

**FINANCIAL AUDIT OF THE
DEPARTMENT OF HUMAN SERVICES
STATE OF HAWAII**

Fiscal Year Ended June 30, 2002



March 24, 2003

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 fiscal year ended June 30, 2002. 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 fiscal year ended June 30, 2002, 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 internal 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 State 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, 2002.

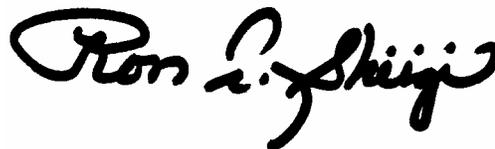
ORGANIZATION OF THE REPORT

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 fiscal year ended June 30, 2002, and our opinion on the basic financial statements.
- Part II - Our report on compliance and on internal control over financial reporting.
- Part III - Our report on compliance with requirements applicable to each major program and internal control over compliance.
- Part IV - The 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.

Sincerely,

A handwritten signature in black ink that reads "Ron T. Shiigi". The signature is written in a cursive, flowing style.

Ron T. Shiigi
Principal

**DEPARTMENT OF HUMAN SERVICES
STATE OF HAWAII**

TABLE OF CONTENTS

	<u>Page</u>
PART I FINANCIAL SECTION	
Independent Auditors' Report	7 - 8
Management's Discussion and Analysis	9 - 20
Basic Financial Statements	
Government-wide Financial Statements	
Statement of Net Assets	21
Statement of Activities	22
Fund Financial Statements	
Balance Sheet - Governmental Funds	23
Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets	24
Statement of Revenues, Expenditures, and Changes in Fund Balances - Governmental Funds	25
Reconciliation of the Change in Fund Balances of Governmental Funds to the Statement of Activities	26
Statement of Revenues and Expenditures - Budget and Actual - General Fund	27
Statement of Revenues and Expenditures - Budget and Actual - Special Revenue Funds	28
Statement of Assets and Liabilities - Agency Funds	29
Notes to the Basic Financial Statements	30 - 42

**DEPARTMENT OF HUMAN SERVICES
STATE OF HAWAII**

TABLE OF CONTENTS

	<u>Page</u>
PART I FINANCIAL SECTION (Continued)	
Supplementary Information	
Schedule of Expenditures of Federal Awards	44 - 46
 PART II AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING	
Independent Auditors' Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of the Basic Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	48 - 49
 PART III AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE	
Independent Auditors' Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in Accordance with OMB Circular A-133	51 - 53
 PART IV SCHEDULE OF FINDINGS AND QUESTIONED COSTS	55 - 64
 PART V SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS	
Status Report	66 - 71
 PART VI RESPONSE OF THE AFFECTED AGENCY	
Response of the Department of Human Services	72 - 81

PART I
FINANCIAL SECTION



NISHIHAMA & KISHIDA, CPA'S, INC.
CERTIFIED PUBLIC ACCOUNTANTS

AMERICAN SAVINGS BANK TOWER
1001 BISHOP STREET, SUITE 1700
HONOLULU, HAWAII 96813-3696
TELEPHONE (808) 524-2255
FAX (808) 523-2090

INDEPENDENT AUDITORS' REPORT

To the Director
Department of Human Services
State of Hawaii

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Department of Human Services of the State of Hawaii (DHS), as of and for the fiscal year ended June 30, 2002, which collectively comprise the DHS's basic financial statements as listed in the foregoing table of contents. These basic financial statements are the responsibility of the DHS's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

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

As discussed in Note 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, each major fund, and the aggregate remaining fund information 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, 2002, and the changes in its financial position, where applicable, for the fiscal 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, each major fund, and the aggregate remaining fund information for the DHS, as of June 30, 2002, and the respective changes in financial position, where applicable, thereof and the respective budgetary comparison for the general and special revenue funds for the

fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note B, the DHS has implemented a new financial reporting model, as required by the provisions of the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, and GASB Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments - Omnibus*, as of July 1, 2001.

As discussed in Note N, the DHS is subject to liabilities arising from certain circumstances, including possible charges for medical services provided to Medicaid and QUEST recipients. The ultimate outcome of these items cannot presently be determined. Accordingly, no provision for any liabilities that may result has been made in the accompanying financial statements.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 3, 2003, 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 grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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

Our audit was performed for the purpose of forming opinions 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.

Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawaii
March 3, 2003

**Department of Human Services
State of Hawaii**

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

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 fiscal year ended June 30, 2002. 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.

The Management Discussion and Analysis (MD&A) is a new element of Required Supplementary Information specified in the Governmental Accounting and Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, issued June 1999. Certain comparative information between the current year and the prior year is required to be presented in the MD&A. However, because this is the first year of implementing the new reporting model and GASB Statement No. 34 permits the omission of the prior year data in the first year of adopting of the new reporting model, the DHS has elected to exclude the comparative data.

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 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 fiscal 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).

**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**

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.

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 fiscal 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 financing 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 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)**

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, 2002. Since this is the initial year of preparing financial statements in accordance with new GASB reporting standards, there is no comparative data available. In future years, when prior-year information is available, a comparative analysis of government-wide data will be presented.

Condensed Statement of Net Assets

	<u>2002</u>
Current assets	\$ 95,623,381
Capital assets, net	<u>35,279,425</u>
Total assets	\$ <u>130,902,806</u>
Current liabilities	\$ 126,982,743
Non-current liabilities	<u>8,187,537</u>
Total liabilities	\$ <u>135,170,280</u>
Net assets	
Invested in capital assets	\$ 35,279,425
Unrestricted deficit	<u>(39,546,899)</u>
Total net assets	\$ <u>(4,267,474)</u>

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 fiscal year ended June 30, 2002, the combined net assets of the DHS decreased by approximately \$5.5 million.

The deficit in unrestricted net assets of the DHS was approximately \$39.5 million as of June 30, 2002. This deficit in unrestricted net assets is principally the result of liabilities for program services that were incurred as of June 30, 2002, for which state allotments are not yet available. The largest liability as of June 30, 2002, is the estimated amount of medical assistance service provided as of June 30, 2002, for which the related claims will be processed and paid subsequently. Of the estimated \$90.9 million of medical assistance payable, the state share of these costs is approximately \$39.6 million. The estimated federal share of these claims to be paid in the future was recorded as intergovernmental revenues in the current fiscal 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 \$12.1 million as of June 30, 2002, 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, 2002.

**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**

The DHS reported a total of approximately \$35.3 million in net assets invested in capital assets as of June 30, 2002. 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 reported as part of its capital assets in accordance with GASB Statement No. 34. 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 fiscal year ended June 30, 2002.

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.

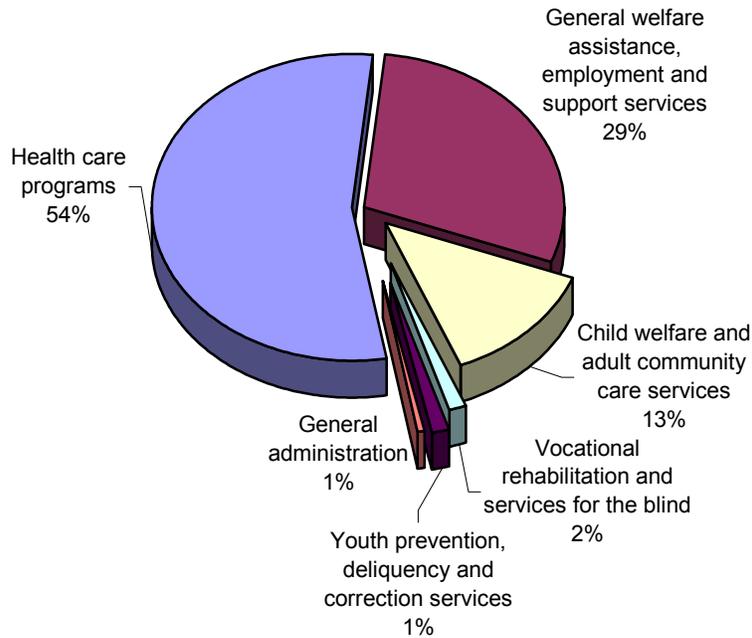
Changes in Net Assets

	2002
Revenues	
Program revenues	\$ 758,255,106
General revenues	562,342,949
Total revenues	1,320,598,055
 Expenses	
Health care programs	722,851,706
General welfare assistance, employment and support services	390,565,862
Child welfare and adult community care services	170,868,464
Vocational rehabilitation and services for the blind	20,018,756
Youth prevention, delinquency and correction services	16,915,538
General administration	8,854,877
Total expenses	1,330,075,203
Deficiency before transfers	(9,477,148)
Transfers	(32,000)
Change in net assets	\$ (9,509,148)

Department of Human Services
State of Hawaii

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

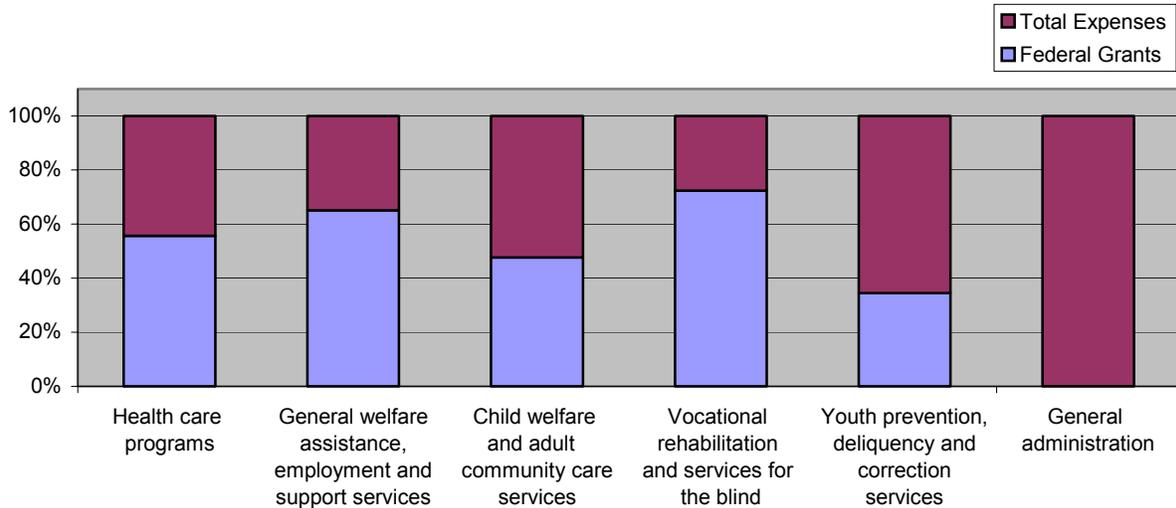
The total cost of all programs and services was approximately \$1.3 billion. Health care and general welfare assistance programs comprised 54% and 29%, respectively, of the total costs. The following chart presents each major activity as a percent of the total cost of all DHS activities:



**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**

Program revenues consist primarily of operating grants from the federal government. Revenues from these federal grants paid for 57% 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:



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 fund 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 fund.

At June 30, 2002, the total governmental fund balance of the DHS consisted of a deficit in unreserved fund balance totaling approximately \$60.3 million. The deficit in the unreserved fund balance of the general fund totaling \$39.5 million is principally the result of liabilities for program services that were incurred as of June 30, 2002, for which state allotments were not yet available. The deficit in the unreserved fund balance of the special revenue fund totaling \$20.8 million is principally the result of federal funds held by DHS at June 30, 2002, that have been committed to liquidate purchase and contractual commitments that were not liabilities as of June 30, 2002, and, therefore, the related intergovernmental revenues were not recorded. Reservations of governmental fund balances for encumbrances totaled approximately \$32.9 million at June 30, 2002. 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.

**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**

The following table presents total revenues and expenditures of the governmental funds of the DHS for the fiscal years ended June 30, 2002 and 2001:

	<u>2002</u>	<u>2001</u>	<u>Percent Change</u>
REVENUES			
State allotted appropriations	\$ 558,646,278	\$ 537,635,618	3.91 %
Intergovernmental revenues	758,255,106	681,540,214	11.26 %
Non-imposed employee fringe benefits	<u>9,605,913</u>	<u>9,526,680</u>	0.83 %
	<u>\$ 1,326,507,297</u>	<u>\$ 1,228,702,512</u>	7.96 %
EXPENDITURES			
Health care programs	722,208,139	634,826,574	13.76 %
General welfare assistance, employment and support services	390,137,437	398,305,341	(2.05) %
Child welfare and adult community care services	170,483,849	138,540,050	23.06 %
Vocational rehabilitation and services for the blind	19,904,391	18,367,385	8.37 %
Youth prevention, delinquency and correction services	16,306,711	15,059,887	8.28 %
General administration	<u>8,717,731</u>	<u>8,140,040</u>	7.10 %
	<u>\$ 1,327,758,258</u>	<u>\$ 1,213,239,277</u>	9.44 %

**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**

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:

	<u>Original Budget</u>	<u>Final Budget</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Health care programs	\$ 314,712,815	\$ 315,357,815	\$ 308,636,726	\$ 6,721,089
General welfare assistance, employment and support services	138,253,653	136,406,525	133,850,501	2,556,024
Child welfare and adult community care services	91,994,242	94,262,905	87,172,569	7,090,336
Vocational rehabilitation and services for the blind	3,939,302	3,939,302	3,899,515	39,787
Youth prevention, delinquency and correction services	10,360,775	10,285,775	9,799,112	486,663
General administration	<u>8,283,467</u>	<u>8,705,250</u>	<u>8,689,679</u>	<u>15,571</u>
	<u>\$ 567,544,254</u>	<u>\$ 568,957,572</u>	<u>\$ 552,048,102</u>	<u>\$ 16,909,470</u>

The difference between the original and final budgeted allotments for child welfare services is due to an emergency appropriation of \$2,268,663 for the foster care program. Other differences between the original and final allotments available for other functions were due to intrafund transfers and restrictions on allotments communicated through executive memorandums.

Actual expenditures for child welfare services was approximately \$7 million less than the budgeted amounts due to an anticipated increase in services to be provided to disadvantaged children that was to be paid for by the State Department of Health that was not as large as estimated for the current period.

**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**

CAPITAL ASSETS

As of June 30, 2002 and 2001, the cost basis of capital assets, net of accumulated depreciation, used by the DHS are presented in the table below. There was a net decrease (additions, deductions, and depreciation) of approximately \$1.3 million or 3.6 percent from the end of last fiscal year. This decrease is primarily a result of annual depreciation totaling approximately \$2 million.

Capital Assets, Net of Depreciation

	<u>2002</u>	<u>2001</u>
State office buildings and improvements	\$ 20,525,373	\$ 21,355,135
Buildings and improvements for the Office of Youth Services	<u>12,355,155</u>	<u>12,940,478</u>
Total buildings and improvements	32,880,528	34,295,613
Furniture, fixtures and equipment	2,398,891	2,296,331
Nondepreciable land	<u>6</u>	<u>6</u>
Total	\$ <u>35,279,425</u>	\$ <u>36,591,950</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).

The events of September 11, 2001, did not have a prolonged effect on the number of people receiving welfare assistance in the State of Hawaii (State). The number of caseloads receiving financial assistance (i.e. cash benefits) increased momentarily in September 2001 by 58 cases and then again in November 2001 by 261 cases from pre-September 11 levels. However, there has been a steady decline in those counts since December 2001. The main reason for the decreasing number of individuals receiving financial assistance is the termination of benefits to welfare cases due to the five year limit on financial assistance under the Hawaii Welfare Reform Program (PONO) that began in December 1996.

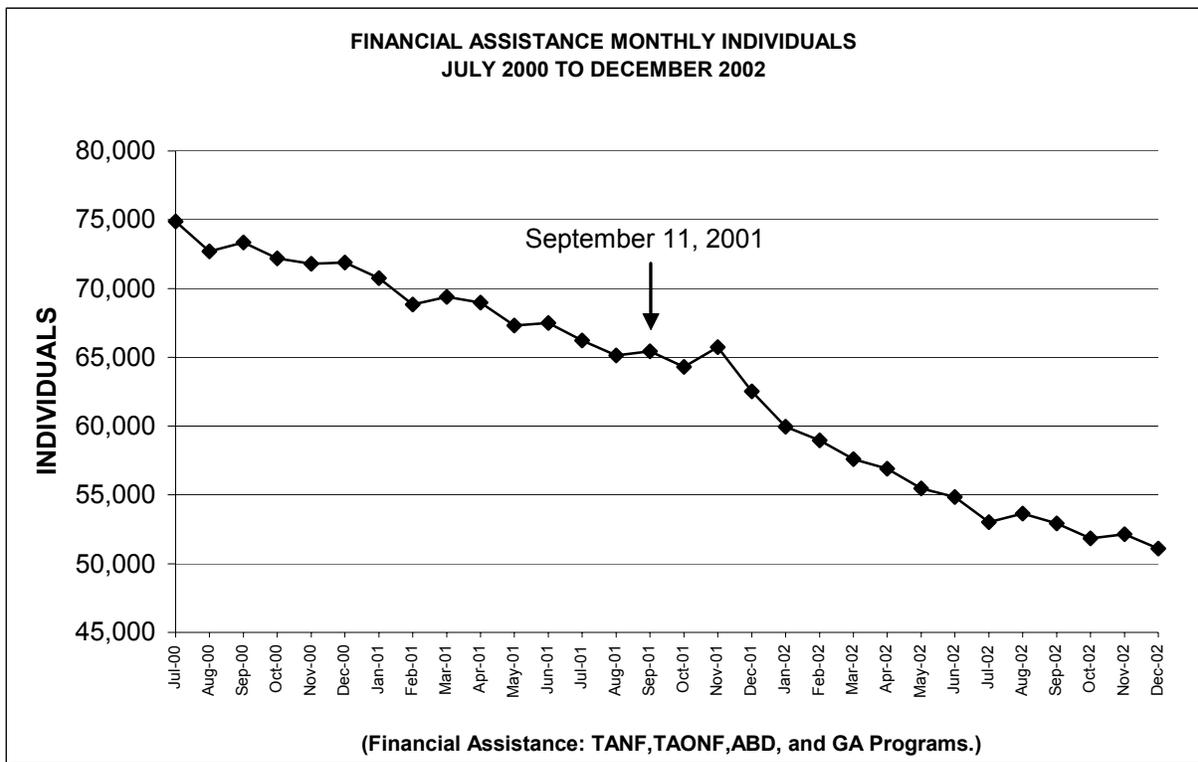
Department of Human Services
State of Hawaii

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

The number of caseloads receiving food stamp assistance actually decreased in September 2001, but then increased over the next six months, most likely due to the effects of September 11. Food stamp caseloads have experienced some volatility since then and it remains to be seen whether the caseloads will stabilize. Although eligibility for the two programs is not linked, Medicaid fee-for-service caseloads have shown a similar pattern to the food stamp caseloads.

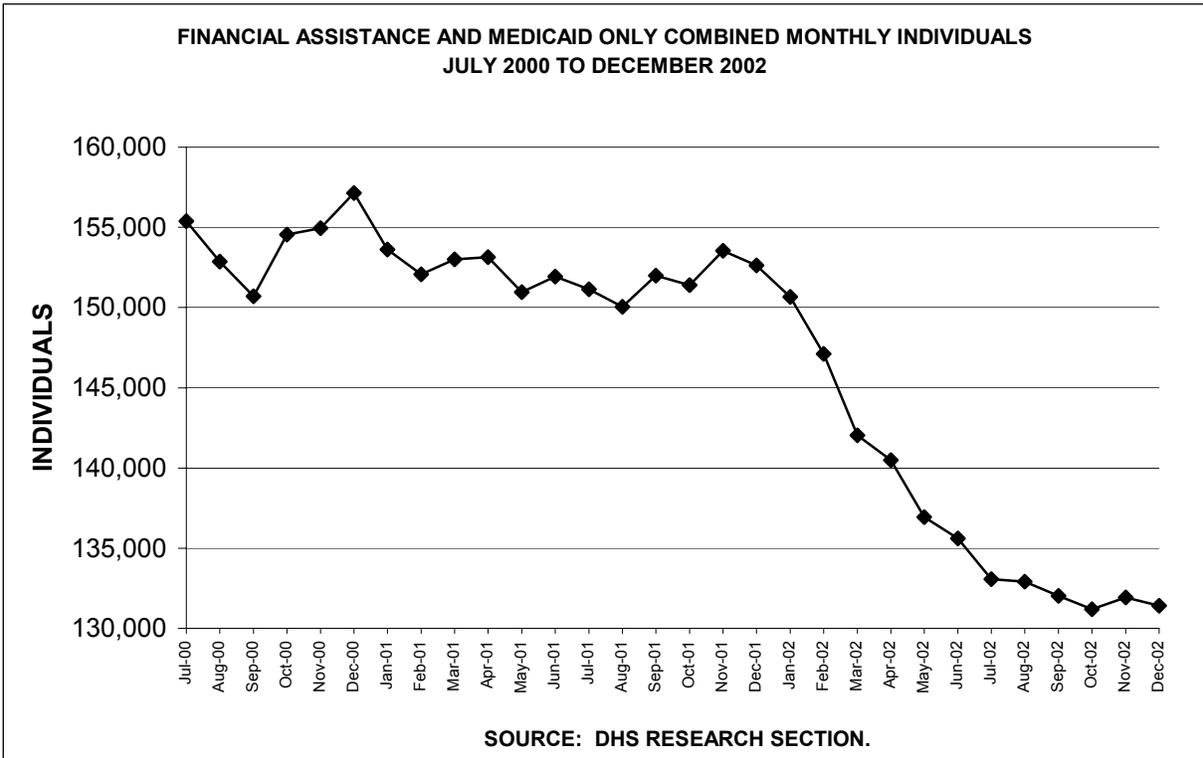
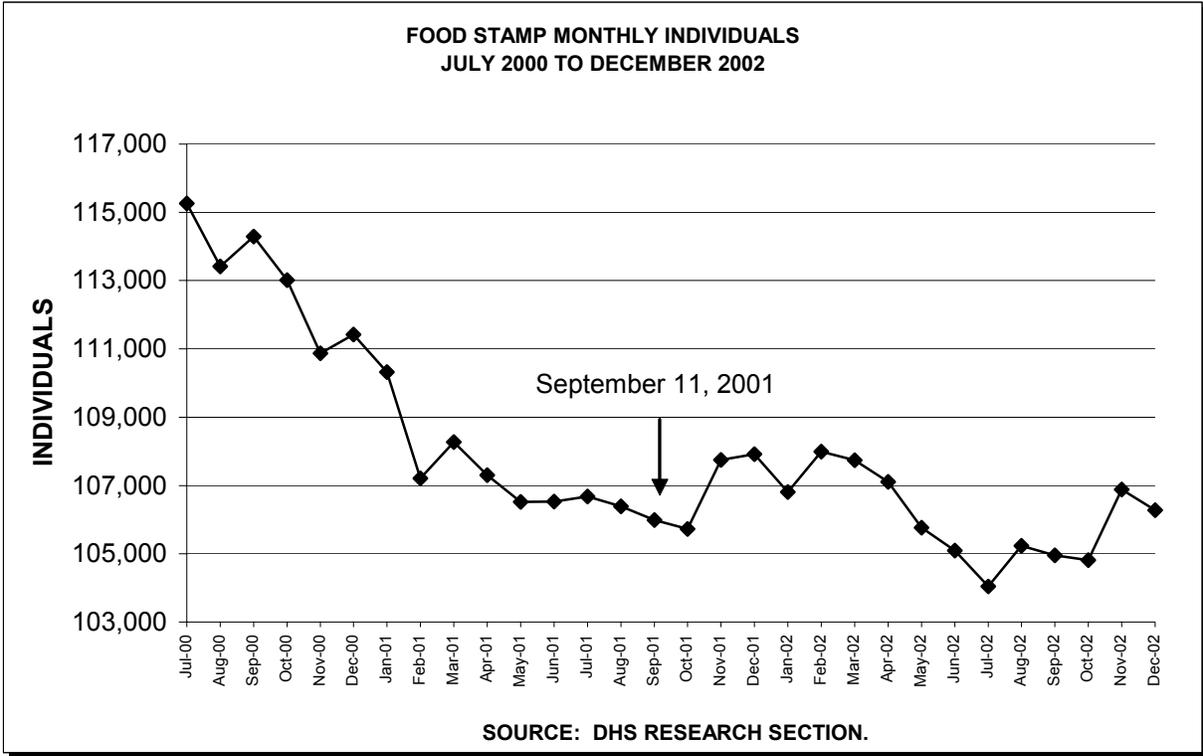
The unemployment rate in the State is a key economic indicator that directly affects caseloads serviced by the DHS. During the two months following September 2001, the unemployment rate peaked. However, there has been a steady decline in unemployment in the period subsequent to November 2001.

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



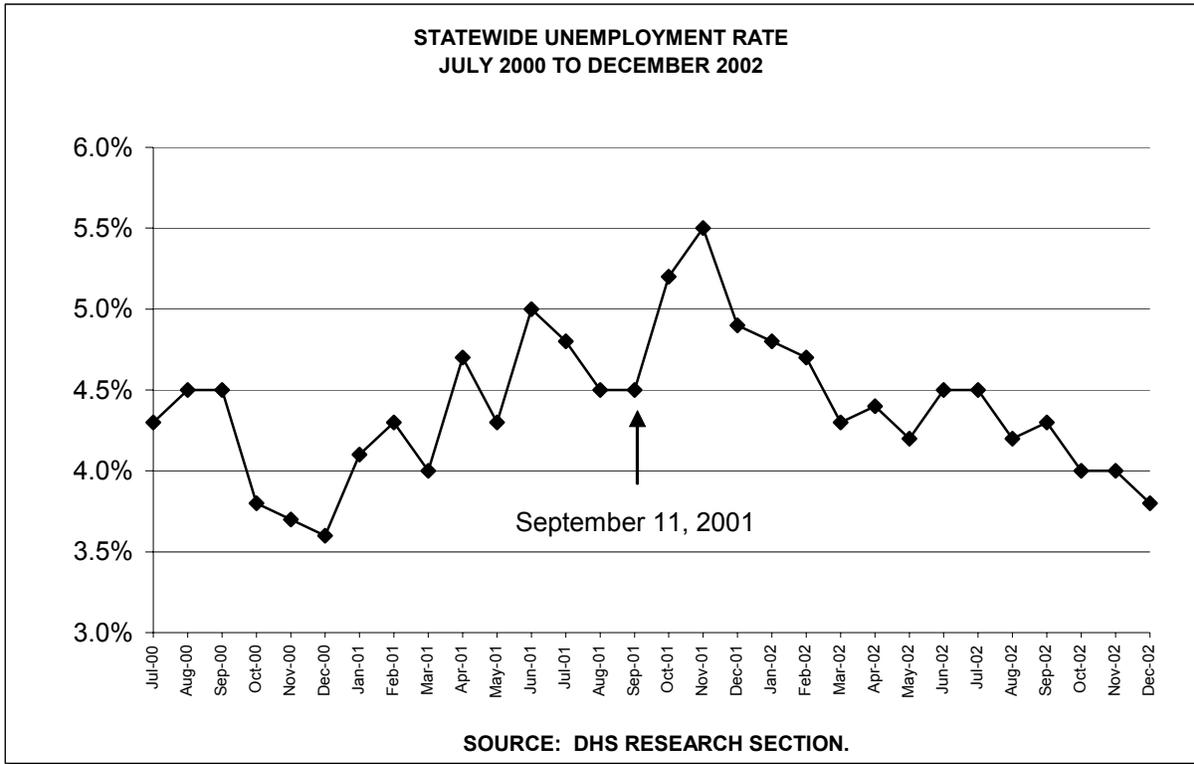
**Department of Human Services
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
(UNAUDITED)**



Department of Human Services
State of Hawaii

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



**Department of Human Services
State of Hawaii
STATEMENT OF NET ASSETS
June 30, 2002**

	<u>Governmental Activities</u>
ASSETS	
Cash and cash equivalents	\$ 48,016,935
Receivables	4,077,961
Due from other governments	<u>43,528,485</u>
Total current assets	95,623,381
Capital assets, net of accumulated depreciation	<u>35,279,425</u>
Total assets	\$ <u><u>130,902,806</u></u>
LIABILITIES	
Vouchers payable	\$ 21,872,410
Accrued wages and employee benefits payable	4,492,937
Due to State of Hawaii	5,767,396
Accrued medical assistance payable	90,900,000
Compensated absences	<u>3,950,000</u>
Total current liabilities	126,982,743
Compensated absences, less current portion	<u>8,187,537</u>
Total liabilities	<u><u>135,170,280</u></u>
NET ASSETS	
Invested in capital assets, net of related debt	35,279,425
Unrestricted (deficit)	<u>(39,546,899)</u>
Total net assets	\$ <u><u>(4,267,474)</u></u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
STATEMENT OF ACTIVITIES
Fiscal Year Ended June 30, 2002**

Functions/Programs	Expenses	Program Revenues			Net Expense and Changes in Net Assets
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	
Governmental activities:					
Health care programs	\$ 722,851,706	\$ --	\$ 402,479,793	\$ --	\$ (320,371,913)
General welfare assistance, employment and support services	390,565,862	--	254,146,198	--	(136,419,664)
Child welfare and adult community care services	170,868,464	--	81,313,333	--	(89,555,131)
Vocational rehabilitation and services for the blind	20,018,756	--	14,479,770	--	(5,538,986)
Youth prevention, delinquency and correction services	16,915,538	--	5,836,012	--	(11,079,526)
General administration	8,854,877	--	--	--	(8,854,877)
Total	\$ 1,330,075,203	\$ --	\$ 758,255,106	\$ --	(571,820,097)
		General revenues:			
					558,646,278
					9,605,913
					(5,909,242)
					(32,000)
					<u>562,310,949</u>
					(9,509,148)
					<u>5,241,674</u>
					<u>\$ (4,267,474)</u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
BALANCE SHEET
GOVERNMENTAL FUNDS
June 30, 2002**

	General	Special Revenue	Total
ASSETS			
Cash and cash equivalents	\$ 23,583,476	\$ 24,433,459	\$ 48,016,935
Receivables	2,475,561	1,602,400	4,077,961
Due from other funds	5,425,993	--	5,425,993
Due from other governments	<u> --</u>	<u>49,908,785</u>	<u>49,908,785</u>
 Total assets	 <u>\$ 31,485,030</u>	 <u>\$ 75,944,644</u>	 <u>\$ 107,429,674</u>
 LIABILITIES AND FUND BALANCES			
LIABILITIES			
Vouchers payable	\$ 11,609,086	\$ 10,263,324	\$ 21,872,410
Accrued wages and employee benefits payable	3,240,989	1,251,948	4,492,937
Due to other funds	--	5,425,993	5,425,993
Due to other governments	--	6,380,300	6,380,300
Due to State of Hawaii	5,565,201	202,195	5,767,396
Accrued medical assistance payable	<u>39,600,000</u>	<u>51,300,000</u>	<u>90,900,000</u>
 Total liabilities	 <u>60,015,276</u>	 <u>74,823,760</u>	 <u>134,839,036</u>
 FUND BALANCES			
Reserved for encumbrances	11,011,814	21,942,595	32,954,409
Unreserved	<u>(39,542,060)</u>	<u>(20,821,711)</u>	<u>(60,363,771)</u>
 Total fund balances (deficit)	 <u>(28,530,246)</u>	 <u>1,120,884</u>	 <u>(27,409,362)</u>
 Total liabilities and fund balances	 <u>\$ 31,485,030</u>	 <u>\$ 75,944,644</u>	 <u>\$ 107,429,674</u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
RECONCILIATION OF THE GOVERNMENTAL FUNDS BALANCE SHEET
TO THE STATEMENT OF NET ASSETS
June 30, 2002**

Total deficit in fund balances - governmental funds		\$ (27,409,362)
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	\$ 49,004,441	
Less accumulated depreciation	<u>(13,725,016)</u>	35,279,425
Accrued compensated absences liability is not due in the current period and therefore is not reported in the governmental funds.		
		<u>(12,137,537)</u>
Net assets of governmental activities		\$ <u>(4,267,474)</u>

See accompanying notes to the basic financial statements.

Department of Human Services
State of Hawaii
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
GOVERNMENTAL FUNDS
Fiscal Year Ended June 30, 2002

	General	Special Revenue	Total
REVENUES			
State allotted appropriations	\$ 558,646,278	\$ --	\$ 558,646,278
Intergovernmental revenues	--	758,255,106	758,255,106
Non-imposed employee fringe benefits	<u>9,605,913</u>	--	<u>9,605,913</u>
	<u>568,252,191</u>	<u>758,255,106</u>	<u>1,326,507,297</u>
EXPENDITURES			
Health care programs	319,728,346	402,479,793	722,208,139
General welfare assistance, employment and support services	135,991,239	254,146,198	390,137,437
Child welfare and adult community care services	89,194,256	81,289,593	170,483,849
Vocational rehabilitation and services for the blind	5,417,452	14,486,939	19,904,391
Youth prevention, delinquency and correction services	10,470,699	5,836,012	16,306,711
General administration	<u>8,717,731</u>	--	<u>8,717,731</u>
	<u>569,519,723</u>	<u>758,238,535</u>	<u>1,327,758,258</u>
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	<u>(1,267,532)</u>	<u>16,571</u>	<u>(1,250,961)</u>
OTHER FINANCING USES			
Operating transfers out	<u>(32,000)</u>	--	<u>(32,000)</u>
	<u>(32,000)</u>	--	<u>(32,000)</u>
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES AND OTHER USES	(1,299,532)	16,571	(1,282,961)
OTHER CHANGES IN FUND BALANCES			
Lapsed appropriations	<u>(5,909,242)</u>	--	<u>(5,909,242)</u>
NET CHANGE IN FUND BALANCES	(7,208,774)	16,571	(7,192,203)
FUND BALANCES (DEFICIT) AT JULY 1, 2001	<u>(21,321,472)</u>	<u>1,104,313</u>	<u>(20,217,159)</u>
FUND BALANCES (DEFICIT) AT JUNE 30, 2002	\$ <u>(28,530,246)</u>	\$ <u>1,120,884</u>	\$ <u>(27,409,362)</u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
RECONCILIATION OF THE CHANGE IN FUND BALANCES OF
GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES
Fiscal Year Ended June 30, 2002**

Net change in fund balances - total governmental funds		\$ (7,192,203)
 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	\$ 823,999	
Less: current year depreciation	<u>(2,070,307)</u>	(1,246,308)
 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>(1,070,637)</u>
 Change in net assets of governmental activities		 \$ <u>(9,509,148)</u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
STATEMENT OF REVENUES AND EXPENDITURES -
BUDGET AND ACTUAL - GENERAL FUND
Fiscal Year Ended June 30, 2002**

	<u>Original</u>	<u>Final</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Revenues				
State allotments	\$ 567,544,254	\$ 568,957,572	\$ 558,646,278	\$ (10,311,294)
Expenditures				
Health care programs	314,712,815	315,357,815	308,636,726	6,721,089
General welfare assistance, employment and support services	138,253,653	136,406,525	133,850,501	2,556,024
Child welfare and adult community care services	91,994,242	94,262,905	87,172,569	7,090,336
Vocational rehabilitation and services for the blind	3,939,302	3,939,302	3,899,515	39,787
Youth prevention, delinquency and correction services	10,360,775	10,285,775	9,799,112	486,663
General administration	8,283,467	8,705,250	8,689,679	15,571
	<u>567,544,254</u>	<u>568,957,572</u>	<u>552,048,102</u>	<u>16,909,470</u>
Excess of revenues over expenditures	--	--	6,598,176	6,598,176
Other financing uses				
Operating transfers out	<u>--</u>	<u>--</u>	<u>(32,000)</u>	<u>(32,000)</u>
Excess of revenues over expenditures and other uses	\$ <u><u>--</u></u>	\$ <u><u>--</u></u>	\$ <u><u>6,566,176</u></u>	\$ <u><u>6,566,176</u></u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
STATEMENT OF REVENUES AND EXPENDITURES -
BUDGET AND ACTUAL - SPECIAL REVENUE FUNDS
Fiscal Year Ended June 30, 2002**

	<u>Original</u>	<u>Final</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Revenues				
Intergovernmental revenues	\$ <u>659,007,588</u>	\$ <u>659,007,588</u>	\$ <u>589,893,035</u>	\$ <u>(69,114,553)</u>
Expenditures				
Health care programs	410,953,544	410,953,544	391,680,388	19,273,156
General welfare assistance, employment and support services	127,049,497	127,049,497	107,122,364	19,927,133
Child welfare and adult community care services	90,493,097	90,493,097	74,817,277	15,675,820
Vocational rehabilitation and services for the blind	16,582,862	16,582,862	13,659,430	2,923,432
Youth prevention, delinquency and correction services	11,185,718	11,185,718	5,686,878	5,498,840
General administration	<u>2,742,870</u>	<u>2,742,870</u>	<u>2,579,019</u>	<u>163,851</u>
	<u>659,007,588</u>	<u>659,007,588</u>	<u>595,545,356</u>	<u>63,462,232</u>
 Excess of revenues over (under) expenditures	 \$ <u> --</u>	 \$ <u> --</u>	 \$ <u>(5,652,321)</u>	 \$ <u>(5,652,321)</u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
STATEMENT OF ASSETS AND LIABILITES - AGENCY FUNDS
June 30, 2002**

ASSETS

Cash	\$ <u>1,511,883</u>
Total assets	\$ <u>1,511,883</u>

LIABILITIES

Due to individuals	\$ 1,120,533
Due to others	<u>391,350</u>
Total liabilities	\$ <u>1,511,883</u>

See accompanying notes to the basic financial statements.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

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.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE A - FINANCIAL REPORTING ENTITY (Continued)

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.

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

As of July 1, 2001, the DHS adopted the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, and Statement No. 37, *Basic Financial Statements - Management's Discussion and Analysis - for Local and State Governments - Omnibus*. These statements require significant changes in financial statement presentation and disclosures. Certain significant changes include the following:

- For the first time the financial statements include a Management's Discussion and Analysis section providing an analysis of the DHS's overall financial position and results of operations.
 - The basic financial statements include the statement of net assets and statement of activities, which include the economic effect of assets and liabilities previously reported as the general fixed asset account group and the general long-term debt account group.
- (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.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 (other than expendable trusts) that are legally restricted to expenditures for specified purposes.

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.

(2) ***Measurement Focus and Basis of Accounting***

Government-wide Financial Statements - The economic resources measurement focus and accrual basis of accounting is 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. 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.

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 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.

Agency Funds - Agency funds are used to account for resources held by the DHS as an agent for individual 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.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

- (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) **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.
- (5) **Accumulated Vacation** - Employees are credited with vacation at the rate of 168 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.
- (6) **Intrafund and Interfund Transactions** - Significant transfers of financial resources between activities included within the same fund are offset within that fund. Transfers of revenues from funds authorized to receive them to funds authorized to expend them have been recorded as operating transfers in the basic financial statements.
- (7) **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.
- (8) **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 in the government-wide financial statements. Capital assets are recorded as expenditures of the current period 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.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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:

Asset Type	Minimum Capitalization Amount	Estimated Useful Life
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

- (9) **Due to Individuals** - Due to individuals represents assets held by the DHS primarily in a agent capacity and is available to individuals receiving benefits under various programs primarily through the Electronic Benefits Transfer System.
- (10) **Operating Grants and Contributions** - Federal grants and assistance awards are recorded as intergovernmental receivables and revenues when all eligibility requirements have been satisfied.
- (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.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE C - BUDGETING AND BUDGETARY CONTROL (Continued)

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 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 fiscal year ended June 30, 2002,

	<u>General</u>	<u>Special Revenue</u>
Excess of revenues over (under) expenditures and other uses - actual on a budgetary basis	\$ 6,566,176	\$ (5,652,321)
Reserved for encumbrances at fiscal year-end	11,011,814	21,942,595
Expenditures for liquidation of prior fiscal year encumbrances	(10,998,233)	(14,906,722)
Net change in unreserved liabilities	(739,043)	4,202,299
Net change in accrued medical assistance payable	(4,200,000)	(10,000,000)
Accruals related to federal reimbursements for program expenditures	(3,028,633)	4,379,820
Net change in other receivables	<u>88,387</u>	<u>50,900</u>
Excess of revenues over (under) expenditures and other uses – GAAP basis	\$ <u>(1,299,532)</u>	\$ <u>16,571</u>

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE D - CASH AND CASH EQUIVALENTS

The State Director of Finance is responsible for safekeeping of all moneys 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, 2002, the carrying amount of total bank deposits was approximately \$190,000 and the corresponding bank balances which are represented were approximately \$622,000.

NOTE E - RECEIVABLES

Receivables of the DHS, net of an allowance for doubtful accounts, consisted of the following at June 30, 2002:

	<u>General</u>	<u>Special Revenue</u>
Welfare benefit overpayments	\$ 19,807,730	\$ 22,712,270
QUEST premiums receivable	2,500,000	--
Social Security interim assistance loans	800,000	--
CSEA receivable	<u>77,961</u>	<u>--</u>
	<u>23,185,691</u>	<u>22,712,270</u>
Less allowance for doubtful accounts:		
Welfare benefit overpayments	18,410,130	21,109,870
QUEST premiums receivable	<u>2,300,000</u>	<u>--</u>
	<u>20,710,130</u>	<u>21,109,870</u>
Receivables, net	\$ <u>2,475,561</u>	\$ <u>1,602,400</u>

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE F - CAPITAL ASSETS

The changes in capital assets were as follows:

	Governmental Activities				Balance June 30, 2002
	Balance July 1, 2001	Additions	Disposals	Net Transfers	
Depreciable assets					
Buildings and improvements	\$ 42,163,734	\$ --	\$ --	\$ --	\$ 42,163,734
Furniture and equipment	4,524,656	396,475	(46,580)	(16,932)	4,857,619
Vehicles	1,558,263	427,524	(8,345)	5,640	1,983,082
Nondepreciable assets					
Land	6	--	--	--	6
Total at historical cost	<u>48,246,659</u>	<u>823,999</u>	<u>(54,925)</u>	<u>(11,292)</u>	<u>49,004,441</u>
Less accumulated depreciation for:					
Buildings and improvements	7,868,121	1,415,085	--	--	9,283,206
Furniture and equipment	2,460,204	463,303	46,580	49,839	2,827,088
Vehicles	<u>1,326,384</u>	<u>191,919</u>	<u>8,345</u>	<u>(104,764)</u>	<u>1,614,722</u>
Total accumulated depreciation	<u>11,654,709</u>	<u>2,070,307</u>	<u>54,925</u>	<u>(54,925)</u>	<u>13,725,016</u>
Total capital assets, net	\$ <u>36,591,950</u>	\$ <u>(1,246,308)</u>	\$ <u>--</u>	\$ <u>(66,217)</u>	\$ <u>35,279,425</u>

Depreciation expense was charged to functions as follows:

	Governmental Activities
Health care programs	\$ 783,613
General welfare assistance, employment and support services	256,151
Child welfare and adult community care services	164,458
Vocational rehabilitation and services for the blind	78,366
Youth prevention, delinquency and correction services	629,450
General administration	<u>158,269</u>
	\$ <u>2,070,307</u>

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE G - LONG-TERM LIABILITY

The only long-term liability of the DHS for governmental activities is for compensated absences. The change in the long-term liability during the fiscal year ended June 30, 2002, was as follows:

	<u>Amount</u>
Balance at July 1, 2001	\$ 11,913,517
Net increase	<u>224,020</u>
Balance at June 30, 2002	\$ <u>12,137,537</u>

The portion of the compensated absences liability due within one year is estimated at \$3,950,000.

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 \$9,606,000 for the fiscal year ended June 30, 2002, 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.

NOTE I - FUND BALANCE DEFICITS

The general and special revenue funds of the DHS have deficits in the unreserved fund balances at June 30, 2002, aggregating to \$39,542,060 and \$20,820,711, respectively. Those deficits resulted primarily from expenditures being recorded on the accrual basis when incurred, and revenues being recognized only when corresponding funds are measurable and available.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE J - CHANGES IN ASSETS AND LIABILITIES OF THE AGENCY FUNDS

The agency funds are purely custodial (assets equal liabilities) and thus do not involve the measurement of results of operations. The changes in assets and liabilities of the agency funds for the fiscal year ended June 30, 2002, were as follows:

	<u>Balance</u> <u>July 1, 2001</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance</u> <u>June 30, 2002</u>
ASSETS				
Cash - special and temporary deposits	\$ <u>976,897</u>	\$ <u>5,119,883</u>	\$ <u>4,584,897</u>	\$ <u>1,511,883</u>
LIABILITIES				
Due to individuals and others	\$ <u>976,897</u>	\$ <u>5,119,883</u>	\$ <u>4,584,897</u>	\$ <u>1,511,883</u>

NOTE K - LEASE COMMITMENTS

The DHS leases office facilities from third party lessors under various operating leases expiring through 2007. Certain leases include renewal and escalation clauses. Future minimum lease rentals under non-cancelable operating leases with terms of one year or more at June 30, 2002, are as follows:

<u>Fiscal Year Ending June 30,</u>	<u>Amount</u>
2003	\$ 2,002,000
2004	1,628,000
2005	733,000
2006	321,000
2007	<u>74,000</u>
	<u>\$ 4,758,000</u>

Total rent expense related to the above leases for the fiscal year ended June 30, 2002, amounted to approximately \$2,285,000.

In addition, the DHS uses state-owned facilities that are reported as capital assets in the government-wide financial statements. The State's share of lease costs for those facilities was not reported in the general fund of the DHS since the allotted appropriations of the DHS were reduced by that amount. The federal share of these lease costs allocable to programs was reported in the special revenue funds of the DHS.

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE L - RETIREMENT BENEFITS

Employees' Retirement System

Substantially all eligible employees of the DHS are required by Chapter 88, Hawaii Revised Statutes (HRS), 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 financial report that includes financial statements and required supplementary information. The report may be obtained by writing to the ERS at City Financial Tower, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Members of the ERS belong to either a contributory or noncontributory option. Only employees of the DHS hired on or before June 30, 1984 are eligible to participate in the contributory option. Members are required by state statute to contribute 7.8% of their salary to the contributory option and the DHS is required to contribute to both options at an actuarially determined rate. No contributions were required or made by the DHS for the fiscal years ended June 30, 2002 and 2001. Contributions by the DHS for the fiscal year ended June 30, 2000, were approximately \$4,003,900. The contribution rate for the fiscal year ended June 30, 2000, was 5.78%.

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 retired state employees. Contributions are financed on a pay-as-you-go basis. The DHS's share of the expense for post-retirement health care and life insurance benefits for the fiscal year ended June 30, 2002, was approximately \$4,061,000.

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.

NOTE M - 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 losses and the first \$2 million with respect to

**Department of Human Services
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE M - RISK MANAGEMENT (Continued)

general liability claims. Losses in excess of those retention amounts are insured with commercial insurance carriers. The limit per occurrence for property losses is \$300 million (\$50 million for earthquake and flood) and the annual aggregate for general liability losses per occurrence is \$23 million. The State also has an insurance policy to cover medical malpractice risk in the amount of \$40 million per occurrence with no annual aggregate limit. 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 N - COMMITMENTS AND CONTINGENCIES

Accumulated Sick Leave

Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service 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, 2002, amounted to approximately \$41,960,000.

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 \$18 million of federal financial participation in the Medical Assistance Program for the period 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) 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 THE BASIC FINANCIAL STATEMENTS
June 30, 2002**

NOTE N - COMMITMENTS AND CONTINGENCIES (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. As of March 3, 2003, 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, 2002, 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.

SUPPLEMENTARY INFORMATION

**Department of Human Services
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Fiscal Year Ended June 30, 2002**

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-through Entity Identifying Number	Federal Expenditures ¹
U.S. Department of Health and Human Services			
Promoting Safe and Stable Families	93.556		\$ 1,542,826
Temporary Assistance for Needy Families (TANF) ²	93.558		64,503,941
Low-Income Home Energy Assistance	93.568		1,714,575
Child Care and Development Block Grant ²	93.575		14,590,568
State Court Improvement Program	93.586		14,461
Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.596		11,198,250
Head Start	93.600		9,952
Children's Justice Grants to States	93.643		130,482
Child Welfare Services - State Grants	93.645		1,051,107
Foster Care - Title IV-E	93.658		16,715,890
Adoption Assistance	93.659		6,217,902
Social Services Block Grant ²	93.667		11,799,888
Child Abuse and Neglect State Grants	93.669		175,882
Family Violence Prevention and Services/Grants for Battered Women's Shelters - Grants to States and Indian Tribes	93.671		781,572
Chafee Foster Care Independent Living	93.674		413,118
State Children's Insurance Program	93.767		3,499,373
State Survey and Certification of Health Care Providers and Suppliers	93.777		372,327
Medical Assistance Program	93.778		418,722,752
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations	93.779		123,132
Pass-through State Department of Labor and Industrial Relations Refugee and Entrant Assistance - State Administered Programs	93.566		<u>20,774</u>
Total U.S. Department of Health and Human Services			\$ <u>553,598,772</u>

**Department of Human Services
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (Continued)
Fiscal Year Ended June 30, 2002**

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-through Entity Identifying Number	Federal Expenditures ¹
U.S. Department of Agriculture			
Food Stamps ³	10.551		\$ 151,890,408
State Administrative Matching Grants for Food Stamp Program	10.561		<u>8,893,812</u>
Total U.S. Department of Agriculture			<u>160,784,220</u>
U.S. Department of Justice			
Juvenile Accountability Incentive Block Grants	16.523		1,557,649
Juvenile Justice and Delinquency Prevention - Allocation to States	16.540		631,442
Title V - Delinquency Prevention Program	16.548		150,719
Part E - State Challenge Activities (Challenge Grants)	16.549		97,354
Byrne Formula Grant Program	16.579		9,872
Enforcing Underage Drinking Laws Program	16.727		<u>365,565</u>
Total U.S. Department of Justice			<u>2,812,601</u>
U.S. Department of Labor			
Employment Programs for People with Disabilities	17.720		39,883
Pass-through State Department of Labor and Industrial Relations			
Senior Community Service Employment Program	17.235	PY00-SCSEP-CC-DHS	<u>272,432</u>
Total U.S. Department of Labor			<u>312,315</u>
Federal Emergency Management Agency			
Individual and Family Grants	83.543	DRS-01-0B-00001	<u>6,614</u>
Total Federal Emergency Management Agency			<u>6,614</u>
U.S. Department of Education			
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126		7,489,506
Rehabilitation Services - Service Projects	84.128		205,428
Rehabilitation Long-Term Training	84.129		77,876
Independent Living - State Grants	84.169		324,103
Rehabilitation Services - Independent Living Services for Older Individuals Who are Blind	84.177		227,524
Supported Employment Services for Individuals with Severe Disabilities	84.187		253,000

**Department of Human Services
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (Continued)
Fiscal Year Ended June 30, 2002**

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-through Entity Identifying Number	Federal Expenditures ¹
Assistive Technology	84.224		\$ 220,804
Projects with Industry	84.234		126,140
Rehabilitation Training - State Vocational Rehabilitation Unit In-Service Training	84.265		18,659
Capacity Building For Traditionally Underserved Populations	84.315		149,899
Pass-through State Office of Children and Youth Safe and Drug-Free Schools and Communities - State Grants	84.186	S186B990012	48,633
		S186B000012	<u>347,334</u>
Total U.S. Department of Education			<u>9,488,906</u>
Corporation for National and Community Service			
Foster Grandparent Program	94.011		436,264
Senior Companion Program	94.016		<u>368,564</u>
Total Corporation for National and Community Service			<u>804,828</u>
Social Security Administration			
Social Security - Disability Insurance	96.001		<u>4,399,152</u>
Total Social Security Administration			<u>4,399,152</u>
TOTAL FEDERAL EXPENDITURES			<u>\$ 732,207,408</u>

¹ The accompanying schedule of expenditures of federal awards is prepared on the cash basis of accounting.

² Grant awards totaling \$12,300,000 were transferred from CFDA 93.558 Temporary Assistance for Needy Families to CFDA 93.667 Social Services Block Grant (\$4,200,000) and to CFDA 93.575 Child Care and Development Block Grant (\$8,100,000).

³ Expenditures represent assistance utilized through the Electronic Benefits Transfer System.

PART II

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



NISHIHAMA & KISHIDA, CPA's, INC.
CERTIFIED PUBLIC ACCOUNTANTS

AMERICAN SAVINGS BANK TOWER
1001 BISHOP STREET, SUITE 1700
HONOLULU, HAWAII 96813-3696
TELEPHONE (808) 524-2255
FAX (808) 523-2090

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND
ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN
AUDIT OF THE BASIC FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

To the Director
Department of Human Services
State of Hawaii

We have audited the basic financial statements of the Department of Human Services of the State of Hawaii (DHS), as of and for the fiscal year ended June 30, 2002, and have issued our report thereon dated March 3, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the DHS's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 that are required to be reported under *Government Auditing Standards*.

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 basic financial statements and not to provide assurance on the internal control over financial reporting. 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 basic financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 02-1 through 02-2.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the basic 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.

This report is intended solely for the information and use of 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.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
March 3, 2003

PART III

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



NISHIHAMA & KISHIDA, CPA'S, INC.
CERTIFIED PUBLIC ACCOUNTANTS

AMERICAN SAVINGS BANK TOWER
1001 BISHOP STREET, SUITE 1700
HONOLULU, HAWAII 96813-3696
TELEPHONE (808) 524-2255
FAX (808) 523-2090

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
APPLICABLE TO EACH MAJOR PROGRAM AND 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 of the 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 fiscal year ended June 30, 2002. 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; 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 02-3 to 02-7 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.
93.778	Medical Assistance Program	Eligibility, Special Tests and Provisions	02-3, 02-4, 02-5
93.575 and 93.596	Child Care Cluster	Allowability, Eligibility	02-6, 02-7

Compliance with those 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 fiscal year ended June 30, 2002.

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.

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 02-3 to 02-7.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts and grants 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 item 02-6 to be a material weakness. We also noted other matters involving the internal control over compliance that we have reported to the management of the DHS in a separate letter dated March 3, 2003.

This report is intended solely for the information and use of 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.

Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawaii
March 3, 2003

PART IV
SCHEDULE OF FINDINGS AND QUESTIONED COSTS

**Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
Fiscal Year Ended June 30, 2002**

SECTION I - SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued: Unqualified

Internal control over financial reporting:

 Material weakness(es) identified? ___ yes no

 Reportable condition(s) identified
 not considered to be material weaknesses? yes ___ none reported

Noncompliance material to the financial statements noted? ___ yes no

Federal Awards

Internal control over major program:

 Material weakness(es) identified? yes ___ no

 Reportable condition(s) identified
 not considered to be material weaknesses? yes ___ none reported

Type of auditors' report issued on compliance
for major programs: Qualified

Any audit findings disclosed that are required
to be reported in accordance with OMB
Circular A-133, Section. 510(a)? yes ___ no

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
10.551	Food Stamps
10.561	State Administrative Matching Grants for Food Stamp Program
84.126	Rehabilitation Services-Vocational Rehabilitation Grants to States
93.558	Temporary Assistance for Needy Families
93.575	Child Care and Development Block Grant
93.596	Child Care Mandatory and Matching Funds of the Child Care and Development Fund
93.658	Foster Care - Title IV-E
93.767	State Children's Insurance Program
93.777	State Survey and Certification of Health Care Providers and Suppliers
93.778	Medical Assistance Program
96.001	Social Security - Disability Insurance

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

Auditee qualified as a low-risk auditee? ___ yes no

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

SECTION II - FINANCIAL STATEMENT FINDINGS

Ref.
No. Internal Control Findings

02-1 Replace the Existing Automated Recovery System (ARS)

The DHS accounts for welfare overpayments to individuals in both the ARS and the Hawaii Automated Welfare Information (HAWI) System. The ARS includes receivable balances from both active and inactive welfare case files. The HAWI System includes receivable balances from only active welfare case files (i.e., individuals currently receiving assistance). Once welfare overpayments are identified, the income maintenance workers (IMWs) enter the overpayment claims into the HAWI System and provide the necessary information to the Investigations Office for input into the ARS.

Since the ARS contains receivable balances from both active and inactive cases, the population of accounts is large. As of June 30, 2001, there were approximately 38,000 accounts totaling more than \$46 million in overpayments receivable. Because no accounts have ever been written-off, some accounts have balances that have been outstanding for over a decade. As a result, the DHS has been identifying long outstanding receivable balances on inactive cases and submitting these accounts to the State Department of the Attorney General for approval for write-off. As of August 2002, approximately \$9 million (6,647 accounts) of long outstanding receivables were written-off. These uncollectible receivable balances have been transferred to a separate database to be used as an archive file to identify welfare participants that may return to the program and have prior outstanding balances due.

Although the ARS is used to account for all outstanding receivable balances and related collections, the only automated interface between the ARS and the HAWI System is related to recoupments (programmed deductions from monthly benefit checks of active participants). Since the programming language used to develop the ARS is obsolete, the DHS has found it difficult to make enhancements to the program. As a result, all new welfare overpayment accounts are added to the ARS as follows:

- On a weekly basis, the HAWI System's *Overpayment Claim Report or Claim Change Report* (Form 1484) is printed for each new welfare overpayment account entered into the HAWI System by the IMWs.
- The IMWs must manually complete Form 1484 in order to establish a new account on the ARS when the overpayment claim cannot be set up through the HAWI System.
- All HAWI System generated and manual Forms 1484 are then submitted to the Investigations Office for manual data entry into the ARS.

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

In addition to recoupments, individuals may repay welfare overpayments by direct payments of cash, checks, or money orders to the Collections and Recovery Section (CRS). CRS clerks manually enter all cash receipts into both the ARS and the HAWI System. As a result, every cash receipt transaction handled by the CRS must be recorded twice.

Beginning in August 1999, the DHS implemented a lockbox collection system with a bank for all direct payments of welfare overpayments handled by the CRS. This new process reduces the volume of receipts that must be manually inputted into the ARS. Information related to these direct payment collections is transferred to the ARS by electronic files for all payments mailed directly to the bank by recipients. However, the cash receipts information must still be manually inputted into the HAWI System. This new process improves security over collections by minimizing the amount of cash receipts held at the CRS and reduces the risk that collections will not be deposited intact on a timely basis. In addition, the process to receive, deposit and record collections is more efficient which allows CRS personnel to focus on resolving unidentified receipts, resolving trust fund suspense account balances, and increasing collection efforts.

After evaluating the alternatives to develop a new system to replace the ARS and evaluating other states' systems, the DHS has determined that the application program used by the State of Arizona to process the billing and collection of welfare overpayments is a suitable replacement for the ARS. The new Hawaii Accounts Receivable Information (HARI) System was built on the same platform as the HAWI System, and can be integrated with the HAWI System. The DHS has also determined that with some modifications, the cash receipts information processed through the lockbox collection system could be exported to the HARI System. However, the HARI System is not targeted to be operational until May 2003.

Beginning March 2002, the DHS has ceased to record any new overpayment receivables and the related collection of those new receivables. In November 2002, the posting of all collections stopped as the ARS was completely shut down. As a result there is a large backlog of receivables and receipts that need to be recorded into the HARI System.

Recommendation

The DHS should implement the HARI System as soon as possible. To increase operational efficiencies, the HARI System should be integrated with the HAWI System. The HARI System should also be interfaced with the lockbox collection system, which will allow the DHS to maintain current levels of accounting controls and operational efficiencies.

In addition, the DHS should continue with its plans to identify long outstanding receivable balances and submit those accounts for approval for write-off by the State Department of the Attorney General. By transferring these uncollectible receivable balances to a separate database, the DHS will be working with only recent data when data from the ARS is exported to the HARI System. This should allow the DHS to monitor receivable balances more closely through a better analysis of the aging and collection history of a smaller population of accounts.

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

Ref.
No. **Internal Control Findings (Continued)**

02-2 Maintain Vacation and Sick Leave Records Properly

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 understatement of accrued vacation and sick leave totaling \$25,750.
- There was an instance where the Form G-1 was submitted to request sick leave, but the leave was recorded as vacation leave.
- There was an instance where there was no signature authorizing the leave on the Form G-1.
- There was an instance where an employee accumulated more than 120 vacation hours during the fiscal year.

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.

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

SECTION III - FEDERAL AWARD FINDINGS

Ref. No.	Compliance and Internal Control Findings	Questioned Costs
---------------------	---	-----------------------------

02-3 Improve Utilization Controls over Medicaid Claims

During our tests of the internal controls, we noted the following conditions:

- 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 a component of the DHS's utilization and post-payment controls. 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.
- In accordance with Title 42 CFR Part 456, the DHS contracted an External Quality Review Organization (EQRO)/Peer Review Organization (PRO) to perform post-payment reviews for a sample of acute hospital care and ambulatory surgical services. However, the EQRO/PRO report for calendar year 2000 was not completed until April 2002. In addition, the EQRO/PRO review for the calendar year 2001 is not expected to be completed until June 2003. The actual and expected completion dates of the EQRO/PRO reviews diminish the value and effectiveness of this utilization and integrity control.
- During the fiscal year June 30, 2002, the DHS had the Surveillance and Utilization Review Subsystem (SURS) of the MMIS in place to generate utilization data on providers and recipients that is analyzed by staff nurses of the Medical Standards Branch of the DHS for potentially fraudulent or abusive behavior as required by Title 42 CFR Part 456.23. However, as of the date of this report, the DHS has not completed reviews of SURS reports for the fiscal year ended June 30, 2002. This was due to the impending integration of the claims system into the Hawaii Prepaid Management Information System (HPMMIS) and the transition to a new fiscal agent. This integration was part of the Hawaii Arizona PMMIS Alliance (HAPA) project. The DHS has devoted significant resources to programming and testing of the claims processing subsystem of the HPMMIS and toward being in compliance with the Health Insurance Portability and Accountability Act (HIPAA), which is expected in October 2003.

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

Questioned
Costs

In November 2002, the HPMMIS was in operation and the majority of fiscal agent responsibilities had been shifted; however, as of the date of this report, the HPMMIS was not being used to review post payment utilization data for potential fraud and abusive behavior.

\$ --

Recommendation

Although the transition to a new claims system and a new fiscal agent requires a substantial amount of resources, the DHS must comply with federal regulations regarding utilization controls over Medicaid services by performing the following:

- Conduct 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 45 CFR Part 455.14. The method of documentation should be more standardized to provide better information on complaints received, referrals of suspect 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.

Given the reports of widespread Medicaid fraud occurring at the local and national level, the DHS should consider committing additional resources to the MIU, which is presently staffed by one person.

- The new utilization review subsystem of the HPMMIS was available in November 2002. Therefore, the DHS should finalize parameters and procedures necessary to put into operation the HPMMIS utilization post-payment review subsystem as soon as possible.
- The DHS should consider selecting its sample claims for review by the EQRO/PRO on a quarterly basis based on claims paid. Selecting claims paid for post-payment review by the EQRO/PRO on a quarterly basis would allow the DHS to identify problematic areas, and if necessary, to recoup funds in a more timely manner.

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

<u>Ref. No.</u>	Compliance and Internal Control Findings (Continued)	<u>Questioned Costs</u>
------------------------	---	--------------------------------

02-4	Improve Accuracy of Medicaid Claims Processing	
-------------	---	--

As part of our review of internal controls, we performed detailed tests of Medicaid (CFDA 93.778) claims. The non-drug claims tested were processed by HMSA (DHS's fiscal agent through October 2003) using the state-owned system, Medicaid Management Information System (MMIS). 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 (HPMMIS) operated and maintained by the State of Arizona.

During our tests, we noted numerous errors caused by one or a combination of the following: examiner error, improper authorization, procedural errors, and/or system errors. The errors noted are similar in nature to those found in prior fiscal years. The errors resulted in a net overpayment totaling \$6,810.

\$ 6,810

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 results of our tests in the current fiscal year reinforce our recommendation that the 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.

**Department of Human Services
 SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
 Fiscal Year Ended June 30, 2002**

Ref. No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
02-5	<p>Complete Eligibility Applications and Annual Eligibility Re-verifications in a Timely Manner</p> <p>Title 42 CFR Part 435.911 requires the DHS to determine the eligibility of individuals who apply for Medicaid 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.</p> <p>Since September 11, 2001, the DHS has fallen behind in its processing of Medicaid applications and annual eligibility re-verifications. As of June 30, 2002, there were approximately 430 applications not processed within 45 days and 2,300 annual re-verifications over due, which is about twice as many as there were at the end of fiscal year 2001.</p>	<p>\$ <u> --</u></p>

Recommendation

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

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

Ref. No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
02-6	<p>Maintain all Required Documentation in Child Care Case Files</p> <p>During fiscal year 2002, third party contractors performed the majority of monthly child care payment services. During our tests of allowability and eligibility for the Child Care Cluster (CFDA's 93.575 and 93.596), we noted that required documentation was not always maintained. 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. The errors noted were as follows:</p> <ul style="list-style-type: none">• One instance in which the participant was not eligible resulting in an overpayment of \$452.• Three instances in which the participant case file did not contain all documents required for eligibility determination. As such, child care reimbursements, totaling \$976 should not have been made.• Four instances in which the participant case file did not contain all documents required to compute and authorize the monthly payment. As such, child care reimbursements totaling \$4,815 should not have been made.• Two instances in which child care reimbursements were authorized prior to receipt of documents required for the calculation of the amount of reimbursement. Ultimately the proper reimbursement was made; however, payment should not be authorized until all required documents are received.	\$ <u>6,243</u>

Recommendation

The DHS should ensure that proper eligibility determinations are made and that all required documents are received timely and are properly maintained in each case file to support the allowability and eligibility of the child care payments being claimed for federal reimbursement. The DHS should implement formal procedures to monitor the agency contracted to perform monthly child care payment services in order to assess contractor performance. During fiscal year 2002, the DHS did perform a review of case files at a single unit and similar errors were noted. Follow-up reviews should be performed until the error rate has decreased at all units.

Department of Human Services
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2002

Ref. No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
---------------------	---	-----------------------------

02-7 Improve the Accuracy of Child Care Reimbursements

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

- One instance in which there was an improper application of the required co-payment percentage. The reimbursement error resulted in an overpayment of \$25.
- One instance in which there was an incorrect payment calculation. The reimbursement error resulted in an overpayment of \$2.
- One instance in which the reimbursement to the participant was greater than the maximum amount allowed for the respective child care category. The reimbursement error resulted in an overpayment of \$224.

\$ 251

Recommendation

In June 2002, the DHS implemented a new payment system, Hawaii Automated Network for Assistance (HANA), which automatically calculates child care reimbursements. Upon implementation, the DHS noted errors in payment calculation and corrective action was taken to improve the accuracy of reimbursement calculations performed by HANA. The DHS should continue to monitor and assess system performance to ensure that reimbursements to child care program participants are calculated properly.

PART V
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

STATUS REPORT

This section contains the current status of our prior audit recommendations. The recommendations are referenced to the pages of the previous audit report for the fiscal year ended June 30, 2001, dated March 1, 2002.

Recommendations	Status
SECTION II - FINANCIAL STATEMENT FINDINGS	
01-1 Replace the Existing Automated Recovery System (ARS) (pages 42-43)	
<p>The DHS should continue its efforts to replace the ARS with the ARICS application software from the State of Arizona. The ARICS can be modified to integrate with the HAWI System, which should increase operational efficiencies. The ARICS can also be interfaced with the lockbox collection system, which will allow the DHS to maintain current levels of accounting controls and operational efficiencies.</p> <p>In addition, the DHS should continue with its plans to identify long outstanding receivable balances in the ARS and submit those accounts for approval for write-off by the State Department of the Attorney General. By transferring these uncollectible receivable balances to a separate database, the DHS will be working with only recent data when the ARS is replaced with the ARICS. This should allow the DHS to monitor receivable balances more closely through a better analysis of the aging and collection history of a smaller population of accounts.</p>	Not accomplished. See Reference No. 02-1.
01-2 Maintain Vacation and Sick Leave Records Properly (page 44)	
<p>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.</p>	Not accomplished. See Reference No. 02-2.
01-3 Record Fixed Asset Additions in the State Property Inventory Records (page 45)	
<p>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 report all fixed asset acquisitions and disposals to the State Procurement Office on a quarterly basis. Also, the DHS should perform a physical inventory of their fixed assets to determine the accuracy of the state property inventory records.</p>	Accomplished.

Recommendations	Federal CFDA Number	Status
SECTION III - FEDERAL AWARD FINDINGS		
01-4 Perform Required Automated Data Processing Reviews (page 46-47)		
<p>The DHS should assess the procedures performed and results of its on-site review of the security and personnel practices related to the MMIS and determine whether its review meets the biennial ADP security systems review requirements of Title 45 CFR Part 95.621. The DHS should also prepare and maintain reports of its review, together with pertinent supporting documentation, for federal review.</p>	93.778	Accomplished. The DHS conducted an on-site review in February 2002.
01-5 Improve Utilization Controls Over Medicaid Claims (page 48-51)		
<p>The DHS must perform the following to be in compliance with federal regulations:</p> <ul style="list-style-type: none"> • Conduct 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 45 CFR Part 455.14. Documentation should include the number of complaints, the nature of the complaint, action taken, and disposition of the case. <p>For each full investigation opened, the DHS should document the provider's name, the source of the complaint, the type of provider, the nature of the complaint, the approximate range of dollars involved, the action taken, and the final disposition of each case, including actions taken by law enforcement officials to whom the case had been referred. The records should indicate the activity of the MIU and demonstrate the work performed by the investigator. 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.</p>	93.778	Not accomplished. See Reference No. 02-3.

Recommendations	Federal CFDA Number	Status
<p>As a result of the substantial time and effort necessary to complete the migration of the claims processing system to HPMMIS and ensure compliance with HIPAA, there has been a shift in focus away from the DHS's responsibility to maintain strong, ongoing program utilization controls, such as the SURS, the PRO, and the automated data processing reviews. Although the DHS expects to be transitioning to a new claims system it should not disregard the importance of maintaining strong utilization controls to ensure correct processing, proper payments, and accurate reporting.</p>		
<ul style="list-style-type: none"> • The DHS should maintain its commitment to strong utilization controls by ensuring that the PRO reviews are completed on a timely basis and continuing the SURS analysis of claims. • The DHS should consider committing additional resources to the MIU, which is presently staffed by one person. A strong commitment is warranted given the reports of widespread Medicaid fraud occurring at the local and national level. 		
<p>01-6 Improve Accuracy of Medicaid Claims Processing (page 52-53)</p>		
<p>Due to the complexity of the Medicaid claims processing function, there is a high inherent risk that claims processing errors may occur. 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 results of our tests in the current fiscal year reinforce our recommendation that the DHS should perform regular post payment reviews on a sample of claims to detect processing errors and identify ways to improve the MMIS and the claims processing procedures.</p>	93.778	Not accomplished. See Reference No. 02-4.

Recommendations	Federal CFDA Number	Status
<p>01-7 Improve Controls Over Documentation in Participant Case Files (page 54-56)</p>	<p>10.551 93.558 93.778</p>	<p>Partially accomplished. The review of case files as of June 30, 2002, showed an improvement by the DHS over case file management. However, we still noted instances in which the IMW did not certify the application or the MERF was not properly filed in the case file. The DHS has begun to implement its corrective action plan which includes additional monitoring by both the QC office and BESSD.</p>
<p>The DHS should establish procedures to ensure that administrative policies to maintain proper documentation in participant case files are adhered to. The DHS should address the following recommendations for each program by division:</p>		
<ul style="list-style-type: none"> • Ensure that IMWs in the Benefit, Employment and Support Services Division (BESSD) maintain adequate documentation of eligibility determinations for the TANF program. Proper documentation must include completed applications that are both signed by the participant and certified by the IMW. In addition, IMWs must document their assessment of participant skills for the TANF program. IMWs should also adhere to DHS policies to review and sign-off on the Monthly Eligibility Report (MERF Form 1311). • Ensure that IMWs in the BESSD maintain adequate documentation of eligibility determinations for the Food Stamps program. Proper documentation must include completed applications that are both signed by the participant and certified by the IMW. • Ensure that IMWs in the Med-Quest Division (MQD) maintain adequate documentation of eligibility determinations for the MAP program. Proper documentation must include completed applications that are both signed by the participant and certified by the IMW. In addition, IMWs must document their verification of the identification, income and asset information declared by the participant. IMWs also must document that the required annual re-determinations were performed. • The QC office of the Management Services Office (MSO) should monitor the IMW's compliance with administrative policies and report deficiencies noted in the participant case files to the respective 		

Recommendations	Federal CFDA Number	Status
<p>units within each division. The QC office should also increase communication with the division supervisors to improve the work performed by the IMWs and related documentation. Increased communication could lead to formal recommendations to the Office of the Director that are aimed at streamlining the process through policy changes or improving work through increased training.</p>		
<p>01-8 Execute New Provider Agreements for All Medicaid Providers (page 57)</p>	93.778	Partially accomplished. The DHS has executed provider agreements for all facility providers. However, they are still in the process of executing the updated provider agreements with the non-facility providers and removing inactive providers from its provider listing.
<p>01-9 Maintain All Required Documentation in Child Care Case Files (page 58)</p>	93.575 93.596	Not accomplished. See Reference No. 02-6.
<p>The DHS should ensure that all required documents are properly maintained in each case file to support the allowability and eligibility of the child care payments being claimed for federal reimbursement. The DHS should consider requiring regular supervisory reviews and having personnel outside of the program perform periodic reviews. Based upon the results of the reviews, the DHS should consider additional training for the units.</p>		

Recommendations	Federal CFDA Number	Status
01-10 Improve the Accuracy of Child Care Reimbursements (page 59)	93.575 93.596	Not accomplished. See Reference No. 02-7.
The DHS should ensure that reimbursements to child care program participants are calculated properly. The DHS should consider performing periodic reviews of case files and assess whether further training is necessary to improve the accuracy of the child care reimbursements.		
01-11 Ensure Only Allowable Payroll Costs are Claimed Under Federal Awards (page 60)	93.658 93.659	Accomplished. To correct the error, an adjustment was made to the Form ACF IV-E 1 report for the quarter ended March 31, 2002.
The DHS should review the allocation of the payroll costs being charged to the Title IV-E grant to ensure that only allowable costs are being claimed under federal awards.		
01-12 Ensure Payments are Made Only to Fully Licensed Foster Care Homes (page 60)	93.658	Accomplished. The DHS implemented programming changes to the Child Protective Services System (CPSS) to help ensure that providers meet all requirements for full licensure as required under Title IV-E.
The DHS should ensure that all foster care homes are fully licensed before payments to these homes are claimed for federal reimbursement. In a review conducted in April 2001, by the U.S. Department of Health and Human Services Administration for Children and Families, it was recommended that the State of Hawaii should consider amending its statutes to not require the FBI clearance at the time of the initial full licensure, but require that it be completed within a specified period of time after licensing.		

PART VI
RESPONSE OF THE AFFECTED AGENCY



STATE OF HAWAII
DEPARTMENT OF HUMAN SERVICES
P. O. Box 339
Honolulu, Hawaii 96809

March 18, 2003.

Mr. Ronald T. Shiigi
Nishihama & Kishida, CPA's, Inc.
American Savings Bank Tower
1001 Bishop Street, Suite 1700
Honolulu, Hawaii 96813-3696

Dear Mr. Shiigi:

We have reviewed your report *Financial Audit of the Department of Human Services, State of Hawaii, Fiscal Year Ended June 30, 2002*. Generally, we concur with your findings and recommendations.

Attached are our responses and corrective action plans related to your audit findings and recommendations. We wish to thank you for this opportunity to respond.

Sincerely,

A handwritten signature in black ink, appearing to read "Lillian B. Koller".

Lillian B. Koller, Esq.
Director

Attachment

Audit Finding: 02-1 Replace the Existing Automated Recovery System (ARS)

Auditor's Recommendation: The DHS should implement the HARI System as soon as possible. To increase operational efficiencies, the HARI System should be integrated with the HAWI System. The HARI System should also be interfaced with the lockbox collection system, which will allow the DHS to maintain current levels of accounting controls and operational efficiencies.

In addition, the DHS should continue with its plans to identify long outstanding receivable balances and submit those accounts for approval for write-off by the State Department of the Attorney General. By transferring these uncollectible receivable balances to a separate database, the DHS will be working with only recent data when the data from the ARS is exported to the HARI System. This should allow the DHS to monitor receivable balances more closely through a better analysis of the aging and collection history of a smaller population of accounts.

Corrective Action Taken or Planned: The HARI system is presently in the implementation phase and is scheduled to be operational by June 2003. As a part of the system modifications, applications to interface HARI with the HAWI and lockbox systems were developed.

The write-off of uncollectible accounts, including requesting the approval of the State Department of the Attorney General, will be performed on a regular basis, at least annually.

Start Date: November 1998

End Date: Ongoing

Responding Person: Derek Oshiro, Chief Accountant, Fiscal Management Office (FMO)

Audit Finding: 02-2 Maintain Vacation and Sick Leave Records Properly

Auditor's 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.

Corrective Action Taken or Planned: Quality control reviews of leave records were conducted affecting 19 employees in 2000, and 42 employees in 2001.

In-depth training has been completed for appropriate staff on the neighbor islands with 68 attendees in 2001. On Oahu, 117 people received training in 2002.

The department's Personnel Office will continue to provide training to staff responsible for maintaining accurate leave records.

The summary leave schedule will be reviewed by other staff (e.g. the supervisor) to ensure that the correct balances are reported to the State Comptroller.

Start Date: August 1997

End Date: Ongoing

Responding Persons: Edwin Nose, Personnel Officer
Edwin Igarashi, Fiscal Management Officer

Audit Finding:

02-3 Improve Utilization Controls Over Medicaid Claims

**Auditor's
Recommendation:**

Although the transition to a new claims system and a new fiscal agent requires a substantial amount of resources, the DHS must comply with federal regulations regarding utilization controls over Medicaid services by performing the following:

- Conduct 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 45 CFR 455.14. The method of documentation should be more standardized to provide better information on complaints received, referrals of suspect 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.

Given the reports of widespread Medicaid fraud occurring at the local and national level, the DHS should consider committing additional resources to the MIU, which is presently staffed by one person.

- The new utilization review subsystem of the HPMMIS was available in November 2002. Therefore, the DHS should finalize parameters and procedures necessary to put into operation the HPMMIS utilization post-payment review subsystem as soon as possible.
- The DHS should consider selecting its sample claims for review by the EQRO/PRO on a quarterly basis based on claims paid. Selecting claims paid for post-payment review by the EQRO/PRO on a quarterly basis would allow the DHS to identify problematic areas, and if necessary, to recoup funds in a more timely manner.
- The MQD will update its internal procedures to better track the complaints received and actions taken. As discussed previously, many of the complaints received are closed when clarification of MQD's procedures, policies and covered benefits is given to the person filing the complaint.

**Corrective Action
Taken or Planned:**

Additional Medicaid Investigation Unit positions have not been budgeted. The MQD needs to assess and prioritize

needs for changes and staffing increases in each of its branches and offices. The MQD will consider this recommendation in its assessment.

- The Medical Standards Branch (MSB) has taken on the following new responsibilities in the operation of the new system:
 1. Online authorization of all services/items that require authorization. This requires data entry of the approvals by MSB staff and increases the time required for each authorization by at least ten (10) times;
 2. Authorization and arrangement for neighbor island air transportation; and
 3. Adjudication and prepayment review of claims. This function requires that the MSB adjudicate claims online. This has increased the time required for each adjudication by ten (10) to twenty five (25) times.

Given the above additional responsibilities, we will put into operation a utilization review system as soon as possible.

- The EQRO/PRO reviews are not focused on correct payment. Their purpose is to evaluate whether the level of care billed was provided and if the services provided were medically necessary. Thus, the findings are related to the specific case(s) reviewed and cannot be easily generalized to identify problematic areas of utilization. However, this recommendation will be taken into consideration when renewing the contract.

Start Date: July 1999

End Date: Ongoing

Responding Persons: Dr. Lynette Honbo, Medical Standards Branch Administrator and Ron Kim, Medicaid Investigator; MQD

Audit Finding: 02-4 Improve Accuracy of Medicaid Claims Processing

Auditor's 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 results of our tests in the current fiscal year reinforce our recommendation that the 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 Action Taken or Planned: The DHS implemented a new claims processing system in November 2002 that has more system edits than the previous HMSA system to control payments. As payments are being made, the department is reviewing the claims to be sure they are current and accurate. The DHS has already made several table changes to correct identified errors. The department agrees that post payment processes should be in place to review claims on a regular basis. The Quality Control Staff of the Management Services Office and Med-QUEST Division staff will perform some reviews.

Start Date: November 2002

End Date: Ongoing

Responding Person: Aileen Hiramatsu, Med-QUEST Division Administrator

Audit Finding: 02-5 Complete Eligibility Applications and Annual Eligibility Re-
verifications in a Timely Manner

Auditor's Recommendation: The DHS should make every effort to eliminate the backlog of applications pending eligibility determinations and the over due annual re-verifications to reduce the risk that ineligible recipients are receiving Medicaid benefits.

Corrective Action Taken or Planned: Backlogged Applications: The backlog of applications pending eligibility determinations is due to the staffing situation. Staff continue to leave for better positions within the DHS or the State system. This problem of inadequate staffing is further exacerbated by the continual freeze on hiring and the amount of time that it takes to get the necessary approvals to hire.

Currently, as in the past, we have initiated a project to deal with the backlog of applications. The number of applications has also gone up due to the economic slump which started after 9/11. To keep current with the applications, the MQD/EB needs stable, experienced staff.

Annual Eligibility Reviews: The MQD/EB has done a good job in keeping up with the annual reviews considering that it has vacant positions, caseloads of over 600 Medical Only cases with full responsibility of ERs and all related actions/problems, and, an additional responsibility of trouble-shooting for over 500 QUEST cases. The EB staff is overwhelmed with the work and is doing its best to keep current. In order to do better the MQD/EB needs to have additional staff resources and a reasonable workload.

Inadequate staffing at EB is the main reason that our work is not always current. We have had various projects to fix problem areas and continue to do so when necessary. However, without adequate staffing there is not much more that can be done. We have streamlined operations several times, instituted self-declaration at the point of applications, and instituted a task assignment type of operation in some of the more overwhelmed units trying to deal with the number of applications. We will continue to do these things as they are the only way we have been able to keep as current as we are. To have things function at a higher level we will need more staff. This does not appear to be possible given the current economic climate of the State.

Start Date: Ongoing

End Date: Ongoing

Responding Person: Ann G. Tam Sing, Eligibility Branch Administrator, MQD

Audit Finding: 02-6 Maintain all Required Documentation in Child Care Case Files

Auditor's Recommendation: The DHS should ensure that proper eligibility determinations are made and that all required documents are received timely and are properly maintained in each case file to support the allowability and eligibility of the child care payments being claimed for federal reimbursement. The DHS should implement formal procedures to monitor the agency contracted to perform monthly child care payment services in order to assess contractor performance. During fiscal year 2002, the DHS did perform a review of case files at a single unit and similar errors were noted. Follow-up reviews should be performed until the error rate has decreased at all units.

Corrective Action Taken or Planned: The Employment and Child Care Program Office (ECCPO) has reminded the contracted staff, through formal discussions and formal staff training sessions, to request required documents from clients in a timely fashion and maintain them in each case file to support the allowability and eligibility of the child care payments. The department is planning to conduct annual audits of all units regardless of the error rates. The DHS is also planning to issue formal procedures to monitor the agency contracted to perform monthly child care payment services in order to assess contractor performance.

The DHS is considering discontinuation of the child care payment service contracts and issuing payments through the DHS staff. The ECCPO and Branches are currently conducting a cost analysis to determine the following:

1. Whether contractors have provided services of "equivalent or better quality" than could have been provided by a government agency at lower cost; and
2. The appropriateness of continuing to privatize the services.

Start Date: July 2002

End Date: Ongoing

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

Audit Finding: 02-7 Improve the Accuracy of Child Care Reimbursements

Auditor's Recommendation: In June 2002, the DHS implemented a new payment system, Hawaii Automated Network for Assistance (HANA), which automatically calculates child care reimbursements. Upon implementation, the DHS noted errors in payment calculation and corrective action was taken to improve the accuracy of reimbursement calculations performed by HANA. The DHS should continue to monitor and assess system performance to ensure that reimbursements to child care program participants are calculated properly.

Corrective Action Taken or Planned: The DHS will continue to monitor the accuracy of child care reimbursements through system generated payment reports and annual review of case records.

Start Date: July 2002

End Date: Ongoing

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