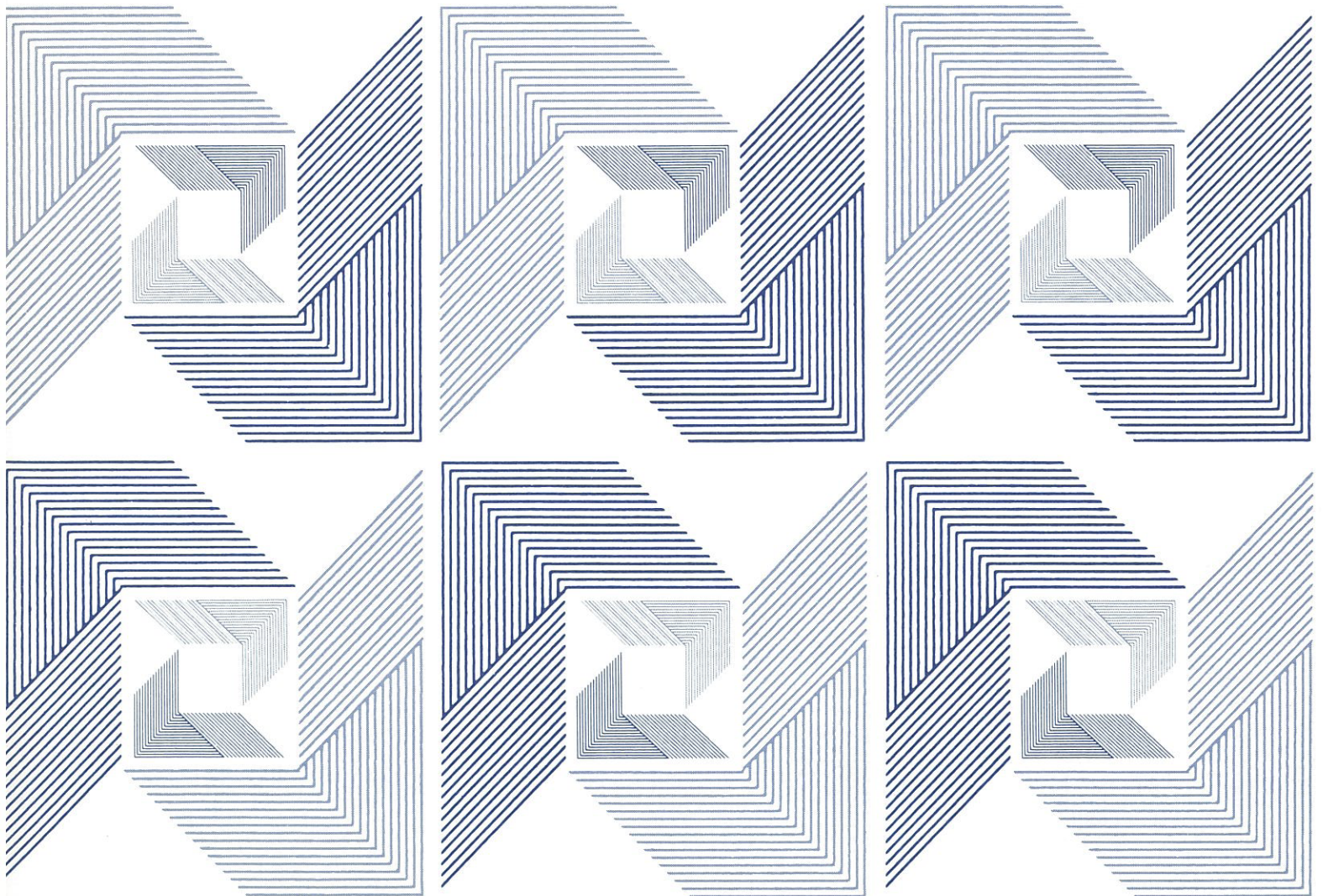


REPORT NO. 82-3  
FEBRUARY 1982

# EXAMINATION OF SELECTED ASPECTS OF THE STATE GENERAL OBLIGATION BOND FUND

A REPORT TO THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF HAWAII



SUBMITTED BY THE LEGISLATIVE AUDITOR OF THE STATE OF HAWAII

## THE OFFICE OF THE LEGISLATIVE AUDITOR

The office of the legislative auditor is a public agency attached to the Hawaii State legislature. It is established by Article VII, Section 10, of the Constitution of the State of Hawaii. The expenses of the office are financed through appropriations made by the legislature.

The primary function of this office is to strengthen the legislature's capabilities in making rational decisions with respect to authorizing public programs, setting program levels, and establishing fiscal policies and in conducting an effective review and appraisal of the performance of public agencies.

The office of the legislative auditor endeavors to fulfill this responsibility by carrying on the following activities.

1. Conducting examinations and tests of state agencies' planning, programming, and budgeting processes to determine the quality of these processes and thus the pertinence of the actions requested of the legislature by these agencies.
2. Conducting examinations and tests of state agencies' implementation processes to determine whether the laws, policies, and programs of the State are being carried out in an effective, efficient, and economical manner.
3. Conducting systematic and periodic examinations of all financial statements prepared by and for all state and county agencies to attest to their substantial accuracy and reliability.
4. Conducting tests of all internal control systems of state and local agencies to ensure that such systems are properly designed to safeguard the agencies' assets against loss from waste, fraud, error, etc.; to ensure the legality, accuracy, and reliability of the agencies' financial transaction records and statements; to promote efficient operations; and to encourage adherence to prescribed management policies.
5. Conducting special studies and investigations as may be directed by the legislature.

Hawaii's laws provide the legislative auditor with broad powers to examine and inspect all books, records, statements, documents, and all financial affairs of every state and local agency. However, the office exercises no control functions and is restricted to reviewing, evaluating, and reporting its findings and recommendations to the legislature and the governor. The independent, objective, and impartial manner in which the legislative auditor is required to conduct his examinations provides the basis for placing reliance on his findings and recommendations.



LEGISLATIVE AUDITOR  
KEKUANA'O A BUILDING, RM. 500  
465 SOUTH KING STREET  
HONOLULU, HAWAII 96813



**EXAMINATION OF SELECTED ASPECTS  
OF THE STATE  
GENERAL OBLIGATION BOND FUND**

**A Report to the Governor and the Legislature  
of the State of Hawaii**

**Submitted by the  
Legislative Auditor of the State of Hawaii**

**Report No. 82-3**

**February 1982**





## FOREWORD

State capital improvements projects are largely paid for with the proceeds from the sale of State General Obligation Bonds. The accounting entity responsible for recording project appropriations, bond sale proceeds and expenditures is the General Obligation Bond Fund.

An examination of selected aspects of the Bond Fund was conducted by our office and the independent CPA firm of Peat, Marwick, Mitchell & Co. This resultant report contains our findings and recommendations and covers such aspects as the financial condition of the General Obligation Bond Fund, encumbrance practices, appropriation transfers and the Project Adjustment Fund, and the Bond Fund Report.

We wish to acknowledge the cooperation and assistance extended by the officials of the Departments of Budget and Finance and Accounting and General Services.

Clinton T. Tanimura  
Legislative Auditor  
State of Hawaii

February 1982





## TABLE OF CONTENTS

<i>Chapter</i>		<i>Page</i>
	<b>PART I</b>	
	<b>INTRODUCTION AND BACKGROUND</b>	
1	INTRODUCTION .....	3
	Objectives of the Examination .....	3
	Scope of the Examination .....	3
	Organization of the Report .....	3
2	BACKGROUND .....	5
	The Bond Fund of the State of Hawaii .....	5
	The CIP Budgeting and Execution Process .....	5
	Constitutional and Other Constraints .....	7
	<b>PART II</b>	
	<b>FINDINGS AND RECOMMENDATIONS</b>	
3	FINANCIAL CONDITION OF THE GENERAL OBLIGATION BOND FUND .....	11
	Summary of Findings .....	11
	Capacity of the General Obligation Bond Fund .....	11
	Backlog of Authorized But Unissued Debt .....	12
	Interfund Borrowing: The Use of Treasury Advances .....	15
	Fiscal Year 1981: Problems With General Obligation Bond Sales .....	15
	Interfund Borrowing in 1981 .....	16
	Opportunity Cost of Interfund Borrowings .....	18
	Summary of the Problem .....	19
	Recommendations .....	20

<i>Chapter</i>		<i>Page</i>
4	ENCUMBRANCE PRACTICES OF THE GENERAL OBLIGATION BOND FUND .....	21
	Summary of Findings .....	21
	Background and Criteria .....	21
	Encumbrances Without Legal Commitments .....	22
	Inadequacy of the State's Encumbrance Policy .....	22
	Excess Encumbering of Funds .....	24
	Inadequate Monitoring of the State's Encumbrance Policy .....	26
5	TRANSFERS AND THE PROJECT ADJUSTMENT FUND .....	29
	Summary of Finding .....	29
	Purpose of the Project Adjustment Fund .....	29
	Use of the Project Adjustment Fund .....	30
	Legislative Requirement Not Being Met .....	30
	Recommendations .....	31
6	THE BOND FUND REPORT .....	33
	Summary of Finding .....	33
	The Problem with the Bond Fund Report .....	33
	Recommendation .....	34
 <b>PART III</b> <b>RESPONSES OF AFFECTED AGENCIES</b>		
	Comments on Responses of Affected Agencies .....	37

## LIST OF TABLES

<i>Table</i>		<i>Page</i>
3.1	Legislative Authorizations for Capital Improvement Projects, Fiscal Years Ending June 30 .....	12
3.2	Authorized But Unissued General Obligation Debt as of November 1, 1970 to 1978 and as Indicated .....	13
3.3	Expenditures for Selected Appropriations Acts (General Obligation Bond Fund) .....	14
3.4	Pattern of Interfund Borrowings Fiscal Years 1975 to 1981 .....	15
3.5	State of Hawaii General Obligation Bond Sale Plan .....	16
3.6	Hawaii State General Fund Cash Balance and Unappropriated Surplus, Fiscal Years Ended June 30 .....	18
3.7	Opportunity Cost Analysis of Not Issuing \$75 Million of General Obligation Bonds in Fiscal Year 1981 .....	19
4.1	Encumbrances Without Legal Commitments as of June 30, 1981 .....	23
4.2	Encumbrances Supported by Terminated or Completed Contracts as of June 30, 1981 .....	26

## LIST OF FIGURES

<i>Figure</i>		<i>Page</i>
2.1	Capital Budget Execution in Relation to the Capital Spending and Debt Issuance Process State of Hawaii .....	6
3.1	20 Bond Index, July 1, 1980 to June 30, 1981 .....	17





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## **PART I**

### **INTRODUCTION AND BACKGROUND**

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## **Chapter 1**

### **INTRODUCTION**

This is a report on the results of an examination of selected aspects of the State of Hawaii's General Obligation Bond Fund (GO Bond Fund).

The examination was conducted pursuant to Hawaii Revised Statutes, Section 23-4, which requires the state auditor to conduct post-audits of all transactions, accounts, programs and performance of all departments, offices and agencies of the State and its political subdivisions. The examination was conducted by Peat, Marwick, Mitchell & Co., an independent CPA firm, and the Office of the Legislative Auditor.

#### **Objectives of the Examination**

The objectives of the examination were:

1. To determine whether adequate accounting and financial controls are exercised over the GO Bond Fund.
2. To determine whether selected aspects of the GO Bond Fund facilitate management and control of the capital improvements program.
3. To make appropriate recommendations for improved management and operational controls of the GO Bond Fund.

#### **Scope of the Examination**

The examination consisted of a review of the GO Bond Fund as of June 30, 1981. Where necessary to form a conclusion, transactions and procedures followed prior and subsequent to this date were also examined. The examination did not include a review of the accounting and other records for the purpose of expressing an opinion on the fairness of the financial statement of the GO Bond Fund.

#### **Organization of the Report**

This report is organized into the following:

Part I (Chapters 1 and 2) presents this introduction and background information on the GO Bond Fund and the State's capital improvements program budgeting and execution process.

Part II (Chapters 3, 4, 5, and 6) presents our findings and recommendations on the management and operational controls over the GO Bond Fund.

Part III contains the responses of the agencies affected by this report, and our comments on their responses.



## Chapter 2

### BACKGROUND

This chapter describes the General Obligation Bond Fund (GO Bond Fund) of the State of Hawaii and the capital improvements program (CIP) budgeting and execution process.

#### The Bond Fund of the State of Hawaii

The Bond Fund of the State of Hawaii is the accounting entity which records the receipts and disbursements of cash for the State's capital improvements program. The resources of the Bond Fund are derived from the proceeds of general obligation bond and revenue bond sales. The disbursements from the fund consist of CIP expenditures. The authority to incur CIP expenditures is granted by the Legislature in its general appropriations acts and supplemental appropriations acts. The authority to issue general obligation and revenue bonds to finance these expenditures is also granted by legislative act and is equal in amount to the related appropriations authorized.

The CIP appropriations are classified into one of two subsidiary funds of the Bond Fund, based upon funding source. The CIP projects that are intended to benefit a wide spectrum of the public (e.g., public schools, university and community college facilities and public parks) are usually authorized funding by general obligation bonds. These bonds carry the pledge of the State's "full faith and credit" which is the strongest credit pledge a jurisdiction can provide. The debt service on these bonds is

paid out of the State's general fund revenues. Conversely, CIP projects that are intended to benefit a select group of users (e.g., airport and harbor facilities) are usually authorized funding by revenue bonds. These bonds do not carry a credit pledge by the State and are secured primarily by the CIP project being funded. The debt service on revenue bonds is paid out of the revenues from the operations of the completed project.

As stated in the introduction chapter, the subject of this study is the GO Bond Fund. Our examination did not include the Revenue Bond Fund.

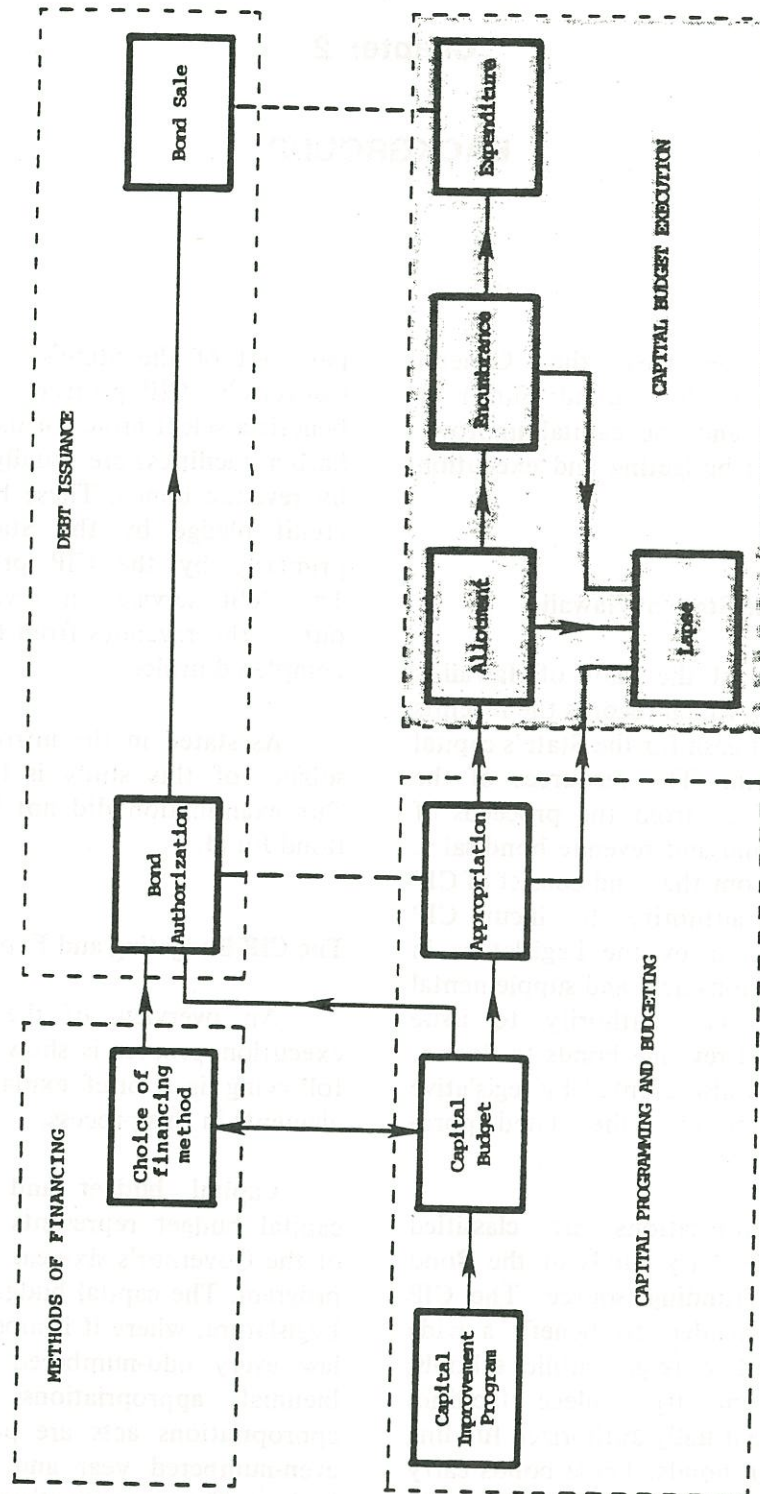
#### The CIP Budgeting and Execution Process

An overview of the CIP budgeting and execution process is shown in Figure 2.1. The following is a brief explanation of the major elements in this process.

**Capital budget and appropriation.** The capital budget represents the first two years of the Governor's six-year capital improvements program. The capital budget is submitted to the Legislature, where it is modified and passed into law every odd-numbered year as part of the biennial appropriations act. Supplemental appropriations acts are passed into law every even-numbered year and augment the capital budget. The appropriations authorized by both acts serve as the basis for and the upper limit of CIP expenditures.



Figure 2.1  
Capital Budget Execution in Relation to the  
Capital Spending and Debt Issuance Process  
State of Hawaii



**Allotment.** Overall implementation of the capital budget is the responsibility of the Governor and the executive departments. Prior to the incurrence of expenditures, the Governor must release funds through the signing of an allotment advice which has previously been reviewed and approved by the Department of Planning and Economic Development (DPED) and the Department of Budget and Finance (B&F).

**Expenditure and encumbrance.** The responsibility for the implementation of specific CIP projects rests with the designated expending and user agencies. The expending agencies contract with outside providers of services and otherwise supervise the development of the projects. Final approval of the projects, however, is the responsibility of the user agencies. To prevent unexpended appropriations from lapsing in accordance with provisions in the CIP appropriations act, expending agencies reserve them through the use of contracts, purchase orders or other types of encumbrances.

**Bond authorization and sale.** Funding for CIP projects is authorized by the Legislature, after which it becomes the responsibility of B&F. To finance CIP expenditures, B&F either issues bonds or uses borrowings from the General Fund and other funds that have surplus cash. The actual payment for expenditures is the responsibility of the Department of Accounting and General Services.

### **Constitutional and Other Constraints**

General obligation bond proceeds represent the primary funding source for the GO Bond Fund. This type of bond is subject to the debt limit provisions of Article VII, Section 13, of the Constitution of the State of Hawaii, which states in part:

“SECTION 13. General obligation bonds may be issued by the State; provided that such bonds at the time of issuance would not cause the total amount of principal and interest payable in the current or any future fiscal year, whichever is higher, on such bonds and on all outstanding general obligation bonds to exceed: a sum equal to twenty percent of the average of the general fund revenues of the State in the three fiscal years immediately preceding such issuance until June 30, 1982; and thereafter, a sum equal to eighteen and one-half percent of the average of the general fund revenues of the State in the three fiscal years immediately preceding such issuance.”

The above provisions place an overall constraint upon the size of the GO Bond Fund. Because of increasing General Fund revenues and existing and potential debt service that is below the maximum debt service allowed, this constraint has not thus far had a direct impact on limiting CIP authorizations.

Another constraint placed upon the GO Bond Fund is related to the State's ability to issue bonds in amounts that are adequate to meet the requirements of the CIP and that carry interest rates that are within the legislatively imposed statutory interest rate ceiling. Without the ability to issue bonds (e.g., during periods of high interest rates), the State has resorted to interfund borrowings to finance CIP expenditures.

Probably the most significant constraint placed upon the CIP, however, is not constitutional or legislative in origin. This is the State administration's borrowing plan. In recent years, this plan has called for the issuance of \$150 million of GO bonds per year, based upon the understanding of State finance officials as to the amount of bonds which can safely be marketed. The level of bonds issued represents the true maximum level of CIP activity currently allowable.



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**PART II**

**FINDINGS AND RECOMMENDATIONS**

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## **Chapter 3**

### **FINANCIAL CONDITION OF THE GENERAL OBLIGATION BOND FUND**

In this chapter, we discuss the overall financial condition of the General Obligation Bond Fund (GO Bond Fund). In particular, our objectives were to ascertain if the GO Bond Fund has the capacity to adequately meet the State's capital improvements program (CIP) requirements; and to determine the extent to which interfund loans have been used to finance the CIP and the costs of such practices to the State.

#### **Summary of Findings**

In summary, our findings are as follows:

1. The GO Bond Fund is inadequate to meet current and future anticipated CIP requirements. The fund is in a deficit position, and it cannot meet current CIP commitments without replenishment of its bond resources.

2. Interfund borrowings have been used extensively to finance CIP expenditures and are the result of:

- The Department of Budget and Finance's (B&F) lack of flexibility in issuing general obligation bonds due in part to the statutory interest rate ceiling.

- The existence of substantial surpluses in the General Fund of the State of Hawaii.

The B&F's decision not to go to the bond market in anticipation of a decline in bond market interest rates.

The cost of this practice has been a decrease of the State's pool of investable funds and a corresponding loss of investment income.

#### **Capacity of the General Obligation Bond Fund**

Aside from those projects funded by special funds or revenue bonds for which special funds are responsible for their debt service, the State's expenditures on public improvement projects are generally limited to \$150 million annually, the amount which can be acquired through the issuance of general obligation bonds. Although the State could conceivably increase its bond issuance, the \$150 million ceiling is probably reasonable given the following: (1) the ceiling is based upon the advice of the State's bond counsel and contacts in the bond market, (2) the present status of the State's infrastructure warrants a lower level of expenditures than made in the early- and mid-seventies, and (3) the current uncertainty in the financial markets requires prudent fiscal management.

As we discuss in a subsequent section of this report, the State's plan to acquire bond resources in the amount of \$150 million annually has been interrupted. The result is that the GO Bond Fund is in a deficit position. The latest Bond Fund Report shows that as of December 31, 1981, cumulative expenditures



from the GO Bond Fund have exceeded cumulative general obligation bond resources by \$34.2 million. In addition, as of that date, encumbrances were in the amount of \$119 million. Therefore, it is evident that without a replenishment of bond fund resources, the fund itself cannot meet the expenditures made and the additional expenditures arising from CIP obligations already entered into by the State, let alone the full magnitude of prior CIP appropriations represented by the backlog of unauthorized but unissued debt.

**Backlog of Authorized But Unissued Debt**

Historically, annual legislative authorizations have exceeded the State administration's bond issuance ceiling. Table 3.1 shows that for fiscal years 1981 and 1982 the legislative authorizations have exceeded the current \$150 million limit. These legislative authorizations have created a large backlog of authorized but unimplemented CIP projects and a correspondingly large backlog of authorized but unissued general obligation bond debt.

Table 3.1

Legislative Authorizations for  
Capital Improvement Projects  
Fiscal Years Ending June 30

1981	\$181,489,000
1982	161,311,000

Source: *Session Laws of Hawaii 1980*, and Act 3, First Special Session, Eleventh Legislature, 1981.

Rapid expansion of the amount of authorized but unissued debt became a real concern of the State when balances exceeded

\$1 billion from 1975 through 1977. The 1978 Constitutional Convention addressed this issue and proposed a constitutional provision for the periodic lapsing of authorized but unimplemented appropriations and the related authorized but unissued debt. This provision was ratified by the electorate as an amendment to the State Constitution on November 7, 1978.

The amendment attempted to approach the problem in two ways. *First*, in dealing with the existing backlog, the amendment specified that all appropriations dated November 7, 1978 and earlier which had not been expended or encumbered by June 30, 1980 would lapse. The related general obligation bond authorizations would also be reduced equal to the amount lapsed. *Second*, in dealing with future appropriations, the maximum period for which an appropriation could be made was set at three years. Thus, any appropriation or any part of an appropriation not expended or encumbered would lapse at the end of three years. An exclusion from lapsing was allowed only if the Legislature determined that continuance of an appropriation was required to qualify for federal aid financing or reimbursement.

Table 3.2 shows the balance of authorized but unissued debt for selected years. As can be seen on Table 3.2, the rapid growth in the pool of authorized but unissued general obligation debt was curtailed as a result of the 1978 lapsing provision. The number and amount of older bond authorizations outstanding was reduced significantly when this new measure took effect on June 30, 1980. However, there still remains a substantial balance of unissued debt.

The present balance of authorized but unissued debt represents in excess of three years of capital improvements expenditures, under the administration's current expenditure ceiling. This means that even if the Legislature were to abstain entirely from authorizing additional appropriations, it would still take from two to four years to fund the current backlog of appropriations.

Table 3.2

Authorized But Unissued General Obligation Debt  
As of November 1, 1970 to 1978<sup>1</sup>  
and as Indicated

1970	\$ 544,788,427
1971	786,654,326
1972	832,306,326
1973	688,145,217
1974	927,360,574
1975	1,058,157,514
1976	1,050,281,818
1977	1,098,825,587
1978	1,000,872,064
February 22, 1979 <sup>2</sup>	1,049,353,270
May 15, 1980 <sup>2</sup>	847,918,167
July 27, 1981 <sup>2</sup>	517,280,667

1. Certificate of Total Indebtedness of the State of Hawaii, November 1, 1970 to 1978.
2. State of Hawaii Official Statement pertaining to general obligation bonds issued at date specified.

This large backlog of authorized but unissued debt has two primary impacts. For one, it lengthens the lead time between legislative authorization of CIP projects and actual implementation of these projects. This is illustrated in Table 3.3. As the table shows, a very small percentage of CIP appropriations are actually expended in the first two years after passage. Because of this long lead time between authorization and implementation, there is the potential that due to rising construction and other costs, the original appropriation amounts are no longer adequate to properly fund the related CIP projects. This causes the GO Bond Fund to understate the actual demands upon its resources. This has also caused the CIP budget to become an unrealistic spending plan, as it cannot possibly be implemented within its legislatively mandated time frame.

The secondary impact of the backlog is one that has been expressed many times before in various reports on the State's debt management program. This is that because there is a large pool of authorized but unimplemented CIP projects, the Governor is free to "pick and

choose" which projects will be implemented and which will not.

The present large backlog, then, represents a major obstacle towards the achievement of a balanced and effective capital improvements program.

This situation indicates that some restraint needs to be exercised over CIP budgeting and appropriation levels until such a time as this backlog of authorized but unimplemented appropriations and authorized but unissued debt is reduced to manageable proportions.

Ideally, administrative agencies must recognize the need to keep CIP appropriation requests within realistic limits. The requests should take into account the outstanding backlog of authorizations and the ability of the State to complete the projects within the time period for which appropriations are requested. Realistically, however, the agencies cannot be expected to maintain total appropriation requests within the mandated statewide spending ceiling. This task must be left to a central agency that clearly understands the financial constraints upon the GO Bond Fund and the financial consequences of the State's actions. This leads us to the conclusion that the B&F, in its role as the reviewing body for appropriation requests in the budgetary process, must ensure that recommended appropriations be realistic.

**Recommendation. We recommend that:**

*The Department of Budget and Finance should ensure that the executive branch agencies refrain from requesting CIP appropriations when, considering the backlog of projects, the appropriations cannot reasonably be expected to be expended within the time frame for which the appropriations are requested.*



Table 3.3  
Expenditures for Selected Appropriations Acts  
(General Obligation Bond Fund)

Act/year	Legislative authorizations	Expenditures – first year		Expenditures – second year		Expenditures third year		Balance – authorized but not expended at June 30, 1981	
		Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
10/1977 (UAC 78)	\$138,898,000	\$5,645,000	4.1%	\$17,655,000	12.7%	\$27,379,000	19.7%	\$ 16,591,000	N/A <sup>1</sup>
214/1979	138,369,000	3,064,000	2.2	9,648,000	7.0	N/A	N/A	123,841,000 <sup>2</sup>	89.5%
214/1979 (UAC 80)	148,355,000	8,820,000	5.9	N/A	N/A	N/A	N/A	139,535,000	94.1

Source: Bond Fund Report as of June 30 for 1979, 1980, and 1981.

1. Not valid due to extensive lapsing of appropriations on June 30, 1980.
2. Decreased insignificantly by changes in financing.



## Interfund Borrowing: The Use of Treasury Advances

The State of Hawaii has regularly relied upon the use of cash advances from the treasury, accounted for as interfund loans, to finance ongoing capital projects pending the issuance of its bonds. Advances are made from the General Fund and Special Funds to the Bond Fund. The pattern of interfund borrowings over the past seven years is shown in Table 3.4.

## Fiscal Year 1981: Problems with General Obligation Bond Sales

The late 1970s and early 1980s brought about milestone events in the financial markets of the world. Followers of gold saw its price skyrocket to \$800 per troy ounce. Interest rates on money market certificates surged above a 16 percent annualized yield. The prime commercial paper rate finished 1980 above the 18 percent mark. During this same period,

Table 3.4  
Pattern of Interfund Borrowings  
Fiscal Years 1975 to 1981

	<i>Interfund borrowings — beginning of fiscal year</i>	<i>Additional borrowings</i>	<i>Repayments</i>	<i>Interfund borrowings — end of fiscal year</i>
1975	\$ 225,000	\$113,400,000	\$ 79,800,000	\$ 33,825,000
1976	33,825,000	134,100,000	146,500,000	21,425,000
1977	21,425,000	106,310,000	120,010,000	7,725,000
1978	7,725,000	43,500,000	49,225,000	2,000,000
1979	2,000,000	12,000,000	14,000,000	--
1980	--	84,500,000	84,500,000	--
1981	--	124,000,000	--	124,000,000

Source: Bond Fund general ledger.

As Table 3.4 shows, annual interfund borrowings for the past seven fiscal years have sometimes exceeded \$100 million. There are three underlying reasons for this level of interfund borrowings: (1) the lack of flexibility caused by the legislatively imposed statutory interest rate ceiling on general obligation bonds, (2) the availability of substantial cash surpluses in the State's General Fund and (3) the B&F's decision not to go to market in anticipation of decreasing rates. Although the use of interfund borrowings is a valid debt management tactic, it does result in the loss of significant amounts of investment income to the State when used over an extended period. This is demonstrated by the following recap of the events of fiscal year 1981.

the prime rate (the rate that banks charge their most credit-worthy customers) jumped past 20 percent and finished above that mark in June 1981.

This upward movement of interest rates took its toll on the country's bond markets. Yields of tax-exempt municipal securities topped 10 percent in December 1980 and remained at that level through June 1981.

The inflationary expectations of financial market participants was but one of the many pressures leading to the increased yields demanded by investors. This, in turn, led to difficulties with bond issuance for the State in fiscal year 1981, as the interest rate yield

demand by the market for the State's GO bonds was in excess of the statutory limit for most of the year. As a consequence, the State could not go to the bond market to obtain CIP funds. The State decided to utilize its treasury cash reserves to maintain its capital improvements program.

Figure 3.1 illustrates the pattern of bond interest rates over the 1981 fiscal year. Market interest rates rose above the statutory ceiling in November 1980 and remained above the mark for the rest of the year. Consequently, B&F had no alternative but to utilize treasury advances until the Legislature raised the ceiling temporarily to 12 percent through an act approved on June 29, 1981.

Because the State did not issue any GO bonds in fiscal year ended June 30, 1981 it was behind \$150 million in its bond sale plan and had revised the plan to reflect this condition. As noted in Table 3.5, total planned bond sales for each of the next two fiscal years has been increased from \$150 million to \$225 million.

then faced with the same situation as before; it had to wait until the market rate dropped below the statutory ceiling or the Legislature lifted the ceiling in order to issue bonds. B&F succeeded in issuing another \$75 million of GO bonds before the end of the 1981 calendar year. However, bond yields in early 1982 indicate that the State's interest rate ceiling has been exceeded, and the State cannot now market another issue. In the meantime, the State has continued to utilize interfund loans to finance its CIP.

### Interfund Borrowing in 1981

The events of 1981 were unusual but they do point out the potential problems inherent in the State's debt management practices. There is the question of why the State did not issue any bonds in the first four months of fiscal year 1981 when the market interest rates were below the statutory ceiling. Two explanations are offered here by B&F.

According to B&F, the State had just sold \$75 million of GO bonds in June 1980. Under-

Table 3.5

State of Hawaii General Obligation Bond Sale Plan

<i>Fiscal year</i>	<i>No. of sales</i>	<i>Amount per issue</i>	<i>Total</i>
1981-82	3	\$75,000,000	\$225,000,000
1982-83	3	75,000,000	225,000,000
1983-84	2	75,000,000	150,000,000
1984-85	2	75,000,000	150,000,000
1985-86	2	75,000,000	150,000,000
1986-87	2	75,000,000	150,000,000

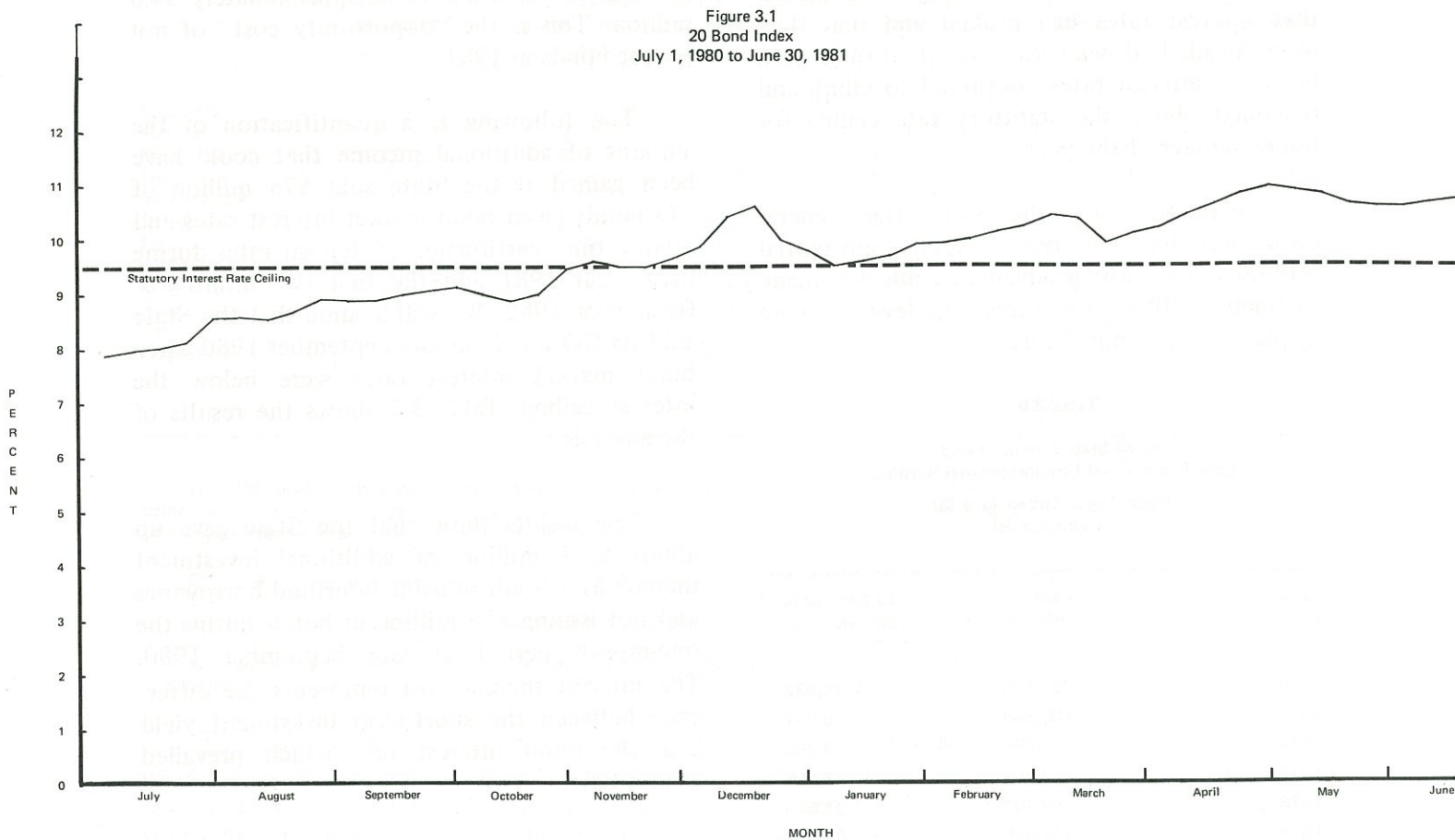
Source: Department of Budget and Finance.

Shortly after the ceiling was raised to 12 percent in June 1981, the market rose to 13 percent in September 1981. Fortunately, the State issued \$75 million of GO bonds in August 1981 when the rate was below the 12 percent ceiling. However, the State was

writers usually request at least 90 days "market protection" on issues larger than \$50 million.<sup>1</sup>

1. Market protection refers to assurances given by a seller of bonds to the underwriters to refrain from issuing more bonds within a given time frame in order to allow the underwriter enough time to retail all bonds in the current issue before a subsequent issue is brought to market.





Source: Department of Budget and Finance



Thus, the State could not sell another issue of bonds for the first three months of the fiscal year 1981.

The second reason the State did not go to the market in October 1980 was the anticipation that interest rates had peaked and that they were headed downward. As it turned out, however, interest rates continued to climb and remained above the statutory rate ceiling for the remainder of the year.

Fortunately for the State, the General Fund has had, in recent years, substantial surpluses from which advances could be made to finance CIP expenditures. The level of these surpluses is shown in Table 3.6.

Table 3.6  
Hawaii State General Fund  
Cash Balance and Unappropriated Surplus  
Fiscal Years Ended June 30  
(In Thousands)

Fiscal year	Cash balance	Unappropriated surplus
1980	\$230,105	\$179,032
1979	108,568	66,927
1978	53,054	2,355
1977	72,559	35,206
1976	142,742	41,810
1975	134,875	83,467

Source: *Government in Hawaii: 1981*, Tax Foundation of Hawaii, p. 41.

Opportunity Cost of Interfund Borrowings

By not issuing bonds in fiscal year 1981 and financing CIP expenditures with General Fund loans, the State decreased its pool of available cash and forfeited interest income that could have been earned by investing these idle funds. Of course, if the State had gone to market, it would have been required to pay debt service (interest) on the bonds issued. So there

are some savings in interest costs that resulted from not going to market. The amount of forfeited interest, however, far exceeded the savings in debt service, and based upon reasonable calculations, we estimate the actual net loss to the State to be approximately \$4.8 million. This is the “opportunity cost” of not issuing bonds in 1981.

The following is a quantification of the amount of additional income that could have been gained if the State sold \$75 million of GO bonds given bond market interest rates and 30-day time certificates of deposit rates during fiscal year 1981 and the first two months of fiscal year 1982. We will assume that the State sold its GO bonds in late September 1980 when bond market interest rates were below the interest ceiling. Table 3.7 shows the results of the analysis.

The results show that the State gave up about \$3.7 million of additional investment income as a result of using interfund borrowings and not issuing \$75 million in bonds during the one-month period in late September 1980. The interest income lost represents the difference between the short-term investment yield and the bond interest rate which prevailed at that time.

Making the assumption that, if it had been able to, the B&F would have followed its bond sale plan and made a second bond issue of \$75 million approximately six months after the issue in late September and using the same type of analysis as with the first \$75 million issue, we find that the State gave up about \$1.1 million in additional investment income as a result of not issuing bonds a second time. The total lost investment income to the State, then, for not issuing bonds during the period from October 1980 and August 1981 was about \$4.8 million. This sum represents the “opportunity cost” associated with the State’s decision to rely exclusively upon interfund borrowings to fund CIP expenditures during this period.

Table 3.7  
Opportunity Cost Analysis of Not Issuing \$75 Million of General Obligation Bonds in Fiscal Year 1981<sup>1</sup>

	30-day TCD average annual yield (percent) <sup>2</sup>	20 bond index average annual yield (percent)	Average annual yield differential (percent)	Average monthly yield differential percent <sup>3</sup>	Net interest lost	Cumulative balance of investment dollars
September	—	—	—	—	—	\$75,000,000
October	11.375	9.18 <sup>4</sup>	2.195	.1829167	\$ 137,188	75,137,188
November	12.75	9.18	3.57	.2975	223,533	75,360,721
December	15.875	9.18	6.695	.5579167	420,450	75,781,171
January 1981	15.625	9.18	6.445	.5370833	407,008	76,188,179
February	15.0	9.18	5.82	.485	369,513	76,557,692
March	13.5	9.18	4.32	.36	275,608	76,833,300
April	12.625	9.18	3.445	.2870833	220,576	77,053,876
May	15.375	9.18	6.195	.51625	397,791	77,451,667
June	15.25	9.18	6.07	.5058333	391,776	77,843,443
July	15.75	9.18	6.57	.5475	426,193	78,269,636
August	16.125	9.18	6.945	.5787	452,946	78,722,582
					\$3,722,582	

1. This analysis does not consider the “opportunity gain” from not issuing bonds. This gain is the benefit derived from delaying principal payments by one year. This gain, however, is more than offset by the foregone increase in investable surplus cash over the life of the issue represented by the “net interest lost” above.

2. Yield figures represent the average of the high and low yields for the month.

3. Average monthly yield differential is simply 1/12 of the average annual yield differential.

4. Bond sale was assumed to have occurred during the last week of September 1980. The bond rate as of September 25, 1980 was 9.18%.

The magnitude of this opportunity cost presents a persuasive argument against the extensive use of interfund borrowings as an alternative to not issuing bonds. At a given point in time, investment yields are, in general, greater than the interest rate that the State must pay on its bonds. Because of this an argument could be made for going to the market at regular intervals, regardless of the level of interest rates. Another argument for going to the market at regular intervals is that it is probable that in the near future, the State will no longer have access to General Fund surpluses in the amounts that have been available in recent years. The Constitution now specifies a formula which triggers a tax refund or tax credit to taxpayers whenever the balance of the State’s General Fund exceeds a certain percentage.<sup>2</sup> This provision reduces the likelihood of large General Fund surpluses continuing, and thus will limit the

amount of cash available for interfund loans. In order to maintain the State’s CIP at an acceptable level, then, regular bond issuances must take place. Sound debt management practice, however, does require that bond sales be timed so as not to burden the State with unreasonably high debt service. Interfund borrowings, as such, cannot be entirely eliminated. Their use, however, should be restricted.

Summary of the Problem

From the foregoing, it is evident that the State is facing a difficult problem. If the Legislature lifts and extends the temporary interest rate ceiling or removes the statutory interest rate ceiling so as to permit the State to

2. State Constitution, Article VII, Section 6.



re-enter the borrowing market, the State will very likely be faced with extraordinarily high interest rates. On the other hand, if the State is not allowed to re-enter the borrowing market, the capital improvements program will very likely have to be reduced or curtailed, because the State cannot for long rely on interfund borrowing to finance the program. An early policy direction is required from the Legislature as to which course of action the State should pursue.

Recommendations

We recommend that:

- 1. The Legislature should review the issue of the interest rate ceiling and reach an

early decision as to whether the State should re-enter the long term borrowing market. If the Legislature decides not to lift or remove the interest rate ceiling, it should provide policy direction to the State administration as to whether additional CIP commitments should be curtailed or reduced.

- 2. Should the Legislature decide that the State should continue to finance CIP projects through long term borrowing, the Department of Budget and Finance should implement a program of regular general obligation bond issuance and restrict the use of interfund borrowings to finance CIP expenditures. This would help to ensure the stability of the State's capital improvements program and minimize the amount of lost income due to the decrease of investable cash.

Chapter 4

ENCUMBRANCE PRACTICES OF THE  
GENERAL OBLIGATION BOND FUND

An effective lapsing policy is essential towards reducing the level of authorized but unimplemented appropriations and authorized but unissued debt. Because encumbering funds is one means by which appropriations can be kept from lapsing, the condition of the General Obligation Bond Fund (GO Bond Fund) can vary depending on how effective the constitutional lapsing provisions are complied with through an effectively and properly policed encumbrance policy.

This chapter presents our findings and recommendations on the adequacy of the State's encumbrance policy and procedures and their effectiveness in ensuring that the financial condition of the GO Bond Fund is properly maintained.

Summary of Findings

Our basic finding is that the State's encumbrance policy limits the effectiveness of the constitutionally mandated capital improvements project authorization lapsing provisions. A difficult-to-interpret section of a policy on encumbrances and loose monitoring of expending agencies' compliance with the policy have contributed towards lessening the effectiveness of the lapsing provisions in (1) reducing the GO Bond Fund's large backlog of authorized but unissued debt and (2) providing a mechanism by which appropriations must again be submitted for legislative consideration. Specifically, our findings are that:

- 1. The State's policy allows the encumbrance of appropriations for anticipated future expenditures for which there is no existing legal commitment to expend funds.
- 2. The application of the State's policy allows the encumbrance of funds in amounts far in excess of the sums needed to complete existing legal commitments.
- 3. Poor monitoring of the State's policy allows the continued existence of encumbrances that are supported by terminated or completed commitments.

Background and Criteria

As required by the State Constitution,<sup>1</sup> each general appropriations and supplemental appropriations act contains lapsing provisions that limit the life of all appropriations to a maximum of three years. At the end of this period, all unexpended and unencumbered appropriations remaining are automatically lapsed.

This lapsing of unused or unrequired appropriation balances serves two basic purposes. *First*, it reduces the GO Bond Fund's backlog of authorized but unissued debt by removing appropriations for projects that have a very small probability of implementation and by

1. State Constitution, Article VII, Section 11.



removing excess appropriations for completed projects.

Second, lapsing provides a mechanism by which unimplemented or partially implemented projects that were authorized in prior legislative sessions must be resubmitted to the Legislature for review and consideration as to whether the project should remain in the capital improvements program (CIP). This is important for the simple reason that these projects may possibly no longer be valid in the view of the current Legislature when compared to other current projects being considered. Without lapsing provisions of some kind, dated or invalid projects would not be subject to legislative reconsideration. As such, regardless of the priorities of the current Legislature, these projects may still be implemented over time.

In order to prevent appropriations from lapsing, expending agencies have two alternatives. They may either fully expend appropriations prior to the lapse date or they may encumber unexpended balances. Herein lies the importance of the State's encumbrance policy. If the policy is inadequate or if it is not properly monitored, the constitutionally mandated lapsing provisions will be bypassed and its primary purposes will not be achieved. This portion of our examination, then, had the objective of ascertaining if both the State's encumbrance policy and the application of the policy are adequate to ensure effective lapsing of appropriations that should no longer be reflected in the GO Bond Fund.

Encumbrances Without Legal Commitments

During the course of the examination, we found that expending agencies routinely encumber appropriations based upon future anticipated expenses for which there is no present legal commitment to expend funds. Table 4.1 lists examples of cases which came to our attention.

In each, the encumbrance balance in question had been budgeted by the expending

agency for design consultants or construction costs. At the time that the encumbrances were made, however, no legal commitment (in the form of a contract or evidence that a contract award was imminent) existed. The appropriations were encumbered solely to provide funding for anticipated future project costs. Without the encumbrances, the appropriation balances would have lapsed as of June 30, 1980.

By encumbering the appropriation balances in question, the expending agency has ensured that a certain amount of funding will be made available for what it estimates as necessary costs to complete the projects. The negative impact of this, however, is that these projects have effectively avoided the lapsing provisions and, as a consequence, legislative reconsideration.

The legislative authorization in each of the cases cited originated from appropriations acts passed from three to seven years ago. Regardless of the stage of implementation the projects are in, the age of the appropriations alone indicates that they need to be re-evaluated by the Legislature. Such re-evaluations would enable the Legislature to reconsider specific projects in terms of the current economic environment and changes in its priorities. One of the reasons the lapsing provisions are included is to show that appropriation authorizations do not have an indefinite life and that periodic reconsideration of appropriations may be necessary. As the cases indicate, this goal of legislative reconsideration is routinely being circumvented through the use of the encumbrance process, and the mechanism that makes this possible is the State's encumbrance policy.

Inadequacy of the State's Encumbrance Policy

The State's encumbrance policy consists of Section 470 of the State of Hawaii Accounting Manual. Section 470 defines encumbrances in the following manner:

Table 4.1  
Encumbrances Without Legal Commitments  
As of June 30, 1981

Project	Expending Agency	Appropriation Symbol (Year, Number)	Appropriation Amount	Encumbrance Balance	Encumbrance Balance in Question
Moanalua High School science building	DAGS—Public Works	74 771M	\$1,068,330	89,488	87,844
Foreign Trade Zone—renovation and alteration of Pier 2	DAGS—Public Works	75 137M	945,000	759,597	755,000
DOE—minor CIP	DAGS—Public Works	75 410M	3,111,919	134,142	126,142
Kapiolani Community College—new campus development	DAGS—Public Works	78 236M	637,000	628,050	281,477
Vineyard parking garage	DAGS—Public Works	78 306M	2,991,780	2,143,430	731,663

“Encumbrances Generally. Generally, encumbrances are obligations in the form of purchase orders, contracts, or other such commitments that do not become liabilities until performance of the conditions stated in the commitment. The general features of encumbrances are:

- (a) Encumbrances reserve an appropriation (or a portion of an appropriation) to cover obligations or commitments that have been incurred against the appropriation.
- (b) Encumbrances are not firm liabilities, but are converted to liabilities upon performance of the acts required by the obligations or commitments (such as delivery of goods or services).
- (c) Encumbrance obligations or commitments are not merely anticipated future expenses, but are enforceable rights that bind the parties involved to complete a transaction based on proper performance of the acts called for by the obligation or commitment.” (Emphasis added.)

This definition states clearly that anticipated future expenses should not be used as a basis for encumbering funds. Certain other paragraphs of Section 470, however, allow for an apparent deviation from this provision and, consequently, encumbering appropriations based upon anticipated future expenses (with no underlying legal commitment) is permitted. The portion of Section 470 that allows this to occur is paragraph 8—Incomplete Project Encumbrances, which is as follows:

“Incomplete Project Encumbrances.

- (a) With regard to encumbrance determinations under these instructions, and in accordance with the description of encumbrances generally as contained in item 3 of these instructions, encumbrances of estimated project costs may be recorded without executing a written agreement or issuing a purchase order if the following conditions are met:
  - (1) The appropriation to be charged with the encumbrances was made by the Legislature in terms of providing for completion of a project or a portion of a project, and not in terms of providing for operations of a fiscal period.
  - (2) The encumbrance of the estimated project costs is necessary to complete a project for which there is a commitment of the State to another party who has related enforceable rights against the State.
- (b) Categories of costs for which incomplete project encumbrances may be recorded are:
  - (1) Personal services of both State employees and non-State providers of personal services, if the personal services are required to meet the State's commitment in item 8(a)(1).
  - (2) Other current expenses necessary for the personal services described in item 8(b)(1) to be performed.
  - (3) Contract construction, equipment acquisition, and other capital outlay



required to meet the State's commitment in item 8(a)(1).

- (c) Incomplete project encumbrances are supported by the employing agency's signed statement incorporating the following information.
- (1) Evidence that the conditions in item (a) are met.
  - (2) Details of costs by categories in item 8(b)." (Emphasis added.)

The interpretation of this paragraph by the Department of Accounting and General Services—Accounting Division (DAGS—Accounting Division) and the various expending agencies is that appropriations may be encumbered without an underlying contract, purchase order or other legal commitment as long as (1) the encumbrance is necessary to complete the project and (2) there is an existing legal commitment (e.g., contract) on the project. The encumbered amounts themselves are not required to be necessary to fund the existing legal commitment. We believe that the foregoing paragraph of Section 470 and how it is being interpreted allow the basic encumbrance policy to be circumvented to the detriment of sound financial management.

In addition to the examples listed in Table 4.1, we illustrate our views by citing still another example, which is interesting in its history. The bond fund has shown over the years an appropriation of \$250,000 for a "General Aviation Field on Oahu," and the authority for this appropriation is listed as Act 195, Session Laws of Hawaii 1961. There is, in fact, no specific appropriation in the foregoing amount and purpose in the 1961 Act. However, the 1962 annual report of the Comptroller shows an amount of \$250,000 for the purpose of general aviation which was transferred from another appropriation which had been made to the Department of Transportation (DOT) in the 1961 Act.

The 1961 Act contained no lapsing provision, and over the years, various expenditures were charged against the \$250,000

appropriation but there still was a remaining balance at June 30, 1980. That balance would ordinarily have lapsed on that date because of the constitutional lapsing provision. However, on July 11, 1980, the DOT, among other encumbrances requested, asked for an encumbrance in the amount of \$11,396 against the 1961 "appropriation" for the purpose of "General Aviation Field on Oahu, Poamoho" and more specifically, for "Poamoho Field Master Plan Study," citing as authority the State's encumbrance policy, and specifically paragraph 8. There are other documents which indicate that subsequently, the expenditures from the encumbrance were actually Dillingham Field expenditures. Apart from the mysterious origins of the "appropriation" and the curiosity that it was able to survive, without lapsing, for twenty years, this example again illustrates the consequence of a loose encumbrance policy.

#### Excess Encumbering of Funds

This interpretation of paragraph 8 of the State's encumbrance policy by DAGS—Accounting Division has created a situation where contract-type commitments are being used to justify encumbering appropriation amounts far in excess of what is required to fulfill those commitments. In the cases presented in Table 4.1, all of the encumbrance balances in question were justified by citing paragraph 8. For example, the "DOE—minor CIP" encumbrance was \$134,142 to fund the cost of personal services required to fulfill existing contract commitments on various projects. However, the Public Works' budget for this multi-project program showed only \$8,000 as the expected cost of those services. The balance of \$126,142 should thus have been lapsed.

As of April 30, 1981, approximately \$12 million in encumbrances recorded in the GO Bond Fund were classified as incomplete project-type encumbrances. This represented in excess of 10 percent of the fund's total encumbrance balance outstanding.

The conclusion should not be drawn at this point that all incomplete project encumbrances are invalid. With each contract (or other legal commitment), there are certain administrative costs that will be incurred over the life of the commitment that are not included in the contract amount. These are costs that originate from field inspections, contract administration and other functions that must be performed in order for the State to fulfill its legal obligation. The majority of incomplete project encumbrances, however, do not fall in this category and instead are based upon the anticipated cost of legal commitments not yet entered into.

Expending agencies may argue that incomplete project encumbrances are necessary to reserve funds for legitimate anticipated costs to complete CIP projects. The legitimacy of anticipated costs, however, is not the key issue. By setting a three-year life for appropriations, the Constitution has established a time frame within which these appropriations should be implemented. And this is rightly so. If appropriations are not implemented within this time frame, serious questions arise as to the appropriateness of the timing of the authorization (e.g., why were the funds requested if they were not to be expended in the near future?), and the adequacy of the amounts authorized to accomplish legislative intent (e.g., the appropriations may be inadequate due to rising costs). Both of these factors (and the fact that it is possible that legislative intent may have changed during the three-year time frame) strongly support the concept of legislative reconsideration of appropriations and unimplemented CIP projects. This concept, in turn, supports the argument for a strict encumbrance policy, one that ensures against (1) the possibility of agencies "front-loading" or "hoarding" appropriations and (2) the possibility that CIP projects that have become nonpriority are implemented.

The State's present encumbrance policy does not fit this description and will not, as long as its incomplete project encumbrance provisions remain in their present form.

Some modification of the State's encumbrance policy, then, would appear to be warranted. As was indicated, however, not all incomplete project encumbrances are invalid. Legitimate contract administration costs originating primarily from in-house planning, design, project management, and inspection staff represent definite commitments by the State that should be properly encumbered for. Presently, then, there is a need for incomplete project encumbrances. The existence, however, of any provisions for incomplete project encumbrances in the State's encumbrance policy would present a distinct opportunity for abuse and a continuance of the discrepancies noted above.

The most direct way to deal with the problem would be to eliminate in-house contract administration costs from the CIP funding process. This could be done by financing such costs with operating funds rather than general obligation bond proceeds. Once this is accomplished, there would no longer exist a valid need for incomplete project encumbrances and paragraph 8 of the State's encumbrance policy could be removed entirely.

This recommendation may appear to deviate from a strict application of capital budgeting theory which would require that all direct and indirect costs associated with a capital improvement project be financed by the funding for that project. Realistically, however, contract administration costs are not project costs in a true sense because they originate from in-house staff personnel who are permanent full-time civil service employees. The continued employment of these staff personnel is not contingent upon the status of the State's CIP and as such, they represent more of an operating rather than a project-type of expense. It is reasonable, therefore, that these costs should be financed by operating funds as opposed to general obligation bond proceeds.

*Recommendations. Our recommendations are as follows:*



1. We recommend that all in-house contract administration costs related to the implementation of general obligation bond funded capital improvements program projects be financed by operating funds rather than the General Obligation Bond Fund. This will eliminate the need to allow for incomplete project encumbrances in the State's encumbrance policy.

2. Upon the implementation of recommendation 1, we recommend that the State's encumbrance policy (Section 470 of the State of Hawaii Accounting Manual) be revised, eliminating paragraph 8—Incomplete Project Encumbrances.

3. Until such time as recommendations 1 and 2 are implemented, we recommend that the State's encumbrance policy be revised to disallow incomplete project encumbrances in all cases except when the encumbering of appropriations is necessary to provide funding for the administration of existing legal commitments.

### Inadequate Monitoring of the State's Encumbrance Policy

Paragraph 4 of the State's encumbrance policy requires that contract encumbrances be supported by a valid, fully executed contract or evidence that a contract award is imminent. During the course of our examination, however, several of the contract encumbrances reviewed were found to be supported by terminated or completed contracts. These exceptions are noted in Table 4.2.

Had it not been for the contract encumbering of these amounts, the balance remaining in each of the appropriations would have lapsed. The normal procedure on terminated or completed contracts is for the expending agency to notify DAGS—Accounting Division which then prepares the necessary journal entries to have the contract encumbrance removed and the appropriation balance lapsed.

In the cases cited in Table 4.2, the expending agencies neglected to inform DAGS—

Accounting Division of the change in status of the contracts. An apparent breakdown in procedures took place and, as a result, the balances of the contract encumbrance amounts were not lapsed as they properly should have been.

To ensure effective lapsing of unnecessary appropriations, each expending agency should have established procedures by which all contract encumbrances are reviewed periodically (e.g., annually) to determine if they continue to be supported by valid, legal commitments. Contracts having no expenditures for the past

year or two are obvious candidates for periodic review.

**Recommendation.** We recommend that the Department of Accounting and General Services require that all expending agencies periodically review contract encumbrances to ensure that they are valid legal commitments and that expending agencies submit to the Department of Accounting and General Services a list of all contracts having no expenditures for the past year, including reasons why there has been no activity.

Table 4.2  
Encumbrances Supported by Terminated or Completed Contracts  
As of June 30, 1981

Project	Expending Agency	Appropriation Symbol (Year, Number)	Contract Encumbered Balance	Contract Number	Contract Date	Date of Last Contract Activity
North Kohala Water System development	County of Hawaii	74 806W	\$26,705	6,904	May 19, 1976	August 1977
New State Office Building No. 2	DAGS—Public Works	75 758M	9,065	6,601	May 17, 1976	March 1977
Kaiser High School— renovation of classrooms	DAGS—Public Works	75 409M	4,250	7,771	September 6, 1977	September 1978
Wahiawa Civic Center expansion	DAGS—Public Works	75 760M 77 810M	63,476 16,080	10,438	June 29, 1979	February 1980



## Chapter 5

### TRANSFERS AND THE PROJECT

#### ADJUSTMENT FUND

Each appropriations act contains provisions for the establishment of a Project Adjustment Fund, to be used to make supplemental appropriations to capital improvement projects with insufficient funding.

The funding for the Project Adjustment Fund, in turn, is derived from legislative appropriation authorizations and unrequired balances from capital improvement projects. This fund plays an important role in the State's capital improvements program (CIP). Because the Legislature does not meet throughout the year, CIP projects with insufficient funding may be unnecessarily postponed or stalled for lack of additional appropriations. The Project Adjustment Fund provides a mechanism by which these projects can be continued without unreasonable delay. In this chapter, we describe and assess the operations of this fund.

#### Summary of Finding

Our general finding is that the legislative requirement that all unrequired appropriation balances be transferred to the Project Adjustment Fund (to serve as supplemental appropriations thereto) is not being met. Instead, transfers are made to the Project Adjustment Fund only when a simultaneous transfer out is made to a project within the same user agency. As such, the pool from which supplemental appropriations can be made is equal to the legislatively authorized initial appropriation.

Because of this, the importance of the fund as a source of discretionary supplemental appropriations has been reduced.

#### Purpose of the Project Adjustment Fund

Every general appropriations and supplemental appropriations act contains provisions for the establishment of a Project Adjustment Fund. In the event that a capital improvement project authorized by the Legislature in the current year or any prior or future year requires additional funding, the Governor may make supplemental allotments to the project from the Project Adjustment Fund. The only restrictions on such supplemental allotments are that: (1) the receiving project's funding source must be designated as the General Obligation Bond Fund (GO Bond Fund) and (2) the supplemental allotments must not be used to increase the scope of the receiving project. The following is an example of the appropriations act provision governing the Project Adjustment Fund:

"Section 155. All unrequired balances after the objectives of appropriations made in this Act for capital investment purposes from the general obligation bond fund have been met shall be transferred to the project adjustment fund appropriated in Part III of this Act and shall be considered a supplementary appropriation thereto.

In the event that the amount specified for a capital investment project listed in this Act or authorized by the legislature in a prior year or in the future is insufficient, and where the source of funding for the project is designated as the general obligation



bond fund, the governor may make supplemental allotments from the project adjustment fund appropriated in Part III; provided that such supplemental allotments from the project adjustment fund shall not be used to increase the scope of the project, and provided further that a report of such supplemental allotments and transfers into the project adjustment fund for the period ending December 31 of each calendar year shall be made to the legislature by February 1 of the following year.

Any provision in this Act to the contrary notwithstanding, supplemental allotments from the project adjustment fund may be made for any capital investment cost element.”<sup>1</sup>

While the 1979 general appropriations act provided for an annual report on activity of the Project Adjustment Fund to be submitted to the Legislature, there was no such requirement in the 1981 general appropriations act.<sup>2</sup> Because a report on activity is a convenient mechanism by which the Legislature can monitor the use of the Project Adjustment Fund, it would appear to be both reasonable and in the legislative interest to require annual reports to be submitted.

Although the Project Adjustment Fund has been designated as a “fund,” it is not accounted for as a separate fund entity. Instead, it is included in the Bond Fund and is accounted for in the same manner as other capital improvement appropriations. The Project Adjustment Fund differs from other Bond Fund accounts, however, in that its appropriations are not authorized for any specific projects. As such, its appropriation balances can only be used to fund projects with insufficient appropriations. Any balances remaining in the Project Adjustment Fund automatically lapse at the end of their legislatively authorized life.

#### Use of the Project Adjustment Fund

At the time that a capital improvement project is being implemented, the user agency may find that due to certain factors (cost overruns or an inadequate legislative appropriation) the initial appropriation for the project is insufficient to cover all costs. When

this happens, the user agency first reviews its other projects to determine if unrequired appropriations are available. If so, these surplus appropriations are transferred to the subject project. This transfer is effected with an Allotment Advice. In addition to being recorded as an increase in appropriations to the receiving project and a reduction to the giving project, the transaction is also recorded as a transfer in and transfer out of the Project Adjustment Fund. In this manner, the Project Adjustment Fund serves the function of maintaining a record of transfers between projects.

If the user agency determines that no surplus appropriations are available from its other projects, it can request that the anticipated deficiency be covered by a supplemental allotment from the Project Adjustment Fund. If the request is approved, a transfer of appropriations is effected using (as in the preceding) an Allotment Advice. The second function of the Project Adjustment Fund, then, is as a source of supplemental allotments to capital improvement projects.

#### Legislative Requirement Not Being Met

As is alluded to in the preceding, our review of the activity for the past several fiscal years revealed that the legislative requirement that all surplus appropriations be transferred to the Project Adjustment Fund has not been met. Transfers to the Project Adjustment Fund occur only when a simultaneous transfer out is also made to a project within the same user agency. As such, the size of the Project Adjustment Fund is determined entirely by the legislatively authorized initial appropriation. This amounted to \$1 million and \$3 million for fiscal years 1980 and 1981, respectively.

1. Act 214, Section 155, SLH 1979.
2. See Act 1, Section 126, First Special Session, SLH 1981.

Surplus appropriations are not allowed to accumulate in the Project Adjustment Fund. Indeed, it is only when additional funding for another project is needed that surplus appropriations are declared “surplus” by the user agencies. Rather than providing a pool of surplus appropriations, funding for the Project Adjustment Fund has been limited to the initial legislative authorization included in each appropriations act.

The reason why the legislative requirement is not being met is easy to understand. It is simply not in the best interests of the user agencies to have their surplus appropriations transferred to a fund over which they have no control. Doing so would only limit their flexibility. Each time additional allotments are needed for a project, the user agencies would have to rely upon the Governor’s discretion or the legislative process. By keeping unrequired balances within their own jurisdictions, the user agencies have access to their own “pool” of surplus appropriations that can be drawn upon when deficiencies in funding occur.

Sound practices for allocating supplemental and surplus appropriations to projects deficient in funding require that requests for additional appropriations be reviewed in the context of statewide priorities without special regard to

the expending agency which transferred surplus appropriations into the Project Adjustment Fund. Surplus appropriations should immediately be transferred into the Project Adjustment Fund from which periodic reviews of requests for additional appropriations can be made on the basis of meeting statewide CIP requirements.

#### Recommendations

1. *We recommend that the Department of Budget and Finance as the central budget control agency, require and ensure that expending agencies transfer surplus appropriations into the Project Adjustment Fund immediately upon their availability. If expending agencies request supplemental appropriations from the Project Adjustment Fund, these requests should be evaluated on the basis of the total pool of funds available in the Project Adjustment Fund and statewide CIP requirements.*

2. *We also recommend that the Legislature return to its earlier practice of including a provision in the appropriations acts which would require the submission of annual reports of activity in the Project Adjustment Fund.*



Chapter 6

THE BOND FUND REPORT

The Bond Fund reporting system consists of the records, ledgers and procedures used to record capital improvements program (CIP) appropriations and expenditures and produce the system's primary output—the Bond Fund Report. The Bond Fund Report is the State's official record of the status of CIP appropriations, and represents the only report generated directly by the Bond Fund reporting system. Responsibility for the report rests with the Department of Accounting and General Services.

An adequate report is essential towards monitoring the financial condition of the Bond Fund. In this chapter, we describe the Bond Fund Report and evaluate the usefulness of the report.

Summary of Finding

Our finding is that the Bond Fund Report has little utility. The report is excessively bulky; it contains appropriations and expenditure data on projects which were completed many years ago; and it is difficult to understand. Furthermore, as a report to the Legislature, its sheer size would discourage all but the most resourceful and persevering from using the report for information on current CIP activity.

The Problem with the Bond Fund Report

The Bond Fund Report is a quarterly report which displays by legislative acts and

by the specific projects authorized by each legislative act the following information: the amounts appropriated, the bonds issued against the appropriations, the allotments made, the expenditures made in the prior years, the expenditures made in the current year, allotment balances, and encumbrance balances. It is potentially a useful report from the standpoint of providing recurring information on the condition of the fund and current CIP activity. However, in its present form, the Bond Fund report is of limited utility.

**Size of the report.** The Bond Fund Report is a computer printout which now numbers more than 1500 pages, is nearly six inches thick and grows in size with each new legislative act appropriating bond resources to CIP projects. It contains many thousands of line entries covering the individual CIP projects. It is an unwieldy report so massive in size that it would discourage all but the most persevering and resourceful from trying to locate and derive specific information from the report.

**Obsolete information.** The reason for the unwieldiness of the report is not hard to find. The report contains information dating back to Act 195, Session Laws of Hawaii 1961 and covers every appropriation made in every legislative act since 1961. There are thousands upon thousands of entries which have been closed for years, i.e., the CIP projects have been completed, there are no encumbrance balances, there is no current activity, and there can be no further expenditures against the appropriations. Yet, these many thousands of CIP

project entries are reprinted each quarter, year after year.

**A more manageable and useful report.** The obvious solution is to purge the report of obsolete information, and specifically, project entries for which the appropriations are closed and against which there can be no further activity. The report, then, would contain project information on only those projects for which appropriations are still in effect. The financial condition of the fund can still be monitored by the summary information currently being displayed by legislative acts, a portion of the report which takes up just a few pages. The purging of obsolete information would have

the immediate effect of vastly reducing the bulk of the report. Moreover, it would allow the reader to focus attention on current appropriations which is where the reader's interest is likely to be. Finally, there are obvious cost savings involved.

#### **Recommendation**

*We recommend that the Department of Accounting and General Services purge the Bond Fund Report of project entries for which there can be no further financial activity, and hereafter, limit the report to those projects for which appropriations are still in effect.*

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### **PART III**

#### **RESPONSES OF AFFECTED AGENCIES**

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## **COMMENTS ON RESPONSES OF AFFECTED AGENCIES**

On February 8, 1982, copies of a preliminary draft report of this examination were transmitted to the Governor, the presiding officers of the Legislature, and to the two agencies directly affected by our report, the Department of Budget and Finance and the Department of Accounting and General Services. As is our practice, we invited the affected agencies to comment on the recommendations made in the report.

Copies of the transmittal letters to the Department of Budget and Finance and the Department of Accounting and General Services are included here as Attachments 1 and 2, respectively. The response from the Department of Budget and Finance is included as Attachment 3, and the response from the Department of Accounting and General Services is included as Attachment 4.

### **Response of the Department of Budget and Finance**

The Department of Budget and Finance states that it generally concurs with the findings and recommendations of the report.

The recommendations directed to the department were those to have the department: (1) exercise controls to ensure that executive agencies refrain from requesting capital improvement appropriations when the appropriations cannot reasonably be expected to be expended within the time frame for which the appropriations are requested; (2) restrict the use of interfund borrowings to finance capital improvement expenditures; and (3) ensure that excess capital project funds are transferred to the Project Adjustment Fund and that the use of the funds be controlled and monitored.

### **Response of the Department of Accounting and General Services**

The Department of Accounting and General Services states that it disagrees with both the findings and recommendations of the report.

The recommendations directed to the department were those to have the department: (1) revise its encumbrance policy to prevent encumbrances for which there are no legal commitments and to prevent excess encumbering of funds; and (2) purge the Bond Fund Report of obsolete information so that the report can be more useful.



**Encumbrances.** With respect to our recommendations concerning encumbrances, our focus on the issue is derived from the 1978 constitutional provision concerning the lapsing of appropriations. Article VII, Section 11, states in part:

"All appropriations for which the source is general obligation bonds or general funds shall be for specified periods, and no such appropriation shall be made for a period exceeding three years. Any such appropriation or any portion of any such appropriation which is unencumbered at the close of the fiscal period for which the appropriation is made shall lapse . . . ."

From the various proceedings and documents of the 1978 constitutional convention, the intent of the foregoing provision is clear: it is to provide for the automatic cancellation of appropriations which are not encumbered prior to their lapsing deadline so as to prevent an accumulation of appropriations, and in the case of appropriations financed by general obligation bonds, a build-up of authorized but unissued debt.

In our report, we cite instances where encumbrances have been made without legal commitments and where the amounts encumbered have been excessive. As a result, we believe that the constitutional provision concerning lapsing has been circumvented.

The department's disagreement with our findings and recommendations on this issue revolves around the question as to what constitutes an encumbrance. We believe that an encumbrance must be supported by a contract or evidence that a contract award is imminent.

On the other hand, the department's position can be summarized as one that contends that just so long as there is a contract in effect for a project, the remaining amount of an appropriation can be encumbered if the expending agency asserts that the remaining amount is required, even if the contract does not cover the amount represented by the encumbrance.

Our position and that of the department are, therefore, diametrically opposite.

Given the views of the department and our belief that this issue should be further considered and resolved, we suggest that the encumbrance policy be reviewed by the Department of Budget and Finance. The statutory basis for the Department of Budget and Finance to assume this responsibility is Section 37-33, Hawaii Revised Statutes, which states in the context of the State's allotment system: "In the case of capital improvements . . . the director of finance may . . . prescribe such regulations as will insure proper application and encumbering of funds."

**Bond Fund Report.** Our report recommends that the Bond Fund Report, a computer printout which now numbers 1500 pages and contains thousands upon thousands of project entries which have been closed for years, be purged of all obsolete information and be limited to those projects for which appropriations are still in effect. The report would then be more manageable and useful.

The department disagrees, stating that the "computer data base from which Bond Fund reports are printed is used for many purposes which altogether dictate that the data base remain as all-inclusive as it now is."

Our comment is that if the department for its own purposes needs an all-inclusive report, it can retain its last Bond Fund Report (e.g., the December 31, 1981 quarterly report) and purge the data base of all project entries for which there can be no further financial activity. Accounting control is not advanced by printing the same thousands upon thousands of closed entries, quarter after quarter and year after year.



THE OFFICE OF THE AUDITOR  
STATE OF HAWAII  
465 S. KING STREET, RM. 500  
HONOLULU, HAWAII 96813  
(808) 548-2450



CLINTON T. TANIMURA  
AUDITOR  
RALPH W. KONDO  
DEPUTY AUDITOR

February 8, 1982

*COPY*

Mr. Jensen S. L. Hee, Director  
Department of Budget and Finance  
State Capitol, Room 411  
Honolulu, Hawaii 96813

Dear Mr. Hee:

Enclosed are two preliminary copies, Nos. 4 and 5, of our *Examination of Selected Aspects of the State General Obligation Bond Fund*. We call your attention to the recommendations affecting your office which are made in Chapters 3 and 5 of the report. If you have any comments on the recommendations, we ask that you submit them in writing to our office by February 22, 1982, for inclusion in the final report.

Copies of this preliminary report have also been sent to the State Comptroller for any comments he might have concerning the recommendations affecting his department. The Governor and the presiding officers of the Legislature have also been provided with copies of this preliminary report.

Since the report is not in final form and changes may possibly be made to it, access to this report should be restricted to those officials whom you might wish to call upon to assist you in the review of the report. Public release of the report will be made solely by our office and only after the report is published in its final form and submitted to the Legislature.

We appreciate the assistance and cooperation extended to us.

Sincerely,

Clinton T. Tanimura  
Legislative Auditor

Enclosures

THE OFFICE OF THE AUDITOR  
STATE OF HAWAII  
465 S. KING STREET, RM. 500  
HONOLULU, HAWAII 96813  
(808) 548-2450



CLINTON T. TANIMURA  
AUDITOR  
RALPH W. KONDO  
DEPUTY AUDITOR

February 8, 1982

*COPY*

Mr. Hideo Murakami, Comptroller  
Department of Accounting and  
General Services  
1151 Punchbowl Street  
Honolulu, Hawaii 96813

Dear Mr. Murakami:

Enclosed are two preliminary copies, Nos. 6 and 7, of our *Examination of Selected Aspects of the State General Obligation Bond Fund*. We call your attention to the recommendations affecting your office which are made in Chapters 4 and 6 of the report. If you have any comments on the recommendations, we ask that you submit them in writing to our office by February 22, 1982, for inclusion in the final report.

Copies of this preliminary report have also been sent to the director of the Department of Budget and Finance for any comments he might have concerning the recommendations affecting his department. The Governor and the presiding officers of the Legislature have also been provided with copies of this preliminary report.

Since the report is not in final form and changes may possibly be made to it, access to this report should be restricted to those officials whom you might wish to call upon to assist you in the review of the report. Public release of the report will be made solely by our office and only after the report is published in its final form and submitted to the Legislature.

We appreciate the assistance and cooperation extended to us.

Sincerely,

Clinton T. Tanimura  
Legislative Auditor

Enclosures



ATTACHMENT 3

GEORGE R. ARIYOSHI  
GOVERNOR



HAWAII PUBLIC EMPLOYEES HEALTH FUND  
EMPLOYEES' RETIREMENT SYSTEM  
PUBLIC UTILITIES COMMISSION  
OFFICE OF THE PUBLIC DEFENDER

STATE OF HAWAII  
DEPARTMENT OF BUDGET AND FINANCE  
STATE CAPITOL  
P. O. BOX 150  
HONOLULU, HAWAII 96810

JENSEN S. L. HEE  
DIRECTOR

DENNIS K. GODA  
DEPUTY DIRECTOR

DIVISIONS:  
BUDGET PLANNING AND MANAGEMENT  
HAWAII INSTITUTE FOR MANAGEMENT  
AND ANALYSIS IN GOVERNMENT  
ELECTRONIC DATA PROCESSING  
FINANCE

February 22, 1982

RECEIVED

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OFF. OF THE AUDITOR  
STATE OF HAWAII

The Honorable Clinton T. Tanimura  
Legislative Auditor  
465 S. King Street, Rm. 500  
Honolulu, Hawaii 96813

Dear Mr. Tanimura:

Thank you for the opportunity to review the preliminary report,  
Examination of Selected Aspects of the State General Obligation Bond  
Fund.

Our overall comment is that we generally concur with the findings  
and recommendations of the report. The following are our specific  
comments on the recommendations in Chapters 3 and 5 of the report which  
directly affect the department:

Chapter 3

Recommendation:

The Department of Budget and Finance should ensure that the  
executive branch agencies refrain from requesting CIP appro-  
priations when, considering the backlog of projects, the  
appropriations cannot reasonably be expected to be expended  
within the time frame for which the appropriations are requested.

Comments:

We concur with this recommendation. Steps were taken during  
the recent review of FY 1983 supplemental budget requests to  
limit CIP project requests to "expendable levels." It should  
be noted, however, that the Administration's CIP projects  
represent only a part of total CIP appropriations.

Recommendation:

Should the Legislature decide that the State should continue  
to finance CIP projects through long-term borrowing, the  
Department of Budget and Finance should implement a program of  
regular general obligation bond issuance and restrict the use

-2-

of interfund borrowings to finance CIP expenditures. This  
would help to ensure the stability of the State's capital  
improvements program and minimize the amount of lost income  
due to the decrease of investable cash.

Comments:

We concur with this recommendation. The general obligation  
bond fund should be self-sufficient and should not have to rely on  
interfund borrowings from the general fund. In order to do  
this, the Department of Budget and Finance should have some  
flexibility in implementing a program of regular general  
obligation bond issuances. The interest rate ceiling should  
be removed to accomplish this objective.

We believe that the use of a statutory interest rate ceiling  
to control public debt offerings is unrealistic. Control  
should be exercised at the authorization and allotment stage.  
Once a project receives legislative approval, the Administration  
should have the financial flexibility to meet its CIP commit-  
ments.

Chapter 5

Recommendation:

The Department of Budget and Finance, as the central budget  
control agency, should require and ensure that expending  
agencies transfer surplus appropriations into the Project  
Adjustment Fund immediately upon their availability. If  
expending agencies request supplemental appropriations from  
the Project Adjustment Fund, these requests should be evaluated  
on the basis of the total pool of funds available in the  
Project Adjustment Fund and statewide CIP requirements.

Comments:

We concur in principle with this recommendation. However, the  
mechanism to monitor and control surplus appropriations needs  
to be studied further.

As a follow-up to the report, please be assured that efforts will  
be made to implement those recommendations relative to the department in  
accordance with our present and future means to do so.

Very truly yours,  
  
FOR Jensen S. L. Hee



ATTACHMENT 4



GEORGE R. ARIYOSHI  
GOVERNOR

STATE OF HAWAII  
DEPARTMENT OF ACCOUNTING  
AND GENERAL SERVICES

P. O. BOX 119  
HONOLULU, HAWAII 96810

HIDEO MURAKAMI  
COMPTROLLER

MIKE N. TOKUNAGA  
DEPUTY COMPTROLLER

LETTER NO.

Mr. Clinton T. Tanimura

- 2 -

February 19, 1982

February 19, 1982

RECEIVED

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OFFICE OF THE AUDITOR  
STATE OF HAWAII

Mr. Clinton T. Tanimura, Auditor  
Office of the Legislative Auditor  
State of Hawaii  
465 So. King Street, Suite 500  
Honolulu, HI 96813

Dear Mr. Tanimura:

This letter responds to yours of February 8, 1982, in which you drew our attention to Chapters 4 and 6 of a draft of your report entitled "Examination of Selected Aspects of the State General Obligation Bond Fund". As in the past, we appreciate the opportunity your office provides to agencies for reviewing and reacting to drafts of reports affecting them.

In this particular case, and especially with regard to Chapters 4 and 6, we generally are in disagreement with both the findings and the recommendations of the report. Our basic disagreement centers on the report's position that the statewide encumbrance policy issued by this office has resulted in poor encumbrance practices. While certainly not claiming perfection in the performance of any of the many varied functions assigned by law to the Department of Accounting and General Services, we believe our view is supportable that the statewide encumbrance policy brings appropriate and necessary order to the accounting control aspects of the CIP budgetary process.

Further, and of more fundamental importance, we believe the statewide encumbrance policy conforms entirely to the legislative intent of the various statutory provisions applicable to encumbering and lapsing, as well as to the constitutional provision that specifically addresses the lapsing of unencumbered appropriations. Our policy has, in fact, been revised numerous times for the purpose, among others, of assuring that it conforms to underlying law. I hope it is well understood that we stand ready to incorporate any further revision that becomes appropriate to reflect changing legislative intent.

Finally, with reference to the report's finding and recommendation on our Bond Funds report, there are reasons that we cannot agree with the finding nor accept the recommendation, which reasons are not addressed in your report.

In the following portion of this letter, we would like to discuss our reaction to this and the other previously mentioned findings and recommendations in Chapters 4 and 6.

Chapter 4

Your report finds that our statewide encumbrance policy allows the encumbrance of appropriations for anticipated future expenditures for which there is no existing legal commitment to expend funds. This finding is presented even though your report subsequently quotes a portion of our policy which reads: ". . . encumbrances of estimated project costs may be recorded without executing a written agreement or issuing a purchase order if . . . encumbrance of the estimated project costs is necessary to complete a project for which there is a commitment of the State to another party who has related enforceable rights against the State." The significant elements in this portion of the policy are that anticipated future expenditures may justify encumbrance, but only if the anticipated future expenditures relate to an enforceable obligation that the State has already incurred on the project. To do otherwise would be to force lapsing (contrary to legislative intent, we believe) of amounts that could leave a project only partially completed, and unworked on for the duration of time required for revised funding. As long as an expending agency is already within a binding contract relating to a project for which an appropriation has been made, we believe it is both practical and reasonable, as well as within legislative intent, to encumber the remaining amounts of an appropriation that the expending agency asserts are required to complete the project.

Some comment should be made here with reference to the projects listed in the report's Table 4.1. That table is headed with the title "Encumbrances Without Legal Commitments." Against the background of the foregoing discussion, we would like to point out that we have reviewed each of the accounts listed in the table and have verified that, in each case, our records do show a legal commitment relating to the project. Obviously the entire amount of the appropriations was not directly under contract at the time of encumbrance-request; projects of any magnitude and complexity at all cannot be executed by having all contracts entered into at the same time, as the nature of such projects is in progress through stages over a period of time. Contrary to the impression left by the report on a casual reader, the projects listed in the table actually illustrate the desired result of the statewide encumbrance policy in acknowledging the requirement of funding to complete a project, but only to the extent that the requested encumbrance can be related to a project in which the expending agency already has a legal commitment.

Your report states that you believe the part of the statewide encumbrance policy addressing incomplete projects, and our interpretation thereof,



February 19, 1982

allow "the basic encumbrance policy" to be circumvented to the detriment of sound financial management. As our comments here indicate, we do not believe the evidence in the report supports that statement; to the contrary, we believe that our accounting records do provide evidence that we are controlling against unjustified encumbering of funds while at the same time reserving those funds needed to complete a project under the intent of the appropriations as passed by the Legislature. Again, however, we would like to make it clear that, should the Legislature give other policy guidance in the area, our policy will be promptly revised, as it has been in the past, to remain consistent with that guidance.

Before closing this discussion on the 1st finding in Chapter 4, we would also like to address the project cited in your report as the "General Aviation Field on Oahu." This project did not come from "mysterious origins" as referred to in the report; it came from a \$1,000,000 appropriation made by the Legislature in 1961, and was allotted by the lapse date of June 30, 1962. As the result of an arrangement involving former Navy land at Puunene, Maui, and land used in Kahului airport construction, this \$1,000,000 appropriation was made for various airports projects to be determined in connection with the FAA; when a decision was reached to use \$250,000 of the appropriation for purposes relating to a general aviation field on Oahu, that amount was moved, for accounting control purposes, to a separate account. Your report also makes reference to a "curiosity that it was able to survive, without lapsing, for twenty years," but ignores the obvious fact that the Legislature could have lapsed the unencumbered amount at any time it made a policy decision to do so. Without such action on the part of the Legislature, recent attention to the project purposes seems to bear out that the project was not, in fact, "dead." When Airports Division (under the Department of Transportation, which was designated as expending agency) requested the encumbrance addressed in your report, it was requested under the heading of "General Aviation Field on Oahu, Poamoho," but the inclusion of Poamoho in the title had no accounting control significance in allowance of the encumbrance. Airports Division has advised informally that Poamoho was not intended to have restrictive significance, as various location alternatives were being considered, including Bellows, Kunia, and Dillingham, the last of which was the location in connection with which the encumbrance was ultimately expended. We do not believe it is at all helpful to the report to address the \$250,000 appropriation as though some improprieties were involved in it, when the record discloses compliance with both law and policy throughout the life of the appropriation.

This brings us to the 2nd finding in Chapter 4 -- that the statewide encumbrance policy allows the encumbrance of funds in the amounts far in excess of the sums needed to complete existing legal commitments. This finding appears to assume a degree of second-guessing the expending agency that goes far beyond the limits of accounting control of appropriations. Compare the non-CIP commitments of expending agencies throughout the State government; when an agency

February 19, 1982

issues a purchase order or otherwise encumbers funds as part of its over-all program management responsibilities, it is not the function of accounting control to question whether the expending agency is over-buying the goods or services involved (or under-buying, for that matter). Similarly, when an expending agency assigned a CIP project requests encumbrance of an amount under circumstances that otherwise satisfy the applicable policy constraints, it should not be part of our central accounting control activities to try to exercise judgment on whether or not the expending agency is committing itself to a larger amount than necessary. It is our observation that, in the real world of CIP execution, expending agencies from time to time both over- and under-encumber; absolute perfection cannot be reasonably expected in predicting and estimating future costs to complete a project in actual practice. And we do not believe the Legislature assumes such perfection in making its appropriations.

We would also like to comment on the report's statement that the Constitution, by setting a three-year life for appropriations, establishes a time frame within which appropriations should be implemented. This does not appear to be a rational reading of the constitutional provision, if the writer means that projects should be completely implemented. If projects had to be completely implemented by a lapse date, there would be no use for reserving funds by encumbrance, as the related appropriation would have been fully expended. The only reading of the constitutional provision that can make useful sense from an accounting control standpoint is that, on the applicable lapse date, remaining amounts not obligated for the purpose of the appropriation must lapse. This reading is the one incorporated in the statewide encumbrance policy.

Finally, in connection with the 2nd finding in Chapter 4, we would like to refer to the report's use of terms such as "front-loading" and "hoarding" to describe the effect of our statewide encumbrance policy on CIP appropriations. Such terms do not fit the reality of the CIP appropriation process. The report itself describes elsewhere the high volume of CIP appropriations that typically accumulate; if these appropriations subsequently become non-priority in status to the Legislature, and assuming that implementation has not formally begun with legal commitments already made, it is the unarguable prerogative of the Legislature to delete or otherwise amend the appropriations -- and this prerogative is well recognized in practice. What the report describes as "front-loading" and "hoarding" is not the result of administrative policy.

The recommendations related to the 1st and 2nd findings in Chapter 4 are all toward the purpose of not allowing encumbrances for incomplete projects. Partly for reasons already discussed, we do not believe such recommendations to be workable. Another reason for the same conclusion is that there are frequently end-of-project costs that occur after completion of the construction or acquisition contracts themselves. Especially in larger, more complex projects involving



February 19, 1982

multi-phases, there are unavoidable amendments to existing contracts for unexpected additional work. Final audit and settlement of utility agreements in highways construction, and final relocation of utilities in home construction are other examples of the practical need to encumber estimated completion costs of projects. A more comprehensive review in your report of the many varied costs frequently required to complete any but the simplest CIP projects would, we believe, result in reconsideration of the report's recommendations relating to the 1st and 2nd findings in Chapter 4.

The 3rd finding in Chapter 4 is that poor monitoring of the statewide encumbrance policy allows the continued existence of encumbrances that are supported by terminated or completed commitments. This finding, and the related recommendation, seem to suggest policy action that goes beyond the legal authority on which the policy is based. From time to time, this office does request expending agencies to review their outstanding encumbrances and to submit reduction transactions for those that should be reduced or eliminated; however, these communications, which are made in cooperation with other staff departments concerned with executing the capital improvements program of the State, are not based on legal authorities granted to the State Comptroller. While to our knowledge there has been no challenge to these efforts, it must be recognized that expending agencies are also the contracting officers for encumbered contracts and are empowered accordingly as the ultimate parties responsible for whether a contract has actually ended.

In summary, and as these comments suggest, we do not believe the recommendations in Chapter 4 should be followed, as we are in disagreement with the findings on which they are based.

#### Chapter 6

Your report finds that our Bond Funds report "has little utility" because it is "excessively bulky," "contains appropriations and expenditure data on projects which were completed many years ago," and "is difficult to understand."

The computer data base from which Bond Funds reports are printed is used for many purposes which altogether dictate that the data base remain as all-inclusive as it now is. For example, it is the only accounting-oriented record that exists for reconciling Bond Funds authorizations, by act, with the records of the Director of Finance which are used to certify the State's debt limit; therefore, for any act (no matter how old) with accounts that remain "alive," the entire act must be retained in the data base intact.

This does not mean, of course, that the entire data base must be printed for a particular report. There are, in fact, reports derived from the data base

February 19, 1982

that do not include all accounts, and we make the data base available to any department or agency that would like to use it for such purposes (without, of course, allowing any alterations to the data base).

For our routine Bond Funds report, however, its usefulness to us requires that the data base be fully reflected. It may also be helpful to point out that this report is printed not only by act, but also by expending agency (which then enables distribution to an agency of only its own portion of the report) and by governmental function (which has saved an extremely high number of manhours formerly consumed in manual compilation for financial reporting at the end of each fiscal year). We regard the report as very versatile and useful, and we encourage users to let our staff be of assistance if there is any difficulty in understanding some aspect of it.

For the reasons given here, we cannot follow your report's recommendation that projects be purged on the sole criterion of whether there can be further financial activity. Whenever there is an expressed need, however, we have no objection to other reports being printed from the Bond Funds data base using different criteria.

If any expansion of clarification of our comments is desired, or if you believe we have inadvertently misunderstood any of the content of your report, we will be happy to have further discussion with you on it.

Very truly yours,



HIDEO MURAKAMI  
Comptroller