions that would address some of the recommendations noted in our report. These included the addition of a position to the Information Technology System Office to augment short staffing, as well as training an additional ten system administrators to supplement system quality assurance resources. The department was also in the process of identifying locally available project management training opportunities. Lastly, the interim director assured us that the department will continue to review our recommendations as it monitors for improvements.

Affected Agency Response to
Previous Recommendations

Review of Revolving Funds, Trust Funds, and Trust Accounts for the Departments of Accounting and General Services, Agriculture, Budget and Finance, and Land and Natural Resources

Report No. 09-01

Recommendations	Affected Agency Response
No recommendations.	

Management and Financial Audit of Hawai‘i Tourism Authority’s Major Contracts

Report No. 09-02

Recommendations	Affected Agency Response
<p>1. The HTA board of directors should provide the leadership needed to ensure that the authority:</p> <ul style="list-style-type: none"> a. Develops an action plan that provides stakeholders with a clear picture of its strategic marketing directions and expected outcomes under the Hawai‘i Tourism Strategic Plan; 	<p>HTA Board of Directors</p> <p>In 2009, the HTA board adopted the Hawai‘i Tourism Authority Strategic Plan: 2010-2012 (HTA Plan) to prioritize the agency’s work in support of the statewide Hawai‘i Tourism Strategic plan: 2005-2015 (State TSP), and more importantly, to stabilize Hawai‘i’s visitor industry during the U.S. economic crisis and curtail consecutive months of double-digit declining visitor arrivals and expenditures. The HTA plan provides specific directives to achieve the state goals and objectives in the following areas: Marketing (leisure, business, air, and cruise access, in-market representation, sports), Tourism Product Development, Research and Planning, and Communications and Outreach. These areas were also identified in the State TSP as strategic initiatives for which the HTA is identified as one of the lead entities for implementing the strategic initiative.</p>

- b. To the extent possible, incorporates quantifiable goals, objectives, and measures as a basis for objective evaluations and accountability for its achievements; and

The HTA plan provided short-term and long-term goals for 2010 (6.7 million visitors; \$188 per person per day expenditures; \$11.8 billion economic impact in direct visitor spending) and for 2011-2012 (6.9 million visitors; \$202 per person per day expenditures; \$13 billion economic impact in direct visitor spending). The HTA plan also provided for the incorporation of objectively measurable outcomes and performance indicators for its contractors. The following key performance indicators (KPIs) with corresponding target (covering calendar years 2011, 2012, and 2013) have been utilized:

- Visitor arrivals
- Per person per day expenditures
- Length of stay
- Total expenditures
- Visitor days

Additional performance indicators for each major market area contractors have also been utilized, such as the following:

- Cost per arrival
- Visitor expenditures per marketing dollar (amount in increased visitor expenditures for every dollar spent on marketing)
- An attitudinal awareness survey of Potential Visitors (marketing effectiveness study)
- 360-degree evaluations
- Room night (utilized for the corporate meetings and incentive market and for the convention center sales and marketing)
- Tax revenues generated

- c. Reports its achievements in terms of its success in meeting planned outcomes, using benchmarks and performance measures to the extent feasible.

Prior to the development of an annual tourism marketing plan and budget by each marketing contractor, various targets for each major market area are provided to the contractor. The contractor would provide a marketing plan and budget intended to achieve the designated targets for a major market area. The KPIs discussed above are subsequently utilized to measure a contractor's performance against the targets.

2. With regard to its oversight over contracts, the Hawai'i Tourism Authority should:
 - a. To the extent possible, incorporate objectively measurable outcomes and performance indicators in its contracts;

HTA

In 2009, the HTA adopted the Hawai'i Tourism Authority Strategic Plan: 2010-2012 (HTA Plan) to prioritize the agency's work in support of the statewide Hawai'i Tourism Strategic Plan: 2005-2015 (State TSP), and more importantly, to stabilize Hawai'i's visitor industry during the U.S. economic crisis and curtail consecutive months of double-digit declining visitor arrivals and expenditures.

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- Room night (utilized for the corporate meetings and incentive market and for the convention center sales and marketing)
- Tax revenues generated

- b. Clearly define deliverables with measurable outcomes, performance measures and benchmarks as a basis for evaluation and contract renewal/extension purposes;

As previously discussed above, various key performance indicators have been utilized and will be used to evaluate contractors, especially when determining whether to renew or extend a contract.

RFP for Tourism Destination Marketing Management Services or Extension of Current Contracts.

The HTA is currently contemplating whether to extend its current major marketing contracts or to finalize its process for the issuance of a RFP for Tourism Destination Marketing Services and desires to award contractor(s) effective January 1, 2012. The HTA is considering the incorporation of various RFP specifications and contract terms to objectively evaluate/measure a contractor(s) performance, such as the following:

- Require contractors to achieve objective and measurable targets in a major market area as an essential component for complete performance under the contract;
- Require the submission of financial reports for expenditures that are related to a program initiative and aligned with key performance indicators; and;
- Require the conduct of periodic evaluation meetings to discuss any variance between actual results and targets.

Any consideration for any renewal or extension of a contract will be fully documented and based upon objective criteria, including HTA's periodic evaluation of a contractor's performance in achieving objective targets. Any extension must be in the State's best interest.

- c. Include objectively measurable outcomes in its annual tourism marketing plans;

Prior to the development of an annual tourism marketing plan and budget by each marketing contractor, various targets for each major market area are provided to the contractor. The contractor would provide a marketing plan and budget intended to achieve the designated targets for a major market area. The KPIs discussed above are subsequently utilized to measure a contractor's

- d. To the extent possible, consider alternative providers to the existing major contractors and ensure that such consideration is documented;
- e. Adopt a review process which ensures that original agreements, modifications, and supplements to contracts are free of errors and accurately reflect the intent of the parties;

performance against the targets.

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- Require the submission of financial reports for expenditures that are related to a program initiative and aligned with key performance indicators; and;
- Require the conduct of periodic evaluation meetings to discuss any variance between actual results and targets.

Any consideration for any renewal or extension of a contract will be fully documented and based upon objective criteria, including HTA's periodic evaluation of a contractor's performance in achieving objective targets. Any extension must be in the State's best interest.

The HTA has reorganized its staff to achieve the goals and objectives described in the HTA plan. Despite furloughs and staff vacancies, HTA is utilizing its best efforts to operate efficiently, effectively and productively and in a manner to eliminate errors in its agreements, modifications and supplements.

Additionally, the HTA is currently implementing various recommendations provided in a diagnostic review study conducted by KMH, LLP. The objective of the study was to introduce potential

- f. Ensure that contract provisions are adhered to or modify contractual provisions in writing where enforcement is deemed impractical; and
- g. Ensure that established policies and procedures for procurement of goods and services are adhered to by contractors, mandating appropriate tasks to be performed by contractors’ auditors where necessary. With regard to strategic planning:

operational efficiencies enabling HTA to better utilize its resources and operate more effectively; and, to strengthen the design of HTA’s internal controls within the accounting and contract management functions and identify any deficiencies in the design of its system of internal controls. The implementation of these recommendations will allow HTA to “reinvent” itself.

The HTA is utilizing its best efforts and to allocate staff to understand and to require adherence to various contract provisions unless the provisions are modified or amended in writing.

The HTA has reorganized its staff by designating a staff employee to be specifically responsible for the management of a major marketing contractor. It is HTA’s desire that by designating a staff employee, there will be a better understanding of the contractors’ duties and responsibilities, including the need to ensure compliance of policies and procedures for procurement of goods and services. In the past, the management of major marketing contracts was a shared task.

Procurement Audit of the Department of Education: Part 1

Report No. 09-03

Recommendations	Affected Agency Response
<p>The Board of Education and the superintendent of education should take immediate action to strengthen their control environment over procurement.</p> <p>1. The Board of Education should:</p> <ul style="list-style-type: none"> a. Adopt a code of ethics and conflicts of interest policy. The department currently 	<p>BOE and DOE</p> <p>BOE</p> <p>The Board of Education did not provide an update on our recommendations.</p>

has draft guidelines regarding these; however, we have not reviewed these guidelines. The board should review and adopt these, or similar, guidelines and ensure they, at a minimum, incorporate Chapter 84, HRS, Code of Conduct, and Section 3-131-1.02, HAR, Procurement Code of Ethics. The board could also consider developing policies specific to senior management and require all employees to acknowledge understanding of the policies.

- b. Establish an environment that effectively manages the department's fraud risk that incorporates the principles identified by the previously referenced *Managing the Business Risk of Fraud: A Practical Guide*:
 - i. Establish a fraud risk management program that includes a written policy conveying the expectation of board members, the superintendent, and all other employees.
 - ii. Ensure that the department develops an adequate fraud risk assessment process that would include regular reports submitted to the board. Regarding procurement, these reports could include contract awards and change orders/modifications exceeding a predetermined threshold, total awards/expenditures by procurement method, and violations.
 - iii. Ensure the department has adequate fraud prevention controls (i.e., appropriate segregation of duties, authority/transaction limits) and fraud detection controls (i.e., whistleblower hotlines, appropriate process controls such as reconciliations).
 - iv. Require the department to report on all alleged fraud and reported violations of the code of conduct/ethics, including any disciplinary or corrective actions.

- c. Consider increasing the authority and responsibilities of the Internal Audit Branch. The Internal Audit Branch should be operationally responsible for the department's risk management program and governance processes (including procurement).
2. The superintendent of education should:
- a. Design, develop, and operate an effective internal control system based on the Committee of Sponsoring Organizations of the Treadway Commission's published findings in Internal Control-Integrated Framework.
 - b. Ensure that procurement reports are developed and disseminated on a recurring basis for review approval by the superintendent, as well as for the assistant superintendents and applicable managerial employees. These periodic reports should contain relevant procurement information and should be disseminated quickly to be meaningful for monitoring purposes.
 - c. Formalize the existing Guidelines for Procurement and Contracting into enforceable policies and procedures. A formal process for reporting procurement violations, including remedial actions should be incorporated.
 - d. Through the Procurement and Contracts Branch, continue to provide procurement training and tailor the programs to the specific needs of each school and branch. Periodic training should be mandatory for employees having procurement authority, and attendance should be formally tracked. The superintendent should make officers, directors, and managers having procurement authority aware of Section 3-131-1.02, HAR, Procurement Code of Ethics.

DOE

New procedures have been developed to strengthen the control environment over procurement in the Office of School Facilities and Support Services. The DOE is in the process of contracting an external firm to review the new procedures to ensure that these procedures are in line with best practices and ensure compliance with these procedures.

The DOE is working with its consultant to enhance its FACTRAK project management system to generate meaningful reports to meet the intent of the Auditor's recommendation.

The DOE has such guidelines.

PCB has scheduled these districts for training and will be completed according to the following scheduled:

- I. Maui District administrators:
January 20, 2011
- II. Leeward District administrators:
February 15, 2011
- III. Kona Complex administrators:
March 8, 2011

- e. Provide program/project management training to ensure projects are properly planned, budgeted, and administered. A reporting system should be developed to track budget to actual results, with explanations for material discrepancies. This system would track the project through completion and reflect any change orders or modifications.
- f. Revoke procurement authority over construction contracts that was recently granted to the Office of School Facilities, returning such authority to the Procurement and Contracts Branch.

IV. New or newly promoted administrators:
August 9, 2011

PCB has also worked with Office of Human Resources to schedule all procurement and contract training session via PDE3, which includes tracking of all participants and attendance at each workshop.

The DOE concurs that training in the areas of program, project management and cost estimated are beneficial. As previously cited, the departmental FACTRAK project management system is being enhanced to improve reporting capability and allow for documentation on significant variances between budgeted and actual costs.

The DOE has taken corrective action by revising procedures, creating written procedures, and checklists. Furthermore, a close working relationship has been maintained with the Attorney General's Office on the review of contract language and format, with direct contract review and oversight vested with the assistant superintendent of OSFSS. The final review and approval for each construction and consultant contract is accomplished through the superintendent's signature.

Procurement Audit of the Department of Education: Part 2

Report No. 09-04

Recommendations	Affected Agency Response
<p>Regarding specific procurement violations, ethical concerns, and potential fraud</p> <p>1. The superintendent of education should conduct an investigation regarding the fol-</p>	<p>DOE</p> <p>The DOE contracted an external independent investigator to conduct an investigation on the</p>

lowing professional service contracts:

- \$300,000 contract to Provide Construction Management and Professional Services at Wilson and Anuenue Elementary awarded on April 23, 2006.
- \$22,205 contract for Jefferson Elementary School Building S Reroof awarded on July 9, 2008.
- Approximate \$80,000 contract for playground maintenance that was never awarded.
- \$325,000 contract for Professional Services to Assist in the Development of a Facilities Asset Management System Request for Proposals awarded on April 4, 2008.

The investigation should focus on the following issues:

- a. Inappropriate discussions and meetings with contractors prior to public notice that provided those contractors with an unfair advantage.
- b. Inappropriate discussion with and involvement of former department employees now employed by contractors.
- c. Manipulation of the selection committee process by:

noted contracts and received the completed report on April 15, 2009. A copy was sent to the Office of the Auditor in December 2009.

The contract was awarded and executed properly and upon further investigation, the DOE found no evidence of any wrongdoing. In addition, the report misquoted the date, as the award was made on April 23, 2007.

Consultant selection was hampered by a change in project requirements. Ultimately, the correct decision was made to conduct a new selection. Procedures have been implemented to clarify these situations when they occur.

The execution of a contract was hampered by a disagreement between procurement units. Because of the program's inability to process a contract on a timely basis, the award was rescinded and a new selection was made.

The meetings in question were initiated by the Facilities Development Branch (FDB). The RFP for the Facilities Asset Management System was placed by Auxiliary Services Branch. The FDB meetings were also about asset management, but on topics unrelated to the RFP. The branch in charge of the contract did not hold meetings prior to selection. The audit does not distinguish between the different purposes and merely looks at the timing of meetings.

An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

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- i. Overriding the normal process for selecting committee members.
 - ii. Providing the committee with recommended contractors.
 - iii. Placing high-ranking personnel on the committee who are also responsible for approving the committee's decision.
 - iv. Changing committee decisions after-the-fact without reconvening or adequate justification.
- d. Authorizing contractors to start work without an executed contract, and in one case, department denial of granting such authorization.
2. The superintendent of education should also investigate the former assistant superintendent of the Office of Business Services actions regarding the \$600,000 contract for Project Management and Technical assistance for Repair and Maintenance & Capital Improvement Projects awarded on February 4, 2005. The investigation should focus on the following issues:
- a. A review of the contract award to

The report provided no evidence that any law was violated or that any change in procedure violated any law.

The report construed a comment which served as a point of reference to be a recommendation. No recommendation was made to the selection committee members and the selection was based on the fact that the construction management consultants were assigned based on geographical location.

Although not a violation, changes have been made to separate functions and approvals.

The selection of the consultant was to reroof a building at Jefferson Elementary School. Economies of scale make it logical to have the same consultant design the roof and an on-going air conditioning job affecting the same roof. The committee did not know this and selected another consultant for reroofing. Reconsideration was done by email, instead of committee meeting. This type of situation is rare and procedures have been written to address the Auditor's recommendations.

The volume of work and construction timetables may require work to start ahead of an executed contract. There are no statutes which prohibit this practice. In order to accommodate necessary situations, the superintendent is now authorized to approve situations where starting without a contract is in the best interest of the DOE.

The Superintendent of Education did not include the former assistant superintendent of the Office of Business Services in the investigation as she was no longer an employee of the Department. However, the investigation did cover the former assistant superintendent's interactions with current DOE personnel.

An external independent investigator performed

determine if the consultant was preselected based on emails between the department and the consultant prior to selection committee convening.

- b. A review of emails from the former assistant superintendent to the consultant instructing him to hire specific sub-consultants in order to circumvent procurement rules.
 - c. A review of the sub-consultants' work performed to determine whether these fit under the scope of the contract and whether these services should be performed by department employees.
 - d. A review of other work performed by these sub-consultants, whether directly or indirectly, for the department.
 - e. A review of other contracts involving sub-consultants to determine whether this practice is widespread.
3. The superintendent of education should also investigate the practice of "holding checks" within the Office of School Facilities. This practice should be banned immediately and individuals responsible should be properly disciplined.

Regarding outsourcing of program and construction management services

1. The superintendent of education should review the use and structure of the following project and construction management contracts:
 - \$2,349,000 contract for Program and Project Management for Classroom Renovation Projects for Various Schools Statewide awarded on January 12, 2007.

an independent examination of all audit findings. See No. 1 above.

An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

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An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

This is a one-time situation that has not happened since. Procedures are in place to ensure that services are completed before payment is made.

Contracts were appropriate and required to manage the workload.

An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

- \$7,350,000 contract for Classroom Renovation Project for Various Central & Leeward District Schools awarded on November 21, 2006.
- \$6,825,000 contract for Classroom Renovation Projects for Various Hawai‘i, Maui, and Kaua‘i District Schools awarded on November 21, 2006.
- \$4,440,000 contract for Classroom Renovation Projects for Honolulu District Schools awarded on November 21, 2006.

The review should focus on the following issues:

- a. Inappropriate involvement and influence of project management consultants in awarding these contracts.
- b. Whether these management functions qualify as professional services and should be performed in-house.
- c. Why consultants were able to influence/determine the contract and program budgets.
- d. Why consultants were responsible for determining scope, and ultimately compensation, of their own contracts.
- e. Why consultants were provided with so much authority including:
 - i. Responsibility for reviewing and approving other consultants’ and contractors’ proposals.
 - ii. Negotiating other consultants’ and contractors’ fees and change orders.

An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

An external independent investigator performed an independent examination of all audit findings. See No. 1 above.

The report did not provide any evidence of inappropriate involvement and does not define what the alleged inappropriate influences were.

The DOE is making a conscious effort to keep most management functions in-house performed by DOE personnel.

Program budgets were developed by FDB prior to project implementation.

This is consistent with Hawai‘i Revised Statute (HRS) §103D-304(h).

When hiring a design team, it is common practice for the sub-consultants on that team to negotiate their fee with the prime consultant and this does not violate any law.

When hiring a design team, it is common practice for the sub-consultants on that team to negotiate their fee with the prime consultant and this does not violate any law.

iii. Evaluating the performance of other consultants and contractors.

iv. Recommending changes to the department's procurement and internal routing processes.

f. Determine whether these contracts violate the procurement code, specifically Section 3-122-13(e), HAR, by allowing the consultants to determine their own scopes and fees.

Regarding the lax environment and leadership void

The Board of Education and the superintendent of education should take immediate action to strengthen their control environment over procurement.

1. The Board of Education should:

a. Adopt a code of ethics and conflicts of interest policy. The department currently has draft guidelines regarding these; however, we have not reviewed these guidelines. The board should review and adopt these, or similar, guidelines and ensure they, at a minimum, incorporate Chapter 84, HRS, Code of Conduct, and Section 3-131-1.02, HAR, Procurement Code of Ethics. The board should also consider developing policies specific to senior management and require all employees to acknowledge understanding of the policies.

A 360-degree evaluation is a management tool that is becoming more common to assess performance. It is not unusual for clients and contractors and consultants to rate each other's performance.

The report did not provide any evidence that such an incident occurred.

Hawai'i Administrative Rule (HAR) §3-122-13(e) states, "A contractor paid for services to develop or prepare specifications of work statements shall be precluded from submitting on offer or receiving a contract for that particular solicitation." The DOE practice of negotiating consultant's contracts is consistent with Hawai'i Revised Statute (HRS) §103D-304(h). No laws or rules were violated in the awarding of these contracts

BOE, DOE

BOE

The Board of Education did not provide an update to our recommendations.

- b. Establish an environment that effectively manages the department's fraud risk that incorporates the principles identified by the previously referenced *Managing the Business Risk of Fraud: A Practical Guide*:
 - i. Establish a fraud risk management program that includes a written policy conveying the expectation of board members, the superintendent, and all other employees.
 - ii. Ensure that the department develops an adequate fraud risk assessment process that would include regular reports submitted to the board. Regarding procurement, these reports could include contract awards and change orders/modifications exceeding a predetermined threshold, total awards/expenditures by procurement method, and violations.
 - iii. Ensure the department has adequate fraud prevention controls (i.e., appropriate segregation of duties, authority/transaction limits) and fraud detection controls (i.e., whistleblower hotlines, appropriate process controls such as reconciliations).
 - iv. Require the department to report on all alleged fraud and reported violations of the code of conduct/ethics, including any disciplinary or corrective actions.
- c. Consider increasing the authority and responsibilities of the Internal Audit Branch and having the branch report directly to the board. The Internal Audit Branch should be operationally responsible for the department's risk management program and governance processes (including procurement).

2. The superintendent of education should:

DOE

- a. Design, develop and operate an effective internal control system based on the Committee of Sponsoring Organizations of the Treadway Commission's published findings in Internal Control-Integrated Framework.
- b. Ensure that procurement reports are developed and disseminated on a recurring basis for review approval by the superintendent, as well as for the assistant superintendents and applicable managerial employees. These periodic reports should contain relevant procurement information and should be disseminated quickly to be meaningful for monitoring purposes.
- c. Formalize the existing Guidelines for Procurement and Contracting into enforceable policies and procedures. A formal process for reporting procurement violations, including remedial actions, should be incorporated.
- d. Through the Procurement and Contracts Branch, continue to provide procurement training and tailor the programs to the specific needs of each school and branch. Periodic training should be mandatory for employees having procurement authority, and attendance should be formally tracked. The superintendent should make officers, directors, and managers having procurement authority aware of Section 3-131-1.02, HAR, Procurement Code of Ethics.
- e. Provide program/project management training to ensure projects are properly planned, budgeted, and administered. A reporting system should be developed to track budget to actual results, with explanations for material discrepancies. This system would track the project through completion and reflect any change orders or modifications.

New procedures have been developed to strengthen the control environment over procurement in the Office of School Facilities and Support Services. The DOE is in the process of contracting an external firm to review the new procedures to ensure best practices and compliance.

The DOE is working with its consultant to enhance its FACTRAK project management system to generate meaningful reports to meet the intent of the Auditor's recommendation.

The DOE has such guidelines.

DOE – OSFSS employees participate in procurement training presented by the State Procurement Office that specifically affects their areas of concern (i.e. professional services, contract administration, requests for proposals, etc.)

<http://www4.hawaii.gov/spoh/tng/trainingschedule.htm>

The DOE concurs that training in the areas of program, project management, and cost estimates are beneficial. As previously cited, the departmental FACTRAK project management system is being enhanced to improve reporting capability and allow for documentation on significant variances between budgeted and actual costs.

- f. Revoke procurement authority over construction contracts that was recently granted to the Office of School Facilities, returning such authority to the Procurement and Contracts Branch.

- g. Perform a detailed investigation on the specific procurement violations cited in this report and take appropriate and visible action.

The DOE has taken corrective action by revising procedures and creating written procedures and checklists. Furthermore, a close working relationship has been maintained with the Attorney General’s Office on the review of contract language and format, with direct contract review and oversight vested with the assistant superintendent of OSFSS. The final review and approval for each construction and consultant contract is accomplished through the superintendent’s signature.

The DOE has taken corrective action by conducting an internal investigation through an independent investigator. Administrative action has been taken as appropriate, and a report of finding has been forwarded to the Attorney General.

Study on the Appropriate Accountability Structure of the Hawai‘i Teacher Standards Board

Report No. 09-05

Recommendations

We recommend that the Legislature amend the laws relating to the Hawai‘i Teacher Standards Board, as set forth in draft language provided in Appendix D and proposed Senate Bill No. 1308 and House Bill No. 1613 of the 2009 legislative session, to include:

- Transferring to the Board of Education the powers, duties, and responsibilities for administering the teacher licensing process, and serving as the final adjudicator of appeals;
- Repealing the establishment of Hawai‘i Teachers Standards Board and the setting of licensing standards, efforts relating to teacher quality, and penalties;
- Assigning the Board of Education the adoption of policies for licensure require-

Affected Agency Response

The Legislature did not amend the laws relating to the Hawai‘i Teacher Standards Board in the 2009 and 2010 legislative sessions.

ments, and the approval of teacher education programs for professional development;

- Authorizing the Board of Education or its superintendent of education to be the “designated State Official” for Hawai‘i to negotiate and enter into contracts under the Interstate Agreement on Qualifications of Educational Personnel;
- Transferring to the Board of Education the powers, duties, and responsibilities for developing, implementing, and administering the national board candidate certification support program and state approval of teacher education programs; and
- Allowing for a one year automatic extension of licenses set to expire between January 1, 2009 and June 30, 2010 and providing the Board of Education the discretion to grant an additional one year extension.

We also recommend the Legislature consider authorizing retroactively the extension of licenses by the Hawai‘i Teacher Standards Board. Language to this effect is included in the draft bill.



Audit of the State of Hawai‘i Information Technology: Who’s in Charge?

Report No. 09-06

Recommendations	Affected Agency Response
<p>IT Strategic Planning Process</p> <ol style="list-style-type: none"> 1. The governor should formally assign responsibility for development and execution of the IT Strategic Plan to the State CIO. 	<p>Governor</p>

2. A dedicated CIO should:

- Adopt an IT strategic planning process based on nationally recognized best practices such as COBIT;
- Ensure the IT Steering Committee is involved with the State's IT strategic planning process;
- Ensure the State's IT strategic plans are linked to the State's goals and objectives, and take into consideration risks to the State's operations; and
- Ensure the plans include objectives with sufficient detail so that adequate action plans, tasks, and criteria to monitor progress can be established.

3. The IT Steering Committee should:

- Work closely with the CIO to develop and implement the State's IT strategic plans;
- Continuously assess the administration's progress in accomplishing the objectives defined in the State's IT strategic plans;
- Use the State's IT strategic plans to make management decisions;
- Periodically update the State's IT strategic plans, at least every two years; and
- Ensure technology projects are selected based on their potential impact and risk to the State, as well as their strategic value.
- Ensure departments maintain sufficient tools to assess the value and benefit of technology initiatives.

CIO

4. The Legislature should consider establishing a full time, dedicated, CIO to organize, manage, and oversee statewide IT governance,

CIO

IT Steering Committee

On July 7, 2010, Act 200 became law without Governor Linda Lingle's signature. Act 200 established a full-time CIO within the Office of

including the roles and responsibilities recommended by COBIT.

5. The CIO should:

- Report directly to the governor and in conjunction with the IT Steering Committee:
- Develop, implement, and manage statewide IT governance;
- Develop, implement, and manage the State's IT strategic plans; and
- Develop and implement statewide technology standards; and
- Ensure the IT Steering Committee is evaluated periodically.

6. The governor should:

- Thoroughly evaluate the necessary knowledge, experience, skills and abilities in selecting the State CIO;
- Define and communicate the roles, responsibilities, and authority of the CIO to the executive departments, considering COBIT recommendations; and
- Formally evaluate the performance of the State CIO.

IT Steering Committee

7. The Legislature should consider establishing an IT Steering Committee, including roles and responsibilities recommended by COBIT. The committee should:

the Governor. According to the office, a CIO is expected to be hired by July 1, 2011. In addition, the office recommended to the Legislature that the CIO and a small staff of senior technology professionals remain within the Office of the Governor during the initial planning phase or until June 30, 2013.

Governor

Act 200 also established an information technology steering committee. According to the Office of the Governor, the committee is scheduled to hold its first meeting on August 1, 2011.

- Be chaired by the CIO;
- Include representatives from each executive department, the Legislature, and provide individuals; and
- Have clear roles, responsibilities and authority for shaping IT governance and steering the State's priorities.

8. The IT Steering Committee should:

- Assist the CIO in the development of State's IT strategic plan;
- Monitor and assess the State's implementation of the State's IT strategic plan;
- Assist the CIO in developing the State's IT standards and policies; and
- Review, approve, and monitor large scale IT projects for the State.

ICSD

9. The Legislature should consider clarifying the roles, responsibilities, and authority of ICSD, specifically as it relates to its statewide duties.

10. ICSD should:

- Adopt a customer focus;

Act 200 instructed the IT Steering Committee to assist the CIO in clarifying the roles, responsibilities, and authority of ICSD, specifically as it relates to its statewide duties.

ICSD

- Established quarterly customer reports specific to department being reported on.
- Provided the ICSD management team with the IT Infrastructure Library IT Service Management booklet. The series of documents were posted on the division's local area network for reference.
- Set up an internal intranet site to include customer information, reports, forms, policies, data, etc. Posted ICSD's project list and weekly status reports as well.
- Created an outage notification policy to assure that our customers knew what communication to expect and when.
- Developed and RCA-CAP; root cause

- Assess and modify its operating model and service offerings based on its roles and responsibilities and departmental needs;
- Assess its staffing and training needs and develop a plan to recruit and train appropriate staff to accomplish its mission;
- Provide value to the departments by further developing its core competencies, taking advantage of its unique position as a statewide

analysis—corrective action plan. This process documents events resulting in outages for a customer facing service. The documentation is shared with the customer and the customer is required to sign off on the corrective action to confirm it. Addresses the problem before the report can be closed.

- In addition to existing MOUs with various customers, ICSD is building a services catalog identifying the various services customers can request of ICSD including service level expectation.
- Developing an IT request system that establishes a single interface for our customers to initiate ICSD service requests.
- Established three goals in 2010:
 - o “Keep the boat afloat,”
 - o “Lighten the load,” and
 - o “Make a difference with what we have.”
- Administration meets with executive branch technology leaders monthly to address technology issues statewide.
- Assessed low-value, high-cost services provided to two or less customers and eliminated them. Services such as microfiche and impact printers were eliminated.
- Currently working on delivering reports electronically and eliminating round reel tapes.
- Minimal progress was made due to reduced resources as a result of the reduction of force and shortened resource availability due to furloughs.
- Utilized online training via websites that offered free information on technology topics. This information was made available to staff via ICSD’s intranet page. <http://icsd.higov.net/training>
- Continue to encourage professional staff attendance at free seminars conducted by vendors, and online webinars as training and networking opportunities.

Several agencies and departments have approached the ICSD to house some of their equipment:

IT organization, providing:

- o Centralized computing solution;
- o Network and Internet connectivity;
- o Data center services; and
- o Disaster recovery services; and
- o Establish processes to ensure technology investments provide the greatest value to the State.

- Juvenile Justice
 - Department of Education
 - Department of Labor
 - Hawai'i Criminal Justice Data Center
 - Department of Taxation
 - Department of Transportation
- o Pursued replacement of the 15-20 year old Storage Tek tape silo with a newer, more efficient, energy savings solution called a Virtual Tape System. Covered with maintenance funds.
 - o Created a redundant core switch infrastructure in the Hemmeter Building to protect the network if the Kalanimoku Building is unavailable. Implemented MPLS network improvements for departments that increased speed and lowered costs.
 - o Manual data entry continues to decrease in volume as automated processes and digital data sharing are introduced.
 - o Cyber security improvements that protect our customers from malicious network traffic were introduced in the form of IronPort, Rationale Appscan, IPS and deny all/allow known firewall consulting.
 - o Entered into an agreement with the University of Hawai'i to reserve space in the new UH Data Center for ICSD digital backup.
 - o All ICSD projects are posted and projects are assessed to reduce costs, increase productivity, simplify the environment and meet customer expectations. Furthermore, procurement training is attended by all staff engaged in purchasing items.
 - o Data were gathered and provided to CIO relative to current costs of IT statewide to gauge current investment.

Investigation of the Procurement and Expenditure Practices of the Department of Business, Economic Development & Tourism and Selected Attached Agencies

Report No. 09-07

Recommendations	Affected Agency Response
<p>We recommend that the Department of Business, Economic Development & Tourism strive for greater accountability and transparency in governance.</p> <ol style="list-style-type: none"> 1. The department must create the proper balance of funding the projects legislatively mandated versus those with funding denied, while still focusing on its main objective to spur business development in Hawai'i. To address this, the department should: <ol style="list-style-type: none"> a. Ensure that financial records are properly maintained and any deviations from standard procedure are appropriately documented; b. Ensure that all individuals working within these areas are appropriately trained; and c. Develop a monitoring function to ensure that procedures are being carried out appropriately. The department should also consider doing spot check audits as deemed necessary for high risk areas. 2. As the Legislature desires to be more aware of these funding vehicles and ensure greater transparency and accountability in government, the Legislature should: <ol style="list-style-type: none"> a. Devise a reporting mechanism to incorporate transfers into future budgets. As "savings" are identified in one program, the savings should be carried over via decreasing base budgets for the following 	<p>DBEDT</p> <p>DBEDT continues to follow the recommendations contained in the Auditor's report.</p> <p>Legislature</p>

period; and

- b. Require justification of transfer to also include impact on existing programs and to formalize new programs by establishing goals, objectives and performance measures.
3. The department should ensure that the Hawai'i Public Procurement Code is adhered to at all levels within the department and its attached agencies. To address this, the department should:
- a. Ensure all staff and management dealing with the procurement of goods, services, and construction are familiar with and properly trained in the requirements of the Hawai'i Public Procurement Code;
 - b. Revise the current Procurement/Contracts Manual to clarify procedure and roles and responsibilities of individuals within branches, divisions, and central support offices. Procedures should include detail such as forms to compete, time-frames, chain of command, retention policy, and how to address questions. Upon completion of Procurement/Contracts Manual update, a department wide training should be held to ensure all staff is aware of requirements;
 - c. Clearly establish responsible parties within each division to ensure that policies and procedures are followed and that the maintenance of records related to procurement are closely adhered to;
 - d. Develop procedures to ensure that procurements and subsequent resulting contracts are appropriately monitored. And as necessary, employ a process to audit compliance;
 - e. If the procurement and contracting process continues to have a decentralized focus, develop procedures to ensure responsible parties are adequately trained and have technical exper-

DBEDT continues implementing policies consistent with the Auditor's report as reflected in our initial departmental response.

tise to conduct procurement for the State. As necessary, revise position descriptions in order to hold individuals accountable to the procurement choices made; and

- f. In instances where individuals procuring items have intentionally violated procurement requirements, the department should seek appropriate remedies, including disciplinary action, to ensure there is an understanding between staff and management that fraud, waste, and abuse will not be tolerated.



Management Audit of Information Technology Within the Office of Hawaiian Affairs

Report No. 09-08

Recommendations	Affected Agency Response
<p>We recommend that the Office of Hawaiian Affairs:</p> <ol style="list-style-type: none"> 1. Create the position of a Chief Information Officer (CIO) to assume the overall governance duties over its information systems, to direct IT policy and strategic planning, and to provide oversight to the agency's varied information assets; 	<p>OHA</p> <p>OHA adopted a six-year, comprehensive strategic plan in September 2009, and the organization was restructured to align with strategic priorities. The Chief Financial Officer (CFO) heads the resource management line of business (LOB) which consists of six programs, one of which is Information Systems & Records Management (ISRM Program). Our Board of Trustees (BOT) and Chief Executive Officer (CEO) reviewed your recommendation and after careful consideration, decided to support our original communication dated May 28, 2009, which is to designate CIO responsibilities to our CFO, primarily because the CFO has direct access to the BOT as well as the executive team which includes the CEO, Chief Operation Officer, Corporate Counsel, and three LOB directors. In addition, the CFO possesses the following qualifications:</p>

2. For an IT steering committee to support the CIO in formulating an IT strategic plan that identifies, prioritizes, and monitors IT requirements across the agency and to assist the CIO in maximizing value and minimizing risk in the delivery of the IT strategy; and

- Is entrusted to mandate the alignment of strategic priorities with information systems governance.
- Has direct access to decisionmakers; participates in cross-divisional meetings, and ensures IT issues are considered in all strategic decisions.
- Has a proven success record: He brings a wealth of experience, vision, and a sound business knowledge base to the executive team and understands the importance of integrating information systems with business operations.
- Has technical support from the ISRM program that is comprised of a manager who reports directly to the CFO, an information systems specialist, and two information technology specialists.

The small size of our agency (approximately 150 employees) and the flat state of our economy were also considered in our decision.

In November 2010, OHA's CEO authorized the formation of an IS steering committee, headed by our CFO. In addition to participating in periodic BOT and executive team meetings, additional steering committee meetings will be held as needed to address strategic and operational issues associated with OHA's electronic systems, data, and technologies. The steering committee consists of representatives from the BOT, executive team, and all the LOBs.

Our priority is to continue to support our IT strategic plan. To name a few accomplishments, we've evaluated risks and costs associated with centralizing our network infrastructure. In addition, LOB-specific databases will be centralized under a newly created position of information systems coordinator while enterprise-wide databases are centralized in the ISRM program.

In addition to the steering committee, several IT

3. Implement an IT strategic plan as part of the overall strategic planning process it is currently going through. Headed by the CIO and supported by the IT Steering Committee, this IT strategic planning effort should articulate the appropriate IT infrastructure and identify the support it requires during the current period and in the future.

strategic plan components such as identifying, prioritizing, and monitoring IT requirements across our enterprise are documented in the ISRM program work plan. This plan is formally updated annually and includes, but is not limited to, the following:

- Evaluation and reporting of information systems security issues and responses.
- Timely installation, updates, monitoring, and maintenance of our IT infrastructure and hardware/software provided to end users.
- Automated help desk work order responses, tracking, and performance reporting.
- Network infrastructure and data protection as well as connection uptime.
- Timely and cost conscious evaluations, development, procurement, testing, installations, and training on new business tools, templates, and customized applications; includes review of updated and future technologies.

As a result of your recommendation and the implementation of our new strategic priorities, the CFO, in his capacity as CIO, accomplished the following through calendar year December 31, 2010, and aims to ensure the same strategies are aggressively pursued in the future:

- Aligned IT strategies with business strategies.
- Evaluated organization-wide business plans to ensure top-to-bottom integration among the BOT, executive team, and other LOBs.
- Assessed organizational structures that provided the framework for the implementation of ISRM program strategies and goals through the management of resources.

- Identified risks and reviewed risk neutralization strategies to protect our network, end users, and beneficiaries; this includes overseeing spot check audits (to be implemented soon) and the agency’s compliance with best practices, policies, and procedures.
- Initiated methods to measure, communicate, and take action on IT-related service delivery, performance, and customer satisfaction standards.

In addition to the IS steering committee, the BOT and executive team recognize the importance of IT in the workplace and understand that they also have roles and responsibilities that must be practiced to ensure continued sustainability and success.

Study of the Social and Financial Impacts of Mandatory Health Insurance Coverage for the Diagnosis and Treatment of Autism Spectrum Disorders

Report No. 09-09

Recommendations	Affected Agency Response
<p>Enactment of SB No. 2532, Senate Draft 1, is not recommended.</p>	<p>Legislature did not enact SB No. 2532, Senate Draft 1.</p>

Investment Portfolio Review of the Office of Hawaiian Affairs

Report No. 09-10

Recommendations	Affected Agency Response
<p>Board structure and governance</p> <p>With respect to board structure and governance, we recommend that the Board of Trustees of the Office of Hawaiian Affairs:</p> <ol style="list-style-type: none"> 1. Adopt written policies and procedures regarding investment management, service provider oversight, investment manager oversight, including the activities OHA performs in regard to due diligence of its investment advisors, and policies and procedures with respect to contracts, including review and approval. In addition, OHA should include a policy on the agency's website that clearly states the public can request documentation with respect to the trust and the organization. 2. Assess and document its decision to retain the manager-of-managers approach annually through the observations identified and following recommendations, which are described in further detail throughout the report, in order to demonstrate its overall fiduciary obligation to the Native Hawaiian Trust Fund. 3. Consider initiating enhanced training with a mandatory attendance requirement. The board will be required to sign off on trustees' attendance, which will be entered into a board training log to be maintained by OHA's administrator. At least annually, all board members should be required to receive training on their roles and responsibilities. Training for the board should include: fiduciary respon- 	<p>OHA Board of Trustees</p> <p>OHA's investment policy statement outlines the delegation of authority and responsibility of trustees, staff, advisors, consultant, and custodian with respect to the Native Hawaiian Trust Fund (NHFT). In addition, OHA has dedicated processes and procedures regarding procurement, contract evaluation, and renewal that are consistent with the State's procurement laws. The NHFT operational procedures outline on-going investment, due diligence activities, and operational controls. OHA's website has a search function for publically available documents as well as a prominent link to info@oha.org on the homepage for information requests. OHA's BOT executive policy includes a policy on beneficiary access of information.</p> <p>OHA conducts an annual assessment of the NHFT performance and investment advisors' performance and activities. The review is presented and discussed at OHA's Asset and Resource Management (ARM) committee. Documented meeting minutes are available on our website at www.oha.org.</p> <p>OHA has revised its policy to require mandatory trustee investment training. Since the date of the audit report, OHA has provided the Board of Trustees with opportunities for 16 investment training sessions, including training on OHA's investment policy, investment principles and strategies, and advisors' performance reports. Several of the trainings provided were conducted at regularly scheduled ARM committee meetings.</p>

sibilities, accounting, financial and investment matters, and the understanding of quarterly reports provided by the investment advisors. To achieve consistency and efficiency, training should be provided to the board, as a whole, and could potentially be done in conjunction with regularly scheduled board or committee meetings.

4. Consider enhancing the current Investment Advisory Committee and requiring additional experts as committee members. New members should include the chair of the ARM Committee, a trustee-at-large, and the CFO. The improved sub-committee would provide recommendations to the ARM Committee on a structured basis (e.g., quarterly).
5. As a best practice, consider having the board members certify, no less frequently than annually, that they have abided by the OHA Code of Ethics and document the evaluation of potential conflicts of interest related to trust fund activities. In addition, the board may want to consider logging beneficiary and community complaints via a complaint log. This log would enable the board to identify trends in complaints. The board also should consider instituting a whistleblower policy for trustees, employees, and other individuals to report illegal, unethical, or inappropriate activity anonymously and confidentially.
6. Consider clarifying and formalizing its fiscal reserve policy to include specific criteria for use of the fiscal reserve, as discrepancies have been noted during administrative staff and trustee interviews. In addition, the board may want to consider establishing a fiscal reserve cap to ensure the fiscal reserve is spent in a timely manner and according to the policies of the trust. Unspent amounts would lose their reserve status and become principal investment dollars in the trust.

OHA plans to continue providing the Board of Trustees with investment education at regularly scheduled ARM committee meetings. In addition, OHA also provides trustee training on fiduciary responsibilities, risk management, and other financial and procurement matters periodically.

Consistent with Mr. Calvin Hangai's email on December 22, 2009, regarding OHA's Investment Advisory Committee (IAC), the advisory committee is "a resource to advise and consult with the board on specific matters." As such, we have formally included the chairperson and vice-chairperson as committee members. The CFO was already a member of the IAC at the time of the audit. The IAC meets quarterly to provide feedback and advice to OHA (including trustees) on investment matters.

As State of Hawai'i elected officials, OHA's trustees are required to file gift disclosure statements with the Hawai'i State Ethics Commission annually. As a state agency, OHA also abides by chapter 84 of the Hawai'i Revised Statutes (HRS). In accordance with Mr. Calvin Hangai's email on December 22, 2009, OHA has revised its IPS to include a reference to HRS Chapter 84 and the State's standard of conduct. OHA continues to open every board and community meeting with a time dedicated to community concerns. The complaints are documented in the meeting minutes. To date, there have not been any complaints or concerns regarding the NHTE.

The fiscal reserve policy was updated and approved by the BOT (second reading) on May 21, 2009, which addresses the Auditor's concerns. Currently, the fiscal reserve policy has a \$3 million annual spending cap and includes the specific criteria for the use of the fiscal reserve.

Monitoring of investment performance and advisors

With respect to monitoring of investment performance and advisors, we recommend that the Board of Trustees of the Office of Hawaiian Affairs:

1. Consider reviewing the investment policy statement and asset allocations on a more frequent basis to address whether tactical changes should be made given market factors. We note that the failure to beat the overall target objective may most likely be attributed to market events; however, the board should consider inquiring with the investment advisors as to why the trust has been outperformed by the Trust Universe Comparison Service (TUCS) database in 18 of 20 quarters reviewed. As a best practice, the board may want to consider performing a quarterly analysis of CommonFund, as well as TUCS data or the Council on Foundations to help evaluate the investment performance of the trust against a peer universe and document such analysis.

We note that OHA receives an annual analysis based on the CommonFund Study with respect to peer average investment returns via the Frank Russell Investments quarterly performance report, however, this information is not presented to the board in the investment consultant's annual report. The board may want to consider requiring the investment consultant to include a section in the annual report that compares the CommonFund Study as presented by Russell and one other peer universe to the performance of the trust. In addition, the board should consider increasing the frequency with which such an analysis is performed by the investment consultant, specifically by requiring quarterly analysis to help evaluate the average portfolio performance of peer universes against the trust's overall performance. This quarterly review would provide the board with information regarding the returns achieved by their peers and would give the board the opportunity to question on a timely basis the current investment advisors as to why they fell below the

OHA Board of Trustees

OHA currently reviews its IPS on an annual basis. Tactical investment decisions are delegated to investment advisors and short-term asset allocation recommendations by OHA's investment advisors are reviewed periodically during the year as needed. As noted in the Auditor's report, OHA has included the peer institutional performance comparison in the internal quarterly performance report prepared by OHA staff as well as the consultant's annual review.

average of the peer universes. Our report used the TUCS study for comparison based on the information readily available; however, the CommonFund Study may likewise be a suitable peer comparison to be utilized by OHA.

2. Review the investment policy on an annual basis or more frequently as market conditions and OHA funding requirements dictate. We note that the investment policy, previously dated 2003, was updated in October 2008 and implemented in January 2009 and has clarified its overall target return.
3. Consider reviewing the performance of the investment managers more frequently via the on-line access through ClientLINK, provided after the review period of fiscal years 2004 to 2008. The board should consider clarifying the investment policy to state that the monthly review of statements refers to the custodian statements and not the investment performance of the trust. In addition, the board should consider creating a written procedure to ensure that the standardized quarterly performance reports as created by OHA are being effectively implemented by the investment managers. We note that Goldman Sachs has been providing Lipper and TUCS comparisons on a consistent basis since the start of 2007 and that Frank Russell Investments has provided Lipper comparisons throughout the duration of the relationship. Additionally, Frank Russell Investments has consistently worked well with regard to standardizing the performance reports, while Goldman Sachs has had issues when conforming to the method prescribed by OHA.
4. Review, approve, and implement the recently developed risk assessment as soon as reasonably feasible, along with an approved risk management policy. The risk management policy should include a risk assessment methodology describing procedures and guidelines for assigning appropriate risk rankings.

OHA staff and consultant currently review the IPS on an annual basis and present recommendations to the board.

OHA staff prepare monthly performance reports, quarterly reviews, and an annual review. OHA has worked with both Goldman Sachs and Russell Investments to standardize the executive summary section of the quarterly presentation. OHA has also recently contracted with State Street Bank and Trust to be its new custodian. State Street Bank and Trust will provide both custody and performance reporting services. As such, State Street Bank and Trust will work with advisors to produce standardized quarterly performance reports for the Board of Trustees.

OHA has approved NHFT operational procedures that outlines responsibilities and controls to minimize operational risk. OHA developed a risk assessment matrix in 2009 and implemented the risk assessment self-audit in 2010. OHA is in the process of formalizing an organization-wide risk management policy and refining OHA's internal risk management program. .

5. Consider soliciting additional investment advisors in order to identify any potential cost savings for comparable services, or at the very least to negotiate with the current advisors for fee reductions.

6. Due to the complexities of valuing illiquid securities, consider developing a valuation policy for the trust, which could adopt the valuation policy and procedures of its advisors and managers. The valuation policy should describe the process whereby the administrative staff and the ARM Committee shall review periodic (i.e., quarterly or annually) valuation reports provided by the advisors to ensure compliance with stated policies and assess the description of the controls employed around valuation by the advisors. Any material valuation matters identified as a result of the periodic review of advisor valuation processes should be reported to the board.

7. Establish written policies and procedures to ensure reconciliations are accurately and properly documented between the custodian and the investment advisors. We noted that under the new custodian agreement dated November 2008, all assets are held with Frank Russell Investments, with State Street acting as sub-custodian. Under the new agreement, the custodian will perform reconciliations, and OHA will obtain monthly asset verification reviews and sign-off from State Street. In addition, the investment analyst has implemented quarterly investment manager invoice verification worksheets.

8. Require both Russell and Goldman Sachs to submit a proxy voting report to the investment

OHA has issued two requests for information for asset management services since the date of the audit report. OHA staff and consultant are currently in the process of evaluating the proposals, including the fees. During 2009, OHA trustees and consultant requested fee reductions based on responses from the first RFI, and both advisors lowered fees by roughly \$40,000 annually each at the beginning of 2010.

OHA has adopted a valuation policy in the NHTF operational procedures. OHA has documentation of the advisors' valuation policies and reviews it on an annual basis or as needed as a part of its annual due diligence. OHA also undergoes an annual independent financial audit conducted by a reputable independent auditor. The financial audit includes the audit of OHA's investment valuations. OHA has not received any findings or management advisory comments regarding the NHTF asset valuations or valuation policy in the last two years.

OHA currently has internal process and procedures to reconcile the advisors' reports with the custodian's reports. The investment advisors also have their own independent reconciliations process to reconcile with OHA's custodian. OHA has recently hired State Street Bank and Trust directly as custodian. The duty to reconcile monthly is included as a part of the custody agreement. OHA has also implemented an annual certificate of compliance for the advisors to certify compliance with OHA's investment policy statement, which includes the duty to reconcile with OHA's custodian. In addition, OHA has Goldman Sachs' documented performance reporting and reconciliation process. OHA also receives a signed certification verifying the monthly market values from Russell Investments.

OHA's IPS includes OHA's proxy voting policy. Proxy voting is delegated to the advisors, who

consultant/analyst on a periodic basis (e.g., quarterly) in addition to creating a trust Proxy Voting Policy to be adopted by the board. Additionally, OHA should review proxy reporting information on a periodic basis to ensure investment advisors are voting proxies timely and without conflicts of interest. Any material matters or concerns identified should be reported to the board.

9. Consider requiring the investment consultant to include a section in the annual report that compares the CommonFund Study as presented by Russell to the applicable trust investment policy. Additionally, consider requiring a quarterly analysis of the CommonFund data to help evaluate the average asset allocation of a peer universe against the trust's strategic asset allocation. This quarterly review would provide the board with information regarding current trends among their peers and would enhance the members' decision making abilities with respect to the trust's asset allocation plan. As noted previously, a common practice in the industry is to review more than one peer study when performing comparison analysis with respect to asset allocation strategies. In addition to CommonFund, OHA may want to consider the review of the NACUBO study, TUCS information, or the Council on Foundations reports. Each of these would be an appropriate peer universe given that the structure of the OHA trust most resembles an endowment. We noted that the NACUBO data was used for comparison based on the information readily available to us and that the CommonFund Study may likewise be a suitable peer comparison to be utilized by OHA.

10. Consider requiring the investment advisors to provide enhanced reporting regarding the transition into Private Equity from the US Large Cap target allocation. The advisors should include documented updates on the capital call structure of the Private Equity investments and estimated schedule of capital commitments until all of the committed capital is fully realized, along with the current quarterly report. Doing so will also allow OHA and its board to be better informed

in turn delegate the proxy voting authority to the fund's underlying managers for certain institutional commingle funds provided that the sub-managers comply with the advisors proxy voting policies. OHA reviews the advisors proxy voting policies and proxy voting reports (where applicable) on an annual basis.

CommonFund and NACUBO have teamed up to provide annual endowment reports since the date of the Auditor's report. OHA currently includes the TUCS performance comparison in its internal quarterly reviews and uses the CommonFund endowment and foundations report on an annual basis.

OHA's private equity advisors provide a forecast of capital contribution and distribution on an annual basis. The investment decision to hedge the committed capital in traditional assets is delegated to the investment advisors. OHA holds monthly update calls to discuss advisor activities, including any assets allocation changes. OHA has also recently issued a request for information for alternatives asset management, which may help to streamline the management of OHA's alternatives assets.

with regard to the attainability (or not) of their target asset allocation model, as well as provide data to assist in measuring performance attribution from being over weighted in Large Cap and Core Fixed Income. We note that OHA has contracted with Russell (sub-contracted with State Street) for its trust custody in November 2008. This new relationship should provide aggregated reports that potentially will provide more valuable information for OHA, including aggregated asset allocation reports.



Review of Revolving Funds, Trust Funds, and Trust Accounts for the Departments of the Attorney General and Business, Economic Development & Tourism, and the University of Hawai‘i

Report No. 09-11

Recommendations	Affected Agency Response
No recommendations.	

Office of the Auditor Appropriations and Expenditures on a Budgetary Basis for the Fiscal Year Ended June 30, 2010

Appropriations

Act 1, SLH 2008 (operations)	2,619,685.00
Act 1, SLH 2008 (special studies)	150,000.00
Act 1, SLH 2008 (Audit Revolving Fund)	2,550,828.00
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	\$5,320,513.00

Expenditures

Staff salaries	2,071,085.00
Contractual services (operational)	187,232.00
Other expenses	188,435.00
Special studies	-
Contractual services (audit revolving fund)	2,550,828.00
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	\$4,997,580.00

Excess of Appropriation Over Expenditures

Act 1, SLH 2008 (operations)	172,933.00
Act 1, SLH 2008 (special studies)	150,000.00
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	\$322,933.00

The Office of the Auditor

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

To carry out its mission, 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, trust, and revolving funds** determine if proposals to establish these funds meet legislative criteria.
7. **Analyses of existing trust and revolving funds determine if such funds** meet legislative and financial criteria.
8. **Procurement reports** include studies and audits relating to the State's procurement of goods, services, and construction.
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.

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