
Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014

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

Report No. 15-02
April 2015



THE AUDITOR
STATE OF HAWAI'I

Office of the Auditor

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

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

1. Financial audits attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. Sunset evaluations evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
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6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.
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Hawai'i's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



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The program's continued reliance on self-reported amounts increases the risk of under-reporting by distributors and over-reporting by redemption centers.

Recommendations

Response

Prior Audits

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Deposit Beverage Container Program still relies on self-reported data, still at risk

Unaddressed program flaws result in millions of dollars in overpayments and undermine financial sustainability

This is our fifth audit of the Deposit Beverage Container (DBC) Program. As in our previous audits, we found that the program relies on self-reported data from distributors that may be fraudulently or erroneously under-reporting beverage containers sold or distributed, and certified redemption centers that may be fraudulently or erroneously over-reporting beverage containers redeemed. This systemic flaw, coupled with the absence of a detailed audit function, has exposed the program to abuse and risk of fraud since program inception.

From FY2013 through FY2014, the DBC Program paid \$2.6 million in deposit refunds for approximately 3.5 million pounds of recycled materials that cannot be accounted for. The Department of Health, which administers the program, has been aware of this flawed payment system since 2006 but has done little to address it, either with changes to the program or through enforcement of inspections. As a result, the program continues to be exposed to fraud, which may result in higher program costs and an unreliable reported redemption rate.

Program was unaware that distributor substantially underpaid the DBC Fund for more than six years

Distributors are required by law to report the number of deposit beverage containers sold/distributed and pay beverage container deposit and container fees to the program on a monthly basis. The program, however, continues to rely on unsupported amounts reported by distributors because it lacks a systematic verification or inspection process. We reviewed distributor receipts and found that one distributor—Whole Foods Market, Inc.—underpaid beverage container deposits and fees for more than six years, which went undetected by the program. For the six years it has been operating in Hawai'i, Whole Foods was paying the DBC fund 6¢ per case instead of 6¢ per container. Whole Foods reported that the underpayment is approximately \$34,000 for FY2012 through FY2014. The DBC Program has consulted with the Department of the Attorney General on whether the program will be able to collect the full amount of the six-year underpayment. The attorney general has advised that the program could collect the last two years, but likely not the prior four. These errors highlight the need for the program to closely monitor amounts reported and paid by distributors. Not doing so exposes the DBC Program to fraud.

Agency Response

The department concurred with many of our findings. However, it felt that two statements represented "incomplete findings," namely, that the program does not pay a shrinkage rate above 2.5 percent and the program reimburses no more than 5¢ per container, but redemption centers may choose to reimburse consumers more than that. The department also expressed concern with the layout of our report, claiming that certain formatting effects could be misleading and create confusion. Based on the department's comments, we made edits for clarity and style but we stand by our findings and conclusions. We did not change our report layout, which reflects our standard style.

Regarding our recommendation to adopt a back-end payment system to address risks associated with continued reliance on redemption centers' self-reported numbers, the department disagreed such a system will shift risk away from the State and asserted that it should no longer be considered a viable solution. The department did not, however, offer another solution to address the risk. We implore the department to develop an alternative plan to address systemic flaws in the deposit and redemption process as soon as possible. Until such a solution is implemented, the DBC Program will continue to be under significant risk of fraud and abuse.

Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014

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

Conducted by

The Auditor
State of Hawai'i
and
N&K CPAs, Inc.

Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 15-02
April 2015

Foreword

This is a report on the management and financial audit of the Department of Health's Deposit Beverage Container Program as of and for the fiscal year ended June 30, 2014. The audit was conducted pursuant to Section 342G-107, Hawai'i Revised Statutes, which requires the Office of the Auditor conduct a management and financial audit of the Deposit Beverage Container Program and Deposit Beverage Container Deposit Special Fund in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005. The audit was conducted by the Office of the Auditor and the certified public accounting firm of N&K CPAs, Inc.

We wish to express our appreciation for the cooperation and assistance extended by the officials and staff of the Department of Health and other offices and individuals whom we contacted during the course of the audit.

Jan K. Yamane
Acting State Auditor

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Chapter 1

Introduction

In 2002, the Hawai‘i Legislature passed Act 176 (Bottle Bill) to establish the Deposit Beverage Container (DBC) Program. The act, codified in Chapter 342G, Part VIII, Hawai‘i Revised Statutes (HRS), also established the Deposit Beverage Container Deposit Special Fund (DBC 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 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 contracted the certified public accounting firm of N&K CPAs, Inc. (N&K) to conduct this financial and program audit.

Background

Manufacturers and distributors of beverage containers are responsible for paying deposits and fees into the DBC 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 consumers.

Deposit and container fee collection process

The deposit is 5¢ per container, and the fee is 1.5¢ per container on each eligible beverage container manufactured in or imported to Hawai‘i. The container fee was originally 1¢ but was raised to 1.5¢ as of September 1, 2012. When statewide redemption rates are above 70 percent, state law requires a 1.5¢ fee. Redemption rates for fiscal years 2006 to 2014 are shown in Exhibit 1.1. The redemption rate is calculated as the ratio of containers redeemed to containers manufactured or distributed, as represented by deposits collected from distributors.

Exhibit 1.1 Deposit Container Redemption Rates, FY2006–2014

| Fiscal Year Ended | Redemption Rate |
|-------------------|-----------------|
| June 30, 2006 | 68% |
| June 30, 2007 | 68% |
| June 30, 2008 | 72% |
| June 30, 2009 | 79% |
| June 30, 2010 | 76% |
| June 30, 2011 | 76% |
| June 30, 2012 | 77% |
| June 30, 2013 | 75% |
| June 30, 2014 | 73% |
| Average | 74% |

Source: Department of Health

Section 342G-101.5, HRS, exempts commercial passenger-vehicle companies from paying 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.

Redemption process

The DBC Program uses redemption centers to collect empty beverage containers and return deposits to consumers, as well as to deliver redeemed beverage containers to recyclers. During FY2013–2014, the program paid handling fees between 2¢ and 4¢ per container, depending on the location of the redemption center and the end use of the recycled containers. Except for glass containers, redemption centers on O‘ahu were paid 2¢ per beverage container delivered to recyclers/recycling mills, while redemption centers on other islands were paid 3¢ per beverage container. To encourage remanufacturing of glass, handling fees for glass were 2¢ for agriculture/construction and 4¢ 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 of Health. In addition to conditions listed in the permit and certification, redemption centers must comply with statutory requirements in Section 342G-114, HRS, which are: (1) accept all types of empty deposit beverage containers for which a deposit has been paid; (2) verify that all containers to be redeemed bear a valid Hawai‘i refund value; (3) pay 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 (conditions for refusal); (4) ensure each deposit beverage container collected 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) forward the documentation necessary to support claims for payment as stated in Section 342G-119, HRS (redemption center reporting requirements).

As of June 2014, there were 99 certified redemption centers statewide. Exhibit 1.2 provides a breakdown of sites on each island.

Exhibit 1.2 Certified Redemption Centers

| Island | Number of Centers |
|----------|-------------------|
| O'ahu | 55 |
| Maui | 15 |
| Hawai'i | 18 |
| Kaua'i | 8 |
| Lāna'i | 1 |
| Moloka'i | 2 |
| Total | 99 |

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 containers 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 5¢ per beverage container redeemed, but is intended to average 5¢ on a statewide basis. The number of beverage containers per pound by material type is required to be posted at all redemption centers.

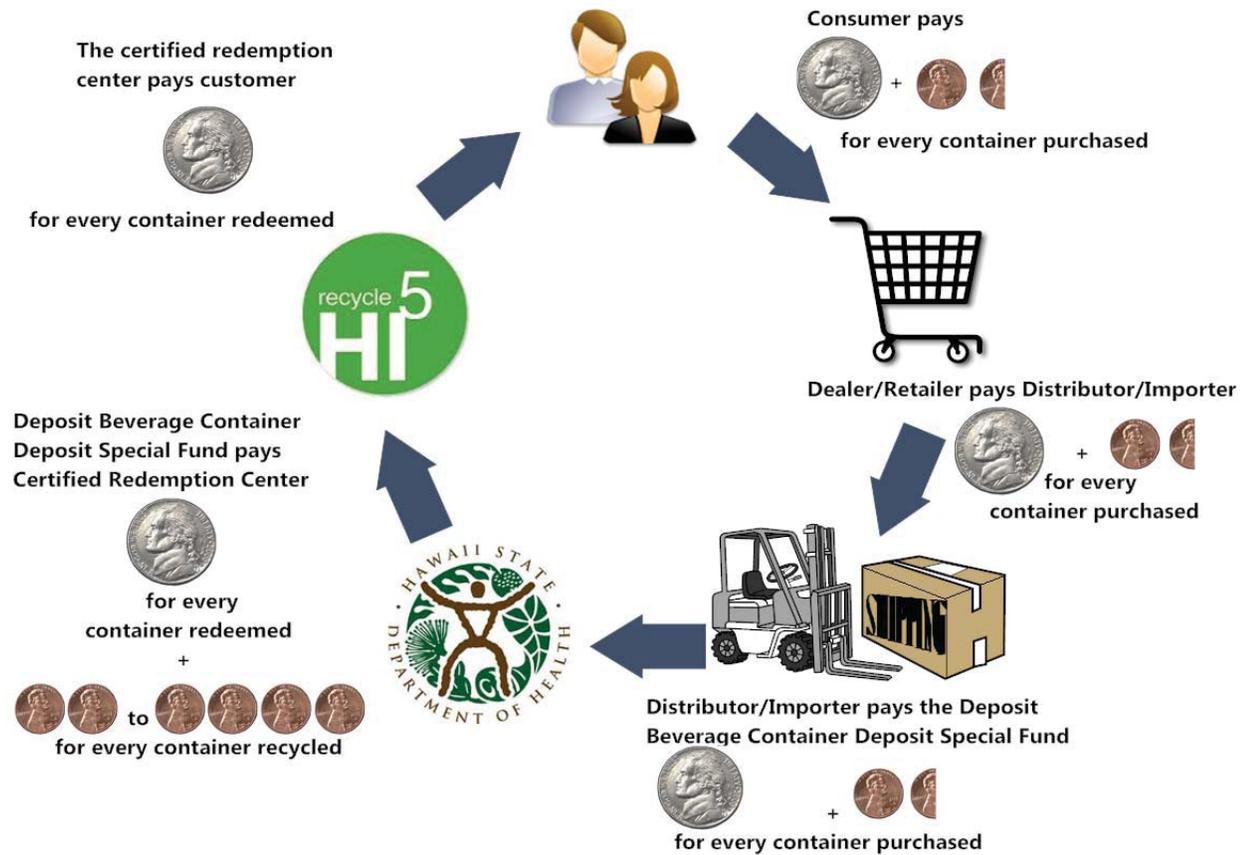
Exhibit 1.3 contains the current segregated rates in effect during FY2013–2014, which were effective beginning December 2010. Redemption centers may not issue refunds for beverage containers redeemed without a *HI-5¢* marking. Exhibit 1.4 shows an overview of the deposit and redemption process.

Exhibit 1.3
Hawai'i Deposit Beverage Container Segregated Rates

| Container Material Type | Number of Containers per Pound | Price per Pound |
|--------------------------|--------------------------------|-----------------|
| Aluminum | 32.0 | \$1.60 |
| Bi-Metal | 5.9 | \$0.295 |
| Glass | 2.4 | \$0.12 |
| Plastic | 18.8 | \$0.94 |
| Plastic (17 oz. or less) | 26.3 | \$1.315 |

Source: Department of Health

Exhibit 1.4
Overview of the Deposit and Redemption Process



Source: Office of the Auditor

Program organization and revenues

The department's Environmental Management Division, Solid Waste Branch administers the DBC Program and DBC Fund. The program is managed by the solid waste management coordinator.

In FY2013–2014, the DBC Program had revenues of \$23.8 million and expenditures of \$21.1 million, resulting in a \$2.7 million increase in the DBC Fund balance to \$16.5 million at June 30, 2014. The program's container deposit liability remained unchanged from \$1.9 million at July 1, 2013 and 2014. The DBC Fund had \$20.4 million in equity in cash and cash equivalents and investments in State Treasury at June 30, 2014, to refund deposits and to pay for other liabilities and expenses. Additional information on the program's financial information is included in the DBC Fund's financial statements in Chapter 3.

Prior Audits

The Office of the Auditor has conducted four previous audits of the DBC Program.

In Report No. 05-09, *Audit of the Deposit Beverage Container Program* (2005), we found numerous delays at the department negatively impacted program planning and implementation. The department failed to submit a timely budget request for program funding and was late in hiring staff. Redemption centers were poorly operated, with inconsistent operations, because the department had not developed standard redemption procedures or levels of service. The department failed to develop procedures to verify that data submitted by distributors were accurate or that resulting payments received from distributors were justified. Payments to redemption and recycling centers were based on unverified numbers. Inspections by environmental health specialists were limited, sporadic, and reactive. Lastly, the department failed to establish a financial accounting system for the program, was unable to complete reconciliations of accounting records or adjustments to prepare the financial statements, and lacked internal controls.

The *State of Hawai'i Deposit Beverage Container Deposit Special Fund Financial and Program Audit June 30, 2008* (unnumbered report), conducted by Accuity LLP, found that the program lacked adequate procedures to prevent or detect whether distributors fraudulently or erroneously under-reported containers sold or distributed, or whether certified redemption centers fraudulently or erroneously over-reported containers redeemed. Deposit and fee collections from distributors as well as payments to certified redemption centers were based on unverified numbers with limited inspections performed by program personnel. The program lacked controls to prevent or detect unauthorized beverage containers from entering the redemption stream.

The program's management also misstated the program's fund balance by \$5 million in FY2007, which resulted in a \$5 million restatement of the beginning fund balance in FY2008.

The State of Hawai'i Deposit Beverage Container Deposit Special Fund Financial and Program Audit June 30, 2010 (unnumbered report), also conducted by Accuity LLP, found that there were several deficiencies that exposed the program to fraud, including 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 were unsupported. Exempt commercial passenger vessel companies had not been inspected since the program's inception. Consequently, the program was potentially operating at a greater cost than necessary, and the reported redemption rate may not have been reliable.

Report No. 13-08, *Management and Financial Audit of the Deposit Beverage Container Program, June 30, 2012* (2013), conducted by the Office of the Auditor and Accuity LLP, found that mismanagement of the program put its continued operation at risk. We found that unaddressed program flaws resulted in millions of dollars in overpayments and undermined the program's financial sustainability. Factors that contributed to this included continued reliance on self-reported data from distributors and certified redemption centers and an absence of a detailed audit function. We also found that inattention to basic management functions exacerbated the program's ability to prevent fraud and abuse.

Objectives of the Audit

1. Perform a financial and program audit of the DBC Fund.
 - a. Assess the adequacy of the program's internal controls over financial reporting.
 - b. Perform tests of compliance with applicable laws and regulations and the provisions of contracts and agreements.
 - c. Perform testing of distributors' and redemption centers' compliance with Chapter 342G, Part VIII, HRS.
2. Follow up on prior audit findings to determine the status of corrective actions taken by the program.
3. Make recommendations for improvements as appropriate.

Scope and Methodology

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

For testing of beverage distributors, N&K obtained from the department a list of cash receipts from 243 distributors for the fiscal year ended June 30, 2014, and judgmentally selected the largest 24 distributors for further testing. Invoices were selected from the respective distributors' monthly detail of beverage container sales to verify that all containers reported as sold (or otherwise distributed) on the distributors' invoices were properly substantiated by supporting documents and the proper deposit and container fees were paid to the program. The distributors selected for testing are shown in Exhibit 1.5.

Exhibit 1.5 Distributors Selected for Testing

| Distributor | FYE 6/30/14 Total Receipts | Month Selected for Testing |
|--------------------------------------|-------------------------------|-------------------------------|
| Paradise Beverages, Inc. | \$12,358,490 | July 2013 |
| BCI Coca-Cola Bottling of LA | 9,753,951 | July 2013 |
| Pepsi Beverage Company | 9,069,122 | August 2013 |
| Anheuser-Busch Sales of Hawaii, Inc. | 8,277,578 | August 2013 |
| Costco Wholesale Corporation | 4,153,451 | September 2013 |
| Hawaiian Isles Water Company | 4,005,456 | September 2013 |
| ITOEN(USA), Inc. | 2,616,597 | October 2013 |
| Safeway, Inc. | 1,634,905 | October 2013 |
| Maui Soda & Ice Works, Ltd. | 1,294,165 | November 2013 |
| Hawaiian Sun Products, Inc. | 1,287,653 | November 2013 |
| Hawaiian Springs LLC | 813,571 | December 2013 |
| Sam's Club East | 753,738 | December 2013 |
| Young's Market Company, LLC | 548,252 | January 2014 |
| Johnson Brothers of Hawaii, Inc. | 440,577 | January 2014 |
| Target Corporation | 418,609 | February 2014 |
| Menehune Water Co., Inc. | 390,116 | February 2014 |
| Wal-Mart Stores East LP | 370,896 | March 2014 |
| C & S Wholesale Grocers, Inc. | 349,701 | March 2014 |
| The Home Depot USA, Inc. | 203,836 | April 2014 |
| Times Super Market | 155,070 | April 2014 |
| Nishimoto Trading Co. Hawaii Ltd. | 112,586 | May 2014 |

| Distributor | FYE 6/30/14 Total Receipts | Month Selected for Testing |
|---|-------------------------------|-------------------------------|
| Southern Foods Group dba Meadow Gold Dairy | 98,367 | May 2014 |
| Deep Ocean Enterprises, LLC | 79,655 | June 2014 |
| Whole Foods Market, Inc. | 75,088 | June 2014 |
| Total | \$59,261,430 | |

Source: N&K CPAs, Inc.

N&K visited ten of the State’s 99 certified redemption centers as of June 30, 2014, and observed whether the redemption centers were open during posted hours, informed customers of the procedures/policies of the redemption count, used properly calibrated scales to weigh redeemed beverage containers, paid appropriate refunds to consumers, provided consumers with a receipt for their redemptions, and properly recorded the redemption transactions. N&K’s tests included determining that the deposit refunds followed segregated rate schedules. The ten redemption centers visited are shown in Exhibit 1.6.

**Exhibit 1.6
Redemption Centers and Locations Tested**

| Redemption Center | Island | Address |
|-----------------------------|---------|--|
| Reynolds Recycling | O’ahu | 99-1160 Iwaena Street, Hālawā |
| RRR Recycling Kiosk | O’ahu | 3109 Wai’ālae Avenue, Kaimukī |
| Island Container Redemption | O’ahu | 1803 Dillingham Boulevard, Kalihi |
| Depot Metal | O’ahu | 94-037 Waipahu Depot Road, Waipahu |
| Reynolds Recycling | O’ahu | 1105 University Avenue, Mōili’ili |
| RRR Recycling Kiosk | O’ahu | Alaloa Street, Kāne’ohe |
| Business Services Hawaii | Hawai’i | 16-639 Kipimana Street, Kea’au |
| Atlas Recycling Centers | Hawai’i | 30 Maka’ala Street, Hilo |
| Reynolds Recycling | Kaua’i | Corner of Wilcox & Kanoa Street, Nāwiliwili Harbor |
| Maui Disposal | Maui | 60 Kanoa Street, Wailuku |

Source: N&K CPAs, Inc.

N&K redeemed beverage container deposits at each of the selected redemption centers and traced its redemption transaction through the redemption center’s reimbursement request/reporting process and subsequent payment by the program.

Audit fieldwork was conducted from August 2014 through December 2014, in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*. Those standards require that N&K plan and perform the audit

to obtain sufficient and appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. N&K believes that the evidence obtained provides a reasonable basis for its findings and conclusions based on the audit objectives.

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Chapter 2

Deposit Beverage Container Program Still Relies on Self-Reported Data, Still at Risk

This is our fifth biennial financial and program audit of the Deposit Beverage Container (DBC) Program. As in our previous audits, we found that the program still relies on self-reported data from distributors that may be fraudulently or erroneously under-reporting beverage containers sold or distributed, and certified redemption centers may be fraudulently or erroneously over-reporting beverage containers redeemed. This systemic flaw, coupled with the absence of a detailed audit function, has exposed the program to abuse and risk of fraud since its inception.

From FY2013 through FY2014, the DBC Program paid \$2.6 million in deposit refunds for approximately 3.5 million pounds of recycled materials that cannot be accounted for. The Department of Health, which administers the program, has been aware of this flawed payment system since 2006 but has done little to address it, either with changes to the program or through enforcement and inspections. Because these deficiencies contribute to an inherent incentive for distributors, certified redemption centers, and exempt companies to misreport data, the program continues to be exposed to fraud, which may result in higher program costs and an unreliable reported redemption rate. Redemption centers may also be operating in violation of state law and program rules.

Summary of Findings

1. The Deposit Beverage Container Program continues to rely on self-reported and unsupported deposit and fee collections data from distributors.
2. Program payments made to certified redemption centers for beverage containers redeemed are unsupported.

Deposit and Fee Collected From Distributors Are Unsupported

Distributors are required by law to report the number of deposit beverage containers sold/distributed and pay beverage container deposits and fees to the program on a monthly (semi-annually for smaller companies) basis.¹ Distributors are also required to maintain adequate records and support for beverage sales. The program, however, continues to rely on unsupported amounts reported by distributors because it lacks a systematic verification or inspection process. We reviewed distributor receipts and found that one distributor underpaid beverage container deposits and container fees for more than six years, which went undetected by the program.

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

Distributors are required to pay deposit beverage container fees and deposits monthly, based on distributor inventory reports, and submit to the department documentation identifying the net number of deposit beverage containers sold, donated, or transferred, by container size and type.² In addition, beverage distributors who manufacture or import beverages in deposit beverage containers are required to pay the deposit on each filled deposit beverage container, pay a deposit beverage container fee, and register with the State.

Because distributors can pass on beverage container costs to retailers, distributors have an added incentive to under-report sales and distributions of deposit beverage containers. Distributors could collect deposits and container fees from retailers but not pay them to the program. Undetected underpayments by distributors would 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 may be understated. Further, the department could use an overstated redemption rate to justify increasing DBC fee rates to sustain program operations.

Program was unaware that a distributor substantially underpaid the DBC Fund for more than six years

During our review of 24 distributors' records, we found instances of both underpayment and overpayment of deposits and fees by distributors. While some errors were clerical or caused by a system miscalculation, we found one distributor—Whole Foods Market, Inc.—underpaid deposits and fees for all of its stores statewide for more than six years.

Whole Foods stated that the error was due to a misunderstanding of the unit amount subject to the deposit and fee. It had been applying the deposit and fee amounts on *cases* sold rather than each *beverage container* sold. Thus, for the more than six years of operations in Hawai'i, Whole Foods has been paying 6¢ per case instead of 6¢ per container. Whole Foods has reported to the program that the underpayment is approximately \$34,000 for FY2012 through FY2014. Prior to our review, the department had been unaware of the underpayment and has since asked Whole Foods for supporting documentation for its underpayment estimate before deciding whether or not to accept the report.

The program also has consulted with the Department of the Attorney General on whether the program would be able to collect from Whole Foods the full amount of the six-year underpayment. The attorney general advised that the program could collect the last two years, but likely not the prior four. Earlier detection by the program of the errors would have minimized the dollars lost to the State.

Program still lacks a systematic process to detect under- and non-reporting by distributors

Moreover, these errors highlight the need for the program to closely monitor amounts reported and paid by distributors—something it has not done. The program’s reliance on distributor self-reporting without a strong enforcement and substantiation function exposes the DBC Program to fraud.

Distributors operating within the state are required to register with the department and maintain records reflecting the manufacture of their beverages in deposit containers as well as the importation and exportation of deposit beverage containers.³ Distributor records must be made available, upon request, for audits and inspections by the department and State Auditor.

To encourage compliance, the DBC Program has broad enforcement powers, including assessing an administrative penalty, ordering corrective action, commencing civil action in circuit court, and revoking a certification or permit. Lack of effective distributor compliance inspections by the program, however, hobbles the program from deploying these enforcement tools and effectively limiting the risk of underpayment by distributors of beverage container deposits and container fees.

Robust enforcement would encourage distributors to accurately pay deposits and container fees. Penalties for non-compliance that include public announcements of violations could heighten distributor awareness of penalties and potentially hurt distributors’ reputations, creating an incentive to comply with DBC laws.

In its *Report to the Twenty-Seventh Legislature State of Hawai‘i 2013*, the department reported issuing 51 warning letters to distributors, certified redemption centers, and retailers, and five enforcement notices and orders during FY2012. In its *Report to the Twenty-Eighth Legislature State of Hawai‘i 2014*, the department reported issuing 28 warning letters and 14 informal notices of violations to distributors, certified redemption centers, and retailers, and nine administrative penalties during FY2013.

Program Regularly Pays for Unsupported Amounts of Beverage Containers Redeemed at Redemption Centers

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

The program reimburses and pays for beverage containers redeemed by certified redemption centers on a monthly basis based on reports prepared by the centers. We found, however, that the program lacks adequate procedures to prevent or detect whether such centers erroneously or fraudulently over-report beverage containers redeemed, thus overcharging the program.

The program pays certified redemption centers handling and deposit refunds based on collection reports submitted by redemption centers.⁴ Redemption center 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 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.

The program pays certified redemption centers 50 percent of the handling fees claimed at the time of the 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. The program also reimburses certified redemption centers 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.

The program relies on certified redemption center self-reporting and does not require such centers to submit supporting documents with deposit refund reimbursement requests. Because the program reimburses certified redemption centers for all deposits refunded, nothing prevents redemption centers from overpaying and over-reporting redemptions. Consistent overpayment of deposit refunds by certain redemption centers may encourage consumers to redeem deposit beverage containers at those specific locations, resulting in greater volume and handling fees to the redemption center.

The program previously indicated that it plans to address this issue by paying the combined deposit reimbursement and handling fees only on the quantity of beverage containers shipped to and received by material end-use recyclers. To date, however, the program has done little to implement its plan.

The program also attributes part of the difference between the weight of materials in collection reports and the weight of materials delivered to the end recycler to “shrinkage,” the result of inherent and expected inefficiencies in the recycling process. For instance, the accumulation and evaporation of liquid in DBC containers could account for some of these differences. The program has established a standard shrinkage rate of up to 2.5 percent; thus, the program pays the handling fee at the time it receives documentation for the actual weight of materials recycled. However, shrinkage could also be an indicator of theft, fraudulent reporting, or other weaknesses and inefficiencies in redemption center operations. For FY2013 and FY2014, we found shrinkage rates that ranged from as little as 1 percent to as much as 18 percent. These rates varied widely from vendor to vendor and from year to year.

Ultimately, redemption overpayments—irrespective of the cause—will result in the program having fewer funds available to pay deposit refunds and may justify increasing handling fees on beverage containers redeemed. During FY2013, handling fees were between 2¢ and 4¢ per container, depending on the location of the redemption center and the end use of the recycled containers, which is two- to four-times the amount of the container fees paid into the DBC Fund by distributors. Program inefficiency or inability to validate redemption center reports, however, should not justify increased container fees.

Program still lacks process to detect over-reporting by redemption centers

Redemption centers have an inherent incentive to overstate the amount refunded for deposit beverage containers redeemed to increase demand for their services and the amount of handling fees generated. Knowing this, the program should have a process in place to detect such over-reporting by redemption centers. However, we found that none of the 99 inspections conducted during FY2014 included procedures to detect over-reporting, such as inspecting deposit refund reimbursement request forms by obtaining and validating amounts reported to certified redemption centers’ supporting documents. In fact, the program neither has scheduled nor systematically performed compliance inspections of redemption centers with any regularity. Instead, the program’s compliance inspections either checked daily customer transactions at certified redemption centers to determine if refunds were properly calculated and whether the proper segregated rates were used, or

investigated complaints received from the public. The program has failed to implement a systematic compliance inspection and enforcement process that would limit the risk of overpayment of redemptions.

In Report No. 13-08 *Management and Financial Audit of the Deposit Beverage Container Program, June 30, 2012*, we reported that from FY2010 through FY2012, the DBC Program paid \$6.2 million in deposit refunds for almost 7.5 million pounds of materials that cannot be accounted for. In response to our finding, the program reported that it had consulted with the State Department of the Attorney General (AG) to determine whether any action could be taken against the certified redemption centers, including whether the program could seek reimbursement of overpayments made to redemption centers. The AG responded that it would be extremely difficult, if not impossible, to retrieve overpayments without documentation and evidence, especially many years after the fact.

Additionally, the program has explored implementation of a back-end payment system as recommended in our 2013 audit.⁵ It met with certified redemption center operators and was told that many operators cannot financially support operations for a period beyond ten days without receiving reimbursements for deposit fees and payments for handling fees. Although state law provides the program 30 days to reimburse operators, the program has decided to increase internal auditing capacity instead. This solution continues to shift risk to the State and away from redemption center operators, especially since the State has no process in place to detect over-reporting by redemption centers. Recruitment and filling of staff positions for this purpose await a reorganization of the Office of Solid Waste Management, a potentially lengthy process.

Redemption centers' errors are passed on to the DBC Program

During our audit, we visited ten redemption centers to redeem beverage containers by count (three redemption centers) and by weight (seven redemption centers) and noted numerous errors, which were subsequently passed on to the DBC Program. In our testing of deposits refunded by certified redemption centers via count, we found that one redemption center paid refunds of 6¢ per aluminum can instead of the 5¢ rate. However, this redemption center did not accurately count the number of cans redeemed, which resulted in a net underpayment to the redeeming consumer. We did not find any discrepancies for redemption centers where we redeemed deposits by weight.

Of the ten redemption centers visited, we found:

- One was not operating during posted hours, as required by law.⁶ The redemption center explained that it was not able to redeem deposits during posted hours due to late delivery of cash from its armored car service that day;
- One redemption center did not appear to have redemption policies and procedures posted, as required by departmental rules;⁷ and
- Two redemption centers did not perform visual load inspections, also required by departmental rules.⁸

For the same ten redemption centers, we also requested copies of our redemption transactions and traced them through the redemption center's reimbursement request/reporting process and subsequent payment by the program. We found that:

- One of ten receipt quantities on the receipt obtained at one redemption center did not match the quantities reported by the redemption center to the program; and
- Two of ten redemption centers' daily receipts totals provided to us did not match summaries submitted to the program to request payment. In both instances, amounts reported on the summary sheets were greater than the supporting receipts provided, indicating a request by the redemption center to the program for a larger payment than substantiated by its receipts.

Conclusion

The DBC Program's continued reliance on self-reporting by distributors and certified redemption centers and lack of systematic inspections expose the program to a greater risk of fraud. Plans to address these program weaknesses are pending and remain unimplemented. Until the program implements controls to verify reports submitted, underreported deposits and fees, and over-reported redemptions 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 concerns over the cost of the State's beverage container recycling program, including questions regarding the container fee rate necessary to operate the program.

Recommendations

The Deposit Beverage Container Program management should:

1. Combine the deposit redemption reimbursement request and handling fee request to streamline the payment process by moving beyond the multi-year assessment and adopting and implementing a back-end payment system. Review and adopt administrative rules to implement a back-end payment system.
2. Develop a risk-based process to select distributors and redemption centers to audit. The program should consider a variety of risk factors, including the amount of money transacted, prior audit findings, and the frequency of distributor's or redemption's prior audits.
3. Report results of distributor and redemption center audits annually and conduct follow-up audits, as necessary.

Notes

Chapter 2

1. Sections 342G-105 and 342G-110, HRS.
2. Section 342G-105, HRS.
3. Section 342G-103, HRS.
4. Section 342G-119, HRS, and Section 11-282-47, Hawai'i Administrative Rules.
5. Hawai'i, The Auditor, *Management and Financial Audit of the Deposit Beverage Container Program, June 30, 2012*, Report No. 13-08, Honolulu, November 2013.
6. Section 342G-114, HRS.
7. Section 11-282-46, Hawai'i Administrative Rules.
8. Section 11-282-45, Hawai'i Administrative Rules.

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Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Deposit Beverage Container Deposit Special Fund (DBC Fund) of the Department of Health as of and for the fiscal year ended June 30, 2014. This chapter includes the report of independent auditors and the report on internal control over financial reporting and compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays the DBC Fund's financial statements together with explanatory notes.

Summary of Findings

In the opinion of N&K, based on their audits, the financial statements present fairly, in all material respects, the financial position of the DBC Fund as of June 30, 2014, and the changes in financial position and budgetary comparison thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America. N&K noted certain matters involving the DBC Fund's internal control over financial reporting and its operations that the firm considered to be significant deficiencies, as defined in the report on internal control over financial reporting and on compliance and other matters performed in accordance with *Government Auditing Standards*. N&K also noted that the results of its tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Independent Auditor's Report

The Auditor
State of Hawai'i

Report on the Financial Statements

We have audited the accompanying balance sheet of the State of Hawai'i, Deposit Beverage Container Deposit Special Fund (DBC Fund) as of June 30, 2014, and the related statement of revenues, expenditures and changes in fund balance, and budgetary comparison for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the

design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the DBC Fund as of June 30, 2014, and the changes in its financial position and the budgetary comparison thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note A, the financial statements present only the DBC Fund, and do not purport to, and do not present fairly the financial position of the State of Hawai'i or the State of Hawai'i, Department of Health, as of June 30, 2014, and changes in its financial position and budgetary comparison for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Management has omitted the management's discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 11, 2015 on our consideration of the DBC 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the DBC Fund's internal control over financial reporting and compliance.

/s/ N&K CPAs, Inc.

Honolulu, Hawai'i
March 11, 2015

**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 Hawai'i

We have audited, in accordance with the 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, the financial statements of the State of Hawai'i, Deposit Beverage Container Deposit Special Fund (DBC Fund), as of and for the year ended June 30, 2014, and the related notes to the financial statements, and have issued our report thereon dated March 11, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the DBC Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the DBC Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the DBC Fund's internal control.

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, or detect and correct, misstatements on a timely basis. *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. *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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in Chapter 2 of this report, that we consider to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the DBC Fund's financial statements are free from 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*.

DBC Fund Management's Response to Findings

The DBC Fund management's responses to the findings identified in our audit are described in the attached response. The DBC Fund management's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

/s/ N&K CPAs, Inc.

Honolulu, Hawai'i
March 11, 2015

Description of Financial Statements

The following is a brief description of the financial statements audited by N&K which are presented at the end of this chapter.

Balance Sheet

This statement presents the assets, liabilities, deferred inflows of resources and fund balance of the DBC Fund as of June 30, 2014.

Statement of Revenues, Expenditures and Changes in Fund Balance

This statement presents the revenues, expenditures and changes in fund balance of the DBC Fund for the fiscal year ended June 30, 2014.

Statement of Budgetary Comparison

This statement presents the comparison of the budgeted amounts with the actual amounts on a budgetary basis for the DBC Fund for the fiscal year ended June 30, 2014.

Notes to Financial Statements

Explanatory notes that are pertinent to an understanding of the financial statements are discussed in this section.

Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
BALANCE SHEET
June 30, 2014

ASSETS

| | |
|--|-----------------------------|
| Equity in cash and cash equivalents and investment in State Treasury | \$ 20,428,262 |
| Accounts receivable | <u>1,447,690</u> |
| Total assets | \$ <u><u>21,875,952</u></u> |

LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND FUND BALANCE

| | |
|--|-----------------------------|
| Liabilities | |
| Vouchers and contracts payable | \$ 3,309,898 |
| Accrued wages and employee benefits | 37,435 |
| Beverage container deposits | <u>1,864,042</u> |
| Total liabilities | <u>5,211,375</u> |
| Deferred inflows of resources | |
| Unavailable revenue | <u>181,207</u> |
| Total deferred inflows of resources | <u>181,207</u> |
| Fund balance | |
| Committed to deposit container program | <u>16,483,370</u> |
| Total fund balance | <u>16,483,370</u> |
| Total liabilities, deferred inflows of resources, and fund balance | \$ <u><u>21,875,952</u></u> |

The accompanying notes are an integral part of this financial statement.

Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCE
Fiscal Year Ended June 30, 2014

REVENUES

| | |
|---------------------------------|---------------|
| Deposit beverage container fees | \$ 13,936,385 |
| Unredeemed deposits | 9,823,040 |
| Non-imposed fringe benefits | <u>4,264</u> |

Total revenues 23,763,689

EXPENDITURES

| | |
|------------------------------|------------------|
| Administrative expenditures | 158,658 |
| Handling and redemption fees | 18,215,408 |
| Other operating expenditures | <u>2,715,919</u> |

Total expenditures 21,089,985

Change in fund balance 2,673,704

Fund balance at July 1, 2013 13,809,666

Fund balance at June 30, 2014 \$ 16,483,370

The accompanying notes are an integral part of this financial statement.

Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
STATEMENT OF BUDGETARY COMPARISON
Fiscal Year Ended June 30, 2014

| | <u>Budgeted Amounts</u> | | <u>Actual Amounts</u> |
|--------------------------------------|-------------------------|------------------------|--------------------------|
| | <u>Original</u> | <u>Final</u> | <u>(Budgetary Basis)</u> |
| Revenues | | | |
| Current-year funds | \$ <u>87,295,331</u> | \$ <u>87,311,232</u> | \$ <u>59,658,362</u> |
| Total revenues | <u>87,295,331</u> | <u>87,311,232</u> | <u>59,658,362</u> |
| Expenditures | | | |
| Environmental health administration | <u>87,295,331</u> | <u>87,311,232</u> | <u>61,828,768</u> |
| Total expenditures | <u>87,295,331</u> | <u>87,311,232</u> | <u>61,828,768</u> |
| Excess of expenditures over revenues | \$ <u> --</u> | \$ <u> --</u> | \$ <u> (2,170,406)</u> |

The accompanying notes are an integral part of this financial statement.

Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2014

NOTE A - FINANCIAL REPORTING ENTITY

Establishment and Purpose of the Fund

In 2002, the State of Hawai'i Legislature passed Act 176 to establish the Deposit Beverage Container Program and the Deposit Beverage Container Deposit Special Fund (DBC 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, Hawai'i Revised Statutes (HRS), the DBC 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 DBC Fund, the State of Hawai'i collects from manufacturers and distributors, a 5¢ 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 DBC Fund assesses a per container handling fee of 1.5¢ per container.

The DBC Fund is administered by employees of the Solid Waste Branch, Environmental Management Division of the State of Hawai'i, Department of Health.

The accompanying financial statements are intended to present only the DBC Fund and do not purport to, and do not present the financial position, changes in financial position and budgetary comparison of the State or the department in accordance with accounting principles generally accepted in the United States of America.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

(1) ***Basis of Presentation*** - The financial statements of the DBC 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 DBC 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 1.5¢ per beverage-container-sold handling fee. In addition, the amounts for deposits of 5¢ are deferred when collected, and the amount estimated to be forfeited is recognized into income at the end of the fiscal year.

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.

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 DBC Fund's portion of these department-wide accruals includes adjustments for capital assets and accrued vacation. At June 30, 2014, the DBC Fund's portion of these accruals was as follows:

| | |
|--|----------------------|
| Total fund balance on the modified-accrual basis of accounting | \$ 16,483,370 |
| Capital assets used in governmental activities are not financial resources and therefore are not reported as an asset in the governmental funds | 12,504 |
| Compensated absences reported in the statement of net assets do not require the use of current financial resources and are not reported as liabilities in the governmental funds | <u>(82,118)</u> |
| Total net assets on the full accrual basis of accounting | \$ <u>16,413,756</u> |

At June 30, 2014, the DBC Fund's portion of the department-wide activities was not materially different from the DBC Fund's activity.

(2) *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.

(3) **Governmental Funds – Fund Balance** - The DBC Fund accounts for governmental fund balances in accordance with Governmental Accounting Standards Board (GASB) Statement No. 54 (GASBS 54), *Fund Balance Reporting and Governmental Fund Type Definitions*. GASBS 54's hierarchical fund balance classification structure is based primarily on the extent to which a government is bound to follow constraints on how resources can be spent. Classifications include:

- *Nonspendable fund balance* - amounts that are not in spendable form (such as inventory) or are required to be maintained intact;
- *Restricted* - amounts constrained to specific purposes by their providers (such as creditors, grantors or other governments) through constitutional provisions, or by enabling legislation;
- *Committed* - amount constrained to specific purposes by a government itself, using its highest level of decision-making authority; to be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest level of action to remove or change the constraint;
- *Assigned* - amounts a government intends to use for a specific purpose; intent can be expressed by the governing body or by an official or body to which the government delegates the authority; and
- *Unassigned* - amounts that are available for any purpose; positive amounts are reported only in the general fund.

When both restricted and unrestricted balances are available for use, it is the DBC Fund's policy to use restricted fund balance first, then unrestricted fund balance. Furthermore, committed fund balances are reduced first, followed by assigned amounts, and then unassigned amounts when expenditures are incurred for purposes for which amounts in any of those unrestricted classifications can be used.

(4) **Equity in Cash and Cash Equivalents and Investments in State Treasury** - All moneys of the DBC 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 moneys 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, 2014, 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 DBC 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.

(5) **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, 2014.

(6) **Beverage Container Deposits** - Deposits of 5¢ are made by distributors to the fund for each qualifying container. The DBC Fund maintains all deposits until the recycling centers claim reimbursement for the deposits that they pay out to the consumers. The DBC Fund maintains the deposits that are expected to be redeemed.

Amounts paid out to the 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 adjusts the deposit liability balance and unredeemed deposit revenue recognized based on the amount of deposits reimbursed to redemption centers in the first three months of the subsequent fiscal year related to deposits collected prior to year end.

(7) **Deferred Outflows/Inflows of Resources** - In addition to assets, governmental funds balance sheet will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, deferred outflows of resources, represents a consumption of net position that applies to a future period(s) and will not be recognized as an outflow of resources (expense/expenditure) until then. The DBC Fund does not have any items that qualify for reporting in this category.

In addition to liabilities, the governmental funds balance sheet will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, deferred inflows of resources, represents an acquisition of net position that applies to future period(s) and so will not be recognized as an inflow of resources (revenue) until that time. The DBC Fund has only one type of item, unavailable revenue, which arises only under the modified accrual basis of accounting that qualifies for reporting in this category. Accordingly, the item is reported only in the governmental funds balance sheet. The

amounts are deferred and recognized as an inflow of resources in the period that the amounts become available.

(8) **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 DBC Fund, since they are not practical to determine.

(9) **New Accounting Pronouncements** - Effective for the fiscal year ended June 30, 2014, the DBC Fund adopted GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. The objective of this statement is to reclassify certain assets and liabilities as deferred outflows of resources and deferred inflow of resources and recognizes certain assets and liabilities as outflows of resources or inflows of resources. The adoption of this statement did not have a material effect on the DBC Fund's financial statements.

Effective for the fiscal year ended June 30, 2014, the DBC Fund adopted GASB Statement No. 66, *Technical Corrections – 2012 – an amendment of GASB Statements No. 10 and No. 62*. The objective of this statement is to improve accounting and financial reporting for a governmental financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, and GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The adoption of this statement did not have a material effect on the DBC Fund's financial statements.

Effective for the fiscal year ended June 30, 2014, the DBC Fund adopted GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. The objective of this statement is to enhance comparability of financial statements among governments by requiring consistent reporting by those governments that extend nonexchange financial guarantees and by those governments that receive nonexchange financial guarantees. The statement also will enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees as well as augment the ability of financial statement users to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee. The adoption of this statement did not have a material effect on the DBC Fund's financial statements.

NOTE C - BUDGETING AND BUDGETARY CONTROL

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

(1) **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.

(2) **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 and will assist in determining the State's program and financial plan and budget.

(3) **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.

A budget is adopted for the DBC 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 excess of expenditures over revenues on a budgetary basis for 2014, to the change in fund balance presented in conformity with GAAP follows:

| | |
|--|---------------------|
| Excess of expenditures over revenues - actual on a budgetary basis | \$ (2,170,406) |
| Reserve for encumbrances at year end | 7,480,093 |
| Expenditures for liquidation of prior year encumbrances | (8,927,423) |
| Accruals and other adjustments | <u>6,291,440</u> |
| Change in fund balance - GAAP basis | <u>\$ 2,673,704</u> |

NOTE D - BEVERAGE CONTAINER DEPOSITS

The changes to the beverage container deposit liability during fiscal year 2014 were as follows:

| | |
|--|---------------------|
| Balance as of July 1, 2013 | \$ 1,931,621 |
| Increase: Deposits received from distributor | 46,686,419 |
| Decrease: Payments made to recycling centers, net of refunds | (36,930,958) |
| Decrease: Unredeemed deposits recognized as revenue | <u>(9,823,040)</u> |
| Balance as of June 30, 2014 | <u>\$ 1,864,042</u> |

NOTE E - EMPLOYEE BENEFIT PLANS

Substantially all eligible employees of the DBC 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, post-retirement health care 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 Hawai‘i 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 and Accounting and General Services website: <http://ags.hawaii.gov/reports/financial-reports/>. The ERS’s CAFR can be found at the ERS website: <http://ers.ehawaii.gov/resources/financials>.

NOTE F - 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, 2014, the State recorded estimated losses for workers' compensation, automobile, and general liability claims as long-term liabilities 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 DBC Fund did not have a portion of the State's workers' compensation expense for the fiscal year ended June 30, 2014.

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 DBC 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.

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Appendix A

Agency Response to Previous Recommendations

Management and Financial Audit of the Deposit Beverage Container Program, June 30, 2012

Report No. 13-08

| RECOMMENDATION | AGENCY RESPONSE |
|---|--|
| <p>1. Combine the deposit redemption reimbursement request and handling fee request to streamline the payment process by moving beyond the multi-year assessment and adopting and implementing a back-end payment system. Review and adopt administrative rules to implement a back-end payment system.</p> | <p>The Department of Health (DOH) held a series of internal meetings with Deposit Beverage Container (DBC) Program staff to evaluate how a potential back-end payment system could be implemented. The meetings revealed that the major impediment to implementing such a payment system was the duration of time it would take before the DBC Program could make reimbursements and payments to the Certified Redemption Center (CRC) operators for the deposit fees and handling fees respectively.</p> <p>Although State law provides the DBC Program 30 days to make reimbursements, many CRC operators cannot financially support operations for a period beyond 10 days. This fact was made evident by the closures of CRCs when the DBC Program took up to nine days to make payments to the CRC operator. During FY2014, CRC operators paid consumers approximately \$37 million dollars in deposit reimbursements. This is a huge financial liability for CRC operators to incur. In addition, CRC operators must also fund operating costs and the activities associated with recycling the used beverage containers.</p> <p>In a back-end payment system, CRC operators would float all of these liabilities until the used beverage containers reach their end market. CRC operators may also incur additional delays if their end users fails to provide all the necessary supporting documentation to submit a claim to the DBC Program. This process could take a month or longer. No CRC operator could float this huge monetary liability. In fact, during the CRC closures, the largest CRC operator expressed the DBC Program that they had reached their credit limit within a period of less than ten days. The current approach by the DBC Program is to continue improvements on the current system by increasing internal auditing capacity.</p> |

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| 2. Establish a systematic process for verifying the contents of reports submitted by distributors and redemption centers to mitigate the risk of fraud (underpayments by distributors and overpayments to redemption centers). | The DOH has already taken action towards a solution that will eventually provide a systematic process for verifying the contents of reports and claims submitted by distributors and CRCs respectively. Three new accounting staff positions were authorized for the Office of Solid Waste Management (OSWM) under Act 122/SLH 2014 that includes two accountants and one account clerk. The OSWM intends to utilize these positions to support an internal auditing program to verify the contents of reports and claims submitted to the DBC Program. A solicitation to procure an auditing firm to assist in the development of an audit program is currently being developed. Temporary position numbers have been assigned to these positions, however, DOH's Administrative Services Office (ASO) is requiring a reorganization of the OSWM before these positions can be filled. |
| 3. Consult with the attorney general to determine whether any action can be taken against certified redemptions centers and recyclers which had significant differences in quantity of materials shipped to end-user recyclers versus the amounts they claimed to have received from customers (such as RRR Recycling). If the attorney general agrees action can be taken, including levying fines or receiving reimbursements, the program should initiate these actions as soon as possible. | The DOH consulted with the Office of the Attorney General (OAG) to determine whether any action could be taken against CRCs and recyclers who had significant differences in the quantity of materials shipped to the end-user markets versus the amounts they claimed to have received from customers. At this time, the OAG determined there is an insufficient basis for any DBC Program action to recover any alleged overpayments due to the lack of solid evidence and provable facts regarding the differences in quantities of materials shipped by end-user recyclers versus the amount claimed to be received from customers. The lack of documentation and evidence makes it extremely difficult, if not impossible, for the DBC Program to retrieve, via legal action, the overpayments once they have been made, especially many years after the fact. |
| 4. Define program requirements for each inspection type. Define the program for inspecting redemption centers, distributors, retailers, and exempt commercial passenger vessels and related activities. Establish expectations, targets and goals for each inspection type and monitor/evaluate staff to hold them accountable for the results. The program should publish audit results to serve as a deterrent to other companies. | A DBC Program Operations Manual has been developed and is used to successfully train newly hired employees. The manual clearly defines inspection targets and goals for CRCs, retailers, and commercial passenger vessels. Inspections transitioned to an electronic paperless system utilizing electronic tablets, custom software and cloud storage. Inspectors submit all inspection reports to the OSWM Coordinator for review, comments and possible corrective actions. All completed administrative enforcement actions are forwarded to the OSWM Webmaster and the DOH Public Information Officer for website and media publication respectively. |

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| <p>5. Perform planning to define the resources and strategies required to achieve program goals and to operate efficiently and effectively. Planning should serve as the foundation for other management functions—organizing, staffing, leading, and controlling—by providing direction for the program and increasing the program’s potential for success in accomplishing its goals. This should allow management to become more proactive in its management style and avoid a crisis management style.</p> | <p>The OSWM is simultaneously defining the resources and strategies required to achieve program goals to operate efficiently and effectively as corrective actions are being taken to address the concerns derived from within the OSWM and the audits. The responses to the past audits recommendations show that there have been significant improvements to the DBC Program within a short period of twelve months since the publication of the last audit. The continued improvements to the DBC Program will eventually result in a more proactive management style.</p> |
| <p>6. Re-evaluate and update the environmental health specialist III position descriptions to ensure that minimum qualifications (skills, knowledge, abilities, and education) accurately reflect a realistic appraisal of the duties required to inspect and audit distributors and certified redemption centers on a regular, systematic basis to achieve program goals by performing the following:</p> <ul style="list-style-type: none">a. Conduct a thorough and realistic analysis of the job duties required of the environmental health specialist III (tasks, duties, and responsibilities of the inspectors and the needs of the program regarding enforcement activities);b. Identify the knowledge, experience, skills (competencies) that are useful for someone to have in performing these job duties; andc. Based on the analysis performed, prepare new positions descriptions that outline the job’s goals, responsibilities, and duties; the minimum knowledge, skills and abilities required; and reporting structure for this job. | <p>Prior to the audit, the OSWM determined that the Environmental Health Specialist (EHS) III minimum qualifications as determined by the Department of Human Resources Development (DHRD) adequately reflected a realistic appraisal of the duties required to inspect OSWM facilities. However, the OSWM realized that it was unrealistic to expect an EHS to also meet the minimum qualifications of an Accountant and possess the skills to perform an audit of distributors and CRCs. For these reasons, a conversion of one of the EHS positions to an Accountant, a request to temporarily assign an Accountant to the OSWM and the request for additional accounting positions for the OSWM were pursued by the Solid and Hazardous Waste Branch (SHWB).</p> |
| <p>7. Fill vacant positions to provide sufficient time and resources to perform inspection and enforcement responsibilities over distributors and certified redemption centers to substantiate proper transactions and to detect and prevent improper ones.</p> | <p>Filling vacant positions is a very high priority for the OSWM. The Recycling Coordinator is dedicated and performs all of the recruiting duties in the OSWM as part of her daily duties. As soon as an employee submits a resignation letter, a request to fill the vacant position is immediately submitted. Lists of qualified candidates are always processed with haste by the</p> |

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| | <p>Recycling Coordinator. Whether a potential candidate accepts an offer or stays with the OSWM for any length of time is beyond the control of the OSWM. Multiple candidates have turned down job offers in lieu of higher paying positions.</p> |
| <p>8. Review the knowledge and skills required by the program's inspectors to ensure its existing staff has the appropriate skills to inspect and audit distributors and certified redemption centers on a regular systematic basis and that program goals are accomplished. Establish and conduct training necessary to give staff skills required to inspect and audit distributors and certified redemption centers.</p> | <p>Please see the response to recommendation number six. Additionally, the OSWM has always provided the resources and training opportunities for staff through third party contractors, national conferences and non-government organizations.</p> |
| <p>9. Expedite the hiring of an accountant III to alleviate the burden that has been placed on the accountant IV. In the meantime, department administrators, such as the solid waste management coordinator and recycling coordinator, should be trained and authorized to approve and issue payments in order to ensure the program does not stop operating when the accountant IV is not at work.</p> | <p>The DOH has taken steps to alleviate the burden that has been placed on the Accountant IV by temporarily assigning a vacant Accountant III position from the Environmental Resources Office to the OSWM. On January 26, 2014 the OSWM filled this position at the Accountant I level. The training of the Accountant I to achieve the level of an Accountant II has taken longer than expected and will likely take another year to get this individual up to a supportive (Accountant III) level. In addition, three new accounting positions were authorized under Act 122/SLH 2014 that included two accountants and one account clerk. These additional accounting positions will also alleviate the burden on the Accountant IV. The OSWM is awaiting approval from the Human Resources Office to fill these positions.</p> |
| <p>10. Perform an industry study, including an examination of what handling fee rates for various recycled materials should be to determine what changes can be implemented to balance the business interests of the entities involved in the recycling process with the fiscal feasibility of the DBC Fund. The study should also consider market costs for the shipping and processing of recycled materials as well as the value of end product recycled materials.</p> | <p>The OSWM will work on drafting a request for proposals (RFP) to hire a contractor to perform a industry study after the newly hired Planner is trained and has successfully implemented the segregated rate study. The industry study will take into consideration market costs for shipping and processing of recycled materials in addition to the value of the end product recycled materials.</p> |
| <p>11. Implement controls to identify uncertified redemption centers and ensure deposit redemption reimbursements and handling fee requestes are paid only to redemption</p> | <p>The DBC Program pays deposit redemption reimbursements and handling fee request to only CRCs. Several controls including the issuance of annual contracts, tracking of expiration of certifications</p> |

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| center operators for beverage containers redeemed at certified redemption centers. | and the inspection of each CRC's posted certification signs are controls that assure payments are only made to CRCs. |
| 12. Regularly evaluate the segregated rates used to convert the weight of deposit beverage containers redeemed into container equivalents to ensure rates approximate hand counts.. | The OSWM is cognizant that the segregated rate should be updated on a regular basis. However, the Planner IV position that is responsible for the evaluation and update of the segregated rates has been vacant since July 5, 2013. In addition, this position has been chronically vacant. Multiple candidates selected by OSWM for this position have declined acceptance in lieu of higher paying positions. However, after six rounds of interviews, a Planner was selected and is anticipated to start on January 20, 2015. Regardless of this vacancy, the OSWM is developing a draft RFP to conduct a segregated rate study that includes the development of a sampling plan. Finalizing, soliciting and implementing this RFP will be the highest priority for the newly hired Planner. |
| 13. Ensure that significant estimates such as the deposit beverage container liability and unredeemed deposits revenue are regularly reviewed, including retrospective reviews to determine if previous estimates were accurate or require adjustment. | The DBC liability and unredeemed deposit revenue is reviewed and reconciled by the DBC Program three months after the close of each fiscal year therefore, no adjustments would be necessary. The DBC Program requires the additional three months beyond the end of the fiscal year because the deposit liability balance and unredeemed deposit revenue recognized is based on the amount of deposits reimbursed to CRCs in the first three months of the subsequent fiscal year related to deposits collected in the prior fiscal year. |

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Response of the Affected Agency

Comments on Agency Responses

We transmitted a draft of this report to the Department of Health on April 2, 2015. A copy of the transmittal letter is included as Attachment 1. The department's response dated April 8, 2015, and received on April 9, 2015, is included as Attachment 2.

The department concurred with many of our findings. However, it felt that two statements represented "incomplete findings," namely, that the program does not pay a shrinkage rate above 2.5 percent and the program reimburses no more than 5¢ per container, but redemption centers may choose to reimburse consumers more than that. The department also expressed concern with the layout of our report, claiming that certain formatting effects could be misleading and create confusion. Based on the department's comments, we made edits for clarity and style but we stand by our findings and conclusions. We did not change our report layout, which reflects our standard style.

Regarding our recommendation to adopt a back-end payment system to address risks associated with continued reliance on redemption centers' self-reported numbers, the department disagreed such a system will shift risk away from the State and asserted that it should no longer be considered a viable solution. The department did not, however, offer another solution to address the risk. We implore the department to develop an alternative plan to address systemic flaws in the deposit and redemption process as soon as possible. Until such a solution is implemented, the DBC Program will continue to be under significant risk of fraud and abuse.

The department concurred with our recommendations regarding developing a risk-based process to select distributors and redemption centers for audit and to report and follow up on such audits.

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



JAN K. YAMANE
Acting State Auditor

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

April 2, 2015

COPY

The Honorable Virginia Pressler, M.D.
Director
Department of Health
1250 Punchbowl Street
Honolulu, Hawaii 96813

Dear Dr. Pressler:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014*. We ask that you telephone us by Monday, April 6, 2015, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit your hard copy response to our office no later than Thursday, April 9, 2015.

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,

A handwritten signature in cursive script, appearing to read "Jan K. Yamane".

Jan K. Yamane
Acting State Auditor

Enclosures

DAVID Y. IGE
GOVERNOR OF HAWAII



VIRGINIA PRESSLER, M.D.
DIRECTOR OF HEALTH

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

In reply, please refer to:
File:

April 8, 2015

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Jan K. Yamane
Office of the Auditor
State of Hawaii
465 South King Street, Suite 500
Honolulu, HI 96813

Dear Ms. Yamane:

Attached are the Department of Health's comments for the Audit of the Deposit Beverage Container Program.

We appreciate the opportunity to comment on the audit report.

Sincerely,

A handwritten signature in blue ink that reads "Virginia Pressler".

VIRGINIA PRESSLER, M.D.
Director of Health

Attachment

SUBJECT: 2014 AUDIT OF THE DEPARTMENT OF HEALTH'S DEPOSIT BEVERAGE CONTAINER PROGRAM

We appreciate the opportunity to comment on the subject report as we continue to work on strengthening Hawaii's recycling efforts. The Deposit Beverage Container Program (Program) essentially concurs with many of the findings in the report. However, we found several statements in this report that are incomplete findings. Our concern is that, without a full description, these statements portray an incomplete picture of the program's adequacy of internal controls and compliance with applicable laws.

Prior to stating our specific comments to address the auditor's concerns, we would like to offer the following observation and examples of incomplete findings:

- The Department of Health (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 audit report states on page 13 that, "...shrinkage rates that ranged from as little as 1 percent to as much as 18 percent-well above the programs established 2.5 percent rate." Regardless of the shrinkage rate for any recycler, the Program **does not** pay a rate above 2.5 percent.
- The audit also states on page 14 that, "...we found that one redemption center paid refunds of 6 cents per aluminum can versus the 5 cents rate set by Hawaii law." State law specifies that the consumers must be reimbursed a redemption value of no less than 5 cents. Individual centers have the freedom to offer the consumer a higher redemption value but the Program is restricted and reimburses a redemption center **no more** than 5 cents per container as determined by law.

The Program recognizes it will continue to operate at greater risk to fraud until an internal auditing program is implemented. The Department has taken steps towards the implementation of an internal auditing program by requesting and obtaining authorization to add three additional accounting positions from the 2014 legislature (Act 122) to support this function. However, due to insufficient staff positions, turnover, and the inability to recruit, the Program has been hampered in its desire to establish a systematic audit procedure.

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

Recommendation No. 1

Combine the deposit redemption reimbursement request and handling fee request to streamline the payment process by moving beyond the multi-year assessment and adopting and implementing a back-end payment system. Review and adopt administrative rules to implement a back-end payment system.

The Program disagrees with the audit that a back-end payment system will shift risk away from the Department. In fact, implementation of a back-end payment system will result in the closure of all the Certified Redemption Centers (CRCs) Statewide and would require the Program to solicit and contract recycling companies to operate CRCs thereby further increasing risk, uncertainties, costs, and liabilities to the Program.

In response to the 2005 Program Audit, the Program prematurely suggested a back-end payment system without fully understanding the financial and operational constraints of such a system. The back-end payment system should no longer be considered as a viable solution to resolve some of the deficiencies associated with CRCs' claims. Please refer to Appendix A in the audit describing the insurmountable issues that would result from the implementation of a back-end system.

Recommendation No. 2

Develop a risk-based process to select distributors and redemption centers to audit. The program should consider a variety of risk factors, including the amount of money transacted, prior audit findings, and the frequency of distributor's or redemption's prior audits.

The Program concurs with the recommendation that a risk-based process is required to select distributors and redemption centers to audit. A solicitation is currently being prepared by the Program to contract an auditing firm to develop a systematic audit program. The audit program will take into consideration and address risk factors, prior audit findings, and the frequency of distributor and certified redemption center audits. The implementation of the audit program is contingent upon the successful completion of the contract, retention of staff and the establishment and recruitment of three new accounting positions that were authorized under Act 122/SLH 2014.

Recommendation No. 3

Report results of distributor and redemption center audits annually and conduct follow-up audits, as necessary.

The Program concurs that the results of distributor and redemption center audits should be published annually. In addition, the Program recognizes that follow-up audits, corrective and enforcement actions are necessary to resolve deficiencies, improve compliance, and alleviate public concerns. These actions are contingent on the Program's successful implementation of a systematic internal auditing program.