

Financial statements and report of independent certified public accountants

**Department of Human Services, State of Hawaii**

Year ended June 30, 2004

June 22, 2005

Ms. Lillian Koller, Director  
Department of Human Services  
State of Hawaii

Dear Ms. Koller:

This is our report on the financial audit of the Department of Human Services of the State of Hawaii (DHS) as of and for the year ended June 30, 2004. Our audit was performed in accordance with the terms of our contract with the State of Hawaii and with the requirements of the U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

### **OBJECTIVES OF THE AUDIT**

The primary purpose of our audit was to form an opinion on the fairness of the presentation of the DHS's basic financial statements as of and for the year ended June 30, 2004, and to comply with the requirements of OMB Circular A-133. More specifically, the objectives of the audit were as follows:

1. To provide a basis for an opinion on the fairness of the presentation of the DHS's basic financial statements.
2. To determine whether expenditures and other disbursements have been made and all revenues and other receipts to which the DHS is entitled have been collected and accounted for in accordance with the laws, rules and regulations, and policies and procedures of the State of Hawaii and the federal government.
3. To determine whether the DHS has established sufficient controls to properly manage federal financial assistance programs and to comply with the applicable laws and regulations.
4. To determine whether the DHS has complied with the laws and regulations that may have a material effect on the basic financial statements and on its major federal financial assistance programs.

### **SCOPE OF THE AUDIT**

Our audit was performed in accordance with auditing standards generally accepted in the United States of America as prescribed by the American Institute of Certified Public Accountants; *Government Auditing Standards*, issued by the Comptroller General of the United States; and the provisions of OMB Circular A-133. The scope of our audit included an examination of the transactions and accounting records of the DHS for the fiscal year ended June 30, 2004.

Ms. Lillian Koller  
Department of Human Services  
State of Hawaii  
June 22, 2005

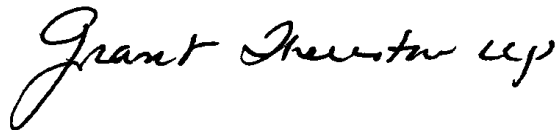
## **ORGANIZATION OF THE REPORT**

This report is presented in six parts as follows:

- Part I – The basic financial statements and related notes of the DHS as of and for the year ended June 30, 2004, and our opinion on the basic financial statements.
- Part II – Our report on internal control over financial reporting and on compliance and other matters.
- Part III – Our report on compliance with requirements applicable to each major program and internal control over compliance.
- Part IV – Schedule of findings and questioned costs.
- Part V – The summary schedule of prior audit findings.
- Part VI – Response of the affected agency.

We wish to express our sincere appreciation for the excellent cooperation and assistance extended by the officers and staff of the DHS.

Very truly yours,

A handwritten signature in black ink that reads "Grant Stewart" followed by a stylized flourish.

Department of Human Services  
State of Hawaii

TABLE OF CONTENTS

	Page
<b>PART I FINANCIAL SECTION</b>	
Report of Independent Certified Public Accountants	7
Management’s Discussion and Analysis	9
Basic Financial Statements	
Government-wide Financial Statements	
Statement of Deficit in Net Assets	20
Statement of Activities	21
Fund Financial Statements	
Balance Sheet – Governmental Funds	22
Reconciliation of the Governmental Funds Balance Sheet to the Statement of Deficit in Net Assets	23
Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds	24
Reconciliation of the Change in Fund Balances of Governmental Funds to the Statement of Activities	25
Statement of Revenues and Expenditures – Budget and Actual – General Fund	26
Statement of Revenues and Expenditures – Budget and Actual – Special Revenue Funds	27
Statement of Assets and Liabilities – Agency Funds	28
Notes to Financial Statements	29
Supplementary Information	
Schedule of Expenditures of Federal Awards	43

Department of Human Services  
State of Hawaii

TABLE OF CONTENTS

	Page
<b>PART II AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS</b>	
Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	47
<b>PART III AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE</b>	
Report on Compliance with Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance with OMB Circular A-133	50
<b>PART IV SCHEDULE OF FINDINGS AND QUESTIONED COSTS</b>	53
<b>PART V SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS</b>	
Status Report	64
<b>PART VI RESPONSE OF THE AFFECTED AGENCY</b>	
Response of the Department of Human Services	72

**PART I**  
**FINANCIAL SECTION**

Report of Independent Certified Public Accountants

To the Director  
Department of Human Services  
State of Hawaii

We have audited the accompanying financial statements of the governmental activities and of each major fund of the Department of Human Services, State of Hawaii (DHS), as of and for the fiscal year ended June 30, 2004, which collectively comprise the DHS's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the DHS's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the DHS's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note A, the financial statements of the DHS are intended to present the financial position and the changes in financial position, where applicable, of only that portion of the governmental activities and of each major fund of the State of Hawaii that is attributable to the transactions of the DHS. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2004, and the changes in its financial position, where applicable, for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and of each major fund, of the DHS, as of June 30, 2004, and the respective changes in financial position, where applicable, thereof and the respective budgetary comparison for the general and special revenue funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.

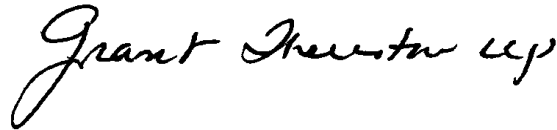
In accordance with *Governmental Auditing Standards*, we have also issued our report dated April 14, 2005, on our consideration of the DHS's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report

To the Director  
Department of Human Services  
State of Hawaii

is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Governmental Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 9 through 19 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the DHS's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

A handwritten signature in black ink, reading "Grant Stewart" followed by a stylized flourish.

Honolulu, Hawaii  
April 14, 2005



Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS  
(UNAUDITED)

June 30, 2004

This discussion and analysis of the financial performance of the Department of Human Services (DHS) provides an overview of the financial activities of the DHS for the year ended June 30, 2004. The intent of this discussion is to allow management to provide an objective and easily readable analysis of the financial activities of the DHS based on currently known facts, decisions, or conditions. Readers are encouraged to consider the information presented here in conjunction with the basic financial statements and other supplementary information.

### **OVERVIEW OF THE FINANCIAL STATEMENTS**

This MD&A serves as an introduction to the basic financial statements of the DHS. The basic financial statements are comprised of three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the basic financial statements.

#### ***Government-wide Financial Statements***

The government-wide financial statements provide a broad overview of the finances of the DHS using the economic resources measurement focus and accrual basis of accounting, in a manner similar to private-sector businesses. It provides both long-term and short-term information about the overall financial status of the DHS.

The statement of net assets includes all of the assets and liabilities of the DHS, with the difference between the two reported as net assets. This statement is similar to that of the balance sheet of a private-sector business. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the DHS is improving or deteriorating. This statement also provides information on how services were financed in the short-term as well as what remains for future spending.

The statement of activities presents information showing how net assets changed during the year. All changes in net assets are reported using the accrual method of accounting, similar to the method used by most private-sector businesses. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are reported when the goods or services are received, regardless of the timing of the related cash flows. The activities of the DHS are principally supported by appropriations made available by the State Legislature and intergovernmental revenues from the federal government (governmental activities). The DHS does not recover any portion of its costs through user fees or charges for services (business-type activities).

#### ***Fund Financial Statements***

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objects. The DHS uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the DHS are divided between either governmental funds or fiduciary funds. Governmental funds are used to account for most, if not all, of a government entity's tax-supported activities. Fiduciary funds are used to account for resources that are held by a government entity as a trustee or agent for parties outside of the government entity. The resources of fiduciary funds cannot be used to support the government entity's own programs.

Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

The fund financial statements of the DHS include the following types of funds:

**Governmental funds** – Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike government-wide financial statements, governmental fund financial statements focus on current sources and uses of spendable resources and balances of spendable resources available at the end of the year. Such information may be useful in evaluating a government entity's near-term financing requirements. By comparing the governmental fund and government-wide financial statements, readers may better understand the long-term impact of the entity's near-term financial decisions. In order to facilitate a comparison between the governmental fund and government-wide financial statements, a reconciliation between the two is provided following each governmental fund financial statement.

**Fiduciary funds** – The fiduciary funds of the DHS consists of agency funds which are clearing accounts for assets held by the DHS in its role as custodian until the funds are allocated to the individuals, private organizations, or government agencies to which they belong. These activities are excluded from the government-wide financial statements of the DHS because the DHS cannot use these assets to finance its operations.

***Notes to the Basic Financial Statements***

The notes to the basic financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

**FINANCIAL ANALYSIS OF THE GOVERNMENT-WIDE FINANCIAL STATEMENTS**

The following table presents a condensed government-wide statement of net assets of the DHS as of June 30, 2004 and 2003.

**Condensed Statement of Net Assets**

	2004	2003
Current assets	\$133,766,280	\$106,803,875
Capital assets, net	33,135,378	34,879,443
Total assets	\$166,901,658	\$141,683,318
Current liabilities	\$182,518,548	\$151,342,478
Non-current liabilities	9,683,051	10,518,424
Total liabilities	\$192,201,599	\$161,860,902
Net assets		
Invested in capital assets	\$ 33,135,378	\$ 34,879,443
Restricted	1,081,855	1,353,823
Unrestricted deficit	(59,517,174)	(56,410,850)
Total net assets	\$ (25,299,941)	\$ (20,177,584)

As noted earlier, an analysis of net assets over time may be a useful indicator of whether a government entity's financial condition is growing stronger or weakening. During the year ended June 30, 2004, the combined net assets of the DHS decreased by approximately \$5.1 million.

The deficit in unrestricted net assets of the DHS was approximately \$59.5 million as of June 30, 2004. This deficit in unrestricted net assets is principally the result of liabilities for program services that were incurred as of June 30, 2004, for which state allotments are not yet available. The largest liability as of June 30, 2004, is the estimated amount of medical assistance service provided as of June 30, 2004, for which the related claims will be processed and paid subsequently. Of the estimated \$157.7 million of medical assistance payable, the state share of these costs is approximately \$64.8 million. The estimated federal share of these claims to be paid in the future was recorded as intergovernmental revenues in the current year and is included in the balance due from other governments. In addition to the estimated medical assistance payable, the liability for compensated absences totaling \$14.7 million as of June 30, 2004, is not funded by state allotments until the employee uses the earned leave or is paid out upon termination. Therefore, there are no assets currently available to the DHS to pay for these liabilities as of June 30, 2004.

Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

The DHS reported a total of approximately \$33.1 million in net assets invested in capital assets as of June 30, 2004. Although the DHS is not the legal owner of the state buildings that are reported as part of its capital assets, the portion of the state facilities used by the DHS are required to be reported as part of its capital assets. The DHS uses these capital assets to provide services; consequently, these assets are not available for future spending and the related annual depreciation expense of the cost of these facilities is included in the statement of activities for the year ended June 30, 2004.

The changes in the net assets of the DHS from governmental activities are summarized below. The DHS directs its resources towards assisting people to meet their basic needs for food, shelter, medical care and other essentials for daily living. As such, the DHS does not conduct business-type activities and the accompanying analysis of the changes in net assets focuses on the cost of services and who provides the funds to pay for the costs.

**Changes in Net Assets**

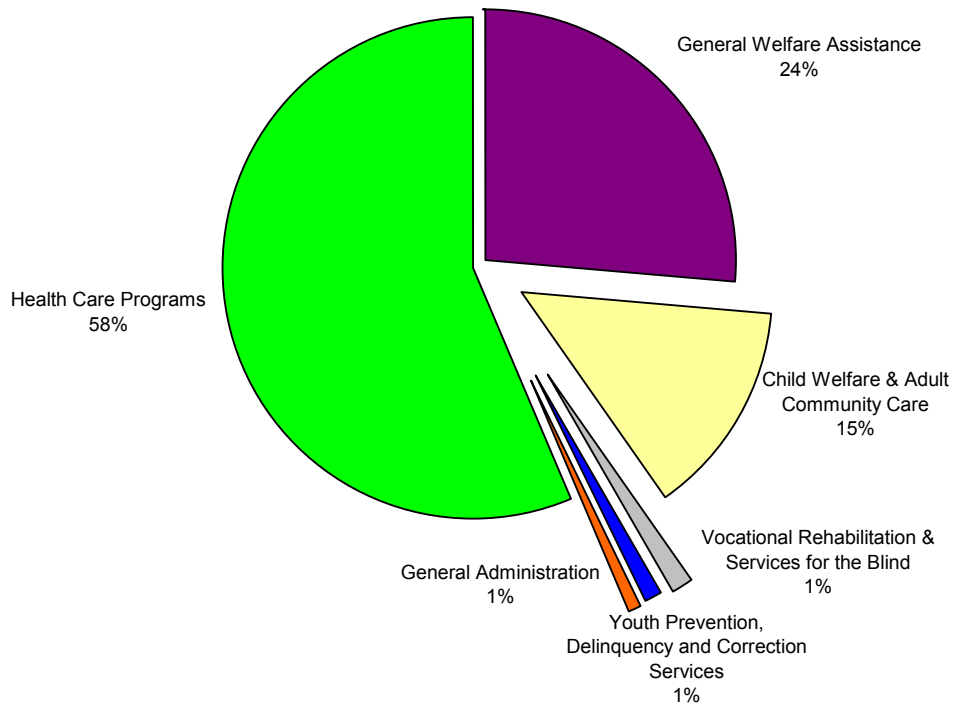
	2004	2003	Percent Change
Revenues			
Program revenues	\$ 942,785,134	\$ 852,668,727	10.57 %
General revenues	611,752,571	587,788,962	4.08 %
Total revenues	1,554,537,705	1,440,457,689	7.92 %
Expenses			
Health care programs	908,437,758	823,251,712	10.35 %
General welfare assistance, employment and support services	366,433,649	383,779,653	(4.52) %
Child welfare and adult community care services	239,097,877	201,368,793	18.74 %
Vocational rehabilitation and services for the blind	20,496,545	21,842,224	(6.16) %
Youth prevention, delinquency and correction services	15,785,973	15,516,562	1.74 %
General administration	9,408,260	10,608,855	(11.32)%
Total expenses	1,559,660,062	1,456,367,799	7.09 %
Change in net assets	\$ (5,122,357)	\$ (15,910,110)	(67.80)%

Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

The total cost of all programs and services was approximately \$1.56 billion, a 7.09 % increase from the prior year. Health care and general welfare assistance programs comprised 58 % and 24 %, respectively, of the total costs. The following chart presents each major activity as a percent of the total cost of all DHS activities:



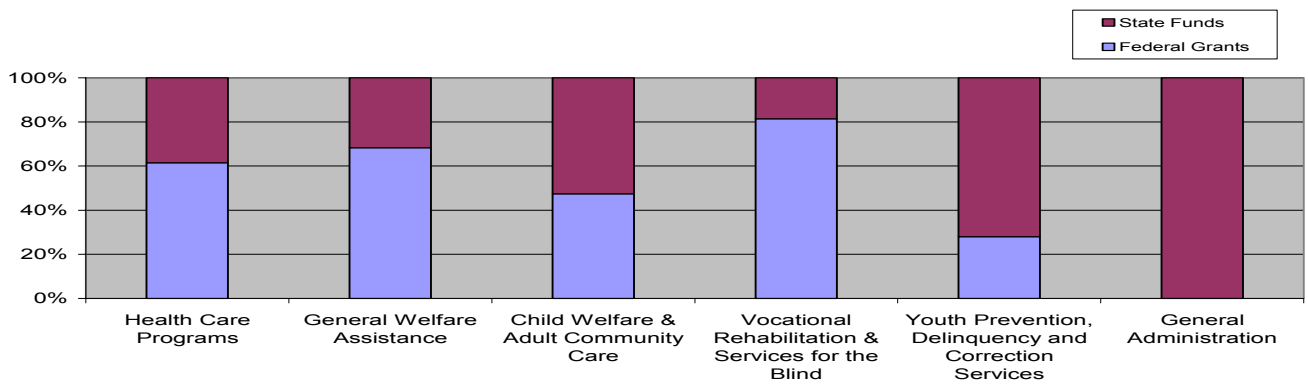
Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

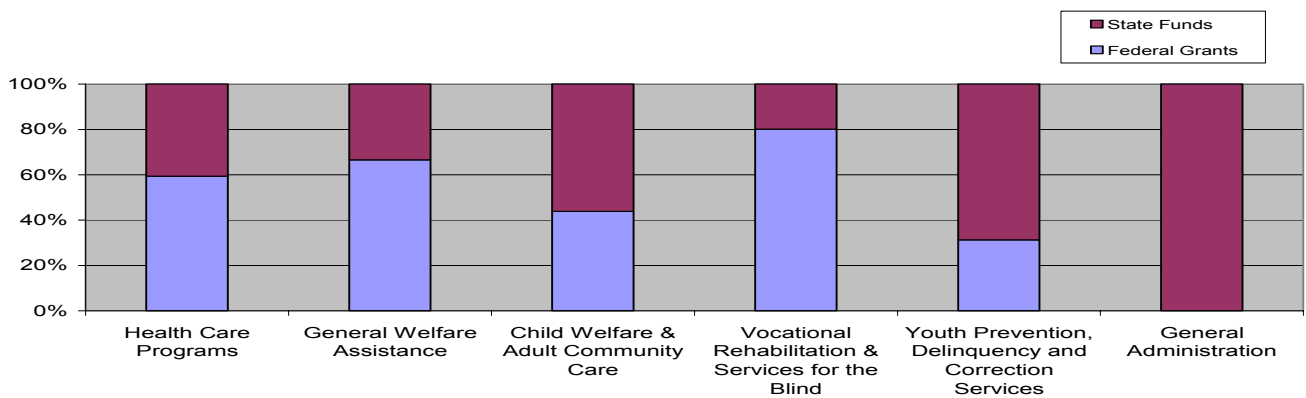
June 30, 2004

Program revenues consist primarily of operating grants from the federal government. Revenues from these federal grants paid for 60.5 % of the cost of all the DHS's activities. The following chart presents the percentage of costs funded by federal grants for each major activity of the DHS for the years ended June 30, 2004 and 2003:

Year 2004:



Year 2003:



Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

**FINANCIAL ANALYSIS OF THE FUND FINANCIAL STATEMENTS**

As noted earlier, the DHS uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The DHS has two governmental fund types; the general fund and special revenue funds. The general fund is used to account for all financial resources except those required to be accounted for in another fund. The special revenue funds are used to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes. In general, operating grants the DHS receives from the federal government are accounted for in the special revenue funds and all allotments of state funds are accounted for in the general fund along with any other resources available to the DHS that are not accounted for in the special revenue funds.

Total expenditures reported on a modified accrual basis increased by \$106.8 million over the prior year. This increase is primarily related to health care program costs administered by the DHS which have increased by approximately \$85.8 million or 10.44 %. In addition, child welfare and adult community care program costs increased by \$39.3 million or 19.63 %. The increased expenditures in these programs are principally due to rising medical and administrative costs and not an increase in recipients.

At June 30, 2004, the total governmental fund balance of the DHS consisted of a deficit in unreserved fund balance of approximately \$104.2 million. The deficit in the unreserved fund balance of the general fund totaling \$60.4 million is principally comprised of liabilities for program services that were incurred as of June 30, 2004, for which state allotments were not yet available. The deficit in the unreserved fund balance of the special revenue fund totaling \$43.8 million is principally the result of the encumbrances that were not liabilities as of June 30, 2004 and, therefore, the related intergovernmental revenues were not recorded.

Reservations of governmental fund balances for encumbrances totaled approximately \$60.5 million at June 30, 2004. Reservations of governmental fund balances indicate the amount of resources that are not available for new spending because it has been reserved to liquidate purchase and contractual commitments.

The following table presents total revenues and expenditures of the governmental funds of the DHS for the years ended June 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>	<u>Percent Change</u>
Revenues			
State allotted appropriations	\$ 596,464,254	\$ 572,829,783	4.13%
Intergovernmental revenues	942,785,134	852,668,727	10.57%
Non-imposed employee fringe benefits	<u>15,288,317</u>	<u>14,959,179</u>	2.20%
	<u>\$1,554,537,705</u>	<u>\$1,440,457,689</u>	7.92%

Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

	2004	2003	Percent Change
Expenditures			
Health care programs	\$ 908,069,420	\$ 822,243,397	10.44%
General welfare assistance, employment and support services	366,475,313	382,570,031	(4.21)%
Child welfare and adult community care services	239,290,609	200,019,683	19.63%
Vocational rehabilitation and services for the blind	20,612,326	21,462,592	(3.96)%
Youth prevention, delinquency and correction services	15,223,966	15,955,720	(4.59)%
General administration	9,371,736	10,035,507	(6.61)%
	\$1,559,043,370	\$1,452,286,930	7.35%

**BUDGETARY ANALYSIS**

As required by Section 37-68, Hawaii Revised Statutes, the DHS prepares a budget that becomes legally adopted when the State Legislature approves the executive budget with the enactment of an appropriations act. A comparison and analysis of the general fund is presented below as additional financial information:

	Original Budget	Final Budget	Actual on Budgetary Basis	Variance Favorable (Unfavorable)
Health care programs	\$355,930,986	\$352,005,728	\$347,981,720	\$4,024,008
General welfare assistance, employment and support services	118,664,196	111,564,196	110,076,643	1,487,553
Child welfare and adult community care services	110,624,234	117,928,352	116,864,659	1,063,693
Vocational rehabilitation and services for the blind	4,365,138	4,365,138	3,857,248	507,890
Youth prevention, delinquency and correction services	10,855,994	10,931,894	10,252,279	679,615
General administration	8,050,754	8,050,754	8,042,405	8,349
	\$608,491,302	\$604,846,062	\$597,074,954	\$7,771,108

The change from the original to the final budgeted allotments for health care programs was due to a reduction in appropriation of \$3,521,140 for the Medicaid Program. Other differences between the original and final budget were due to intrafund transfers communicated through executive memorandums.



Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

Actual expenditures for the health care programs and general welfare assistance, employment and support services were approximately \$4 million and \$1.5 million, respectively, less than the additional amounts budgeted for the anticipated increase in health care costs. Also, expenditures on a budgetary basis do not include accrued claims expense for these health care programs that are outstanding at year end. Thus, the amounts expended in comparison to the amounts budgeted appear favorable.

**CAPITAL ASSETS**

As of June 30, 2004 and 2003, the cost basis of capital assets, net of accumulated depreciation, used by the DHS are presented in the table below. Approximately \$800,000 of capital assets were added in the year ended June 30, 2004. Annual depreciation totaling approximately \$2.2 million decreased the net cost basis during the year ended June 30, 2004.

**Capital Assets, Net of Depreciation**

	<u>2004</u>	<u>2003</u>
State office buildings and improvements	\$18,866,969	\$19,696,171
Buildings and improvements for the Office of Youth Services	<u>12,340,401</u>	<u>12,921,849</u>
Total buildings and improvements	31,207,370	32,618,020
Furniture, equipment and vehicles	1,928,002	2,261,417
Nondepreciable land	<u>6</u>	<u>6</u>
Total	<u>\$33,135,378</u>	<u>\$34,879,443</u>

In addition to the capital assets listed above, the DHS leases numerous office facilities from third-party lessors under operating lease arrangements. Those leases for additional space beyond the state facilities listed above as buildings and improvements are necessary to provide program services throughout the State.

**ECONOMIC FACTORS**

The DHS has three primary types of welfare assistance programs: (1) financial assistance in the form of cash benefits; (2) food stamp assistance that is also delivered in the form of cash benefits; and (3) medical assistance in the form of Medicaid fee-for-service coverage or managed care medical coverage under the Quest program. Individuals, couples and families may be eligible for one or all of these forms of assistance. However, eligibility for one program does not automatically make an individual/family eligible for other programs. The DHS tracks eligible individuals, couples or families as a single case (caseload).

Three and one-half years after the events of September 11, 2001, individuals receiving financial assistance in Hawaii continued to decline from 65,444 individuals in September 2001 to 38,613 individuals in March 2005 or a decrease of 26,831 individuals or 41%. Much of this decline is due to the five-year limit on financial assistance benefits beginning

Department of Human Services  
State of Hawaii

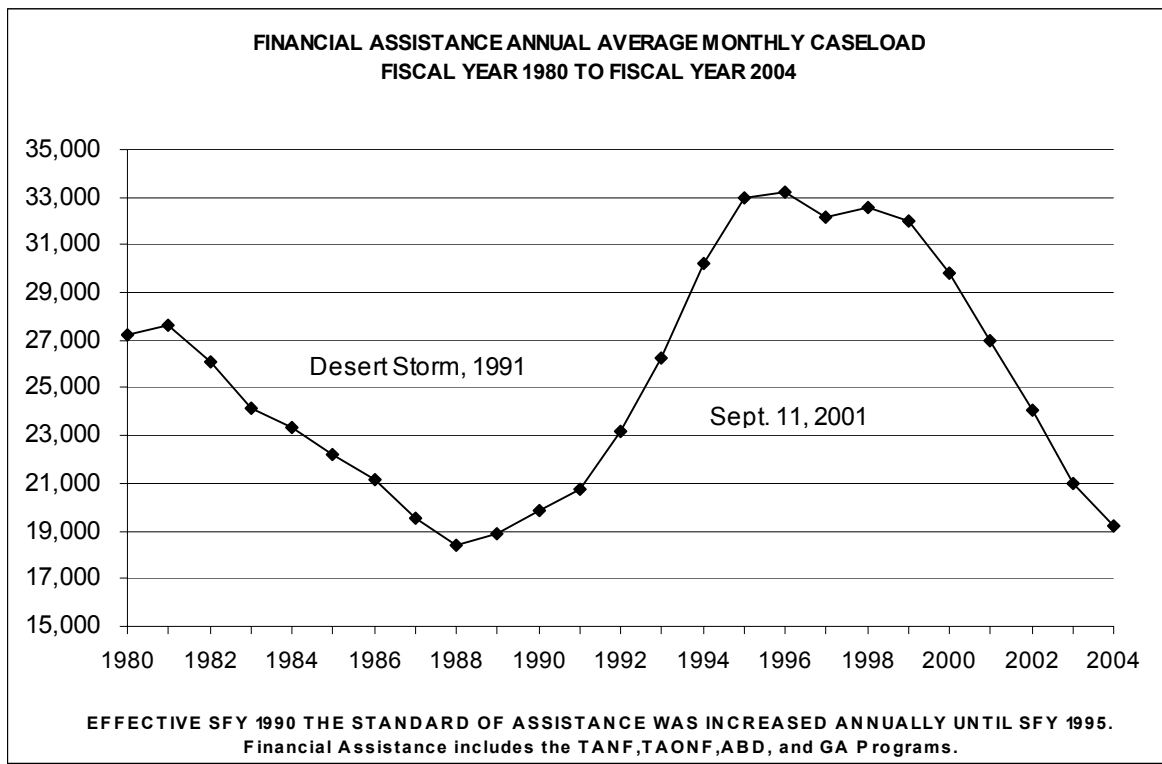
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004

in December 2001 as part of Hawaii's Welfare Reform Program (starting in December 1996) but a large part of it can be attributed to the State's improving economic condition.

The number of individuals in Hawaii receiving Food Stamp benefits also declined since September 11, 2001 from 105,990 individuals in September 2001 to 95,181 individuals in March 2005. This is a decrease of 10,809 individuals or 10.2%. Part of this decline is due to the decrease in the number of individuals receiving financial assistance but part of it may also be attributed to the improving job market in Hawaii.

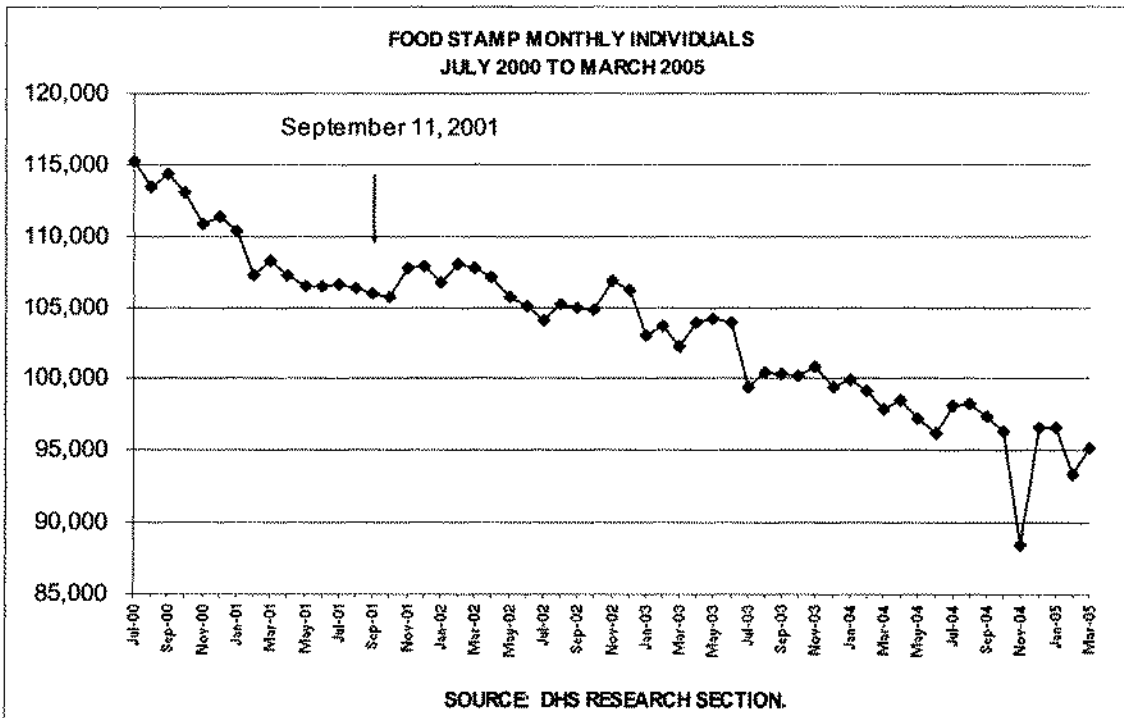
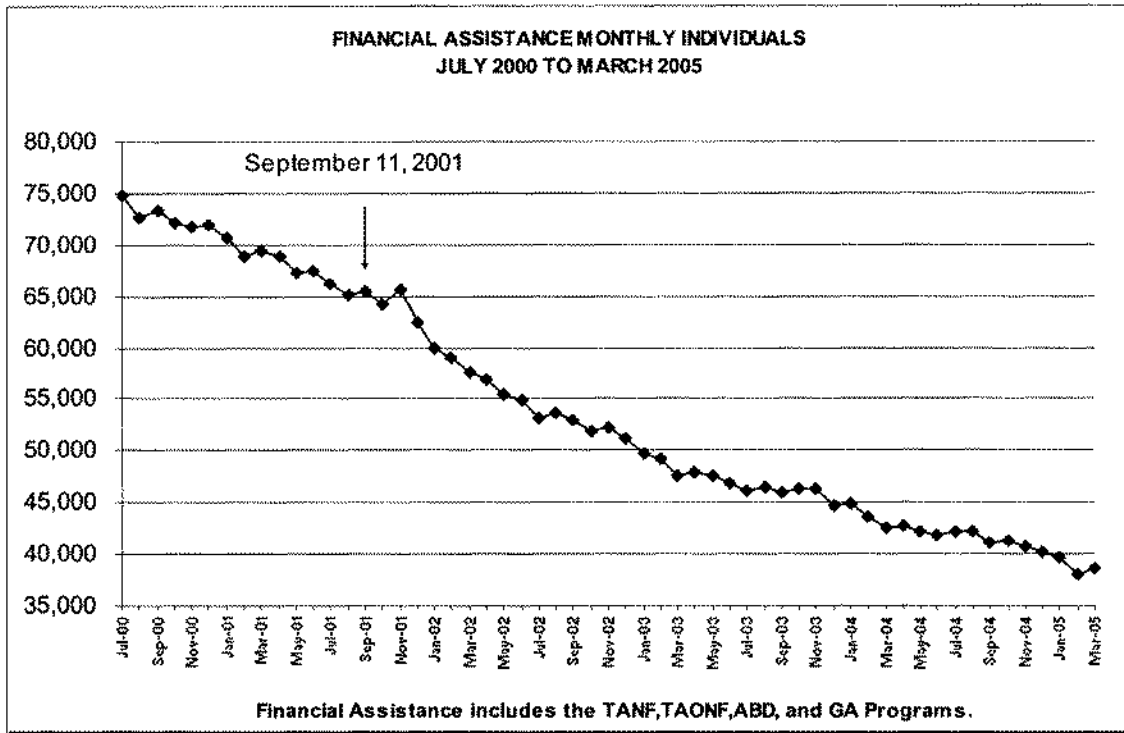
The following charts provide a trend analysis of currently known facts and conditions:



Department of Human Services  
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)  
(UNAUDITED)

June 30, 2004



Department of Human Services  
State of Hawaii

STATEMENT OF DEFICIT IN NET ASSETS

June 30, 2004

ASSETS	<u>Governmental Activities</u>
<b>CURRENT ASSETS</b>	
Cash	\$ 52,091,063
Receivables	3,358,094
Due from other governments	<u>78,317,123</u>
Total current assets	133,766,280
CAPITAL ASSETS, net of accumulated depreciation	<u>33,135,378</u>
Total assets	<u><u>\$ 166,901,658</u></u>
<b>LIABILITIES AND DEFICIT IN NET ASSETS</b>	
<b>CURRENT LIABILITIES</b>	
Vouchers payable	\$ 8,905,273
Accrued wages and employee benefits payable	6,090,266
Due to State of Hawaii	4,815,009
Accrued medical assistance payable	157,700,000
Accrued compensated absences	<u>5,008,000</u>
Total current liabilities	182,518,548
ACCRUED COMPENSATED ABSENCES, less current portion	<u>9,683,051</u>
Total liabilities	192,201,599
<b>DEFICIT IN NET ASSETS</b>	
Invested in capital assets, net of related debt	33,135,378
Restricted	1,081,855
Unrestricted deficit	<u>(59,517,174)</u>
Total deficit in net assets	<u>(25,299,941)</u>
Total liabilities and deficit in net assets	<u><u>\$ 166,901,658</u></u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

STATEMENT OF ACTIVITIES

Year ended June 30, 2004

Functions/Programs	Expenses	Program revenues			Net Expense and Changes in Deficit in Net Assets
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities
Governmental activities:					
Health care programs	\$ 908,437,758	\$ -	\$ 558,593,985	\$ -	\$ (349,843,773)
General welfare assistance, employment and support services	366,433,649	-	250,294,823	-	(116,138,826)
Child welfare and adult community care services	239,097,877	-	112,825,838	-	(126,272,039)
Vocational rehabilitation and services for the blind	20,496,545	-	16,813,992	-	(3,682,553)
Youth prevention, delinquency and correction services	15,785,973	-	4,256,496	-	(11,529,477)
General administration	9,408,260	-	-	-	(9,408,260)
Total	<u>\$ 1,559,660,062</u>	<u>\$ -</u>	<u>\$ 942,785,134</u>	<u>\$ -</u>	(616,874,928)
General revenues:					
State allotments					596,464,254
State-provided payroll fringe benefits					<u>15,288,317</u>
Total general revenues					<u>611,752,571</u>
CHANGE IN NET ASSETS					(5,122,357)
Deficit in net assets at July 1, 2003					<u>(20,177,584)</u>
Deficit in net assets at June 30, 2004					<u>\$ (25,299,941)</u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2004

ASSETS	General	Special Revenue	Total
Cash	\$ 28,228,017	\$ 23,863,046	\$ 52,091,063
Receivables	2,252,184	1,105,910	3,358,094
Due from other funds	2,266,310	-	2,266,310
Due from other governments	-	78,317,123	78,317,123
	<hr/>	<hr/>	<hr/>
Total assets	<u>\$ 32,746,511</u>	<u>\$103,286,079</u>	<u>\$136,032,590</u>
LIABILITIES AND FUND BALANCES			
LIABILITIES			
Vouchers payable	\$ 4,574,642	\$ 4,330,631	\$ 8,905,273
Accrued wages and employee benefits payable	3,612,374	2,477,892	6,090,266
Due to other funds	-	2,266,310	2,266,310
Due to State of Hawaii	4,585,618	229,391	4,815,009
Accrued medical assistance payable	64,800,000	92,900,000	157,700,000
	<hr/>	<hr/>	<hr/>
Total liabilities	77,572,634	102,204,224	179,776,858
FUND BALANCES			
Reserved for encumbrances	15,596,430	44,862,989	60,459,419
Unreserved	(60,422,553)	(43,781,134)	(104,203,687)
	<hr/>	<hr/>	<hr/>
Total fund balances (deficit)	(44,826,123)	1,081,855	(43,744,268)
	<hr/>	<hr/>	<hr/>
Total liabilities and fund balances	<u>\$ 32,746,511</u>	<u>\$103,286,079</u>	<u>\$136,032,590</u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

RECONCILIATION OF THE GOVERNMENTAL FUNDS BALANCE SHEET  
TO THE STATEMENT OF DEFICIT IN NET ASSETS

June 30, 2004

Total deficit in fund balances - governmental funds			\$ (43,744,268)
Amounts reported for governmental activities in the statement of net assets are different because:			
Capital assets used in governmental activities are not financial resources and therefore are not reported in the governmental funds.			
Governmental capital assets	\$	50,952,304	
Less accumulated depreciation		<u>(17,816,926)</u>	33,135,378
Accrued compensated absences liability is not due in the current period and therefore is not reported in the governmental funds			<u>(14,691,051)</u>
Deficit in net assets of governmental activities			<u>\$ (25,299,941)</u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN  
FUND BALANCES - GOVERNMENTAL FUNDS

Year ended June 30, 2004

	General	Special Revenue	Total
Revenues			
State allotted appropriations	\$ 596,464,254	\$ -	\$ 596,464,254
Intergovernmental revenues	-	942,785,134	942,785,134
Non-imposed employee fringe benefits	15,288,317	-	15,288,317
	611,752,571	942,785,134	1,554,537,705
Expenditures			
Health care programs	349,777,552	558,291,868	908,069,420
General welfare assistance, employment and support services	116,180,490	250,294,823	366,475,313
Child welfare and adult community care services	125,869,405	113,421,204	239,290,609
Vocational rehabilitation and services for the blind	3,819,615	16,792,711	20,612,326
Youth prevention, delinquency and correction services	10,967,470	4,256,496	15,223,966
General administration	9,371,736	-	9,371,736
	615,986,268	943,057,102	1,559,043,370
NET CHANGE IN FUND BALANCES	(4,233,697)	(271,968)	(4,505,665)
Fund balances (deficit) at July 1, 2003	(40,592,426)	1,353,823	(39,238,603)
Fund balances (deficit) at June 30, 2004	\$ (44,826,123)	\$ 1,081,855	\$ (43,744,268)

The accompanying notes are an integral part of this statement.



Department of Human Services  
State of Hawaii

RECONCILIATION OF THE CHANGE IN FUND BALANCES OF  
GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES

Year ended June 30, 2004

Net change in fund balances - total governmental funds		\$ (4,505,665)
Amounts reported for governmental activities in the statement of activities are different because:		
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets are depreciated over their estimated useful lives.		
Expenditures for capital assets	\$ 817,552	
Less current year depreciation and other changes	<u>(2,561,616)</u>	(1,744,064)
Change in long-term compensated absences reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds.		<u>1,127,372</u>
Change in net assets of governmental activities		<u>\$ (5,122,357)</u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

STATEMENT OF REVENUES AND EXPENDITURES -  
BUDGET AND ACTUAL - GENERAL FUND

Year ended June 30, 2004

	<u>Original</u>	<u>Final</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Revenues				
State allotments	\$608,491,302	\$604,846,062	\$597,774,399	\$ (7,071,663)
Expenditures				
Health care programs	355,930,986	352,005,728	347,981,720	4,024,008
General welfare assistance, employment and support services	118,664,196	111,564,196	110,076,643	1,487,553
Child welfare and adult community care services	110,624,234	117,928,352	116,864,659	1,063,693
Vocational rehabilitation and services for the blind	4,365,138	4,365,138	3,857,248	507,890
Youth prevention, delinquency and correction services	10,855,994	10,931,894	10,252,279	679,615
General administration	8,050,754	8,050,754	8,042,405	8,349
	<u>608,491,302</u>	<u>604,846,062</u>	<u>597,074,954</u>	<u>7,771,108</u>
 EXCESS OF REVENUES OVER EXPENDITURES	 <u>\$ -</u>	 <u>\$ -</u>	 <u>\$ 699,445</u>	 <u>\$ 699,445</u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

STATEMENT OF REVENUES AND EXPENDITURES -  
BUDGET AND ACTUAL - SPECIAL REVENUE FUNDS

Year ended June 30, 2004

	Original	Final	Actual on Budgetary Basis	Variance Favorable (Unfavorable)
Revenues				
Intergovernmental revenues	\$844,604,025	\$844,604,025	\$771,707,345	\$ (72,896,680)
Expenditures				
Health care programs	558,761,290	558,761,290	552,467,321	6,293,969
General welfare assistance, employment and support services	146,050,062	146,050,062	103,233,958	42,816,104
Child welfare and adult community care services	112,865,150	112,865,150	106,456,146	6,409,004
Vocational rehabilitation and services for the blind	18,290,198	18,290,198	16,592,892	1,697,306
Youth prevention, delinquency and correction services	7,248,986	7,248,986	4,680,887	2,568,099
General administration	1,388,339	1,388,339	1,387,097	1,242
	844,604,025	844,604,025	784,818,301	59,785,724
EXCESS OF REVENUES UNDER EXPENDITURES	\$ -	\$ -	\$ (13,110,956)	\$ (13,110,956)

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

STATEMENT OF ASSETS AND LIABILITIES - AGENCY FUNDS

June 30, 2004

ASSETS

Cash	\$ 1,148,546
Total assets	<u>\$ 1,148,546</u>

LIABILITIES

Due to individuals	\$ 800,699
Due to others	<u>347,847</u>
Total liabilities	<u>\$ 1,148,546</u>

The accompanying notes are an integral part of this statement.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS

June 30, 2004

**NOTE A – FINANCIAL REPORTING ENTITY**

The Hawaii State Government Reorganization Act of 1959 (Act 1, Second Special Session Laws of Hawaii 1959) created the Department of Social Services and Housing. In 1987, the name was changed to the Department of Human Services (DHS). The DHS administers programs that are designed to improve the social well being and productivity of the people of the State of Hawaii (State).

The DHS is part of the executive branch of the State. The DHS's basic financial statements reflect only its portion of the fund type categories. The State Comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually, which includes the DHS's financial activities.

The accompanying basic financial statements reflect the financial position and results of operations of the following activities of the DHS:

**Health Care Programs:** The activities of the Med-Quest division of the DHS include the Medical Assistance Program, which is designed to provide payments for medical services to eligible individuals and families. Services are provided through the Fee-for-Service Medicaid Program or through the managed care QUEST Program. Its operations are reported in the general, special revenue, and agency funds.

**General Welfare Assistance, Employment and Support Services:** The activities of the Benefit, Employment and Support Services division of the DHS provide economic support, employment, training, and educational services to welfare recipients; and child care services and opportunities for early childhood education to preserve and strengthen eligible families and to enable them to achieve personal and economic self-sufficiency. Its operations are reported in the general, special revenue, and agency funds.

**Child Welfare and Adult Community Care Services:** The activities of the Social Services division of the DHS include child welfare services and adult care services under the Social Security Act. In addition, the activities related to the medical waivers programs are included in this functional activity. Its operations are reported in the general and special revenue funds.

**Vocational Rehabilitation and Services for the Blind:** The activities of the Vocational Rehabilitation and Services for the Blind division of the DHS provide for the rehabilitation needs of those disabled persons who cannot meet their vocational needs without assistance. The goal of those services, which are provided to mentally, physically and visually handicapped individuals, is to assist recipients toward employment and the enjoyment of full and independent lives. Its operations are reported in the general, special revenue, and agency funds.

**Youth Prevention, Delinquency and Correction Services:** The activities of the Office of Youth Services of the DHS include developing and administering programs for preventing, rehabilitating and treating juvenile delinquency in the State. Its operations are reported in the general, special revenue, and agency funds.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE A – FINANCIAL REPORTING ENTITY (continued)**

**General Administration:** General administration includes management, accounting, data processing and other administrative services provided to the DHS. Those operations are reported in the general and special revenue funds.

**NOTE B – SIGNIFICANT ACCOUNTING POLICIES**

1. Basis of Presentation

The government-wide financial statements report all assets, liabilities, and activities of the DHS as a whole. The fiduciary funds are excluded from the government-wide financial statements because the DHS cannot use those assets to finance its operations.

The financial transactions of the DHS are recorded in individual funds that are reported in the fund financial statements and are described in the following sections. Each fund is considered a separate accounting entity. The operations of each are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues, and expenditures.

The fund financial statements focus on major funds rather than reporting funds by type. Each major fund is reported in separate columns and non-major funds are combined in one column. Major funds are funds which have total assets, liabilities, revenues or expenditures of the fund that are at least ten percent of the same element for all funds of its fund type or at least five percent of the same element for all governmental funds combined.

a. Governmental Fund Types

General Fund – The general fund is the general operating fund of the DHS. It is used to account for all financial activities except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted.

Special Revenue Funds – Special revenue funds are used to account for the proceeds of specific revenue sources that are legally or contractually restricted to expenditures for specified purposes.

b. Fiduciary Fund Type

Agency Funds – Agency funds are used to account for assets held by the DHS on behalf of outside parties, including other governments, or on behalf of individuals.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE B – SIGNIFICANT ACCOUNTING POLICIES (continued)**

2. Measurement Focus and Basis of Accounting

a. Government-wide Financial Statements

The economic resources measurement focus and accrual basis of accounting are used for reporting the government-wide financial statements. With this measurement focus, all assets and liabilities associated with the operations of the DHS are included on the statement of net assets, except those related to the agency funds. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are recorded at the time liabilities are incurred. Revenue from grants is recognized when all eligibility requirements have been satisfied.

b. Governmental Funds

All governmental funds are accounted for using a current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized in the accounting period when they become both measurable and available. Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after fiscal year end (60 days) to liquidate liabilities existing at the end of the fiscal year. Revenues susceptible to accrual include federal grants and funds appropriated by the State Legislature and allotted by the Governor. Expenditures are generally recorded when the related fund liabilities are incurred.

c. Agency Funds

Agency funds are used to account for resources held by the DHS as an agent for individuals, private organizations or government agencies. Agency funds are custodial in nature (i.e., assets equal liabilities) and do not involve measurement of results of operations.

3. Use of Estimates

The preparation of basic financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

4. Receivables

Receivables in the general and special revenue funds consist primarily of amounts due from recipients of welfare benefit overpayments. The amounts reported as net receivables were established based on management's estimate of amounts collectible.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE B – SIGNIFICANT ACCOUNTING POLICIES (continued)**

5. Capital Assets

Capital assets include land, improvements to land, buildings, building improvements, vehicles, machinery, equipment, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.

When capital assets are purchased, they are capitalized and depreciated using the straight-line method over their estimated useful lives in the government-wide financial statements. Capital asset purchases are recorded as expenditures of the period purchased in the governmental fund financial statements.

Capital assets are valued at cost where historical records are available and at estimated historical cost where no records exist. Donated capital assets are valued at their estimated fair value on the date received.

Improvements to capital assets that materially add to the value or extend the life of the assets are capitalized. Other repairs and normal maintenance are not capitalized. Major outlays for capital assets and improvements are capitalized as projects are constructed.

The State has adopted the following capitalization policy:

<u>Asset type</u>	<u>Minimum capitalization amount</u>	<u>Estimated useful life</u>
Land	All	Not applicable
Land improvements	\$100,000	15 years
Buildings and improvements	\$100,000	30 years
Furniture and equipment	\$5,000	7 years
Motor vehicles	\$5,000	5 years

6. Accumulated Vacation

Employees are credited with vacation at the rate of 96 to 192 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year end and is convertible to pay upon termination of employment. Such accumulated vacation has been accrued and reflected in the statement of net assets.

7. Due to Individuals

Due to individuals represents assets held by the DHS primarily in an agent capacity and is available to individuals receiving benefits under various programs primarily through the Electronic Benefits Transfer System.



Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE B – SIGNIFICANT ACCOUNTING POLICIES (continued)**

8. Appropriations

Appropriations represent the authorizations granted by the State Legislature that permit a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year.

9. Operating Grants and Contributions

Federal grants and assistance awards are recorded as intergovernmental receivables and revenues when all eligibility requirements have been satisfied.

10. Intrafund and Interfund Transactions

Significant transfers of financial resources between activities included within the same fund are offset within that fund.

11. Risk Management

The DHS is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if information indicates that it is probable that a liability has been incurred at the date of the basic financial statements and the amount of the loss is reasonably estimable.

**NOTE C – BUDGETING AND BUDGETARY CONTROL**

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues and budgeted expenditures in the budgetary comparison schedules of the general and special revenue funds are derived primarily from acts of the State Legislature and from other authorizations contained in other specific appropriation acts in various Session Laws of Hawaii.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations such as those related to the special revenue funds.

For purposes of budgeting, the DHS's budgetary fund structure and accounting principles differ from those utilized to present the fund financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP). The DHS's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to (1) the encumbrance of purchase orders and contract

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE C – BUDGETING AND BUDGETARY CONTROL (continued)**

obligations, (2) the recognition of certain receivables, and (3) special revenue funds operating grant accruals and deferrals. These differences represent a departure from GAAP.

The following schedule reconciles the budgetary amounts to the amounts presented in accordance with GAAP for the year ended June 30, 2004.

	General	Special Revenue
Excess of revenues over (under) expenditures and other uses – actual on a budgetary basis	\$ 699,445	\$(13,110,956)
Reserved for encumbrances at year end	15,596,430	44,862,989
Expenditures for liquidation of prior year encumbrances	(10,756,671)	(23,093,755)
Net change in unreserved liabilities	1,758,893	(10,601,069)
Net change in accrued medical assistance payable	(10,100,000)	(14,000,000)
Accruals related to federal reimbursements for program expenditures	–	(1,423,605)
Net change in other receivables	(1,431,794)	(608,290)
Difference for revenues recognized for GAAP purposes	–	17,702,718
Excess of revenues under expenditures and other uses – GAAP basis	\$ (4,233,697)	\$ (271,968)

**NOTE D – CASH**

The State Director of Finance is responsible for safekeeping of all monies paid into the State Treasury (cash pool). The Hawaii Revised Statutes authorize the State Director of Finance to invest in obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions. Cash and deposits with financial institutions are collateralized in accordance with state statutes. 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.

The DHS also maintains cash in banks which are held separately from cash in the State Treasury. As of June 30, 2004, the carrying amount of total bank deposits was approximately \$980,000 and the corresponding bank balances which are represented were approximately \$1,431,000.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE E - RECEIVABLES**

Receivables of the DHS, net of an allowance for doubtful accounts, consisted of the following at June 30, 2004:

	General	Special Revenue
Welfare benefit overpayments	\$18,785,950	\$23,210,050
QUEST premiums receivable	3,000,000	-
Social Security interim assistance loans	1,207,000	-
CSEA receivable	30,094	-
	23,023,044	23,210,050
Less allowance for doubtful accounts:		
Welfare benefit overpayments	17,891,860	22,104,140
QUEST premiums receivable	2,879,000	-
	20,770,860	22,104,140
Receivables – net	\$ 2,252,184	\$ 1,105,910

**NOTE F – CAPITAL ASSETS**

The changes in capital assets were as follows:

	Governmental Activities					Balance June 30, 2004
	Balance July 1, 2003	Additions	Disposals	Net Transfers	Other	
Depreciable assets						
Buildings and improvements	\$43,376,384	\$ -	\$ -	\$ -	\$ -	\$43,376,384
Furniture and equipment	5,420,891	811,803	430,036	(23,327)	(36,751)	5,742,580
Vehicles	2,043,608	5,749	10,289	(119,404)	(86,330)	1,833,334
Nondepreciable assets						
Land	6	-	-	-	-	6
Total at historical cost	50,840,889	817,552	440,325	(142,731)	(123,081)	50,952,304
Less accumulated depreciation for:						
Buildings and improvements	10,758,364	1,446,542	-	-	(35,892)	12,169,014
Furniture and equipment	3,480,230	606,984	289,459	(13,068)	129,930	3,914,617
Vehicles	1,722,852	113,578	10,289	(26,106)	(66,740)	1,733,295
Total accumulated depreciation	15,961,446	2,167,104	299,748	(39,174)	27,298	17,816,926
Total capital assets – net	\$34,879,443	\$ (1,349,552)	\$140,577	\$(103,557)	\$(150,379)	\$33,135,378

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE F – CAPITAL ASSETS (continued)**

Depreciation expense was charged to functions as follows:

	Governmental Activities
Health care programs	\$ 710,953
General welfare assistance, employment and support services	472,126
Child welfare and adult community care services	183,598
Vocational rehabilitation and services for the blind	88,714
Youth prevention, delinquency and correction services	656,529
General administration	55,184
	\$2,167,104

**NOTE G – LONG-TERM LIABILITY**

The only long-term liability of the DHS for governmental activities is for accrued compensated absences. The change in the long-term liability during the fiscal year ended June 30, 2004 was as follows:

	Amount
Balance at July 1, 2003	\$15,818,424
Additions	5,591,735
Reductions	(6,719,108)
Balance at June 30, 2004	\$14,691,051

The portion of the accrued compensated absences liability due within one year is estimated at \$5,008,000. The compensated absences liability has been paid primarily by the general fund in the past.

**NOTE H – NON-IMPOSED EMPLOYEE FRINGE BENEFITS**

Payroll fringe benefit costs of the DHS's employees that are funded by state appropriations (general fund) are assumed by the State and are not charged to the DHS's operating funds. These costs, totaling approximately \$15,288,000 for the fiscal year ended June 30, 2004 have been reported as revenues and expenditures in the general fund of the DHS.

Payroll fringe benefit costs related to federally-funded salaries are not assumed by the State and are recorded as expenditures in the special revenue funds of the DHS.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE I – FUND BALANCE DEFICITS**

The general and special revenue funds of the DHS have deficits in the unreserved fund balances at June 30, 2004 aggregating to \$60,422,553 and \$43,781,134, respectively. The general fund deficit resulted primarily from expenditures being recorded when incurred, and revenues being recognized only when corresponding funds are measurable and available. The special revenue fund deficit is because the encumbrances at June 30, 2004 were not liabilities and therefore the related revenues were not recorded.

**NOTE J – LEASE COMMITMENTS**

The DHS leases various office facilities on a long term basis under various operating leases expiring through 2022. Certain leases include renewal and escalation clauses. The DHS' general fund share of lease costs is paid from the State General Fund. The federal share of these lease costs allocable to programs is reported in the special revenue funds of the DHS. The following is a schedule of the federal share of minimum future rentals on noncancelable operating leases at June 30, 2004:

Year ending June 30,	Amount
2005	\$ 712,000
2006	513,000
2007	463,000
2008	444,000
2009	304,000
Thereafter	<u>2,243,000</u>
	<u>\$4,679,000</u>

The DHS' federal share of rent expense associated with operating leases for the year ended June 30, 2004 was approximately \$971,357 and is included in the accompanying financial statements.

**NOTE K – RETIREMENT BENEFITS**

1. Employees' Retirement System

Plan Description

All eligible employees of the State are required by Chapter 88 of the Hawaii Revised Statutes to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS issues a publicly available comprehensive annual financial report that includes financial statements and required supplementary information for ERS. That report may be obtained by writing to the ERS, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE K – RETIREMENT BENEFITS (continued)**

1. Employees' Retirement System (continued)

Plan Description (continued)

The ERS consists of a contributory plan and a noncontributory plan. Employees covered by Social Security on June 30, 1984 were given the option of joining the noncontributory plan or remaining in the contributory plan. All new employees hired after June 30, 1984, who are covered by Social Security, are generally required to join the noncontributory plan. Both plans provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the payment of salary in lieu of vacation, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after this date is based on the three highest paid years of service excluding the payment of salary in lieu of vacation. Vesting requirements for the contributory and noncontributory plans are five years and ten years, respectively. All contributions, benefits and eligibility requirements are governed by Chapter 88.

Funding Policy

Most covered employees of the contributory plan are required to contribute 7.8% of their salary. Police officers, firefighters, investigators of the department of the prosecuting attorney and the attorney general, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2% of their salary. The actuarial cost or funding method used to calculate the total employer contribution required is the entry age normal actuarial cost method. Under this method, the total employer contributions to the ERS is comprised of normal cost plus level annual payments required to amortize the unfunded actuarial accrued liability over the closed period ending June 30, 2029.

The contribution requirement for all employers as of June 30, 2004, 2003, and 2002 were approximately \$236 million (100% contributed), \$191 million (100% contributed), and \$167 million (100% contributed), respectively.

2. Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to all employees hired prior to July 1, 1996 who retire from State employment on or after attaining age 62 with at least ten years of service or age 55 with at least thirty years of service under the noncontributory plan and age 55 with at least five years of service under the contributory plan. Retirees credited with at least ten years of service excluding sick leave credit qualify for free medical insurance premiums; however, retirees with less than ten years must assume a portion of the monthly premiums. All service-connected disability retirees who retired after June 30, 1984, with less than ten years of service also qualify for free medical insurance premiums. Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive a reimbursement of a portion of the basic medical coverage premiums.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE K – RETIREMENT BENEFITS (continued)**

2. Post-Retirement Health Care and Life Insurance Benefits (continued)

For employees hired after July 1, 1996 and retire with fewer than twenty-five years of service, the State shall pay to a fund a monthly contribution equal to one-half of the retired employee's monthly Medicare or non-Medicare premium for certain medical benefits for retired employees with ten or more years of service; and seventy-five percent of the retired employee's monthly Medicare or non-Medicare premium for retired employees with at least fifteen but fewer than twenty-five years of service.

For active employees, the employer's contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued.

3. Cost of Retirement Benefits

The DHS's general fund share of the expense for pension benefits for the year ended June 30, 2004 are paid from the State General Fund and approximate \$4,426,000. The DHS's federal share of the pension benefits expense for the year ended June 30, 2004 was approximately \$2,288,800. The contribution rate for the year ended June 30, 2004 was 9.14%.

The DHS's general fund share of the expense for post-retirement benefits for the year ended June 30, 2004 is paid from the State General Fund and approximates \$3,589,700. The DHS's federal share of the post-retirement benefits expense for the year ended June 30, 2004 was approximately \$1,856,300.

The DHS's general and federal share of pension and post-retirement benefit expenses are included in the accompanying financial statements.

4. Deferred Compensation Plan

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all State employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but does have the duty of due care that would be required of an ordinary prudent investor. Accordingly, the assets and liabilities of the State's deferred compensation plan are not reported in the State's or DHS's basic financial statements.

Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE L – RISK MANAGEMENT**

The DHS is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; and workers' compensation. The State generally is at risk for the first \$250,000 per occurrence of property and crime losses and the first \$4 million with respect to general liability claims. Losses in excess of these retention amounts are insured with commercial insurance carriers. The limit per occurrence for property losses is as follows: \$100 million for named hurricane, \$50 million for terrorism, and \$25 million for flood and earthquake. The annual aggregate for general liability and crime losses per occurrence is \$10 million.

The State is generally self-insured for workers' compensation and automobile claims. The State's estimated reserve for losses and loss adjustment costs include the accumulation of estimates for losses and claims reported prior to fiscal year end, estimates (based on projections of historical developments) of claims incurred but not reported, and estimates of costs for investigating and adjusting all incurred and unadjusted claims. Amounts reported are subject to the impact of future changes in economic and social conditions. The State believes that, given the inherent variability in any such estimates, the reserves are within a reasonable and acceptable range of adequacy. Reserves are continually monitored and reviewed, and as settlements are made and reserves adjusted, the differences are reported in current operations. A liability for a claim is established if information indicates that it is probable that a liability has been incurred at the date of the basic financial statements and the amount of the loss is reasonably estimable.

**NOTE M – COMMITMENTS AND CONTINGENCIES**

1. Accumulated Sick Leave

Employees hired on or before July 1, 2001 earn sick leave credits at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn sick leave credits at the rate of one and one-quarter or one and three-quarters working days for each month of service, depending upon the employee's years of service and job classification. Sick leave credits may be accumulated without limit, but can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a public employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2004, amounted to approximately \$40,715,000.

2. Medicaid Program

In June 2000, the U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Services (CMS), informed the DHS of its preliminary conclusion that the State's nursing facility tax program resulted in a disallowance of approximately \$17,750,950 of federal financial participation in the Medical Assistance Program for the period from July 1, 1993 through June 30, 1997. The CMS concluded that state income tax credits made available to private pay patients were associated with nursing facility taxes assessed and collected by the State and violated Section 1903(w)(4)(A) and (C) of the Social Security Act and 42 CFR Part 433.68(f), which specifies that a hold harmless provision exists when a state imposing the tax provides for a payment to taxpayers and the amount of such payment is positively correlated either to the amount of such tax or the difference between the amount of the tax and the amount of payment under the state plan.



Department of Human Services  
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2004

**NOTE M – COMMITMENTS AND CONTINGENCIES (continued)**

2. Medicaid Program (continued)

In January 2001, the CMS reached a final decision and issued a notice of disallowance in the amount of \$17,750,950. The CMS instructed the DHS to reduce future federal financial participation awards by the amount of disallowance. The DHS appealed the final decision of the Regional Administrator with the Department Appeals Board under 45 CFR Part 16. If the final administrative decision upholds the disallowance, the amount of the disallowance plus interest will be offset against a subsequent grant award since the DHS elected to retain the disputed funds during the appeals process. As of April 14, 2005, the contingency remains pending and the final outcome cannot be determined at this time.

In the normal course of operating the Medical Assistance Program, the DHS reimburses providers of medical services to Medicaid recipients under a Prospective Payment System (PPS). Under PPS, standard costs and rates are negotiated between the DHS and the State's Medicaid providers in advance. PPS allows providers to file for standard cost and rate adjustments up to five years subsequent to the rendering of those services. The amount of future adjustments, if any, to be made for services provided through June 30, 2004, cannot be determined at this time. Any adjustments would be funded from future appropriations.

The DHS is also subject to liabilities arising from charges for medical services provided to Medicaid recipients.

3. Litigation

The DHS is a party to various legal proceedings, most of which normally occur in governmental operations. The DHS and its counsel are unable to express opinions as to the outcome of the litigation. It has been the State's historical practice that certain types of judgments and settlements against an agency of the State are paid from the State General Fund through an appropriation bill which is submitted annually by the Department of the Attorney General to the legislature. However, it is not known if this practice will continue or whether the legislature will adjust, either directly or indirectly, the DHS's budget in light of a settlement or judgment against the DHS.

SUPPLEMENTARY INFORMATION

Department of Human Services  
State of Hawaii

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year ended June 30, 2004

Federal grantor/pass-through grantor and program title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures <sup>1</sup>	Amount provided to subrecipient
<b>U.S. Department of Health and Human Services</b>				
Promoting Safe and Stable Families	93.556		\$ 2,291,205	\$ -
Temporary Assistance for Needy Families (TANF)	93.558		60,697,483	-
Low-Income Home Energy Assistance	93.568		2,026,417	80,018
Child Care and Development Block Grant	93.575		17,568,812	-
Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.596		4,946,087	-
Head Start	93.600		129,228	-
Adoption Incentive Payments	93.603		208,000	-
Children's Justice Grants to States	93.643		222,576	-
Child Welfare Services - State Grants	93.645		722,287	-
Foster Care - Title IV-E	93.658		20,323,195	-
Adoption Assistance (Title IV-E)	93.659		8,445,551	-
Social Services Block Grant	93.667		13,796,024	1,877,243
Child Abuse and Neglect State Grants	93.669		105,367	-
Family Violence Prevention and Services/Grants for Battered Women's Shelters - Grants to States and Indian Tribes	93.671		901,871	-
Chafee Foster Care Independence Program	93.674		611,629	-
State Children's Insurance Program (SCHIP)	93.767		9,244,745	-
State Survey and Certification of Health Care Providers and Suppliers	93.777		417,055	-
Medical Assistance Program (Medicaid; Title XIX)	93.778		580,114,387	-
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations (CMS Research)	93.779		440,542	-
Pass-through Judiciary State Court Improvement Program	93.586	G9801HISCIP	25,939	25,939
Pass-through State Department of Labor and Industrial Relations Refugee and Entrant Assistance - State Administered Programs	93.566		36,995	-
<b>Total U.S. Department of Health and Human Services</b>			<b>723,275,395</b>	<b>1,983,200</b>
<b>U.S. Department of Agriculture</b>				
Food Stamps <sup>2</sup>	10.551		153,375,071	-
State Administrative Matching Grants for Food Stamp Program	10.561		10,229,801	-
<b>Total U.S. Department of Agriculture</b>			<b>\$163,604,872</b>	<b>\$ -</b>

Department of Human Services  
State of Hawaii

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (continued)

Year ended June 30, 2004

Federal grantor/pass-through grantor and program title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures <sup>1</sup>	Amount provided to subrecipient
<b>U.S. Department of Justice</b>				
Juvenile Accountability Incentive Block Grants (JABG)	16.523		\$ 1,794,175	\$ 1,740,693
Juvenile Justice and Delinquency Prevention - Allocation to States (State Formula Grants)	16.540		609,459	531,363
Title V - Delinquency Prevention Program	16.548		78,369	78,369
Part E - State Challenge Activities (Challenge Grants)	16.549		29,120	22,369
Byrne Formula Grant Program	16.579		195,967	-
Enforcing Underage Drinking Laws Program	16.727		107,220	98,661
<b>Total U.S. Department of Justice</b>			2,814,310	2,471,455
<b>U.S. Department of Labor</b>				
Employment Programs for People with Disabilities	17.720		160,467	160,467
Pass-through State Department of Labor and Industrial Relations Senior Community Service Employment Program	17.235	PY02-SCSEP-CC-DHS	279,971	-
Work Incentive Grant	17.266	WI-13249-03-60	30,945	-
<b>Total U.S. Department of Labor</b>			471,383	160,467
<b>U.S. Department of Education</b>				
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126		9,668,601	842,389
Rehabilitation Services - Service Projects	84.128		15,291	-
Rehabilitation Long - Term Training	84.129		113,345	-
Independent Living - State Grants	84.169		280,836	226,018
Rehabilitation Services - Independent Living Services for Older Individuals Who are Blind	84.177		214,314	62,880
Supported Employment Services for Individuals with Severe Disabilities (Supported Employment State Grants)	84.187		440,108	310,400
Assistive Technology	84.224		337,885	337,885
Projects with Industry (PWI)	84.234		161,802	-
Rehabilitation Training - State Vocational Rehabilitation Unit In-Service Training	84.265		26,029	-
Pass-through State Office of Children and Youth Safe and Drug-Free Schools and Communities - State Grants (Title IV, Part A, Subpart 1 of ESEA)	84.186	S186B010012 S186B020012	73,130 223,768	62,731 220,476
<b>Total U.S. Department of Education</b>			\$ 11,555,109	\$ 2,062,779

Department of Human Services  
State of Hawaii

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (continued)

Year ended June 30, 2004

Federal grantor/pass-through grantor and program title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures <sup>1</sup>	Amount provided to subrecipient
<b>Corporation for National and Community Service</b>				
Foster Grandparent Program	94.011		\$ 473,563	\$ -
Senior Companion Program	94.016		408,748	-
<b>Total Corporation for National and Community Service</b>			882,311	-
<b>Social Security Administration</b>				
Social Security - Disability Insurance (DI)	96.001		4,811,143	-
<b>Total Social Security Administration</b>			4,811,143	-
<b>TOTAL FEDERAL EXPENDITURES</b>			<b>\$907,414,523</b>	<b>\$ 6,677,901</b>

<sup>1</sup>The accompanying schedule of expenditures of federal awards is prepared on the cash basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

<sup>2</sup>Expenditures represent assistance utilized through the Electronic Benefits Transfer System.

**PART II**

**AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL  
REPORTING AND ON COMPLIANCE AND OTHER MATTERS**

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

To the Director  
Department of Human Services  
State of Hawaii

We have audited the financial statements of the Department of Human Services, State of Hawaii (DHS) as of and for the year ended June 30, 2004, and have issued our report thereon dated April 14, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### **Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the DHS's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Accordingly, we express no such opinion. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the DHS's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 04-01 and 04-2.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

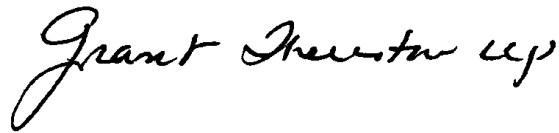
To the Director  
Department of Human Services  
State of Hawaii

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the DHS's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of the laws, regulations, contracts, and grant agreements including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we have reported to management of DHS in a separate letter dated April 14, 2005.

This report is intended solely for the information and use of the Director, management, federal awarding agencies and pass-through entities and it not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Grant Stewart" followed by a stylized flourish.

Honolulu, Hawaii  
April 14, 2005



**PART III**

**AUDITORS' REPORT ON COMPLIANCE  
WITH REQUIREMENTS APPLICABLE TO EACH MAJOR  
PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE**

Report on Compliance with Requirements Applicable to each  
Major Program and on Internal Control over Compliance in Accordance  
with OMB Circular A-133

To the Director  
Department of Human Services  
State of Hawaii

**Compliance**

We have audited the compliance of the Department of Human Services, State of Hawaii (DHS) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2004. The DHS's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the DHS's management. Our responsibility is to express an opinion on the DHS's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the DHS's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the DHS's compliance with those requirements.

As described in items 04-3 to 04-13 in the accompanying schedule of findings and questioned costs, the DHS did not comply with the following requirements:

CFDA number	Name of federal program	Type of compliance requirement	Ref. no.
93.777 and 93.778	Medicaid Cluster	Allowability, Eligibility, Special Tests and Provisions	04-3, 04-4, 04-5, 04-6, 04-7, 04-8, 04-9
93.659	Adoption Assistance (Title IV-E)	Allowability, Eligibility	04-10
93.575 and 93.596	Child Care Cluster	Allowability, Eligibility, Subrecipient Monitoring	04-11, 04-12, 04-13

To the Director  
Department of Human Services  
State of Hawaii

Compliance with such requirements is necessary, in our opinion, for the DHS to comply with the requirements applicable to those programs.

In our opinion, except for the noncompliance described in the preceding paragraph, the DHS complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2004.

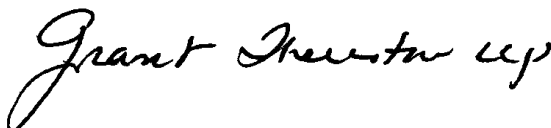
### **Internal Control Over Compliance**

The management of the DHS is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the DHS's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133 and not to provide an opinion on the internal control over compliance. Accordingly, we express no such opinion.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the DHS's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 04-3 to 04-13.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items 04-3 through 04-13 to be material weaknesses. We also noted other matters involving internal control over compliance that we have reported to management of the DHS in a separate letter dated April 14, 2005.

This report is intended solely for the information and use of the Director, management, federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.



Honolulu, Hawaii  
April 14, 2005

**PART IV**  
**SCHEDULE OF FINDINGS AND QUESTIONED COSTS**

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

For the year ended June 30, 2004

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Section I – Summary of Auditor’s Results

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Our report dated April 14, 2005 on the basic financial statements of the Department of Human Services, State of Hawaii, as of and for the year ended June 30, 2004, contained an unqualified opinion.

*Financial Statements*

Type of auditor’s report issued: Unqualified

Internal control over financial reporting:

- Material weakness(es) identified? \_\_\_ yes      √ no
- Reportable condition(s) identified that are not considered to be material weaknesses? √ yes      \_\_\_ none reported
- Noncompliance material to financial statements noted? \_\_\_ yes      √ no

*Federal Awards*

Internal control over major programs:

- Material weakness(es) identified? √ yes      \_\_\_ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? \_\_\_ yes      √ none reported

Type of auditor’s report issued on compliance for major programs: Qualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133, Section .510(a)?

√ yes      \_\_\_ no

Identification of major programs:

<u>CFDA Number(s)</u>	<u>Name of Federal Program</u>
93.575	Child Care and Development Block Grant
93.596	Child Care Mandatory and Matching Funds of the Child Care and Development Fund
93.659	Adoption Assistance (Title IV-E)
93.777	State Survey Certification of Health Care Providers and Suppliers
93.778	Medical Assistance Program (Medicaid; Title XIX)

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

Dollar threshold used to distinguish between Type A and Type B programs: \$3,000,000

Auditee qualified as low-risk auditee?  yes  no

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Section II – Financial Statement Findings

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**Ref.**

**no. Internal Control Findings**

**04-1 Properly Record All Fixed Assets in the State Property Inventory Records**

Divisions within the DHS are responsible for reporting the acquisition and disposal of fixed assets to the State Procurement Office on a quarterly basis to update the state property inventory records.

Section 103D-106 of the Hawaii Revised Statutes states in part, "...the administrative heads of the executive departments, and all other persons, offices, and boards of a public character...shall prepare and file with the administrator of the state procurement office an annual inventory return of state property in the possession, custody, control, or use of the officer making the return, or of the department or office of the government over which the officer presides...."

Although the DHS has issued reminders to all division offices to properly report fixed asset purchases to the State Procurement Office, personnel did not always adhere to the established procedures.

The Department of Accounting and General Services (DAGS) uses the information from the state property inventory records to assist the DHS in compiling the department's fixed assets and depreciation information for the year. We noted that during the current year, the DHS changed the carrying value of items that were acquired in previous years to correctly state the cost of the assets.

We noted several instances where the items' carrying value was corrected with a net change to the fixed asset listing of approximately \$82,000.

**Recommendation**

To ensure that the state property inventory records are complete and accurate, the DHS should implement monitoring procedures to ensure that all appropriate personnel properly and accurately report all fixed asset acquisitions and dispositions to the State Procurement Office on a quarterly basis. The DHS should also implement a process to review, in a timely manner, the transactions that are posted to the department property inventory records to ensure that the transactions were properly posted to the state property inventory records.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref.  
no.**

**Internal Control Findings (continued)**

**04-2 Maintain Vacation and Sick Leave Records Properly**

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

- There were numerous instances where the Form G-1, *Application for Leave of Absence*, was authorized after the employee took vacation.
- There were numerous instances where the accrued vacation and sick leave hours on the summary leave schedule did not agree to the individual Form DPS-7.
- There were two instances where sick leave taken and approved on Form G-1, *Application for Leave of Absence*, was not recorded on the employee's Form DPS-7. This resulted in an overstatement of sick leave totaling 59 hours or \$1,136.

Although the DHS established procedures to conduct secondary reviews and random quality control reviews of leave records, it appears that the leave records were not always updated accurately on a timely basis.

**Recommendation**

We recognize that approvals of vacation could occur after the fact, such as when an employee must care for a dependent who becomes ill the night before. In those instances, we recommend that the employee's record be annotated to reflect that telephonic approval was given.

The DHS should increase the number of random quality control reviews of leave records to ensure that vacation and sick leave records are accurately maintained and reviewed on a timely basis. In addition, a secondary review of the summary leave schedule should be performed before reporting the balances to the State Comptroller.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

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Section III – Federal Award Findings and Questioned Cost

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**Ref.**

**no. Compliance and Internal Control Findings**

**04-3 Improve Utilization Controls over Medicaid Claims**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

In the prior year, the Hawaii Prepaid Medical Management Information System (HPMMIS) was implemented and is being operated and maintained by the Arizona Health Care Cost Containment System (AHCCCS). In addition, the management and processing of pharmacy benefits was contracted to Affiliated Computer Services (ACS).

As discussed in the prior year's auditors' report, the HPMMIS was not able to produce the Surveillance and Utilization Review reports. In addition, post payment reviews of electronic media claims was not being performed and the use of a third party healthcare auditing and consulting company to audit the pharmacy benefits manager's operations was discontinued.

Due to the complexity of the Medicaid processing function and the large volume of Medicaid transactions, it is imperative for DHS to obtain these necessary HPMMIS reports to ensure compliance with federal regulations.

Based on our discussion with DHS personnel, we noted that DHS has been working with AHCCCS on obtaining these necessary HPMMIS reports. Meanwhile, the MQD continues to review claims payment on an ad hoc basis when payment issues are reported by DHS staff, ACS staff or providers.

**Recommendation**

DHS should obtain the necessary HPMMIS management reports to allow post payment review of recipient utilization and provider service profiles and exception criteria based on parameters set by the MQD.

**04-4 Improve Accuracy of Medicaid Claims Processing**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

Due to the complexity of the Medicaid processing function and the large volume of Medicaid transactions, it is imperative for DHS to perform regular post payment reviews on sample claims to detect processing errors and identify ways to improve the claims processing systems and procedures.



Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref. no.**      **Compliance and Internal Control Findings (continued)**

During our review of 120 claims (60 drug and 60 non-drug), we noted the following:

- 5 non-drug claims in which there was a net aggregate overpayment of \$7,586. Approximately \$5,100 was related to a nursing facility services claim in which there was no prior authorization for the specified period. There was authorization for the periods prior and subsequent to the specified period.

DHS contracted Heritage Information Systems, Inc. to perform pharmacy claims audits. The audit results will be used to correct and collect overpayments made by the ACS pharmacy benefit manager.

**Recommendation**

DHS should perform regular post payment reviews on a sample of claims to detect processing errors and identify ways to improve the claims processing system and procedures.

**04-5      Implement Controls To Ensure the Medicaid Program is Credited Timely for Outstanding or Uncashed Checks**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

CFR Title 42, Section 433.40(c) requires the State to credit the Medicaid program for checks that are outstanding or uncashed beyond 180 days of issuance. If the State has claimed and received Federal Financial Participation (FFP) for the amount of the uncashed check, it must refund the amount of FFP received. At the end of each calendar quarter, the State must identify those checks which remain uncashed beyond a period of 180 days after issuance. The State must refund all FFP that it received for uncashed checks by adjusting the Quarterly Statement of Expenditures for that quarter.

Med-Quest Division (MQD) contracts with Affiliated Computer Services, Inc. (ACS) to serve as the Medicaid fiscal agent. ACS is responsible for paying fee-for-service claims. During our audit, we noted MQD did not have adequate controls to monitor ACS's monthly bank reconciliations to properly credit the Medicaid program for checks that are outstanding or uncashed beyond 180 days of issuance. As a result, the federal agency may be overcharged for the federal share of expenditures.

While MQD did not adhere to the Federal regulations concerning outstanding or uncashed checks beyond 180 days of issuance, we noted that they did have controls in place to properly credit the Medicaid program for interest earned on the FFP portion.

**Recommendation**

DHS should implement controls to adequately monitor ACS's monthly bank reconciliations to properly credit the Medicaid program for checks that are outstanding or uncashed beyond 180 days of issuance.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref.**  
**no.**    **Compliance and Internal Control Findings (continued)**

**04-6    Improve Controls over the Medicaid Drug Rebate Program**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

The Centers for Medicare and Medicaid (CMS) program release No. 29 requires that interest must be collected and cannot be disregarded as part of the dispute resolution process by either the manufacturer or the State. CMS program release No. 65 further clarifies that although the obligation for calculating the interests due to the States on late rebate payments rests with the manufacturer, it is the State's responsibility to track the collection of interest due, and report those amounts to CMS.

Med-Quest Division (MQD) contracts with Affiliated Computer Services, Inc. (ACS) to perform the daily operations of the drug rebate program including billing, collection, accounting and dispute resolution. On a quarterly basis, the MQD reports the drug rebate collections including any interest received on Form CMS 64.9R. This amount is used to reduce the amount to be reimbursed by the federal agency for the federal share of expenditures for the Medicaid Program. MQD did not have adequate controls to verify if rebate interest payments were collected. During our review of the ACS Drug Rebate reports, we noted only minimal voluntary interest being collected. As a result, the federal agency may be overcharged for the federal share of expenditures.

In a report dated July 28, 2003, the U.S. Department of Health and Human Services, Office of the Inspector General reported similar findings and recommendations from an audit of the Hawaii Medicaid Drug Rebate program for the year ended June 30, 2002.

We also noted a section regarding the calculation of interest on disputed or unpaid amounts and late drug rebate payments in ACS's Drug Rebate Policies and Procedures dated March 2005.

**Recommendation**

DHS should ensure rebate interest payments are collected and not disregarded as part of the dispute resolution process by either the manufacturer or the DHS.

**04-7    Maintain All Required Documentation in Medicaid Case Files**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

During our review of 30 case files, we noted 17 case files in which application, renewal and/or eligibility determination forms were missing or not properly completed.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref. no.**     **Compliance and Internal Control Findings (continued)**

Often a lack of time and resources as well as clerical error/oversight have contributed to the findings described above. In addition, we also noted a higher priority is placed on updating the information in the database rather than completing the forms in the case files.

**Recommendation**

DHS should ensure that all required documents are properly completed and maintained in each case file to support the allowability and eligibility of the medical assistance payments being claimed for federal reimbursements. A secondary review would help to ensure all required documents are properly completed.

**04-8     Complete Eligibility Applications and Annual Eligibility Re-verifications in a Timely Manner**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

Title 42 CFR Part 435.911 requires the determination of eligibility to be made within 45 days from the date of application for all applicants except for applications made on the basis of disability in which it is 60 days. In order to reduce the backlog of applications, the DHS MQD Eligibility Branch (EB) adopted policies of presumptive eligibility and client self-declaration.

Presumptive eligibility requires that applicants receive services if a decision on eligibility has not been made within the above specified timeframe. Self-declaration requires eligibility determinations to be based on the information provided on the application form. Self-declared information is supposed to be verified by the EB whenever possible; however, such verification is often not performed until the annual eligibility review for redetermination.

While these procedural changes have reduced the backlog of outstanding applications, they have increased the likelihood that ineligible persons may be receiving benefits and also placed more reliance on subsequent eligibility re-verifications to verify clients remain eligible to receive benefits.

During our review of 30 case files, we noted 4 case files in which redeterminations were not made in a timely manner.

As of June 30, 2004, we found approximately 760 applications outstanding greater than 45 days. In addition, the number of overdue annual re-verifications for MQD was approximately 850 as of June 30, 2004. Staffing problems continue to contribute to the backlog of applications, pending eligibility determinations, and overdue annual re-verifications.

In June 2004, the EB introduced passive renewals for families with children in an attempt to reduce the number of overdue annual re-verifications.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref.  
no.**

**Compliance and Internal Control Findings (continued)**

**Recommendation**

DHS should assess the staffing needs at the EB and make every effort to ensure each unit is fully staffed with trained personnel in order to timely process applications and perform annual re-verifications. Adequate staffing would likely reduce the backlog of applications, pending eligibility determinations, and overdue annual re-verifications and also minimize the risk that ineligible recipients are receiving Medicaid benefits.

**04-9 Maintain All Required Provider Documentation**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.777, State Survey Certification of Health Care Providers and Suppliers  
CFDA 93.778, Medical Assistance Program (Medicaid; Title XIX)

In order to participate in the Medicaid program, providers are required to have a current and valid written agreement on file with MQD except for providers for the Social Services Division which uses contracts in place of provider agreements. A completed and signed Provider Information Form (Form 1139) constitutes the full written agreement. Title 42 CFR part 455, subpart B also requires providers to make certain required disclosures to the State. These required disclosures are included in the Provider Information Form and contracts.

In our review of 32 provider files, we noted the following:

- 3 cases where the provider agreement was not present
- 1 case where the provider agreement was not signed

The findings described above are primarily due to clerical error/oversight.

**Recommendation**

DHS should ensure all provider agreements are properly completed and maintained.

**04-10 Maintain All Required Documentation in Adoption Assistance Case Files**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.659, Adoption Assistance (Title IV-E)

During our review of 30 case files, we noted several case files in which required forms were missing or not properly completed including the amount, duration of payment, authorizing signature, etc.

The findings described above are primarily due to clerical error/oversight.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref. no.**      **Compliance and Internal Control Findings (continued)**

The effective dates of the adoption assistance agreements for the case files selected for testing ranged from 1991 to 2003.

**Recommendation**

DHS should ensure that all required documents are properly completed and maintained in each case file to support the allowability and eligibility of the adoption assistance payments being claimed for federal reimbursements. A secondary review would help to ensure all required documents are properly completed.

**04-11 Maintain All Required Documentation in Child Care Case Files**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.575, Child Care and Development Block Grant  
CFDA 93.596, Child Care Mandatory and Matching Funds of the Child Care and Development Fund

During our review of 30 case files, we noted the following:

- 5 case files were missing required documentation supporting \$1,621 in child care benefit payments. These include child care receipt and verification of service forms.
- 9 case files in which redeterminations were not made in a timely manner.
- In addition, we also noted several case files in which the application forms and/or other forms were missing or not properly completed.

The findings described above are primarily due to clerical error/oversight.

**Recommendation**

DHS should ensure that all required documents are properly completed and maintained in each case file to support the allowability and eligibility of the child care payments being claimed for federal reimbursements. A secondary review would help to ensure all required documents are properly completed.

**04-12 Improve the Accuracy of Child Care Reimbursements**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.575, Child Care and Development Block Grant  
CFDA 93.596, Child Care Mandatory and Matching Funds of the Child Care and Development Fund

During our review of 30 case files, we noted the following:

- 4 case files in which there was a net aggregate overpayment of \$902.

The findings described above are primarily due to clerical error/oversight.

Department of Human Services  
State of Hawaii

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

Year ended June 30, 2004

**Ref.**  
**no.**    **Compliance and Internal Control Findings (continued)**

**Recommendation**

The DHS should ensure that reimbursements to child care program participants are calculated properly in accordance with program policies and procedures.

**04-13    Ensure All Subrecipients are Identified for Subrecipient Monitoring**

Federal agency: U.S. Department of Health and Human Services  
CFDA 93.575, Child Care and Development Block Grant  
CFDA 93.596, Child Care Mandatory and Matching Funds of the Child Care and Development Fund

OMB Circular A-133 provides guidance to grantees who provide funds to subrecipients. Section 210 of the circular also provides guidance in assisting grantees in differentiating between a subrecipient and a vendor.

In October of each year, the department's Management Services Office (MSO) sends a memo to the divisions requesting a list of subrecipients that were contracted during the previous year. The listing is used to identify the subrecipients for monitoring purposes.

While MSO performs subrecipient monitoring for the different programs, no monitoring was done in 2004 on any of the subrecipients who received Child Care funds in 2003. Our review of MSO's list of 2003 subrecipients did not disclose any subrecipients relating to the Child Care program.

However, our discussion with the Child Care program accountant indicated that there were several not-for-profit and governmental organizations that did receive funds in 2003 and provided services for the program. Upon inquiry, we were informed that the program had not provided the names of these entities to the MSO because the program had considered the entities to be vendors and not subrecipients.

**Recommendation**

We recommend that the program seek guidance from the federal cognizant agency, oversight agency or the federal awarding agency as to the attributes of a subrecipient versus a vendor relationship as they relate to this specific program. Once such guidance is received, the program should evaluate each of its agreements and document the rationale for its decision.

**PART V**

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

Fiscal year ended June 30, 2004

This section contains the current status of prior audit recommendations. The recommendations are referenced to the pages of the previous audit report for the fiscal year ended June 30, 2003, dated February 20, 2004.

**Ref.**

**no.**

**Internal Control Findings**

**03-1 Properly Record All Fixed Assets in the State Property Inventory Records (page 56)**

Divisions within the DHS are responsible for reporting the acquisition and disposal of fixed assets to the State Procurement Office on a quarterly basis to update the state property inventory records. In the prior fiscal year, we informed the DHS that a building used by the Office of Youth Services with a cost of \$2,153,500 was not included on the state property records.

Section 103D-106 of the Hawaii Revised Statutes states in part, "...the administrative heads of the executive departments, and all other persons, offices, and boards of a public character...shall prepare and file with the administrator of the state procurement office an annual inventory return of state property in the possession, custody, control, or use of the officer making the return, or of the department or office of the government over which the officer presides...."

Although the DHS has issued reminders to all division offices to properly report fixed asset purchases to the State Procurement Office, personnel did not always adhere to the established procedures.

The Department of Accounting and General Services (DAGS) uses the information from the state property inventory records to assist the DHS in compiling the department's fixed assets and depreciation information for the fiscal year. We noted that during the current fiscal year, the DHS changed the carrying value of items that were acquired in previous fiscal years to correctly state the cost of the assets. We noted three instances where the items' carrying value was corrected with a net change to the fixed asset listing of approximately \$79,000.

**Recommendation**

To ensure that the state property inventory records are complete and accurate, the DHS should implement monitoring procedures to ensure that all appropriate personnel properly and accurately report all fixed asset acquisitions and dispositions to the State Procurement Office on a quarterly basis. The DHS should also implement a process to review, in a timely manner, the transactions that are posted to the department property inventory records to ensure that the transactions were properly posted to the state property inventory records.

**Status**

Partially accomplished. The building used by the Office of Youth Services with a cost of \$2,153,500 was properly included on the state property records as of June 30, 2004. See reference No. 04-1.



Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref.  
no.**

**Internal Control Findings (continued)**

**03-2 Maintain Vacation and Sick Leave Records Properly (page 57)**

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

- There were numerous instances where the Form G-1, *Application for Leave of Absence*, was authorized after the employee took vacation.
- There were numerous instances where the accrued vacation and sick leave hours on the summary leave schedule did not agree to the individual Form DPS-7. In one instance, this resulted in an overstatement of accrued vacation and sick leave totaling 190 hours or \$6,684.

Although the DHS established procedures to conduct random quality control reviews of leave records, it appears that the leave records were not always updated accurately on a timely basis.

**Recommendation**

The DHS should increase the number of random quality control reviews of leave records to ensure that vacation and sick leave records are accurately maintained on a timely basis. In addition, the summary leave schedule should be reviewed before reporting the balances to the State Comptroller.

**Status**

Not accomplished. See reference No. 04-2.

**Compliance and Internal Control Findings**

**03-3 Improve Utilization Controls over Medicaid Claims (pages 58-60)**

The development and administration of the state's Medicaid Assistance Program (MAP) is the responsibility of the Med-QUEST Division (MQD). There have been significant changes that have impacted the operations of MAP. On August 1, 2001, the management and processing of DHS's pharmacy benefits was contracted to Affiliated Computer Services (ACS), and effective July 1, 2002, ACS became the MQD's new fiscal agent. In addition, on November 1, 2002, the Hawaii Prepaid Medical Management Information System (HPMMIS), DHS's new non-drug claims processing system, became operational. The HPMMIS is operated and maintained by the Arizona Health Care Cost Containment System (AHCCCS). Substantial time and effort was needed in order to complete the transition to a new fiscal agent, migrate to the new claims

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref.**  
**no.**    **Compliance and Internal Control Findings (continued)**

processing system, and ensure compliance with the Health Insurance Portability and Accountability Act (HIPAA).

Although the pre-payment edit functions contained in the HPMMIS, the Peer Review Organization (PRO) contract, and the DHS's extensive list of medical services and procedures which require prior authorization remain the primary controls used to prevent unnecessary utilization of care the services and to ensure proper and accurate payment of Medicaid claims, we did note that several controls and procedures previously in place were no longer present.

Title 42 CFR Part 456 Subpart A requires a statewide program of control of the utilization of all Medicaid (CFDA 93.778) Services. During our review of the internal controls, we noted the following conditions:

- The review of Surveillance and Utilization Review Subsystem (SURS) reports and Explanation of Medical Benefit (EOMB) responses is no longer being performed. The HPMMIS has not been able to produce these reports and the DHS is currently working with AHCCCS to develop these reports. Without these reports, the DHS is severely limited in its ability to analyze recipient and provider utilization data which could uncover potentially fraudulent or abusive behavior.
- The post payment review of a sample of electronic media claims (EMC) is no longer being performed. Well over 50% of all Medicaid claims are received electronically. This function was previously performed by HMSA, the former DHS fiscal agent.
- Title 42 CFR Part 455.12 requires the DHS to have methods for identification, investigation, and referral of fraudulent activity. The Medicaid Investigations Unit (MIU) is an important component of this process. The MIU continues to receive referrals of potential fraud from the DHS staff nurses as part of their prior authorization duties. However, the number of referrals of potential fraud to the MIU has decreased significantly in large part because utilization control activities such as the review of SURS reports, the review of EOMB responses, and the audit of EMC claims are no longer being performed.
- In addition, the MIU does not maintain adequate records documenting the number of complaints received, the work performed, the disposition of the cases, and follow-up activities. The documentation of the details and results of full investigations performed was adequate; however, without more comprehensive documentation of the activities of the MIU, it is difficult to evaluate the effectiveness of the unit and whether appropriate action is being taken on all complaints.

A lack of staffing and the inability of the HPMMIS to generate the necessary data and reports have contributed to the conditions described above.

In a report dated September 4, 2003, Heritage Information Systems, Inc. (Heritage), a healthcare auditing and consulting company, reported similar findings and recommendations stemming from an audit of ACS

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref.  
no.**

**Compliance and Internal Control Findings (continued)**

activities as the DHS's current pharmacy benefit manager (PBM). For example, Heritage noted the need to explore edits, analysis, and reporting which could aid in anti-fraud efforts.

**Recommendation**

To ensure compliance with federal regulations, we recommend the DHS perform the following:

- Obtain the necessary HPMMIS and ACS PBM management reports to allow a post-payment review of recipient utilization and provider service profiles and exception criteria based on parameters set by the MQD. The analysis of these reports should help identify exceptions or abnormal patterns of treatment or service and allow for the correction of misutilization practices of recipients and providers. It also serves as an important tool to identify and investigate potential fraudulent behavior.
- Given the high percentage of claims submitted via electronic media, the DHS should consider preparing a request for proposal to continue the EMC audits. This could be an opportunity to provide additional provider education as well as a valuable referral source of potential fraud to the MIU.
- Document preliminary investigations of complaints of Medicaid fraud, abuse or any questionable practices, to determine whether there is sufficient basis to warrant a full investigation as required by Title 42 CFR Part 455.14. The method of documentation should be more standardized to provide better information on complaints received, referrals of suspected claims, preliminary investigations performed, and dispositions of all complaints and referrals. Records should indicate the activity of the MIU and demonstrate the procedures for investigation, cooperation with legal authorities, referral of cases and follow-up activities. This will provide the DHS with the information necessary to assess the effectiveness of the MIU's ability to evaluate all complaints and reports regarding fraud or abuse and to conduct investigations of alleged fraud.

**Status**

Partially accomplished. While the ACS PBM provides quarterly pharmacy drug utilization reports, the MQD continues to work with AHCCCS to obtain the necessary HPMMIS management reports to allow a post-payment review of recipient utilization and provider service profiles and exception criteria based on parameters set by the MQD. While waiting for these reports, MQD does attempt to identify aberrant utilization claims for review. The MQD has instituted measures to correct utilization problems if it comes to their attention and refer cases to possible fraud and abuse for further investigation.

The DHS has improved its documentation of the number of complaints and referrals received, the work performed, the disposition of the cases and follow-up activities. A spreadsheet has been developed by the MIU to log all complaints and referrals received by the MIU as well as the status of the complaints and referrals. A separate log is maintained for provider and recipient complaints. See reference No. 04-3.

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref.**  
**no.**

**Compliance and Internal Control Findings (continued)**

**03-4 Obtain the Necessary Reports From the HPMMIS (page 61)**

As part of our review of the Medicaid Program (CFDA 93.778), we noted several instances in which the DHS was unable to comply with federal requirements because necessary reports from the HPMMIS were unavailable. In addition to being unable to perform a review of SURS reports and other valuable utilization control functions, the DHS did not report approximately \$6.3 million of medical waiver expenditures. These medical waiver expenditures are administered by the Social Services Division (SSD), and reported on the Medicaid federal financial report (CMS-64) prepared by MQD.

In the past, the SSD would code each invoice received for payment to the proper waiver program and payments were processed by way of the State's disbursement system using purchase orders and invoices. Beginning November 2002, medical waiver claims were not processed as medical claims through HPMMIS.

However, the HPMMIS was unable to generate reports summarizing medical waiver expenditures by each waiver program, which is required on the CMS-64. Therefore, the DHS has not reported approximately \$6.3 million in medical waiver expenditures.

Based upon discussions with the DHS personnel and review of AHCCCS request logs, there is a large backlog of pending reports and other HPMMIS projects not yet accomplished.

**Recommendation**

The DHS should continue to work with AHCCCS on developing the necessary HPMMIS reports and completing pending projects as soon as possible to ensure compliance with federal reporting requirements and provisions for utilization controls.

**Status**

AHCCCS has provided DHS with the HPMMIS reports summarizing medical waiver expenditures by waiver program. However, DHS has not had an opportunity to resolve prior year's reporting issue. DHS is anticipating that all of the unreported medical waiver expenditures will be resolved and properly reported on the CMS-64 by June 30, 2005.

**03-5 Improve Accuracy of Medicaid Claims Processing (page 62)**

As part of our review of internal controls, detailed tests of Medicaid (CFDA 93.778) claims were performed. Non-drug claims were processed using the state-owned system, Medicaid Management Information System (MMIS) through October 2002. In November 2002, the DHS changed its claims processing system from the MMIS, operated and maintained by HMSA, to the Hawaii Prepaid Medical Management Information System

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref. no. Compliance and Internal Control Findings (continued)**

(HPMMIS) operated and maintained by the State of Arizona. All drug claims were processed by ACS, MQD's pharmacy benefit manager (PBM) for the fiscal year ended June 30, 2003.

During our tests of non-drug claims, we noted several errors caused by either provider billing errors or system errors. The errors resulted in a minimal net underpayment.

We also reviewed the results of the ACS PBM audit performed by Heritage Information Systems, Inc. (Heritage), a healthcare auditing and consulting company. The report noted potential overpayments of approximately \$462,000. The potential overpayments were caused by improper reimbursement formulas being applied, inappropriate quantities or package sizes being paid for, and claims that should have been denied because they were covered under the managed care program.

**Recommendation**

Due to the complexity of the Medicaid claims processing function, there is a high inherent risk that claims processing errors may occur. In connection with its utilization controls over Medicaid claims, the DHS should perform post payment claim reviews. Post payment Medicaid claims testing performed in the past has effectively brought to light areas for improvement in claims processing and has resulted in system changes. The transition to a new claims processing system accentuates the value of this function. The DHS should perform regular post payment reviews on a sample of claims to detect processing errors and identify ways to improve the new claims processing system and procedures.

**Status**

Not accomplished. See reference No. 04-4.

**03-6 Complete Eligibility Applications and Annual Eligibility Re-verifications in a Timely Manner (page 63)**

Title 42 CFR Part 435.911 requires the DHS to determine the eligibility of individuals who apply for Medicaid (CFDA 93.778) benefits within 45 days from the date of application. Applications that are not reviewed within 45 days are presumed to be eligible, resulting in the risk that ineligible recipients may be receiving Medicaid benefits. Hawaii administrative rules also require annual re-verifications of participant eligibility.

Since September 11, 2001, the DHS has fallen behind in its processing of Medicaid applications and annual eligibility re-verifications. As of June 30, 2003, the number of applications outstanding greater than 45 days was reduced to 260; however, the number of overdue applications was as high as 1,000 as of January 2003.

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref. no. Compliance and Internal Control Findings (continued)**

In addition, the number of overdue annual re-verifications remained relatively high at 1,600 as of June 30, 2003.

**Recommendation**

The DHS should make every effort to eliminate the backlog of applications pending eligibility determinations and the overdue annual re-verifications to reduce the risk that ineligible recipients are receiving Medicaid benefits.

**Status**

Not accomplished. See reference Nos. 04-7 and 04-8.

**03-7 Ensure Proper Eligibility Determination and Maintain All Required Documentation in Child Care Case Files (page 64)**

During our tests of allowability and eligibility for the Child Care Cluster (CFDA 93.575 and 93.596), we noted the following errors:

- One instance in which an improper eligibility determination resulted in an overpayment of \$250.
- Six instances in which required documentation was not maintained in the participant case file. Title 45 CFR Part 98.65 (e) requires that appropriate documentation be maintained to allow the verification that funds are expended in accordance with statutory and regulatory requirements of the program. As such, child care benefit payments totaling \$6,685 should not have been made.

**Recommendation**

The DHS should ensure that proper eligibility determinations are made and that all required documents are maintained in each case file to support the allowability and eligibility of the child care payments being claimed for federal reimbursement. The DHS should continue to perform case file reviews in order to assess case manager performance. During fiscal year 2003, the DHS performed a review of case files at units managed by third party contractors and similar errors were noted. Follow-up reviews should be performed until the error rate has decreased at all units.

**Status**

Not accomplished. See reference No. 04-11.

Department of Human Services  
State of Hawaii

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS (continued)

Fiscal year ended June 30, 2004

**Ref.**  
**no.**    **Compliance and Internal Control Findings (continued)**

**03-8**    **Improve the Accuracy of Child Care Reimbursements (page 65)**

During our tests of allowability and eligibility for the Child Care Cluster (CFDA 93.575 and 93.596), we noted several benefit payment errors. The errors noted were as follows:

- Two instances in which the case manager applied improper child care rates. The errors resulted in a total underpayment of \$179.
- One instance in which an income calculation error by the case manager resulted in an improper application of the co-payment percentage. The error resulted in an underpayment of \$25.

**Recommendation**

The DHS should ensure that reimbursements to child care program participants are calculated properly. The DHS should continue to perform case file reviews in order to assess contractor performance. During fiscal year 2003, the DHS performed a review of case files at units managed by third party contractors and similar errors were noted. Follow-up reviews should be performed until the error rate has decreased at all units.

**Status**

Not accomplished. See reference No. 04-12.

**PART VI**  
**RESPONSE OF THE AFFECTED AGENCY**



LINDA LINGLE  
GOVERNOR



LILLIAN B. KOLLER, ESQ.  
DIRECTOR

HENRY OLIVA  
DEPUTY DIRECTOR

STATE OF HAWAII  
DEPARTMENT OF HUMAN SERVICES  
P. O. Box 339  
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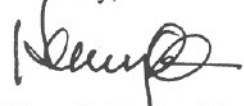
June 20, 2005

Mr. Howard Hanada  
Grant Thornton LLP  
1132 Bishop Street, Suite 1000  
Honolulu, Hawaii 96813

Dear Mr. Hanada:

Attached are the Department of Human Services' responses and corrective action plans related to your fiscal year 2004 audit report findings and recommendations. We appreciate the opportunity to comment on the audit report.

Sincerely,



Lillian B. Koller, Esq.  
Director

Attachment

**Ref. no. 04-1**

**Properly Record All Fixed Assets in the State Property Inventory Records**

Auditor's  
Recommendation:

To ensure that the state property inventory records are complete and accurate, the DHS should implement monitoring procedures to ensure that all appropriate personnel properly and accurately report all fixed asset acquisitions and dispositions to the State Procurement Office on a quarterly basis. The DHS should also implement a process to review, in a timely manner, the transactions that are posted to the department property inventory records to ensure that the transactions were properly posted to the state property inventory records.

Corrective Action  
Taken or Planned:

In March 2003, stricter departmental inventory procedures were issued establishing each employee as being responsible and accountable for maintaining and safeguarding inventory assigned to the individual. In addition, property custodians are assigned to each office/unit and are responsible for fixed assets under their management. The statewide inventory system reports and distributes information for all transactions that have not posted properly to the state inventory. These transaction registers are distributed regularly after each inventory period (i.e. quarterly) to be reviewed by the affected offices. The transactions must be corrected and submitted to ensure that the transactions are properly posted.

Start Date: Ongoing

End Date: Ongoing

Responding Person: Susy Kawamoto, Property and Procurement Staff Supervisor  
Fiscal Management Office (FMO)

**Ref. no. 04-2**

**Maintain Vacation and Sick Leave Records Properly**

Auditor's  
Recommendation:

We recognize that approvals of vacation could occur after the fact, such as when an employee must care for a dependent who becomes ill the night before. In those instances, we recommend that the employee's record be annotated to reflect that telephonic approval was given.

The DHS should increase the number of random quality control reviews of leave records to ensure that vacation and sick leave records are accurately maintained and reviewed on a timely basis. In addition, a secondary review of the summary leave schedule should be performed before reporting the balances to the State Comptroller.

Corrective Action Taken or Planned: The auditor's recommendation to annotate the approval of vacation will be discussed with the central agency.

The DHS will continue to conduct random quality control reviews of the leave records.

In order to reasonably assure the accuracy of the summary leave schedule, the Fiscal Management Office – Pre-Audit Staff will conduct a more extensive review (e.g. increase the sample size of the records checked) of the approximately 2,300 individual leave balances.

Start Date: Ongoing

End Date: Ongoing

Responding Persons: Edwin Nose, Personnel Officer  
Eloise Uehara, Pre-Audit Staff Supervisor, FMO

**Ref. no. 04-3                      Improve Utilization Controls Over Medicaid Claims**

Auditor's Recommendation: DHS should obtain the necessary HPMMIS management reports to allow post-payment review of recipient utilization and provider service profiles and exception criteria based on parameters set by the MQD.

Corrective Action Taken or Planned: Surveillance and Utilization Review reports are being developed. The AHCCCS has completed the programming of the three reports with highest prioritization. The Medical Standards Branch has started reviewing the accuracy of these reports.

Start Date: Ongoing

End Date: Ongoing

Responding Person: Angelina Payne, Acting Med-QUEST Division (MQD) Administrator

**Ref. no. 04-4                      Improve Accuracy of Medicaid Claims Processing**

Auditor's Recommendation: DHS should perform regular post payment reviews on a sample of claims to detect processing errors and identify ways to improve the claims processing system and procedures.

Corrective Actions Taken or Planned: DHS is auditing nursing facility claims through another division of the Department. MQD will provide updated instructions to the

division to include verification of prior authorizations.

Currently, DHS performs post payment reviews and adjustments related to specific problems or areas of concern. SURS reports are a proven method of identifying claims processing errors as well as overpayments. Through a fully implemented SURS program, the DHS can implement the auditor's recommendation for post payment review of a sample of claims.

Start Date: Ongoing  
End Date: Ongoing  
Responding Person: Angelina Payne, Acting MQD Administrator

**Ref. no. 04-5      Implement Controls to Ensure the Medicaid Program is Credited Timely for Outstanding or Uncashed Checks**

Auditor's Recommendation: DHS should implement controls to adequately monitor ACS's monthly bank reconciliations to properly credit the Medicaid program for checks that are outstanding or uncashed beyond 180 days of issuance.

Corrective Action Taken or Planned: We agree with the auditor's findings and are in the process of developing procedures to identify, and credit on the CMS-64 report, any federal funding that has been claimed.

Start Date: May 2005  
End Date: Ongoing  
Responding Person: Brian Pang, Finance Officer, MQD

**Ref. no. 04-6      Improve Controls Over the Medicaid Drug Rebate Program**

Auditor's Recommendation: DHS should ensure rebate interest payments are collected and not disregarded as part of the dispute resolution process by either the manufacturer or the DHS.

Corrective Action Taken or Planned: DHS will instruct ACS-PBM to include outstanding interest on quarterly drug rebate invoices to the manufacturers.

Start Date: May 2005

End Date: Ongoing

Responding Person: Angelina Payne, Acting MQD Administrator

**Ref. no. 04-7      Maintain All Required Documentation in Medicaid Case Files**

Auditor's Recommendation: DHS should ensure that all required documents are properly completed and maintained in each case file to support the allowability and eligibility of the medical assistance payments being claimed for federal reimbursements. A secondary review would help to ensure all required documents are properly completed.

Corrective Action Taken or Planned: The supervisors and eligibility workers have been reminded of the importance of having all required departmental forms in each case record. With additional staffing, the unit's caseload will be reduced, therefore enabling the EW to file documents into case records in a more timely manner.

Having electronic file capability would enable documents to be automatically filed in a record. The elimination of "paper forms and documents" would eliminate existing case records, the need for additional storage space, the destruction of paper forms and documents and reduce the cost of purchasing paper products

Start Date: Ongoing

End Date: Ongoing

Responding Person: Alan Takahashi, Acting Eligibility Branch Administrator, MQD

**Ref. no. 04-8      Complete Eligibility Applications and Annual Eligibility Re-verifications in a Timely Manner**

Auditor's Recommendation: DHS should assess the staffing needs at the EB and make every effort to ensure each unit is fully staffed with trained personnel in order to timely process applications and perform annual re-verifications. Adequate staffing would likely reduce the backlog of applications, pending eligibility determinations, and overdue annual re-verifications and also minimize the risk that ineligible recipients are receiving Medicaid benefits.

Corrective Action Taken or Planned: The Eligibility Branch is initiating recruitment of positions as soon as it is aware of anticipated vacancies. Efforts are made to expedite all recruitment related activities.

While the vacant positions are being recruited, other measures to bolster Branch staffing have been taken. The Branch is utilizing 89-day appointment hiring to fill vacant eligibility worker and clerical support positions. The Branch is utilizing volunteer assistance from the BESSD/First To Work Program to assist with clerical support duties. The Branch has also contracted with Honolulu Community Action Program's Senior Community Service Employment Program to enable seniors to work part-time at the Branch providing clerical support duties.

Even if all of the current eligibility worker and clerical support positions were filled with trained personnel, additional personnel is needed to complete applications and annual eligibility renewals in a timely manner. With additional personnel, the number of presumptive eligibility provided would be reduced. An additional 66 EW positions and 18 clerical support positions would enable EB to properly process applications and annual eligibility renewals in a timely manner. Neighbor Island EB units require additional EW and clerical support positions. For Oahu, additional application and on-going units are required.

With the increase of staffing, space needs would need to be evaluated and additional office space would need to be secured. Additional equipment and supplies would also need to be secured.

Start Date: Ongoing  
End Date: Ongoing  
Responding Person: Alan Takahashi, Acting Eligibility Branch Administrator, MQD

**Ref. no. 04-9                      Maintain All Required Provider Documentation**

Auditor's Recommendation: DHS should ensure all provider agreements are properly completed and maintained.

Corrective Action Taken or Planned: The Health Coverage Management Branch had initiated a process to go through all of the provider applications and was in the process of reviewing the applications at the time of the audit. To date there are over 7,400 provider files that need to be reviewed to assure all pertinent documents are on file, documenting the missing forms, merging files that our old fiscal agent had sent to us with our files to create one complete file, and then sending it to our new fiscal agent for imaging.

Once the files have been reviewed we will be sending out provider agreements to all providers who need to sign updated

provider agreements (that include HIPAA language). We have reviewed approximately 40% of the files and expect to be completed by the end of this calendar year (December, 2005).

We also have initiated a process to review a provider's file when they submit a request for a change in their provider information. If we find that the provider needs to update their provider agreement we are requiring them to sign new agreements at that time so assure compliance.

Start Date: January 2005

End Date: Ongoing

Responding Person: Leslie K. Tawata, Acting Health Coverage Management Branch Administrator, MQD

**Ref. no. 04-10**

**Maintain All Required Documentation in Adoption Assistance Case Files**

Auditor's Recommendation:

DHS should ensure that all required documents are properly completed and maintained in each case file to support the allowability and eligibility of the adoption assistance payments being claimed for federal reimbursements. A secondary review would help to ensure all required documents are properly completed.

Corrective Action Taken or Planned:

The staff will be informed of the documents that were not properly completed and maintained in each case file. The staff will provide feedback regarding the required documents being filed and maintained in the adoption assistance payment case. The CWS procedures on Adoption Assistance for Children with Special Needs will be updated and disseminated to staff. Beginning November 2005, permanency supervisors will conduct monthly reviews of 5 randomly selected adoption assistance payment cases to ensure that the required documentation is filed and maintained in the adoption assistance payment cases.

Start Date: June 2005

End Date: Ongoing

Responding Person: Susan Ogami-Van Camp, Assistant Program Administrator, Child Welfare Services, Social Services Division

**Ref. no. 04-11**

**Maintain All Required Documentation in Child Care Case Files**

Auditor's  
Recommendation:

DHS should ensure that all required documents are properly completed and maintained in each case file to support the allowability and eligibility of the child care payments being claimed for federal reimbursements. A secondary review would help to ensure all required documents are properly completed.

Corrective Action  
Taken or Planned:

To correct this problem, DHS is taking the following actions:

- 1) There will be written procedures for line staff that address the filing of documents in the physical case records.
- 2) There will be a written plan for reviewing case records on a random basis which should point out further training needs for staff who implement the program.
- 3) There will be a checklist developed to assist in case record reviews to insure consistency in the review process.

The Staff Development Staff will continue to train the Eligibility Workers on child care policies and procedures with emphasis on proper eligibility determination and maintenance of documentation in the case records.

The foregoing corrective action plan should decrease errors in payments.

Start Date: May 2005

End Date: Ongoing

Responding Person: Pankaj Bhanot, Employment & Child Care Program Administrator  
Benefit, Employment & support Services Division (BESSD)

**Ref. no. 04-12**

**Improve the Accuracy of Child Care Reimbursements**

Auditor's  
Recommendation:

The DHS should ensure that reimbursements to child care program participants are calculated properly in accordance with program policies and procedures.

Corrective Action  
Taken or Planned:

The Department will pursue automating the HANA application to perform the current manual process of child care payment calculation in determining payment amounts that are authorized to eligible participants. Automation of this calculation will consist of data entering all countable income and activity hours to



determine eligibility for payments and assigning the correct co-pay and tiered reimbursement rate for the type of care used. This automation project is subject to availability of funding.

In the interim, the Department will revise and standardize the current departmental form that is currently being used by line staff to ensure that the following information is captured when authorizing all child care payments:

Benefit month  
Name of payee  
Name(s) of child(ren) requiring child care  
Household size  
Type of activity  
Hours of activity  
Type of care for each child  
Hours of care for each child  
Gross household income  
Co-pay rate  
Actual cost of care for each child  
Authorized child care payment for each child

The Staff Development Staff will continue to train the Eligibility Workers on child care policies and procedures with emphasis on proper calculation of payments (and co-payments) and application of child care rates.

The foregoing corrective action plan should decrease errors in payments.

Start Date: May 2005  
End Date: Ongoing  
Responding Person: Pankaj Bhanot, Employment & Child Care Program Administrator  
BESSD

**Ref. no. 04-13      Ensure All Subrecipients are Identified**

Auditor's Recommendation: We recommend that the program seek guidance from the federal cognizant agency, oversight agency or the federal awarding agency as to the attributes of a subrecipient versus a vendor relationship as they relate to this specific program. Once such guidance is received, the program should evaluate each of its agreements and document the rationale for its decision.

Corrective Action Taken or Planned: The Employment and Child Care Program Office (ECCPO) will be seeking an opinion from the grantor agencies as to the attributes of a subrecipient versus a vendor relationship as they

relate to this specific program. On receipt of such guidance, the ECCPO will evaluate each of its agreements and document the rationale for its decision.

Start Date: May 2005

End Date: March 2006

Responding Person: Pankaj Bhanot, Employment & Child Care Program Administrator  
BESSD