

**State of Hawaii
Deposit Beverage Container
Deposit Special Fund**

Financial and Program Audit

June 30, 2010

Submitted by
The Auditor
State of Hawaii

Financial and Program Audit of the State of Hawaii Deposit Beverage Container Deposit Special Fund June 30, 2010

Executive Summary

Section 342G-107, HRS, requires the Office of the Auditor to conduct a management and financial audit of the Deposit Beverage Container Deposit Program and Special Fund in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005.

The Office of the Auditor hired the certified public accounting firm of Accuity LLP to conduct this financial and program audit for the fiscal year ended June 30, 2010. For the full text of this report, visit the Auditor's website at <http://www.state.hi.us/auditor>.

The Deposit Beverage Container Program Is Exposed to Fraud

Despite five years of experience with the Program, which began in 2005, several deficiencies expose the Program to fraud, including the over-reliance on self-reporting by Program personnel and lack of systematic compliance inspections.

Deposits and fee collections from distributors, as well as payments to redemption centers, are unsupported. For several sample distributor reports selected for testing, distributors could not support amounts reported and payments made to the Program.

Four redemption centers refused to provide support for amounts redeemed and the related deposit reimbursements requested, including two uncertified redemption centers that appear to be operating in violation of the law and rules. There is also at least one large redemption center operator that increases the weights reported on deposit redemption forms submitted to the Program to correct for errors made by redemption center employees.

Exempt commercial passenger-vehicle companies have not been inspected since the inception of the Program, which continues to expose the Program to risk of unauthorized beverage containers entering the redemption stream.

Consequently, the Program may be operating at a greater cost than necessary, and the reported redemption rate may not be reliable. Resolution of these deficiencies is necessary to alleviate public concern over the cost of the State's beverage container recycling program, including questions on the container fee rate necessary to operate the Program.

Agency response

The Department of Health concurred with many of the findings and conclusions in the report. However, the department objected to the formatting of the report, which it believes highlights criticisms without providing underlying reasons for existing problems.

The Program sought to clarify several items in the draft report. The department also provided specific comments for each recommendation, indicating it is addressing the findings.

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Chapter 1: Introduction

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Deposit Beverage Container Deposit Special Fund

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Background

In 2002, the Hawaii Legislature passed Act 176 (the "Bottle Bill") to establish the Deposit Beverage Container Deposit Program (the "Program"). The act, codified in Chapter 342G, Part VIII, Hawaii Revised Statutes ("HRS"), also established the Deposit Beverage Container Deposit Special Fund (the "Fund") to account for program activities. The purpose of the Bottle Bill is to increase participation in deposit programs, increase recycling rates for specified deposit beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter.

Section 342G-107, HRS, requires the Office of the Auditor (the "Auditor") to conduct a management and financial audit of the Program in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005.

The Office of the Auditor hired the certified public accounting firm of Accuity LLP to conduct this financial and program audit.

Deposit Collection Process

Manufacturers and distributors of beverage containers are responsible for paying deposits and fees into the Fund when they sell, donate, or otherwise distribute beverages in applicable containers in the state. Manufacturers and distributors may pass on the deposits and container fees they pay to their customers (e.g., retailers) who, in turn, may pass on the costs to end consumers. The deposit is \$0.05 per container and the fee is \$0.01 per container on each eligible beverage container manufactured in or imported into Hawaii.

The refundable deposits collected are initially recorded as a liability in the Fund and not as revenue, as they are specifically intended to reimburse certified redemption centers, which collect the empty containers and refund consumers for eligible containers redeemed. Subsequently, because not all deposits are expected to be redeemed, the Program records 20 percent of deposits as revenue. The revenues in the Fund are used to administer the program.

If the statewide redemption rate exceeds 70 percent of deposits collected for a fiscal year, the Program can increase the per container fee to \$0.015. The redemption rate is calculated as the ratio of containers redeemed to containers manufactured or distributed as represented by deposits collected from distributors. The Program continued to maintain the per container fee at \$0.01 through fiscal year ("FY") 2010, even though the redemption rate had been more than 70 percent since FY 2008, as reflected in Exhibit 1.1.

Exhibit 1.1 Deposit Beverage Container Redemption Rates

Year Ended	Redemption Rate
June 30, 2006	68%
June 30, 2007	68%
June 30, 2008	72%
June 30, 2009	79%
June 30, 2010	76%

Source: Department of Health

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One group of containers is exempted from the deposit and fee mandate. Section 342G-101.5, HRS, exempts commercial passenger-vehicle companies from paying the Program the deposit and container fees for beverages sold or delivered to such companies when the beverage container is intended for consumption on the commercial passenger-vehicle. Such vehicles include airplanes and cruise ships. To qualify for this exemption, eligible companies must have a beverage container recycling plan approved by the Department of Health (the "Department").

Redemption Process

The Program utilizes redemption centers to receive empty beverage containers from and return deposits to consumers, as well as to deliver redeemed beverage containers to recyclers. During fiscal year 2010, the Program paid handling fees between \$0.02 and \$0.04 per container, depending on the location of redemption center and the end use of the recycled containers. Except for glass containers, redemption centers on Oahu were paid \$0.02 per container delivered to recyclers/recycling mills, while redemption centers on other islands were paid \$0.03 per container. To encourage remanufacturing of glass, handling fees for glass were \$0.02 for agriculture/construction and \$0.04 for remanufacturing uses on all islands.

An individual or business operating a redemption center must receive both a solid waste permit and a redemption center certification from the Department. In addition to the conditions listed in the permit and certification, redemption centers must comply with the statutory requirements in Section 342G-114, HRS, which are: 1) accepting all types of empty deposit beverage containers for which a deposit has been paid; 2) verifying that all containers to be redeemed bear a valid Hawaii refund value; 3) paying the redeemer for the full refund value in either cash or a redeemable voucher for all deposit beverage containers, except as provided in Section 342G-116, HRS (lists conditions for refusal); 4) ensuring each deposit beverage container is recycled through a contractual agreement with an out-of-state recycler or an in-state recycling facility permitted by the Department (not applicable if redemption center is operated by a recycler permitted by the Department); and 5) forwarding the documentation necessary to support claims for payment as stated in Section 342G-119, HRS (redemption center reporting requirements).

As of June 2010, there was a total of 105 certified redemption centers on Oahu and the Neighbor Islands. Exhibit 1.2 provides a breakdown of sites on each island.

Exhibit 1.2 Certified Redemption Centers

Island	Number of Centers
Oahu	59
Maui	13
Hawaii	19
Kauai	11
Lanai	1
Molokai	2
Total	105

Source: Department of Health

When determining the deposit refund to be paid to consumers, redemption centers may weigh redeemed beverage containers in excess of 200 rather than counting them, using department-provided segregated rates to calculate the number of redeemed beverage containers. This practice may result in individual consumers receiving more or less than \$0.05 per beverage container redeemed, but is intended to average \$0.05 on a statewide basis. The number of beverage containers per pound by material type is

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required to be posted at all redemption centers. Exhibit 1.3 contains the segregated rates in effect during fiscal year 2010. Two different rates were used during the fiscal year due to revised rates becoming effective in November 2009. Redemption centers may not issue refunds for beverage containers redeemed without *HI-5¢* marking.

Exhibit 1.3 Hawaii Deposit Beverage Container Law Segregated Rate Schedules

Effective June 1, 2007, through November 15, 2009:

Container Material Type	Number of Containers Per Pound
Aluminum	31.6
Bi-metal	8.0
Glass	2.3
Plastic	17.5
Plastic (17 oz. or less)	22.7

Effective November 16, 2009:

Container Material Type	Number of Containers Per Pound
Aluminum	31.4
Bi-metal	4.6
Glass	2.3
Plastic (mixed sizes)	17.4
Plastic (17 oz. or less)	24.4

Effective December 1, 2010:

Container Material Type	Number of Containers Per Pound
Aluminum	32.0
Bi-metal	5.9
Glass	2.4
Plastic (mixed sizes)	18.8
Plastic (17 oz. or less)	26.3

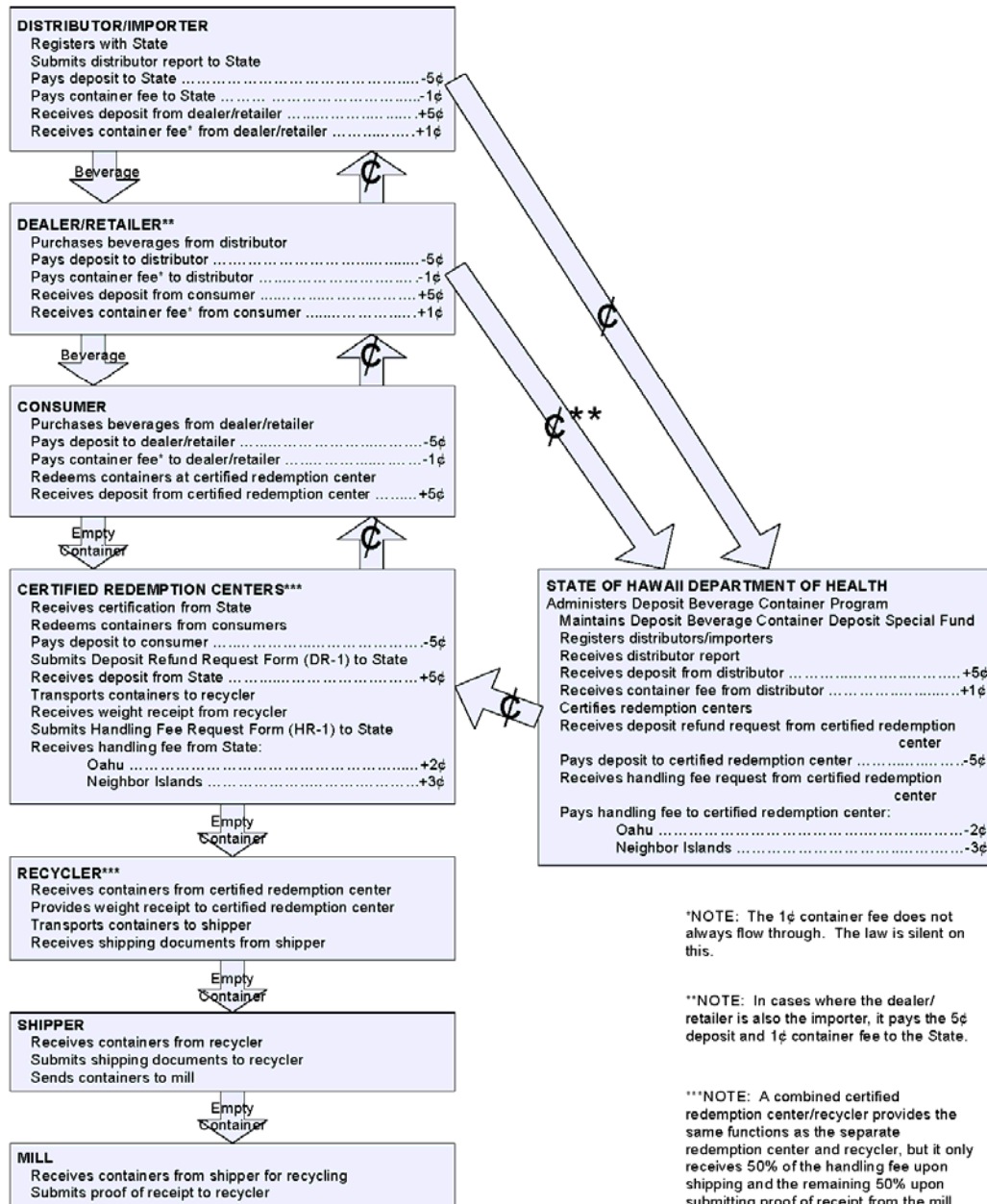
Source: Department of Health

As some of our testing – see Scope and Methodology section below – was performed subsequent to June 30, 2010, we have also included the segregated rates schedule effective from December 1, 2010, in Exhibit 1.3.

Exhibit 1.4 provides a general overview of the complete deposit and redemption process.

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Exhibit 1.4 Overview of Deposit and Redemption Process



*NOTE: The 1¢ container fee does not always flow through. The law is silent on this.

**NOTE: In cases where the dealer/retailer is also the importer, it pays the 5¢ deposit and 1¢ container fee to the State.

***NOTE: A combined certified redemption center/recycler provides the same functions as the separate redemption center and recycler, but it only receives 50% of the handling fee upon shipping and the remaining 50% upon submitting proof of receipt from the mill.

Source: Office of the Auditor Report No. 05-09, Audit of the Deposit Beverage Container Program

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The Department's Solid Waste Branch, Environmental Management Division, administers the Program and Fund. The Program consists of 12 approved positions managed by the Solid Waste Management Coordinator. In its *Report to the Twenty-Fifth Legislature State of Hawaii 2010* (December 2009), the Department reported two Program positions were vacant as of December 2009.

In fiscal year 2010, the Program had total revenues of \$20.3 million and total expenditures of \$25.0 million, resulting in a \$4.7 million decrease in fund balance to \$6.1 million at June 30, 2010. The Program's container deposit liability also increased from \$19.7 million at July 1, 2009, to \$22.7 million at June 30, 2010. The fund had \$32.8 million in cash and cash equivalents at June 30, 2010, to refund deposits and to pay for other liabilities and expenses. Additional information on the Program's financial information is included in the Fund's financial statements, in Chapter 3.

Prior Audits

The Auditor conducted the initial audit of the program and reported the following findings in Report No. 05-09, *Audit of the Deposit Beverage Container Program* issued in 2005:

1. Numerous delays in the Department of Health (the "Department") negatively impacted the program's planning and implementation: the Department failed to submit a timely budget request for program funding, the Department was late in hiring staff to plan and implement the Program, redemption centers were poorly operated, public education efforts were untimely and overlooked the greater environmental message, a structure did not exist to ensure that funds were properly reported and paid by distributors, and payments to redemption centers were based on unverified numbers.
2. The Department has failed to establish a financial accounting system to ensure that transactions are properly recorded and reported and that assets are safeguarded.

We conducted a financial statement audit of the Fund's FY 2008 financial statements, along with limited testing of the Program's compliance with Chapter 342G, Part VIII, HRS. During that audit, we reported that the Department and Program management implemented several of the Auditor's recommendations to address the findings reported. However, we also noted that the finding related to relying on unverified reports by distributors and redemption centers was still applicable. We also found the Program was required to restate the beginning fund balance of the Fund as of July 1, 2007, due to a \$5 million misstatement in the Fund's financial statements for the year ended June 30, 2007.

Objectives of the Audit

1. Perform a financial statement audit of the Deposit Beverage Container Deposit Special Fund.
2. Assess the adequacy of the Deposit Beverage Container Program's internal controls over financial reporting.
3. Make recommendations for improvements as appropriate.

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Scope and Methodology

The scope of the audit was to perform a financial statement audit of the Fund for the year ended June 30, 2010. As part of our financial statement audit, we tested 25 deposit redemptions paid by redemption centers to consumers and 25 handling fee payments from the Program to redemption centers. We recalculated the payments based on supporting documents provided by the Program stating the weight of containers redeemed multiplied by the segregated rates in Exhibit 1.3.

In addition to the financial statement audit procedures, we also performed limited testing of distributors' and redemption centers' compliance with Chapter 342G, Part VIII, HRS.

For the testing of beverage distributors, we obtained a listing of distributors from the Program and selected 15 of the 221 distributors for further testing. For FY 2010, we selected the seven distributors with the highest deposit payments to the Program that were not tested in our FY 2008 audit, judgmentally selected three distributors with annual deposit payments between \$100,000 and \$1,000,000, and judgmentally selected five distributors with annual deposit payments of \$100,000 or less. For each distributor selected, we tested 25 invoices from the respective distributor's monthly detail of beverage container sales for one month/period to verify that all containers reported as sold (or otherwise distributed) on the distributor's invoice were properly substantiated by supporting documents and the proper deposit and container fees were paid to the Program. The distributors tested are shown in Exhibit 1.5.

Exhibit 1.5 Distributors Tested

Distributor	Month/Period Selected
1. Better Brands	September 2009
2. C&S Wholesale Grocers Inc.	January 2010
3. Costco Wholesale Corp.	December 2009
4. Hing Mau Inc.	February 2010
5. Hawaiian Sun Products Inc.	March 2010
6. Marukai Corp.	January to June 2010
7. J&D Investments	January 2010 to June 2010
8. Shimaya Shoten Ltd.	November 2009
9. Big Save Inc.	October 2009
10. Coca Cola Bottling Co.	September 2009
11. General Nutrition Corp.	October 2009
12. Hawaiian Isles Water Co.	February 2010
13. Itoen (USA) Inc.	March 2010
14. Pepsi Bottling Group	August 2009
15. Maui Soda and Ice Works Ltd.	August 2009

Source: Accuity LLP

We had physically visited 11 of the 105 certified redemption centers, as of June 30, 2010, and observed whether the redemption centers were open during posted hours, informed customers of the procedures/policies of the redemption count, properly calibrated the scale used to weigh redeemed beverage containers, paid appropriate refunds to consumers, provided consumers with a receipt for their redemptions, and properly recorded the redemption transactions. In addition, we performed similar procedures at two uncertified redemption centers. The 13 redemption centers we visited are shown in Exhibit 1.6.

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Exhibit 1.6 Redemption Centers and Locations Tested

Redemption Center	Location
1. Island Container Redemption	2960 Waialae Avenue, Honolulu
2. CM Recycling	204 Sand Island Access Road, Honolulu
3. Goodwill Industries	3335 Campbell Avenue, Honolulu
4. R.R.R. Recycling Services	1130 Sand Island Parkway, Honolulu
5. Atlas Recycling	74-5599 Paawai Place, Kona
6. Reynolds Recycling Redemption Center	Hawaii Kai Park & Ride 300 Keahole Street, Honolulu
7. Reynolds Recycling Redemption Center	94-766 Farrington Highway, Waipahu
8. R.R.R. Recycling Services	47-705 Kamehameha Highway, Kahaluu
9. Atlas Recycling	30 Makaala Street, Hilo
10. Aloha Glass Recycling	75 Amala Place, Kahului
11. Island Center Redemption	1803 Dillingham Boulevard, Honolulu
12. R.R.R. Recycling Services (uncertified)	440 Kilani Avenue, Honolulu
13. R.R.R. Recycling Services (uncertified)	Kalani High School 4680 Kalaniana'ole Highway, Honolulu

Source: Accuity LLP

We redeemed test beverage container deposits at each of the selected redemption centers and traced our redemption transaction through the redemption center's reimbursement request/reporting process and subsequent payment by the Program.

The audit fieldwork was conducted from November 2010 through April 2011 in accordance with U.S. generally accepted auditing standards and *Government Auditing Standards*. Those standards require that we plan and perform our audits to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Chapter 2: The Deposit Beverage Container Program Is Exposed to Fraud

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The Deposit Beverage Container Deposit Program was established by the State Legislature to manage and administer a State-run recycling program to increase recycling of beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter. The Program has grown into a multimillion-dollar operation with assets of \$37.0 million, beverage container deposit liabilities of \$22.7 million, and a fund balance of \$6.1 million as of June 30, 2010.

Despite five years of experience with the Program, which began in 2005, we found several deficiencies that expose the Program to fraud. The Program continues to over-rely on self-reporting from distributors and certified redemption centers and lacks adequate controls to monitor the accuracy and completeness of information submitted by them, which exposes the Program to risks of underpayments by distributors and overpayments to certified redemption centers. Uncertified redemption centers may also be operating and collecting reimbursements of deposits paid, as well as handling fees, in violation of state law. The Program also remains exposed to the risk of exempt beverage containers, for which deposits and container fees were not paid, entering the redemption stream. Management must strengthen controls to ensure that the Program is properly collecting deposits and container fees from distributors and the costs of administering the Program (e.g., reimbursements and handling fees paid to certified redemption centers) are minimized.

Summary of Findings

We found a significant deficiency in the Program's and Department's internal control over financial reporting reported below. Significant deficiencies are deficiencies in internal control, or a combination of deficiencies, and are less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Over-Reliance on Self-Reporting from Distributors and Redemption Centers Exposes the Program to Fraud

We found that the Program lacks adequate internal controls to prevent or detect distributors fraudulently or erroneously under-reporting beverage containers sold/distributed or certified redemption centers fraudulently or erroneously over-reporting beverage containers redeemed. Further, uncertified redemption centers may be operating in violation of state law and program rules. The Program also lacks controls to prevent or detect unauthorized beverage containers from entering the redemption stream (e.g., redemption of beverage containers by exempt businesses).

Because these deficiencies fail to address inherent incentives for distributors, redemption centers, and exempt companies, the Program is exposed to fraud that may affect the published redemption rate and result in higher program costs, placing a greater burden on consumers through unwarranted container fee increases.

Deposits and fee collections from distributors are unsupported

Sections 342G-105 and -110, HRS, require distributors to report the number of deposit beverage containers sold/distributed and pay beverage container deposits and container fees to the Program on a monthly (semiannual for smaller companies) basis. While distributors are supposed to maintain adequate records and support for beverage sales, the Program continues to rely on the unsupported amounts reported by the distributors for collections, due to the lack of a systematic verification or inspection process. Distributors could fraudulently or erroneously underpay beverage container deposits and container fees, which is consistent with the exceptions found in the sample of distributor receipts tested.

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Program reliance on self-reported amounts increases risk of under-reporting by distributors

Section 342G-105, HRS, states that payment of the deposit beverage container fee and deposits shall be made monthly, based on inventory reports of the deposit beverage distributors. All deposit beverage distributors shall submit to the Department documentation in sufficient detail that identifies the net number of deposit beverage containers sold, donated, or transferred, by container size and type.

In addition, Section 342G-110, HRS, specifies that the deposit on each filled deposit beverage container shall be paid by the beverage distributor, who manufactures or imports beverages in deposit beverage containers. Beverage distributors shall also pay a deposit beverage container fee and register with the State.

Since distributors can pass on beverage container costs to retailers, they have an inherent incentive to under-report sales/distributions of deposit beverage containers. Distributors could collect deposits and container fees from retailers but not pay them to the Program. However, the only regular review of the reports submitted is the Solid Waste Management Coordinator's scanning of the monthly distributor reports and an account clerk's review for mathematical accuracy. No other support, such as shipping or sales support, is required.

Undetected underpayments from distributors will result in the Program having fewer funds available to pay for deposit redemptions and program administrative costs. This could also lead to an overstated redemption rate, because the number of deposit containers sold (the denominator in the rate calculation) may be understated. An inaccurate redemption rate could then lead to an unjustified increase in container fee rates to sustain the Program's operations.

The Program continues to lack a systematic process to detect under- and non-reporting by distributors

Section 342G-103, HRS, requires all beverage distributors operating within the State to register with the Department and maintain records reflecting the manufacture of their beverages in deposit beverage containers as well as the importation and exportation of deposit beverage containers. The records shall be made available, upon request, for inspection by the Department.

By law, the Department and the Auditor may audit or inspect distributor records.

Despite the performance of 217 compliance evaluation inspections in FY 2010, as reported by the Department in the *Report to the Twenty-Sixth Legislature State of Hawaii 2011*, these inspections are not designed to substantiate distributor reports. The Solid Waste Management Coordinator stated that detailed inspections of distributors by examining reports and supporting documents are not performed by the Program due to vacant positions. Therefore, the Program is unable to schedule and systematically perform compliance inspections of distributors with any regular frequency. The Department reported in its *Report to the Twenty-Fifth Legislature State of Hawaii 2009* (issued in November 2008) that the number of inspectors decreased after October 2007, resulting in a decrease in the number of inspections completed each month.

Although the Fund had a \$6.1 million fund balance as of June 30, 2010, the Program was also subject to a state-wide freeze in filling vacant positions and was unable to hire additional staff, including a Planner and Environmental Health Specialist, to develop control plans and perform inspections. However, the Solid Waste Management Coordinator also admitted that the length of the hiring process and poor recruitment and retention were also factors in position vacancies.

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In other self-reporting programs, such as income and other tax filings, regulators have robust inspection/audit and enforcement programs that encourage compliance by penalizing subject entities for late and/or inaccurate filings, whether intentional or unintentional.

Although the Program has broad enforcement powers – including assessing an administrative penalty, ordering corrective action immediately or within a specified time, commencing civil action in circuit court, and/or revoking a certification or permit – lack of effective compliance inspections on distributors hobbles the Program from effectively deploying these enforcement tools.

Consequently, in FY 2010, the Program issued only four Notices of Findings and Orders to distributors, which stated violation of laws and program requirements, ordered compliance with laws and regulations, and included penalties. The penalties included in the four Notices of Findings and Orders totaled \$6,930.

Despite the inherent incentive for distributors to underpay beverage container deposits and container fees, the Program has failed to implement a systematic compliance inspection and enforcement process to limit this risk. Robust enforcement would encourage distributors to pay deposits and container fees. Public announcements of violations could hurt distributors' reputations, creating an incentive to comply with the deposit beverage container laws. Such announcements could also heighten distributors' awareness of penalties, in addition to the required payment of under-reported amounts.

Distributors could not support amounts reported and payments made to the Program

During our detailed testing of the 15 distributors selected, we found a number of exceptions. As illustrated in Exhibit 2.1, the exceptions included transactions for which no support was provided, as well as underpayments and overpayments by distributors.

Exhibit 2.1 Exceptions Noted in Distributor Testing

Distributor	Date	Invoice Number	Number of Containers	Deposit Amount	Fee Amount	Total Deposit & Fee	Amount Tested	Difference
No Support								
Coca Cola Bottling Co.	09/2009	Various	14,247,421	\$ 712,371.05	\$ 142,474.21	\$ 854,845.26	\$ -	\$ 854,845.26
Pepsi Bottling Group	08/2009	Various	12,764,487	\$ 638,224.33	\$ 127,644.87	\$ 765,869.20	\$ -	\$ 765,869.20
C&S Wholesale Grocers, Inc.	01/2010	Various	3,354	\$ 167.70	\$ 33.54	\$ 201.24	\$ -	\$ 201.24
J&D Investments	1/2010 - 6/2010	Various	340	\$ 17.00	\$ 3.40	\$ 20.40	\$ -	\$ 20.40
			27,015,602	\$ 1,350,780.08	\$ 270,156.02	\$ 1,620,936.10	\$ -	\$ 1,620,936.10
Underpaid								
C&S Wholesale Grocers, Inc.	01/2010	Various	548	\$ 27.40	\$ 5.48	\$ 32.88	\$ 32.88	Note 1
Costco Wholesale Corporation	12/2009	1110277	25,200	\$ 1,260.00	\$ 252.00	\$ 1,512.00	\$ 1,209.60	\$ 302.40
J&D Investments	1/2010 - 6/2010	21062089	12	\$ 0.60	\$ 0.12	\$ 0.72	\$ 0.60	\$ 0.12
Hawaiian Sun Products, Inc.	03/2010	3042994	2,400	\$ 120.00	\$ 24.00	\$ 144.00	\$ 120.00	\$ 24.00
Maui Soda and Ice Works, Ltd.	08/2009	1480844	1,013	\$ 50.65	\$ 10.13	\$ 60.78	\$ 49.32	\$ 11.46
Maui Soda and Ice Works, Ltd.	08/2009	Various	18,840	\$ 942.00	\$ 188.40	\$ 1,130.40	\$ -	\$ 1,130.40
Maui Soda and Ice Works, Ltd.	08/2009	Various	2,880	\$ 144.00	\$ 28.80	\$ 172.80	\$ 187.20	\$ (14.40)
			50,893	\$ 2,544.65	\$ 508.93	\$ 3,053.58	\$ 1,599.60	\$ 1,453.98
Overpaid								
Maui Soda and Ice Works, Ltd.	08/2009	Note 2	Note 2	Note 2	Note 2	Note 2	Note 2	Note 2
C&S Wholesale Grocers, Inc.	01/2010	Various	88	\$ 4.40	\$ 0.88	\$ 5.28	\$ 10.56	\$ (5.28)
Shimaya Shoten, Ltd.	11/2009	Various	3,117	\$ 155.85	\$ 31.17	\$ 1,265.70	\$ 1,452.72	\$ (187.02)
General Nutrition Corporation	10/2009	Various	2,008	\$ 100.40	\$ 20.08	\$ 120.48	\$ 120.60	\$ (0.12)
			5,213	\$ 260.65	\$ 52.13	\$ 1,391.46	\$ 1,583.88	\$ (192.42)

Note 1 Cutoff issues resulting in delayed payments

Note 2 Payments made based on 24 containers per case vs. actual of 12 per case spanning multiple invoices.

Source: Accuity LLP

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Two distributors, Coca Cola Bottling Co. (“Coca Cola”) and Pepsi Bottling Group (“Pepsi”), failed to provide any supporting documents for the months of September and August 2009, respectively. Therefore, we were unable to test or gain assurance over approximately \$1,351,000 in deposits and \$270,000 in container fees reported and paid by two of the largest distributors in Hawaii. We were also unable to obtain support for certain sales of deposit beverage containers by C&S Wholesale Grocers, Inc. (“C&S Wholesale”) and J&D Investments for the periods tested. The deposits and container fees reported and paid for these transactions approximated \$200.

Several reasons were provided by distributors for not providing the support requested and the errors found. Several distributors stated the difficulty in providing the supporting documents requested was due to their systems not readily generating reports that provide such information, raising the question of how they originally determined the amounts reported and paid with their monthly/semiannual filings with the Program.

In the case of smaller distributors, some of the errors were clerical in calculating the number of beverage containers per case. One distributor also noted an error was caused by a system miscalculation. We did not find any other errors related to the distributor’s system error. However, it leaves open the possibility of other such errors in automated information systems environments.

Five distributors underpaid deposits and/or container fees during the periods selected for testing. This included three underreported and underpaid amounts for Maui Soda and Ice Works Ltd., indicating the difficulty some smaller distributors continue to have in complying with the law.

We also found that Hawaiian Sun Products Inc. (“Hawaiian Sun”) did not pay the one cent container fees related to sales to the military, as it was unable to pass on the fee to the military. However, Section 342G-110(d), HRS, specifically requires distributors to pay the container fee associated with each container distributed. Therefore, Hawaiian Sun is required to pay the container fee to the Program regardless of whether it is able to pass on the container fee to its customers.

Four overpayments of deposit and container fees were also discovered and are shown in Exhibit 2.1.

These errors highlight the need for the Program to more closely monitor amounts reported and paid by distributors. While the errors found appeared unintentional, except for Hawaiian Sun’s unpaid container fees, the Program’s reliance on self-reporting by distributors without a strong enforcement and substantiation function exposes it to fraud.

Payments to redemption centers are unsupported

The Program reimburses and pays handling fees for beverage containers redeemed by certified redemption centers on a monthly basis based on reports prepared by the certified redemption centers.

We found, however, that the Program lacks adequate internal controls to prevent or detect whether certified redemption centers fraudulently or erroneously over-report beverage containers redeemed and overcharge the Program.

The Program’s continued reliance on self-reported amounts increases risk of over-reporting by redemption centers

Section 342G-119, HRS, specifies that the Department shall pay certified redemption centers handling fees and deposit refunds based on collection reports submitted by the redemption centers. The redemption reports include the number or weight of deposit beverage containers of each material type accepted at the redemption center for the reporting period; the amount of refunds paid out by material

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type; the number or weight of deposit beverage containers of each material type transported out of state or to a permitted recycling facility; and copies of out-of-state transport and weight receipts or acceptance receipts from permitted recycling facilities. Additionally, section 11-282-47, Hawaii Administrative Rules (“HAR”), states that the Department shall pay certified redemption centers handling fees and refund values based on reports submitted by the redemption centers to the Department.

Certified redemption centers can only receive 50 percent of the handling fees claimed at the time of initial request by submitting weight tickets for the amounts shipped to end-user recycling facilities. The remaining balance is paid upon receipt of corroborating weight reports prepared by the end-user recycling facilities. Certified redemption centers are reimbursed by the Program for the amount of deposit refunds paid to consumers based on reports prepared by the certified redemption centers. The associated handling fees paid to the certified redemption centers are based on container equivalents from the weight of containers redeemed and sent to recycling facilities as reported by both the certified redemption centers and recycling facilities.

However, the Program does not require certified redemption centers to submit any supporting documents with deposit refund reimbursement requests. Similar to the monthly distributor reports, the Solid Waste Management Coordinator only scans the deposit refund (“DR-1”) requests. Because the Program reimburses certified redemption centers for all deposits refunded, there is nothing to prevent redemption centers from overpaying and/or reporting more redemptions than actually occurred. In addition, overpayment of deposit refunds may encourage more consumers to redeem deposit beverage containers at such a redemption center, resulting in greater volume and, consequently, handling fees for the redemption center.

The Program acknowledged this concern in its 2007 and 2010 reports to the State Legislature, stating:

This summer the Program became concerned that the DBC quantity claimed by redemption centers is not a reliable indicator of the actual quantity of DBC material collected, which has been found to be affected/reduced by such factors as material shrinkage, theft, contamination, etc. (2007 report)

DOH has in some cases found significant differences between the number of containers claimed for deposit refunds and the number of containers reportedly shipped later. The DBC quantity claimed by redemption centers is sometimes not a reliable indicator of the actual quantity of DBC material collected . . . (2010 report)

The Program indicated plans to address this by paying the combined deposit reimbursement and handling fees only on the quantity of deposit beverage containers shipped to and received by materials end-use recyclers. However, despite seeing indicators that overpayments have been occurring and planning changes for at least three years, since 2007, the Program has failed to adequately address these concerns by implementing planned changes.

Overpayments of redemptions will result in the Program having fewer funds available to pay deposit refunds and increase the handling fees on beverage containers redeemed. During FY 2010, the handling fees were between \$0.02 and \$0.04 per container, depending on the location of the redemption center and the end use of the recycled containers. This is two to four times the amount of the container fees paid into the Fund by distributors. This could also lead to an overstated redemption rate, because the number of deposit containers redeemed may also be overstated. This may lead Program management to erroneously conclude that a higher container fee is justified and necessary to continue to operate the Program.

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The Program continues to lack a systematic process to detect over-reporting by redemption centers

As previously noted, the Program performed 217 compliance inspections in fiscal year 2010. However, the Program penalized only one certified redemption center, in the amount of \$36,471, during FY 2010 for multiple violations of program rules and certification requirements.

According to the Solid Waste Management Coordinator, many of the inspections are limited to checking the daily customer transactions at certified redemption centers to determine if refunds were properly calculated, including use of the proper segregated rates, and investigating complaints received from the public, rather than inspecting the deposit refund reimbursement request forms by obtaining and agreeing with amounts reported to the certified redemption centers' supporting documents. The Solid Waste Management Coordinator admits that the Program has not scheduled and systematically performed compliance inspections of redemption centers with any regularity due to vacant positions resulting from the state-wide hiring freeze, as well as poor recruitment and retention efforts.

Redemption centers have an inherent incentive to overstate the amount refunded for deposit beverage containers redeemed to increase demand for their services and consequently increase the amount of handling fees generated. There is no financial disincentive for redemption centers for overpaying on deposit redemptions, because the Program reimburses redemption centers for all they refund to consumers. The Program has failed to implement a systematic compliance inspection and enforcement process that would limit the risk of overpayment of redemptions.

Four redemption centers refused to provide support for amounts redeemed and requested reimbursements

As part of our testing of redemption centers, we redeemed deposit beverage containers at the redemption centers shown in Exhibit 1.6 and attempted to trace the transactions from the refunds we received to the Program's payments to the redemption centers for reimbursements of the deposits refunded and handling fees claimed.

However, we were unable to complete our procedures for four out of the 13 redemption centers selected for testing. R.R.R. Recycling Services ("RRR") refused to provide support for the DR-1 forms submitted related to our redemptions at the sites shown in Exhibit 1.6. Therefore, we were unable to substantiate the amount of container deposits RRR claimed to have been refunded to consumers at the four redemption centers, raising the question of whether the Program overpaid RRR for the deposit reimbursements claimed for these four redemption centers, which totaled \$343,255 for the months in question, or approximately 6,865,100 containers. Using the minimum two cents per container handling fee, we estimate that approximately \$137,000 in handling fees also may not be supported. Exhibit 2.2 shows the RRR centers in question.

Exhibit 2.2 RRR Redemption Centers Selected Without Support

Redemption Center	Date of Redemption	Related Monthly DR-1 Request
RRR Sand Island	06/30/2010	\$66,004
RRR Kamehameha Highway	12/24/2010	\$94,661
RRR Kilani Avenue	01/08/2011	\$115,683
RRR Kalani High School	02/05/2011	\$66,907
Total		\$343,255

Source: Accuity LLP

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Uncertified redemption centers may be operating in violation of the law and rules

Although State law requires redemption centers to be certified prior to commencing operations, to protect consumers and control the redemption process, we found uncertified redemption centers that were redeeming container deposits to consumers. These uncertified redemption centers were operated by a company that also operates certified redemption centers, raising the possibility that containers from the uncertified sites are mixed with those from certified sites, resulting in inappropriate reimbursements to the redemption center operator.

Two redemption centers operated without certification

Section 342G-114, HRS, requires the Department to certify redemption centers prior to operation and may revoke a certification. According to Section 11-282-41, HAR, uncertified redemption activities shall not be eligible to collect the refund value or handling fee from the Department.

The Department is required to certify redemption centers to control the redemption process and protect consumers. In addition, by requiring periodic recertification, it also provides the Department the remedy of decertifying a redemption center if it does not comply with applicable laws and rules to further control the redemption process.

We found two RRR redemption centers selected for testing were not certified but were operating. Although the redemption centers at 440 Kilani Avenue and Kalani High School were uncertified, we were still able to redeem deposit beverage containers.

Per the Program Engineer, these two sites were previously certified. However, when their certifications expired on December 8, 2009, the certifications were not renewed, as these redemption centers do not operate at least 30 hours per week as required under Section 342G-114(d)(5). Therefore, these redemption centers were no longer certified at the time we performed our test redemptions in January 2011 (Kilani Avenue) and February 2011 (Kalani High School).

As the Program is not allowed to pay uncertified redemption centers for deposits redeemed or the related handling fees, any payments by the Program are against the law. It also reduces the funds available for operating the program, including paying operators of certified redemption centers who have made additional investments in certification and may, therefore, be at a competitive disadvantage to lower-cost, uncertified redemption centers.

The Program does not have a process that effectively identifies uncertified redemption centers

Although Section 11-282-41, HAR, allows the Program to only pay certified redemption center operators for empty deposit beverage containers returned, the Program does not have controls in place to prevent redemption center operators to add beverage containers from uncertified redemption centers with those of certified redemption centers when requesting payments.

As RRR operates redemption centers and is also a recycler, there is nothing to prevent it from comingling containers redeemed at uncertified redemption centers with those from the certified redemption centers it operates. This was highlighted in our testing of redemption transactions at the four RRR redemption centers. As previously noted, we were unable to complete our testing of these transactions as RRR refused to provide the supporting documents requested, raising questions on the propriety of the deposit refund reimbursements and handling fees the Program paid to RRR.

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If the Program paid RRR deposit refund reimbursements and related handling fees for uncertified redemption centers, it would violate Section 11-282-41, HAR. This would unnecessarily increase program costs by utilizing Program funds for unauthorized payments.

Redemption center errors are passed on to the Program

In our testing of deposits refunded by certified redemption centers, we found various errors in the amounts refunded to consumers based on the weight of deposit beverage containers redeemed. We found that the Program's segregated rates used to convert deposit beverage containers to container equivalents was inaccurate compared to hand counting for several of the refunds we tested. We also noted errors in the redemption centers' calculations for other refunds tested. As the DR-1 forms submitted by redemption centers are based on weight, it is likely that these errors are passed on to the Program, resulting in more deposits and handling fees being paid out than are justified.

Program allows redemption of overweight and underweight containers

Section 11-282-46, HAR, provides:

Redemption centers are allowed to redeem deposit beverage containers and pay refund value based on the weight of these containers presented for redemption, as follows:

- 1) Empty beverage containers should be weighed, recorded, and reported in tons, pounds, or fractions thereof. . .
- 2) To be redeemed by weight, containers must be segregated by material.
- 3) Refund values should be posted and paid according to the container per pound conversion rates issued by the Department in section 11-282-61.
- 4) Redemption centers must inspect loads as required by 11-282-45.
- 5) If requested by a consumer, for loads of two hundred containers or less, redemption centers must compute redemption value by container count rather than by weight.

Exhibit 2.3 shows the differences we found between the deposit refunds we expected to receive, based on our hand count prior to taking the containers to the redemption centers, and the amounts actually received at the redemption centers, based on the weight of the containers redeemed.

While the program allows weighing of deposit beverage containers, based on the official segregated conversion rates (see Exhibit 1.3), the converted container equivalents are expected to approximate a hand count on average. However, we found that, when containers are weighed, it results in significant differences (greater than 5 percent) from the refunds that would be received, based on hand counts, but are processed as redemptions anyway, as allowed under Section 11-282-46, HAR.

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Exhibit 2.3 Differences between Expected and Actual Refunds Due to Segregated Weights

		Key:		A	B	C	D	E	F	G	H	I
		Formula:					= B x C	= A x \$.05	= D x \$.05		= F - E	= H / E
Redemption center	Date	Type	Container Count	Weight in lbs.	Containers per lb.	Equivalent Containers	Redemption refund			Count vs. Weight		
							By Count	By Weight	Actual Refund	Over (Under) Paid	% Difference	
Island Recycling	12/11/2010	Cans	535	14.2	32.0	454.40	\$ 26.75	\$ 22.72	\$ 27.26	\$ (4.03)	-15.0%	
R.R.R. Sand Island	06/30/2010	Cans	5	0.2	31.4	6.28	\$ 0.25	\$ 0.31	\$ 0.31	\$ 0.06	24.0%	
Atlas	06/30/2010	Cans	52	1.7	31.4	53.38	\$ 2.60	\$ 2.67	\$ 2.92	\$ 0.07	3.0%	
Atlas	06/30/2010	Glass	51	38.0	2.3	87.40	\$ 2.55	\$ 4.37	\$ 4.37	\$ 1.82	71.0%	
Atlas	06/30/2010	Plastic	50	1.5	17.4	26.10	\$ 2.50	\$ 1.31	\$ 1.31	\$ (1.19)	-48.0%	
R.R.R. Kahalu'u	12/24/2010	Cans	100	3.3	32.0	105.60	\$ 5.00	\$ 5.28	\$ 5.28	\$ 0.28	6.0%	
R.R.R. Kahalu'u	12/24/2010	Plastic-Sm	40	2.5	26.3	65.75	\$ 2.00	\$ 3.29	\$ 3.29	\$ 1.29	65.0%	
Aloha Glass	12/27/2010	Cans	31	1.1	32.0	35.20	\$ 1.55	\$ 1.76	\$ 1.76	\$ 0.21	14.0%	
Aloha Glass	12/27/2010	Plastic-mix	137	9.4	18.8	176.72	\$ 6.85	\$ 8.84	\$ 8.84	\$ 1.99	29.0%	
ICR Dillingham	01/16/2011	Cans	225	6.8	32.0	217.60	\$ 11.25	\$ 10.88	\$ 10.88	\$ (0.37)	-3.0%	
ICR Dillingham	01/16/2011	Glass	57	16.7	2.4	40.08	\$ 2.85	\$ 2.00	\$ 2.00	\$ (0.85)	-30.0%	
ICR Dillingham	01/16/2011	Plastic-mix	54	5.3	18.8	99.64	\$ 2.70	\$ 4.98	\$ 4.98	\$ 2.28	84.0%	
R.R.R. Kilani Ave. (uncertified)	01/08/2011	Can and plastic	47	N/A	N/A	N/A	\$ 2.35	N/A	\$ 2.35	N/A	N/A	
R.R.R. Kalani HS (uncertified)	02/05/2011	Cans	48	1.7	32.0	54.40	\$ 2.40	\$ 2.72	\$ 2.72	\$ 0.32	13.0%	

Note 1: Test sample brought to redemption center by Accuity.

Note 2: Amount as weighed by redemption center -- Accuity did not weigh before hand.

Note 3: Slight difference in calculation may occur depending on the number of decimals places. Rounded to two decimal places.

Source: Accuity LLP

As part of our testing at the redemption centers, we noted that the scales used appeared appropriately calibrated. However, as illustrated in Exhibit 2.3 above, we found eight redemption transactions resulting in significant overpayments of 6, 13, 14, 24, 29, 65, 71, and 84 percent more than if the containers were hand counted. We also noted three significant underpayments of 15, 30, and 48 percent less than expected.

Overall, we noted that the differences in calculating container equivalents more often resulted in refunds for a greater number of deposit beverage containers than were actually returned at the certified redemption centers tested. These net overpayments result in the Program paying more in deposit redemptions than was originally collected and will eventually lead to a shortfall in the Program's available funds, which will require the Program to charge a higher container fee to sustain operations.

Program pays for redemption center errors through accounting adjustments

The Program is also aware that at least one redemption center operator adjusts the weights reported on DR-1 forms submitted to the Program to correct for errors made by redemption center employees. Consequently, the Program pays for the redemption center operator's errors.

PKF Pacific Hawaii LLP ("PKF") was engaged by the Program to perform an audit of Reynolds Recycling Inc. ("Reynolds") for the two-year period ended June 30, 2010. In its *Report to the State of Hawaii Department of Health on the Program and Compliance Audit of Reynolds Recycling Inc.*, dated September 19, 2011, PKF found that Reynolds' accounting department will modify any calculation errors

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to the refund amount paid out. For example, if \$10.50 was refunded for 200 containers (or equivalent containers if weighed), when only \$10.00 should have been paid, Reynolds' accounting department would adjust the number of containers reported as redeemed to 210, thus overstating the number of containers redeemed. The overstated number of containers is reported on the DR-1 form submitted to the Program. As the Program does not require redemption centers to submit any supporting documents with DR-1 forms, it is unlikely that Program personnel would discover the improper adjustment and deny the amount requested, resulting in an overpayment by the Program.

PKF also found that errors resulting from the use of incorrect segregated conversion weights are adjusted by Reynolds' accounting department. For example, if a redemption center reported the redemption of plastic (17 ounces or less) containers but used the aluminum conversion rate, which is higher, in calculating the deposit refunded to the consumer, the accounting department will modify its records and report that aluminum containers were redeemed. This is unlikely to be discovered by the Program and also results in an overpayment by the Program.

PKF concluded:

Reynolds Recycling seeks refund reimbursements, per Department guidance, based on the deposit refunds paid to customers rather than the actual weight of DBC materials collected. As a result, there is a risk that the Department has reimbursed Reynolds Recycling for DBC materials that were not collected.

The cumulative weight of material for which Reynolds Recycling claimed handling fees is less than the cumulative weight of materials for which it claimed deposit refunds. This suggests that the Department may have paid deposit refunds on materials that were not supported by actual weight.

Such overpayments overstate the redemption rate by artificially increasing the number of containers redeemed and deplete the Program's funds, eventually leading management to conclude that an increase in the container fee is necessary and appropriate.

Redemptions greater than 5 cents per container may be occurring

We also found two redemption centers (shown in Exhibit 2.4) that intentionally paid more than the 5 cents per container deposit. One redemption center, Island Recycling, paid 6 cents instead of 5 cents per container. Atlas Recycling (Kona) paid additional amounts for the scrap value of containers redeemed. We received 20 percent more than expected for our redemption transaction at Island Recycling due to the additional 1 cent paid per container. At Atlas Recycling, our refund was 9.4 percent more than expected.

Exhibit 2.4 Differences between Expected Refund and Actual Refund Based on Weight

		Key:		A	E	F	G	H	I	J	K
		Formula:			= A x \$.05	= D x \$.05		= F - E	= H / E	= G - F	= J / F
Redemption center	Date	Type	Container Count	Redemption refund			Count vs. Weight		Weight vs. Actual Paid Variance		
				By Count	By Weight	Actual Refund	Over (Under) Paid	% Difference	Over (Under) paid Weight vs. Actual	% (rounded) Difference	
Island Recycling	12/11/2010	Cans	535	\$ 26.75	\$ 22.72	\$ 27.26	\$ (4.03)	-15.0%	\$ 4.54	20.0%	
Atlas Recycling	06/30/2010	Cans	52	\$ 2.60	\$ 2.67	\$ 2.92	\$ 0.07	3.0%	\$ 0.25	9.4%	

Note 1: Test sample brought to redemption center by Accuity.
 Note 2: Amount as weighed by redemption center -- Accuity did not weigh before hand.
 Note 3: Slight difference in calculation may occur depending on the number of decimals places. Rounded to two decimal places.

Source: Accuity LLP

Upon further inquiry, both redemption center operators stated the additional amounts paid were to increase volume, and that amounts in excess of the 5 cents per container were paid out of the redemption

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centers' profits and not reimbursed by the Program. However, we were unable to obtain supporting documents at the level of detail necessary to validate this assertion. We noted that, if, similar to Reynolds, the operators adjust the reported amount of containers redeemed to match the amounts actually paid out, the Program will end up overpaying deposit refund reimbursements to these operators. Also, although handling fees are based on the actual weight of redeemed containers sent to recyclers/end users, such operators will gain a competitive advantage and receive greater handling fees from the increased volume of containers redeemed at those sites, which they may not have otherwise generated if not for higher deposit refunds to their customers. This may lead to increased demand for their services, at the expense of the Program, the public, and other redemption center operators following the law of refunding deposits based on the \$0.05 refund value.

Exempt containers continue to be at risk of entering the redemption stream

Certain commercial passenger-vehicle companies are exempt from paying and charging their customers the beverage container deposits and related container fees. However, such companies are only exempt if they have a beverage container recycling plan approved by the Department. We found that the Program does not maintain an updated listing of exempt companies nor does it monitor exempt commercial passenger-vehicle companies once the initial beverage container recycling plan was approved. Consequently, the Program has no assurance that exempt companies are not redeeming the used beverage containers from their operations for the \$0.05 per container deposit, rather than following their approved recycling plans, thus depleting the Program's funds and improperly increasing the reported redemption rate.

Exempt commercial passenger-vehicle companies are not being monitored

The Program is responsible for ensuring companies operating in Hawaii comply with the Deposit Beverage Container Program law. Section 342G-101.5, HRS, provides an exemption for certain passenger-vehicle companies if they have a recycling plan approved by the Department. It further states that exempt beverage containers shall not be redeemed for the refund value or the handling fee.

Implicit in the exemption is that any commercial passenger-vehicle company that does not have an approved recycling plan is not exempt and is thus subject to the \$0.05 deposit and \$0.01 container fee for each deposit beverage container dispensed in its operations. We obtained the listing of exempt commercial passenger-vehicle companies shown in Exhibit 2.5 below from the Program.

Exhibit 2.5 Exempt Commercial Passenger-Vehicle Companies

(continued on next page)

Commercial Passenger-Vehicle Companies with Approved Recycling Plans			
Airline	Island	Caterer	Recycler
Air Canada	Oahu, Maui	Gate Gourmet Inc.	
Air New Zealand	Oahu	Gate Gourmet Inc.	
Air Pacific	Oahu	Gate Gourmet Inc.	
Alaska Airlines	Oahu, Hawaii, Maui, Kauai	Gate Gourmet Inc.	Honolulu Recycling Services, Kona Recycles @ Kealakehe Transfer,

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Commercial Passenger-Vehicle Companies with Approved Recycling Plans			
			Maui Disposal, Garden Island Disposal
All Nippon Airways	Oahu	Gate Gourmet Inc.	
Aloha Airlines	Oahu	Chelsea Food Services, Gate Gourmet Inc., Mauna Kea Beach Hotel	
China Airlines	Oahu	Chelsea Catering	
Continental Airlines	Oahu	Chelsea Food Services	Honolulu Recovery System
Delta Airlines	Oahu, Maui	Gate Gourmet Inc.	Honolulu Recovery System, Maui Disposal
Japan Airlines	Oahu, Hawaii	International In-Flight Catering Co.	
Korean Airlines	Oahu	International In-Flight Catering Co.	
Go! Mokulele	Oahu		Honolulu Recovery System
Northwest Airlines	Oahu	Gate Gourmet Inc.	Honolulu Recovery System
Omni Air International	Oahu	Chelsea Food Service	Honolulu Recovery System
Philippine Airlines	Oahu	International In-Flight Catering Co.	
Qantas Airways/Jetstar	Oahu	Gate Gourmet Inc.	
United Airlines	Oahu, Hawaii, Maui, Kauai		Honolulu Recovery Systems, Business Services Hawaii, Maui Disposal, Garden Island Disposal
US Airways	Oahu, Hawaii, Maui, Kauai	Gate Gourmet Inc., Hawaiian Airlines	Honolulu Recover Systems, Maui Disposal
Cruise Line	Island	Recycler	
Holland America Line	Oahu	PSC Environmental Service	
Norwegian Cruise Line	Oahu, Hawaii, Maui, Kauai	CM & RRR Recycling	
Transmarine Navigation Corp.	Oahu	PSC Environmental Service	
Transportation Management Service	Oahu, Hawaii, Maui, Kauai, Lahaina	PSC Environmental Service	

Source: Department of Health, Office of Solid Waste Management

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Based on our review of the listing, we found that it does not include two of the largest airlines serving Hawaii – American Airlines and Hawaiian Airlines. Upon further inquiry, the Solid Waste Management Coordinator stated that American Airlines and Hawaiian Airlines both have approved recycling plans and were excluded from the listing due to an oversight by Program personnel. The listing is also obsolete, as it includes Aloha Airlines, which ceased operations in March 2008. The Solid Waste Management Coordinator admitted that the listing has not been updated and inspected for accuracy on a regular basis since the inception of the Program. The Solid Waste Management Coordinator also stated that the list is not comprehensive of all commercial passenger-vehicle companies that should submit a recycling plan, again blaming low staffing levels.

We note that the Program could easily update the list by requesting from the Department of Transportation listings of all airlines, cruise lines, and other commercial passenger-vehicle companies operating in Hawaii.

Because the Program has little information on the volume of containers generated by exempt companies, we cannot estimate the magnitude that redemption of exempt containers may be skewing the redemption rate.

Without proper monitoring of commercial passenger-vehicle companies, the Program is unsure of the number of such companies operating in Hawaii and whether those companies are actually exempt from paying beverage container deposits and the related container fees. Commercial passenger-vehicle companies that are not exempt may not be paying the beverage container deposits and container fees, resulting in underfunding of the Program, while exempt companies may inappropriately redeem beverage containers for deposits that were not paid into the Program, depleting the Program's funds and overstating the redemption rate. More important, the Program is unable to ensure that such companies are recycling beverage containers consumed on their commercial passenger-vehicles, which was the primary purpose of the Bottle Bill – to increase recycling of used beverage containers to reduce litter.

Since inception of the Program, exempt commercial passenger-vehicle companies have not been inspected

The Solid Waste Management Coordinator stated that the Program has not developed controls, including inspections of exempt companies, to ensure that containers sold or otherwise disbursed to exempt commercial passenger-vehicles do not enter the redemption stream. Because the Program has failed to monitor whether exempt companies have a recycling plan and whether the plans are being followed, there is little confidence that the exemption is properly administered. The Solid Waste Management Coordinator further stated that the Program has not addressed this area since the inception of the Program due to vacant positions and the hiring freeze.

However, this contradicts statements in the Office of Solid Waste Management's December 2010 *Report to the Twenty-Sixth Legislature State of Hawaii 2011*:

This widespread investigation enabled the Program to evaluate, and subsequently address, areas of noncompliance associated with the disposal of beverage containers that are exempt from the Program and as such, are difficult to track. Also, through this process of inquiry, the Program ensured that each airline and cruise ship develop and implement a recycling plan as required by the Program.

Therefore, Program management was either unaware that program personnel were not monitoring exempt companies or intentionally misreported the monitoring performed in its report to the State Legislature. Although intentional misreporting to the Legislature may have more serious implications,

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either scenario poses significant risk. Proper oversight of the Program, including corrections of control deficiencies, cannot be exercised without appropriate knowledge of existing program operations.

The mere existence of a recycling plan does not meet the exemption requirement that the Department approve the recycling plan. The commercial passenger-vessel exemption recycling program plan guidelines, dated July 12, 2010, that the Department provides on its website detail the required contents of a recycling plan. The guidelines note that "Plan approval may be revoked at any time if the department finds a failure to adhere to any portion of the approved plan." Unfortunately, the Program has done little by way of monitoring adherence to approved recycling plans.

Because exempt companies do not pay the deposit and container fee on beverage containers, they could potentially redeem the exempt containers for deposits, resulting in the Program having fewer funds available to pay for operations, and an overstated redemption rate. An overstated redemption rate may lead Program management to erroneously conclude that a higher container fee is justified and necessary to continue to operate the program.

Conclusion

The Solid Waste Management Coordinator must still improve the Program's internal controls and resolve control deficiencies previously reported related to compliance with Chapter 342G, Part VIII, HRS.

Reliance on self-reporting and lack of systematic compliance inspections expose the Program to a greater risk of fraud. Unless the Program implements controls to verify reports submitted, underreported deposits and fees, over-reported redemptions, including those from uncertified redemption centers, and exempt containers entering the redemption stream may not be detected. Consequently, the Program may be operating at a greater cost than necessary, and the reported redemption rate may not be reliable. Resolution of these deficiencies is necessary to alleviate public concern over the cost of the State's beverage container recycling program, including questions on the container fee rate necessary to operate the Program.

Recommendations

The Department and Program should:

1. Fill vacant positions and/or reevaluate staffing levels to allow sufficient time and resources to perform inspection and enforcement responsibilities over distributors and redemption centers to substantiate proper transactions and to detect and prevent improper ones;
2. In conjunction with additional and more robust inspections, utilize the enforcement tools granted to the Program under Chapter 342G, HRS, to encourage compliance;
3. Combine the deposit redemption reimbursement request and handling fee request to streamline the payment process, better link the amounts redeemed and actually sent to recyclers or other end users, and reduce potential overpayments;
4. Implement controls to identify uncertified redemption centers and ensure deposit redemption reimbursement and handling fee requests are paid only to redemption center operators for beverage containers redeemed at certified redemption centers;
5. Regularly evaluate the segregated rates used to convert the weight of deposit beverage containers redeemed into container equivalents to ensure rates approximate hand counts;

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6. Obtain from the Department of Transportation Airports and Harbors Divisions a listing of exempt commercial passenger-vehicle companies subject to Chapter 342G, Part VIII, HRS; and
7. Monitor and inspect exempt commercial passenger-vehicle companies to ensure approved recycling plans are being followed and exempt containers are not being redeemed for deposit refunds.

Chapter 3: Financial Statements



Report of Independent Auditors

The Auditor
State of Hawaii

We have audited the accompanying balance sheet of the State of Hawaii, Deposit Beverage Container Deposit Special Fund (the "Fund") as of June 30, 2010, and the related statements of revenues, expenditures, and changes in fund balance, and budgetary comparison for the year then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 1, the financial statements referred to above include only the financial activities of the Fund, and do not purport to, and do not, present fairly the financial position of the State of Hawaii or State of Hawaii, Department of Health, as of June 30, 2010, or the changes in its financial position, or cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2010, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report, dated November 14, 2012, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Fund's management has not presented management's discussion and analysis for the year ended June 30, 2010, of accounting principles generally accepted in the United States of America that are required to supplement, although not to be a part of, the basic financial statements.

/s/ Acuity LLP
Honolulu, Hawai'i
November 14, 2012

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Assets

Equity in cash and cash equivalents in State Treasury	\$ 31,978,605
Accounts receivable	<u>5,004,091</u>
Total assets	<u>\$ 36,982,696</u>

Liabilities and Fund Balance

Liabilities

Vouchers and contracts payable	\$ 8,166,950
Accrued wages and employee benefits	35,978
Beverage container deposits	<u>22,680,452</u>
Total liabilities	30,883,380

Fund balance

Reserved for encumbrances	11,253,848
Unreserved	<u>(5,154,532)</u>
Total fund balance	<u>6,099,316</u>
Total liabilities and fund balance	<u>\$ 36,982,696</u>

The accompanying notes are an integral part of these financial statements.

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Statement of Revenues, Expenditures and Changes in Fund Balance
Year Ended June 30, 2010

Revenues	
Deposit beverage container fees	\$ 8,190,372
Unredeemed deposits	9,837,051
Interest income and other	<u>2,302,092</u>
Total revenues	20,329,515
Expenditures	
Administrative expenditures	1,637,043
Handling and redemption fees	19,189,793
Other operating expenditures	<u>4,192,666</u>
Total expenditures	<u>25,019,502</u>
Change in fund balance	(4,689,987)
Fund balance at July 1, 2009	<u>10,789,303</u>
Fund balance at June 30, 2010	<u>\$ 6,099,316</u>

The accompanying notes are an integral part of these financial statements.

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Statement of Budgetary Comparison
Year Ended June 30, 2010

	<u>Budgeted Amounts</u>		<u>Actual Amounts (Budgetary Basis)</u>
	<u>Original</u>	<u>Final</u>	
Revenues			
Current-year funds	<u>\$ 71,120,933</u>	<u>\$ 71,120,933</u>	<u>\$ 54,331,933</u>
Total revenues	71,120,933	71,120,933	54,331,933
Expenditures			
Environmental health administration	<u>71,120,933</u>	<u>71,120,933</u>	<u>68,011,226</u>
Total expenditures	<u>71,120,933</u>	<u>71,120,933</u>	<u>68,011,226</u>
Excess of expenditures over revenues	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (13,679,293)</u>

The accompanying notes are an integral part of these financial statements.

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Notes to Financial Statements
June 30, 2010

1. Reporting Entity

In 2002, the State of Hawaii Legislature passed Act 176 to establish the Deposit Beverage Container Deposit Program. The Deposit Beverage Container Program established the Deposit Beverage Container Deposit Special Fund (the "Fund"). The purpose of Act 176 was to increase participation in deposit programs, increase recycling rates for specified deposit beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter.

Pursuant to Chapter 342G, Part VIII, Hawaii Revised Statutes ("HRS"), the Fund was initiated on July 1, 2005 to implement a deposit beverage container program, establish minimum standards for the collection of empty beverage containers, to foster systems of redemption which facilitate recycling of empty beverage containers, and to minimize costs without inconveniencing customers. Under the Fund, the State of Hawaii (the "State") collects from manufacturers and distributors, a \$0.05 per container refundable deposit on eligible beverage containers manufactured in or imported to the state that are expected to be sold in the state. The deposits are used to reimburse redemption centers. In addition, the Fund assesses a per container handling fee of \$0.01 per container if the beverage container redemption rate is less than 70 percent, however, may increase the handling fee to \$0.015 per container if the redemption rate exceeds 70 percent. The handling fee has been maintained at \$0.01 per container since the Fund's inception, although the redemption rate has historically exceeded 70 percent.

The Fund is administered by employees stationed in the Solid Waste Branch, Environmental Management Division of the State of Hawaii, Department of Health (the "Department").

The accompanying financial statements are intended to present the financial position and results of operations of only those portions of the State and Department that are attributable to the transactions of the Fund and are not intended to present the financial position, results of operations, or cash flows of the State or Department.

2. Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The financial statements of the Fund are reported using the current financial resources measurement focus and modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Fund considers revenues to be available if they are collected within 60 days after the end of the current fiscal year. Revenues susceptible to accrual include a \$0.01 per beverage container sold handling fee. In addition, the amounts for deposits of \$0.05 are deferred when collected, and the amount estimated to be forfeited is recognized into income at the end of the year. Management estimates that the redemption rate will be 80 percent of the deposits collected.

Expenditures are generally recorded when a liability is incurred. However, expenditures related to compensated absences are recorded only when payment is due.

Encumbrances are recorded for obligations in the form of purchase orders or contracts at the time purchase orders or contracts are awarded and executed. Encumbrances outstanding at fiscal year end are reported as reservations of fund balance since they do not constitute expenditures or liabilities.

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Notes to Financial Statements
June 30, 2010

Had the financial statements been presented on the full accrual basis of accounting, additional adjustments would need to be recorded. These adjustments are recorded on a Department-wide level for all governmental activities of the Department. The Fund's portion of these Department-wide accruals includes adjustments for capital assets and accrued vacation. At June 30, 2010, the Fund's portion of these accruals was as follows:

Total fund balance on the modified-accrual basis of accounting	\$ 6,099,316
Capital assets used in governmental activities are not financial resources and therefore not reported as an asset in the Fund.	10,212
Compensated absences reported in the statement of net assets do not require the use of current financial resources and therefore are not reported as liabilities in the Fund.	<u>(42,385)</u>
Total net assets on the full accrual basis of accounting	<u>\$ 6,067,143</u>

At June 30, 2010, the Fund's portion of the Department-wide activities was not materially different from the Fund's activity.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP"), management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Equity in Cash and Cash Equivalents in State Treasury

All monies of the Fund are held in the State Treasury. The State Director of Finance is responsible for the safekeeping of cash in the State Treasury in accordance with State laws. The Director of Finance may invest any monies of the State, which, in the Director's judgment, are in excess of the amounts necessary for meeting the immediate requirements of the State. Effective August 1, 1999, cash is pooled with funds from other State agencies and departments and deposited into approved financial institutions or in the State Treasury Investment Pool System. Funds in the investment pool accrue interest based on the average weighted cash balances of each account.

At June 30, 2010, information relating to the types, insurance, collateral, and related interest rate, credit, and custodial risks of funds deposited with the State Treasury was not available for the Fund since such information is determined on a statewide basis. Cash deposits with the State Treasury are either federally insured or collateralized with obligations of the State or United States. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

In March 2011, the Department of Accounting and General Services ("DAGS") issued guidance informing State agencies participating in the State Treasury Investment Pool that the change in fair value of auction rate securities resulted in a gain for the year ended June 30, 2010, and that each participating State agency would be allocated a portion of the gain. The Fund's total allocated gain for fiscal year ("FY") 2010 approximated \$1,982,000 and is included in interest income and other in the statement of revenues, expenditures, and changes in fund balance.

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Notes to Financial Statements
June 30, 2010

Accounts Receivable

Revenue is earned when it is considered measurable and available. The accounts receivable balance represents the expected receipts from distributors based on deliveries of the containers as of June 30, 2010.

Beverage Container Deposits

Deposits of \$0.05 are made by distributors to the Fund for each qualifying container. The Fund maintains all deposits until the recycling centers claim reimbursement for the deposits they pay out to consumers. The Fund maintains the deposits that are expected to be redeemed.

Amounts paid out to consumers are based on containers redeemed or a predetermined weight per type of container redeemed (i.e., aluminum, mixed plastics, etc.). These weights are determined based on the mix of containers redeemed and are reviewed when necessary. Management estimates, based on past collections and success of recycling in other states, that 80 percent of the containers will be recycled every year. The remaining 20 percent of the containers are expected to be unredeemed; therefore, 20 percent of the deposits collected are recognized as revenue each year.

Administrative Costs

The accompanying financial statements do not reflect certain administrative costs, which are paid for by other sources of funding from the Department. These costs include the Department's and State's overhead costs which the Department does not assess to the Fund, since they are not practical to determine.

In accordance with Act 79, SLH 2009, the Fund incurred approximately \$2,700,000, which represented five percent of the Fund's budgetary basis revenue, in central service expenditures payable to DAGS in FY 2010, that are included in other operating expenditures in the statement of revenues, expenditures, and changes in fund balance.

New Accounting Pronouncements

In March 2009, the GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. This Statement provides clearer fund balance classifications that can be more consistently applied and clarifies the existing governmental fund type definitions. This Statement also establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds and provides for additional classifications such as restricted, committed, assigned, and unassigned fund balances. The provisions of this Statement are effective for the fiscal year beginning after June 15, 2010. Fund balance reclassifications made to conform to the provisions of this Statement will be applied retroactively by restating the fund balance for all prior periods presented.

In June 2011, the GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The Statement is intended to improve financial reporting by standardizing the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. The provisions of this Statement are effective for periods beginning after December 15, 2011. Management has not yet determined the effect this Statement will have on the Fund's financial statements.

In June 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*. The Statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Notes to Financial Statements
June 30, 2010

resources, certain items that were previously reported as assets and liabilities. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012. Management has not yet determined the effect this Statement will have on the Fund's financial statements.

In June 2012, the GASB issued Statement No. 66, *Technical Corrections – 2012 – an Amendment of GASB Statements No. 10 and No. 62*. The Statement amends Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, by removing the provision that limits fund-based reporting of an entity's risk financing activities to the general fund and the internal service fund type. Consequently, governments should base their decisions about fund type classification on the nature of the activity to be reported, as required in Statement No. 54 and Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012, with earlier application encouraged. Management has not yet determined the effect the amendment to Statement No. 10 will have on the Fund's financial statements but does not expect the amendment to Statement No. 62 to have a material effect on the Fund's financial statements.

3. Budgeting and Budgetary Control

The Fund follows these procedures in establishing the budgetary data reflected in the basic financial statements:

- *The Budget* – Not less than 20 days before the State Legislature convenes in every odd-numbered year, the Governor submits to the State Legislature, and to each member thereof, a budget which contains the program and budget recommendation of the Governor for the succeeding biennium. The budget in general contains: the State program structure; statements of statewide objectives; financial requirements for the next biennium to carry out the recommended programs; a summary of State receipts and revenues in the last completed fiscal year; a revised estimate for the fiscal year in progress; and an estimate for the succeeding biennium.
- *Legislative Review* – The State Legislature considers the Governor's proposed program and financial plan and budget, evaluates alternatives to the Governor's recommendations, adopts programs, and determines the State budget. It may, from time to time, request the Department of Budget and Finance and any agency to conduct such analysis of programs and finances as will assist in determining the State's program and financial plan and budget.
- *Program Execution* – Except as limited by policy decisions of the Governor, appropriations by the State Legislature, and other provisions of law, the agencies responsible for the programs administer the programs and are responsible for their proper management. The appropriations by the State Legislature for a biennium are allocated between the two fiscal years of the biennium in the manner provided in the budget or appropriations act and as further prescribed by the Director of Finance. No appropriation transfers or changes between programs or agencies can be made without legislative authorization. Authorized transfers or changes, when made, should be reported to the State Legislature.

Budgetary control is maintained at the appropriation line item level established in the appropriation acts.

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Notes to Financial Statements
June 30, 2010

A budget is adopted for the Fund and is prepared on the basis of cash receipts and amounts disbursed, which is a basis of accounting other than GAAP.

The major differences between the budgetary and GAAP bases are that: (1) the budget is prepared on the basis of cash receipts and amounts disbursed; and (2) encumbrances are recorded as the equivalent of expenditures under the budgetary basis.

Since budgetary basis differs from GAAP, budget and actual amounts in the budgetary comparison statements are presented on the budgetary basis. A reconciliation of expenditures in excess of revenues on a budgetary basis for 2010, to the change in fund balance presented in conformity with GAAP follows:

Excess of expenditures over revenues – actual on a budgetary basis	\$ (13,679,293)
Reserve for encumbrances at year end	11,253,848
Expenditures for liquidation of prior year’s encumbrances	(8,654,076)
Accruals and other adjustments	<u>6,389,534</u>
Change in fund balance – GAAP basis	<u>\$ (4,689,987)</u>

4. Beverage Container Deposits

The changes to the beverage container deposit liability during fiscal year 2010 were as follows:

Balance at July 1, 2009	\$ 19,685,339
Increase: Deposits received from distributors	49,185,256
Decrease: Payments made to redemption centers, net of refunds	(36,353,092)
Decrease: Unredeemed deposits recognized as revenue	<u>(9,837,051)</u>
Balance at June 30, 2010	<u>\$ 22,680,452</u>

5. Employee Benefit Plans

Substantially all eligible employees of the Fund participate in the State’s retirement and post-retirement benefit plans. The State’s plans include the Employee’s Retirement System (“ERS”) of the State of Hawaii, post-retirement healthcare and life insurance benefits, a deferred compensation plan, and sick-leave benefits. For information on the State’s benefit plans, refer to the State of Hawaii and ERS’s Comprehensive Annual Financial Reports (“CAFR”), or the audited financial statements of the Department. The State’s CAFR can be found at the Department of Accounting and General Services’ (“DAGS”) website: <http://hawaii.gov/dags/rpts>. The ERS CAFR can be found at the ERS website: <http://ers.ehawaii.gov/Financials.htm>.

6. Commitments and Contingencies

Insurance Coverage

The State maintains certain insurance coverage to satisfy bond indenture agreements as well as for other purposes, but is substantially self-insured for all other perils including workers’ compensation. The State records a liability for risk financing and insurance-related losses, including those incurred but not reported, if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. At June 30, 2010, the State recorded estimated losses for workers’ compensation, automobile, and general liability claims as long-term liabilities,

State of Hawaii
Deposit Beverage Container Deposit Special Fund
Notes to Financial Statements
June 30, 2010

as the losses will not be liquidated with currently expendable available financial resources. The estimated losses will be paid from legislative appropriations of the State's General Fund. The Fund did not have a portion of the State's workers' compensation expense for the year ended June 30, 2010.

Litigation

The Department is a party to various legal proceedings, the outcome of which, in the opinion of management, will not have a material adverse effect on the Fund's financial position. Losses, if any, are either covered by insurance or will be paid from legislative appropriations of the State's General Fund.

Ceded Lands

The Office of Hawaiian Affairs ("OHA") and the State are involved in litigation regarding the State's alleged failure to properly account for and pay to OHA monies due to OHA under the provisions of the Hawaii State Constitution and Chapter 10 of the Hawaii Revised Statutes for use by the State of certain ceded lands. The ultimate outcome of this matter is still unknown. Full discussion of this matter and other legal matters between OHA and the State are disclosed in the State's CAFR and the Department's audited financial statements.

7. Subsequent Events

According to HRS 342G-104, any funds that accumulate in the Deposit Beverage Container Fund shall be retained by the fund unless determined to be in excess by the Legislature. The Legislature passed Act 192 during the 2010 session, authorizing a transfer of up to \$1,000,000 from the Deposit Beverage Container Fund to the State's General Fund to address the FY 2011 budget shortfall. The Legislature later passed Act 124 during the 2011 session, authorizing an additional \$300,000 to be transferred to the State's General Fund. Acts 192 and 124 were applied to FY2011, resulting in a total of \$1,300,000 transferred from the Deposit Beverage Container Fund to the State's General Fund.

As the redemption rate has been over 70 percent since FY 2008, in accordance with Chapter 342G, Part VIII, HRS, the director of health increased the beverage container fee to \$0.015 per container, effective September 1, 2012.

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

The Auditor
State of Hawaii

We have audited the financial statements of the State of Hawaii, Deposit Beverage Container Deposit Special Fund (the "Fund"), as of and for the year ended June 30, 2010, and have issued our report thereon dated November 14, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, detect, and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, detected, and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified a deficiency in internal control over financial reporting related to reliance on self-reporting by distributors and redemption centers, described in Chapter 2 of this report, that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

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

We noted certain matters that were reported to the Auditor and the Fund's management in a separate letter dated March 31, 2011.

The Fund management's response to the finding identified in our audit is described in the attached response. We did not audit the Fund's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Auditor; the State of Hawaii Legislature; the Fund's management, and the State of Hawaii, Department of Health's management and is not intended to be and should not be used by anyone other than these specified parties.

/s/ Accuity LLP
Honolulu, Hawai'i
November 14, 2012

Management Response

We transmitted drafts of this report to the Department of Health on November 13, 2012. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2.

Comments on Agency Response

The Department of Health concurred with many of the findings and conclusions in the report. However, the department objected to the formatting of the report, which it believes highlights criticisms without providing underlying reasons for existing problems.

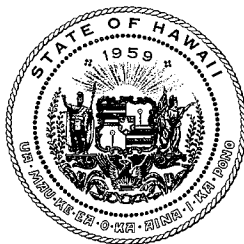
The Program sought to clarify several items in the draft, as follows:

- (a) The Program noted that payments are made only to certified redemption centers. However, our point is that at least one redemption center operator *operates* both certified and uncertified redemption centers and transfers containers from uncertified to certified redemption centers. We are concerned over the operator's controls at the *uncertified* redemption centers, particularly since the operator in question refused to provide us documents to support the payments made to it for the totality of containers. We also believe the redemption activities at uncertified redemption centers violate the law. In its response, the Program effectively sanctioned the uncertified operations and undermined its own enforcement authority by allowing uncertified redemptions to be reimbursed.
- (b) The Program contends that we mischaracterized a single sentence in its December 2010 report to the Legislature as representing the Program's exclusive focus by its compliance inspections on exempt commercial passenger-vehicle companies. A reading of the entire paragraph, however, plus our confirming interview with the Solid Waste Management Coordinator affirmed that monitoring of exempt companies' compliance with their own recycling plans has not been performed since program inception. We stand on the report's language.
- (c) The Program objected to our description of its contractual arrangement with PKF Pacific Hawai'i LLP (PKF) to conduct audit work. We have amended the description, but stand on PKF's title for the report called "Report to the State of Hawai'i Department of Health on the Program and Compliance Audit of Reynolds Recycling, Inc." The Program did not dispute the conclusions of the report.

The department continues to refer to the deposit beverage container program as "new" even though it has been operating since 2005. Many of the issues discussed in this report are not new, and have been acknowledged by the Program in its annual reports to the legislature.

The department also provided specific comments for each recommendation, indicating it is addressing the findings.

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



MARION M. HIGA
State Auditor

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

November 13, 2012

COPY

The Honorable Loretta J. Fuddy
Director
Department of Health
Kīna'u Hale
1250 Punchbowl Street
Honolulu, Hawaii 96813

Dear Ms. Fuddy:

Enclosed for your information are three copies, numbered 6 to 8, of Accuity LLP's confidential draft report, *Deposit Beverage Container Deposit Special Fund Financial and Program Audit, June 30, 2008 and Deposit Beverage Container Special Fund Financial and Program Audit, June 30, 2010*. We ask that you telephone us by Thursday, November 15, 2012, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Tuesday, November 20, 2012.

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

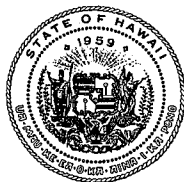
Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
State Auditor

Enclosures

NEIL ABERCROMBIE
GOVERNOR OF HAWAII



LORETTA J. FUDDY, A.C.S.W., M.P.H.
DIRECTOR OF HEALTH

STATE OF HAWAII
DEPARTMENT OF HEALTH
P. O. BOX 3378
HONOLULU, HI 96801-3378

In reply, please refer to:

ASO-F13-202

November 19, 2012

RECEIVED

Ms. Marion M. Higa
Office of the Auditor, State of Hawaii
465 South King Street, Suite 500
Honolulu, HI 96813

2012 NOV 20 PM 4: 16

OFF. OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa,

Attached are the Department of Health's responses to the comments on the Audited Report for the Deposit Beverage Container Deposit Special Fund as of June 30, 2010.

We appreciate the opportunity to comment on this report.

Sincerely,

Loretta J. Fuddy, A.C.S.W., M.P.H.
Director of Health

Attachment

Subject: 2010 AUDIT OF THE DEPOSIT BEVERAGE CONTAINER PROGRAM

We appreciate the opportunity to comment on the subject report. Prior to stating our specific comments to your recommendations, we would like to make the following general observations.

This report correctly points out that most of the shortcomings cited are a direct result of lack of resources and to that extent, the Program essentially concurs with many of the findings of the report. However, it does require a thorough reading of the report and consideration of the Program's comments to ascertain that conclusion. The Department is concerned and wishes to go on record as noting that the practice of the Office of the Legislative Auditor in formatting the report in the manner of highlighting the criticisms in bold letters and not providing the underlying reasons for the existing problems, may have the unintended consequences of being misleading and creating confusion, particularly in light of the possibility that the media may choose to focus on the one particular highlighted point.

The Program wishes to clarify the following sections of the report:

First, we already ensure that payments are made to *only* certified redemption centers. We understand that the auditors visited thirteen sites, two of which were uncertified (Financial and Program Audit, June 30, 2010, pp. 6-7, 14). The two R.R.R. Recycling Services (RRR) sites at 440 Kilani Avenue and Kalani High School were certified at one time. When the certifications were up for renewal, since RRR did not intend to operate each site at least 30 hours per week according to Sec. 342G-114(d)(5), but intended to take deposit beverage containers (DBC) collected from these sites to their certified redemption center at Campbell Industrial Park, which then submits claims to the program, we decided to let them operate this way. The program does *not* issue payments direct to RRR at Kilani Avenue nor Kalani High School because neither site operates independently of the RRR certified redemption center at Campbell Industrial Park.

Second, regarding the claim that Program management was unaware that personnel were not monitoring exempt commercial passenger-vehicle companies or intentionally misreported the monitoring performed in its report to the State Legislature (Financial and Program Audit, June 30, 2010, p. 20), please note that the statement quoted from the Office of Solid Waste Management's December 2010 *Report to the Twenty-Sixth Legislature State of Hawaii 2011* was written in context of the Program issuing requests for information (RFI) letters to over 130 businesses of which included a *limited* number of exempt commercial passenger-vehicle companies in addition to recycling facilities, distributors and manufacturers. The Program did not intend this sole sentence in the December 2010 Report to reflect that compliance inspections were focused entirely on exempt commercial passenger-vehicle companies.

Third, the Program would also like to point out that PKF Pacific Hawaii LLP (PKF) was contracted by the Program to perform a *financial* and compliance audit, and not a *program* and compliance audit (Financial and Program Audit, June 30, 2010, p.16).

As with virtually all new programs, there is always an additional time factor involved before a program comes into fruition and begins to demonstrate the intended results. The Program recognizes it will

continue to have a minimal presence to perform inspection and enforcement responsibilities over distributors and redemption centers while the inability to recruit and retain qualified personnel persists. In response the Department of Health is considering a reorganization to provide manpower and resources to accomplish recommendations in these audits.

Having stated the above, we now offer the following specific comments on the recommendations made in the report:

Recommendation No. 1

Fill vacant positions and/or reevaluate staffing levels to allow sufficient time and resources to perform inspection and enforcement responsibilities over distributors and redemption centers to substantiate proper transactions and to detect and prevent improper ones.

Program Comment No. 1

The Deposit Beverage Container Program (Program) was not able to fill vacant positions during the audit period due to the implementation of the reduction-in-force and hiring freeze by the Governor. Although programs were allowed to submit requests to fill vacant positions for Governor's approval during the hiring freeze, many of those requests were not processed due to the State's financial situation.

Recommendation No. 2

In conjunction with additional and more robust inspections, utilize the enforcement tools granted to the Program under Chapter 342G, HRS, to encourage compliance.

Program Comment No. 2

The Program was not able to perform additional inspections, develop a systematic process, and promote accurate payments by distributors and payments to certified redemption centers due to staffing vacancies.

Recommendation No. 3

Combine the deposit redemption reimbursement request and handling fee request to streamline the payment process, better link the amounts redeemed and actually sent to recyclers or other end users, and reduce potential overpayments.

Program Comment No. 3

The Program has been exploring different methodologies that streamline the payment process that is more reflective of the actual amount of redeemed beverage containers. The Program is considering a methodology we describe as "Back-End Payment". This methodology combines the payment of the deposit and handling fees based upon the certified weight and commodity of DBC loaded into shipping containers that are subsequently sealed and ready to be shipped to end user markets. On October 29, 2012 the Program determined that it is feasible to certify the weight and commodity of DBC in sealed

shipping containers either by using a Certified Marine Surveyor or by Program inspection staff. The Program will continue to evaluate the feasibility of certifying DBC loads and develop a claim and payment system that will accommodate the Back-End Payment methodology.

Recommendation No. 4

Implement controls to identify uncertified redemption centers and ensure deposit redemption reimbursement and handling fee requests are paid only to redemption center operators for beverage containers redeemed at certified redemption centers.

Program Comment No. 4

The Program pays only certified redemption centers. The uncertified redemption centers referenced in the audit do not submit claims to the Program. The uncertified redemption centers take their collected DBC to a certified redemption center who then files the claims to the Program. Therefore it may appear that the Program is paying claims submitted by uncertified redemption centers when this is not the case.

Recommendation No. 5

Regularly evaluate the segregated rates used to convert the weight of deposit beverage containers redeemed into container equivalents to ensure rates approximate hand counts.

Program Comment No. 5

The Program has been performing segregated rate studies since 2005. In 2007 the Program hired Capital Pathways, LLC to develop a systematic sampling procedure that could be performed by the Program. Utilizing the methodology by Capital Pathways, LLC the Program performed additional studies in 2009 and 2010. Each study resulted in the subsequent adjustment of the segregated rates to accommodate the changes in beverage container sizes, construction and the associated changes in container numbers per pound.

Recommendation No. 6

Obtain from the Department of Transportation Airports and Harbors Divisions a listing of exempt commercial passenger-vehicle companies subject to Chapter 342G, Park VIII, HRS.

Program Comment No. 6

Prior to the publication of the draft audit, the Program obtained the list of airlines and cruise ships from the Hawaii State Department of Transportation and requested recycling plans from all companies that were on the list. The program will update its list on an annual basis by requesting the information from the Department of Transportation on all airlines, cruise lines and commercial passenger-vehicle companies that operate in Hawaii.

Recommendation No. 7

Monitor and inspect exempt commercial passenger-vehicle companies to ensure approved recycling plans are being followed and the exempt containers are not being redeemed for deposit refunds.

Program Comment No. 7

The Program recognizes and agrees with the audit that this is an important area that must be monitored and inspected. The Program will need to first overcome position vacancies in order to have the capacity to monitor and inspect exempt commercial passenger-vehicle companies. The Program has extended its search for qualified candidates beyond the State Human Resources Office and has attended several job fairs in an attempt to reach additional candidates. The Program is considering a reorganization to provide manpower and resources to accomplish this task.