
Financial Audit of the Department of Defense

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

Conducted by

The Auditor
State of Hawaii
and
Grant Thornton LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 96-18
November 1996

Foreword

This is a report of our financial audit of the Department of Defense for the fiscal year July 1, 1995 to June 30, 1996. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Grant Thornton LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Department of Defense.

Marion M. Higa
State Auditor

Table of Contents

Chapter 1 Introduction

Background	1
Organization of the Department of Defense	1
Objectives of the Audit	4
Scope and Methodology	4

Chapter 2 Internal Control Practices

Summary of Findings	5
CPA's Disclaimer of Opinion and Reportable Conditions Highlight Problems With Internal Financial Accounting and Reporting	5
Failure to Transfer Moneys to the General Fund is a Material Weakness	6
<i>Recommendation</i>	7
Financial Records Are Not Sufficient and Cannot Be Audited in a Timely Manner	7
<i>Recommendations</i>	8
Improper Procurement Practices Are a Reportable Condition	8
<i>Recommendation</i>	13

Chapter 3 Financial Audit

Summary of Findings	15
Independent Auditors' Report	15
Independent Auditors' Report on the Internal Control Structure Based on an Audit of the Combined Financial Statements Performed in Accordance With Government Auditing Standards	17
Independent Auditors' Report on Compliance Based on an Audit of the Combined Financial Statements Performed in Accordance With Government Auditing Standards	20
Descriptions and Definitions	21
Notes to the Combined Financial Statements	22

Response of the Affected Agency	37
---------------------------------------	----

Exhibits

Exhibit 1.1	State of Hawaii, Department of Defense, Office of the Adjutant General, Organization Chart	3
Exhibit 2.1	Vendor Quotation Information	9
Exhibit A	Combined Balance Sheet - All Fund Types and Account Groups, June 30, 1996	33
Exhibit B	Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types and Expendable Trust Funds, Fiscal year ended June 30, 1996	34
Exhibit C	Combined Statement of Revenues and Expenditures - Budget and Actual - General and Special Revenue Funds, Fiscal year ended June 30, 1996	35

Chapter 1

Introduction

This is a report on the results of work performed to conduct a financial audit of the State of Hawaii, Department of Defense. The work was performed by the Office of the Auditor and the independent certified public accounting firm of Grant Thornton LLP. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Background

Hawaii's Department of Defense administers the Hawaii National Guard, the State Civil Defense Division, the Hawaii National Guard Youth Challenge Program, and the Office of Veterans Services. In the fiscal year ended June 30, 1996, it had an operating budget of approximately \$36 million, of which \$7 million was general fund appropriations, \$27 million was federal funds, and \$2 million was capital improvement appropriations. The federal government provides funding to the department through the National Guard Bureau and Federal Emergency Management Agency. A condition of the funding is that the federal government sets requirements relating to the size, strength and structure of the organization.

The department's purpose is to provide military and civil defense organizations that are adequately staffed, trained, equipped and prepared to expeditiously respond to both federal and state missions. The department's objective is to minimize deaths, injuries, property damages and economic losses in the event of physical disasters, mass casualty situations, or manmade disasters.

Organization of the Department of Defense

As approved in February 1996, the department is organized as shown in Exhibit 1.1.

Office of the Adjutant General

The Adjutant General is the head of the Department of Defense and the director of civil defense for the State.

Office of Veterans Services

This office manages the Hawaii State Veterans Cemetery and is responsible for the development and management of policies and programs related to veterans, their dependents and/or survivors.

Judge Advocate General Office

This office provides legal support on federal matters to the adjutant general, other staff offices and divisions such as the Hawaii National Guard and the U.S. Property and Fiscal Office.

Human Resources Office

This office provides personnel services, human resources management and administrative support services for all federal full-time personnel programs.

U.S. Property and Fiscal Office

This office receives and accounts for all funds and United States property in possession of the Hawaii National Guard, in conformance with applicable federal statutes and regulations.

Engineering Office

This office provides professional engineering and contracting services to the Hawaii Army National Guard, Hawaii Air National Guard, State Civil Defense Division, Office of Veterans Services, Hawaii National Guard Youth Challenge Program, and other departmental staff requiring engineering services.

Administrative Services Office

This office administers the department's fiscal, personnel, and administrative functions, and provides military and administrative support to the Office of the Adjutant General.

Public Affairs Office

This office plans, develops, directs, and administers the department's community relations programs and public and internal information programs.

Civil Defense Division

The mission of this division is to coordinate, integrate and focus on various phases of emergency management for the State of Hawaii. These phases include mitigation, preparedness, response and recovery.

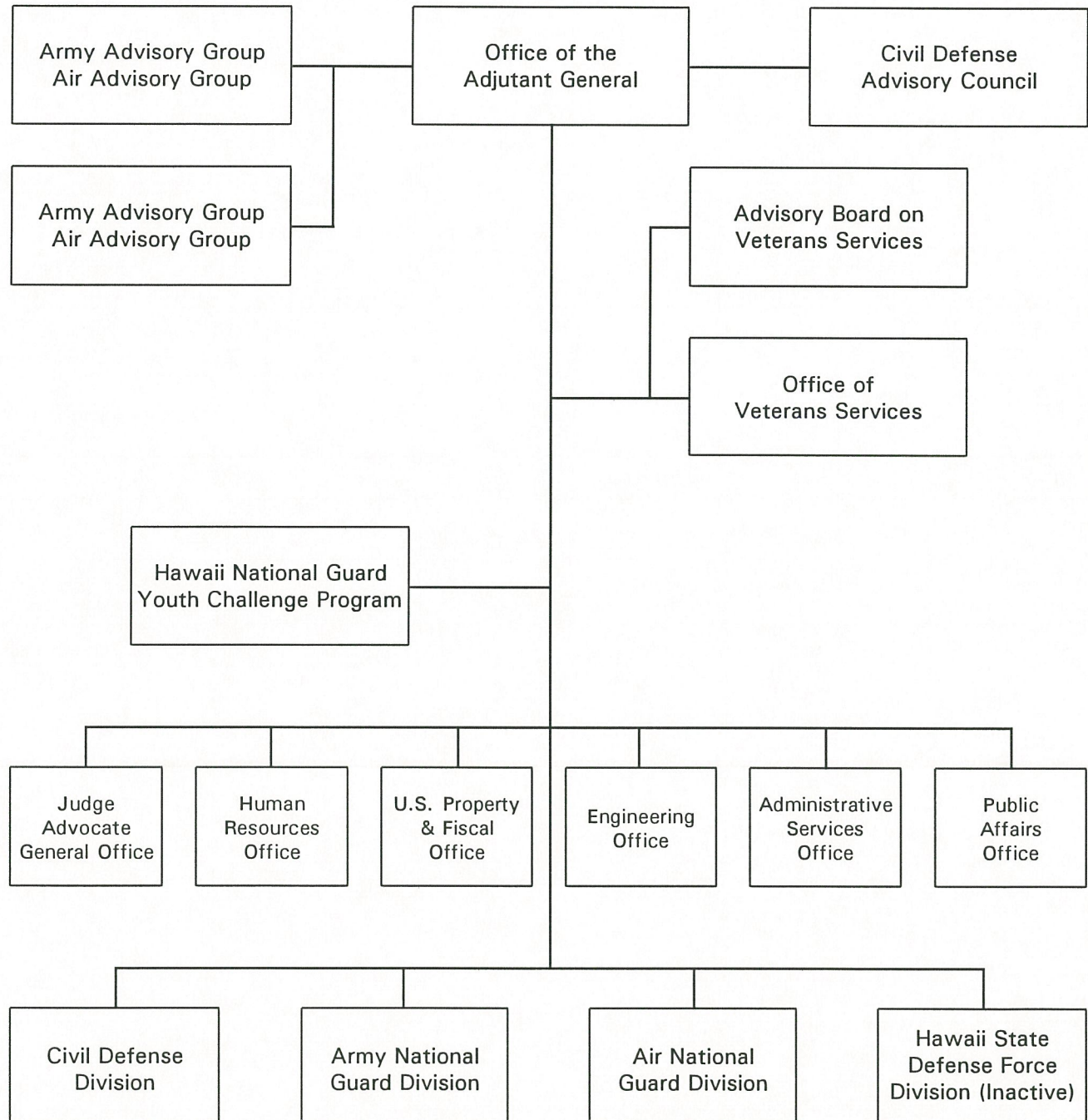
Army National Guard Division

The mission of the Hawaii Army National Guard is to maintain its readiness for state or national active duty through continual training.

Air National Guard Division

The mission of the Hawaii Air National Guard is to provide assistance in preserving peace and ensuring public safety during natural or human-caused disasters. It also provides active personnel for U.S. Air Force duty in time of war or national emergency.

Exhibit 1.1
State of Hawaii
Department of Defense
Office of the Adjutant General
Organization Chart



Objectives of the Audit

1. Report on the fair presentation of the financial statements of the department.
2. Assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal controls, and financial reporting and recommend improvements.
3. Ascertain whether expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

Scope and Methodology

The contract with Grant Thornton LLP requires an audit of the financial records and transactions and review of the related systems of accounting and internal controls of the Department of Defense for the fiscal year July 1, 1995 to June 30, 1996. Included in the scope of work were all fund types and account groups but the general fixed assets account group. The contract also provides for review of the department's transactions, systems, and procedures for their compliance with applicable laws and regulations. Excluded from the scope of the audit were the financial accounting records of other departments providing services and resources to the agency.

To the extent possible, we examined the existing accounting, reporting, and internal control structure. We identified the deficiencies and weaknesses in the internal control structure and made recommendations for improvements, including, but not limited to, the forms and records, the management information system, and the accounting and operating procedures.

The independent auditors' report on the combined financial statements presented in Chapter 3 is that of Grant Thornton LLP. The work was conducted from June 1996 through September 1996 in accordance with generally accepted government auditing standards. Because of the severity of the problems noted, Grant Thornton LLP was unable to express an opinion on the combined financial statements of the department.

Chapter 2

Internal Control Practices

In our review of the department's system and procedures for internal controls, we found several conditions that warrant improvement. We found significant problems with the department's internal financial accounting and reporting procedures. Management needs internal controls to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the internal control practices and procedures of the Department of Defense.

Summary of Findings

1. The department's financial reporting procedures are inadequate. Grant Thornton LLP was unable to express an opinion on the department's financial statements. Further, it identified three reportable conditions in the department's internal controls, one of which is of such magnitude as to be considered a material weakness.
2. The department did not reimburse the State Treasury for general fund advances on behalf of the special revenue accounts. Certain federal reimbursements received and deposited in the special revenue accounts were not transferred in a timely manner to the general fund. As of June 30, 1996, the department owed approximately \$583,000 to the State Treasury.
3. The department is not in compliance with the Hawaii Public Procurement Code. The department has not complied with the State's procurement laws, rules, regulations, or related executive memoranda.

CPA's Disclaimer of Opinion and Reportable Conditions Highlight Problems With Internal Financial Accounting and Reporting

The financial reports as of and for the fiscal year ended June 30, 1995, had not been audited, so Grant Thornton LLP was unable to express an opinion on the department's financial statements for the subsequent year. Furthermore, Grant Thornton LLP has noted three reportable conditions in its *Independent Auditors' Report on the Internal Control Structure* in Chapter 3. One of the reportable conditions is considered to be a material weakness.

Reportable conditions and material weaknesses are serious matters

Reportable conditions are significant deficiencies in the design or operation of an agency's internal control structure that could adversely affect its ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness in the internal control structure is the worst possible reportable condition. A material weakness exists when the design or operation of an agency's internal controls does not reduce risk to a relatively low level. As a result, material errors or irregularities relative to the combined financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Failure to Transfer Moneys to the General Fund is a Material Weakness

The department has failed to transfer federal reimbursements to the State's general fund as it should have. Instead, it has kept federal reimbursements in its special revenue accounts to finance program expenditures that were not approved by the Legislature. It has been able to do this by not identifying expected federal reimbursements in its budget requests to the Legislature. This is a major irregularity, a reportable condition that is a material weakness.

The department knows that certain general fund expenditures will be reimbursed by the federal government. Despite knowing this, the department prepares its budget request without noting those federal reimbursements. As a result, the Legislature unknowingly appropriates general fund moneys to the department without deducting the reimbursable amounts from the federal government. The department is able to expend these funds because general fund appropriations are higher than needed and federal reimbursements are retained and not transferred.

The June 30, 1994 audited financial statements show that the department owed about \$660,000 to the general fund. Accounting records indicate no transfers were made to the general fund during the fiscal year ended June 30, 1995. For the year ended June 30, 1995, department records indicate that the amount owed to the general fund was about \$1.1 million. In June 1996, the department transferred approximately \$500,000 to the general fund. At June 30, 1996, the department should have transferred approximately \$583,000 more. The department should transfer these reimbursements to the State's general fund as they are received. Instead, the department keeps the money in its special revenue accounts for other expenditures.

This appears to circumvent the intent of the budget process and the lapsing law for general fund appropriations. Lapsing does not apply to special revenue accounts where federal reimbursements were retained.

Had the excess general funds been properly transferred, subsequent legislative appropriations would more accurately reflect program needs based on actual general fund and special revenue account balances. Special revenue account balances should not include federal reimbursements that rightly belong to the general fund. Excess general fund balances should lapse and become available for new legislative appropriations.

Recommendation

The department should immediately transfer balances due to the State's general fund and transfer any future amounts due the general fund on a timely basis.

Financial Records Are Not Sufficient and Cannot Be Audited in a Timely Manner

The department has not ensured that its financial accounting records are sufficiently complete and accurate to allow timely audits. Prior financial auditors have found it necessary to extend auditing procedures due to insufficient record keeping. The prior contracted auditors had to determine proper account balances as of June 30, 1995. For our financial audit, this additional work was beyond the scope of the work contracted with Grant Thornton LLP. Thus Grant Thornton LLP was unable to express an opinion on the department's financial condition for us.

During the course of our work, we found errors in the accounting records that had not been corrected. These errors were consistent with those identified by the prior auditors who were contracted to help the department fix its accounting records in order to complete the audits.

Additional work done by prior auditors included preparing and reviewing schedules of certain Federal Emergency Management Agency revenues received from the federal government and transferred to counties and determining other amounts due from the federal government and amounts due to counties. Amounts due to the general fund often had to be determined by prior auditors because accounting records were insufficient.

State departments, agencies, and programs are responsible for maintaining their financial accounting records properly. Poorly or improperly maintained records not only affect the auditors, they prevent management from having the benefit of accurate financial reports. Only if accounting records are properly maintained can they be audited in a timely manner.

The federal government requires annual audits of the department because of federal funds that it receives. Known as a "single audit," the audit is to be completed within 13 months of the end of the state's fiscal year—in this case by July 31 of the following year. The single audit report for the

year ended June 30, 1994, was issued in April, 1996, 22 months after the fiscal year ended. The single audit report for the year ended June 30, 1995 was not completed at the time Grant Thornton LLP was required to finish our audit—September 1996. Because Grant Thornton LLP could not be assured that the June 30, 1995 account balances of the department were correct, it could not express an opinion on the department's financial statements for the year ended June 30, 1996.

Under new federal audit requirements that were signed into law July 5, 1996, the required single audit reports will have to be completed within nine months—four months earlier than the prior requirement. It is even more important that the accounting and financial reporting records be maintained accurately and on a timely basis.

Management is responsible for ensuring that its financial accounting records are accurate and complete. Management should not rely on external auditors to find errors in the accounting records, or rely on external auditors to prepare records necessary to complete an audit. Management must meet these responsibilities.

Recommendations

The Department of Defense should ensure that its accounting and financial reporting records are properly maintained. It should further ensure that required financial audits are completed by the required deadlines.

Improper Procurement Practices Are a Reportable Condition

During our review, we found instances of noncompliance with the State's procurement laws, rules, regulations, or related executive memoranda. Our testing of procurement practices revealed an apparent case of parceling, required informal quotes were not documented, problems with required performance and payment bonds and bid security, services rendered before contracts were executed, and failure to follow the governor's executive memoranda. The four examples of improper procurement practices are described here.

Apparent case of parceling purchases

State agencies that procure goods and services above \$10,000 are required to solicit competitive formal bids. Section 103D-305, HRS, prohibits the parceling of purchases. Parceling divides the purchase of same, like, or related items of goods or services into several smaller units under \$10,000, thereby bypassing the formal bid process. Parceling reduces or eliminates competition for goods and services because it evades the formal, open, competitive bidding requirements of the law.

In our review, we found that the department circumvented competitive bidding by parceling the purchase of like machinery and equipment parts. The department split a \$15,000 purchase into two purchases, each under \$10,000, thereby avoiding the open competitive bidding requirements of the law. Two purchase orders, dated June 1996, were issued to the same vendor for like or related merchandise in amounts totaling \$9,996 and \$5,279. These two purchase orders totaled \$15,275 and exceeded the \$10,000 threshold.

The department has two Summary Vendor Quotation forms on file, one for each of the two purchase orders. We could not find any evidence of the required written quotes from the vendors. The first summary quotation form is dated June 6, 1996 and lists quotes received from three vendors on June 5, 1996. The quotes were solicited for a “Lawn Mower and Deck 52 inch Honda Machine.” However, the original quotes on this summary form had been altered with correction fluid and new quotes written in. Our examination of the summary vendor quotation form indicates all three of the original quotes exceeded the \$10,000 threshold for informal quotes such as this.

The second Summary Vendor Quotation form was dated June 7, 1996 and shows that three quotes were solicited from the same three vendors—again on June 5, 1996. This summary quotation form was for “Restock parts for Honda lawn mowers for STMP.” The quotes and the purchases were for related goods—a Honda lawn mower and Honda lawn mower parts. Details of the quotes are presented in Exhibit 2.1

Exhibit 2.1

Vendor Quotation Information

Vendor	Date of Quote	Quotes for Lawn mower	Quotes for Lawn mower parts
A	June 5, 1996	\$9,999.95	\$5,067.76 plus tax
B	June 5, 1996	\$10,623.60	\$4,685.28 plus tax
C	June 5, 1996	No bid	No bid

Both summary quotation forms originated from the same office and were signed by the same employee. Both forms have a space for justification for non selection of the lowest quotation. Even though the revised price quotation from Vendor A was the lowest, the summary quotation form for the purchase of the lawn mower contained the following statement in the justification section:

Honda tractors have been recommended by the State Mechanics. Parts for Honda machines are easily available through [Vendor A]. The

State Motor Pool has a large stock of Honda parts on hand and are very familiar with the Honda Machines. To eliminate the amount of down time and purchasing hassle, we strongly recommend [Vendor A] as the vendor because of quality equipment and service. State Motor Pool.

The summary vendor quotation form for the purchase of the lawn mower parts stated:

Honda parts have been recommended by the State Mechanics. For Honda machines are easily available through [Vendor A]. The State Motor Pool has a large stock of Honda parts on hand and are very familiar with Honda machines. We strongly recommend [Vendor A] as the vendor account of quality equipment and service. State Motor Pool.

Based on these justifications, Vendor A, was selected for the purchase. General funds were used to purchase the lawn mower and parts from Vendor A. Had the purchase gone through the bid process required of purchases exceeding \$10,000, the department might not have been able to complete the purchase before the appropriation lapse date of June 30, 1996. The transactions by the department appear to be parceling of a purchase to avoid lapsing of funds.

Problems noted relating to contract performance bonds, contract payment bonds, and bid security

A contract performance bond indemnifies the State against loss resulting from a contractor's failure to perform in accordance with the contract. A contract payments bond guarantees payment and protection for those furnishing labor and materials to the contractor or its subcontractors. Section 103D-324, HRS, sets forth the requirements for contract performance and payment bonds.

A bid security is required for construction contracts expected to cost more than \$100,000. A bid security ensures that the bidder is dedicated to its submitted bid and is willing to stand by its construction proposal. The purpose of the bid security is to deter frivolous or poorly prepared bids. Section 103D-323 sets forth the requirements for bid security.

Failure to require bonds

We noted that the department did not comply with Section 103D-324, HRS, that states "a performance and payment bond shall be required for goods and service contracts." The department could not provide evidence that performance and payment bonds were obtained for two supplemental agreements with a contractor to provide goods to the department.

The department's contracting officer informed us that the contract was amended to remove the performance and payment bond requirements.

However, no documentation could be located by the chief procurement officer nor by the head of the purchasing agency who removed the performance and payment bond requirements.

Without performance or payment bonds, the State could be liable for any loss resulting from the contractor's failing to deliver the goods. The State could also be liable for payment and protection of those furnishing the labor and materials to the contractor.

Failing to require performance and payment bonds for one contractor gives that contractor an unfair advantage over other contractors whose bids include the cost of the performance and payment bonds in their bid price for the specified goods.

Performance bonds are not increased for change orders

In our review of contracts executed or amended by the department, we found that four construction contracts had change orders that substantially increased the contract price. However, the corresponding performance bonds were not increased in compliance with Section 3-122-224(b)(1) of the Hawaii Administrative Rules.

The change orders totaled approximately \$147,000. If the contractor was unable or unwilling to perform the change order, the State would have to hire another contractor to perform the change order without the benefit and leverage of increased bonding. The State would have to repeat the bid process and incur additional administrative costs as well as prolong the construction. Performance bonds are insurance for the State that the contractor can and will perform in accordance with the amended terms of the contract.

Failure to hold bid security

We found that the department did not comply with Section 103D-323, HRS, when it returned a bid security to a contractor. The department informed us that the \$100,000+ contract had been amended to remove the bid security requirement, but was unable to provide the supporting documentation. The department gave no explanation or justification of circumventing state law on required bonds and bid security.

Services rendered prior to execution of contracts

The department is responsible for the timely completion and execution of contracts. In the sample of contracts that we reviewed, two were executed *after* the services were provided to the public. Of those contracts that were executed late, one was executed between 30-45 days after services were provided.

Our review of contracts showed that private providers initiated services before contracts were finalized because they expected the contracts to be forthcoming. This practice is not in the best interest of the State, the private providers, or even the public. Properly executed contracts are essential to ensure that (1) the parties have agreed to the type and scope of services to be provided, (2) the services are those for which the Legislature has appropriated moneys, and (3) the roles and responsibilities of the department and service providers are clearly delineated to avoid confusion or misunderstandings.

It is essential that contracts be properly executed before any services are provided. Without the benefit of a contract, there is no assurance that services being provided are those that are necessary or those intended by the Legislature. Additionally, providing services without contractually defined roles and responsibilities puts both the State and the providers in jeopardy should any legal problems arise.

***Noncompliance with
the governor's
executive memoranda***

The last example of improper procurement practices involves noncompliance with governor's executive memoranda. The Governor's Executive Memorandum No. 95-09 effective October 20, 1995 states that, "there shall be no expenditure commitments for consultant/personal services without my *prior* review and approval." Another Governor's Executive Memorandum No. 95-07 states that "requests for initial or amended consultant or personal services during FY 1996 shall be submitted to the governor, through B&F, and clearly identify the following:

The purpose and need for the services.

The initial or amended cost, means of funding, length, and any special conditions of the services.

An explanation of why the services could not be handled internally, or by another state agency as part of its normal responsibilities.

Impact of not implementing the request."

The department did not follow these executive memoranda for prior approval. It amended two personal services contracts during the fiscal year ended June 30, 1996 without the required approvals from the governor. These contract amendments for security services amounted to more than \$220,000.

Executive Memorandum No. 95-07 does provide for subsequent review and approval by stating "contracts inadvertently executed without my prior review and approval ... shall be submitted to me for review."

However, the department has not submitted these contracts for the subsequent review and approval by the governor either.

Recommendation

The department should ensure that it complies with the procurement code, applicable procurement rules and regulations, and related executive memoranda.

Chapter 3

Financial Audit

This chapter presents the results of the contract to conduct a financial audit of the combined financial statements of the State of Hawaii Department of Defense as of and for the fiscal year ended June 30, 1996. This report includes the independent auditors' report and reports on the internal control structure and compliance with laws and regulations as they relate to the Department of Defense. It also displays financial statements of all fund types and account groups included in the scope of the contract, together with explanatory notes.

Summary of Findings

The certified public accounting firm of Grant Thornton LLP was unable to express an opinion on the combined financial statements of the Department of Defense. The inability to express an opinion was caused primarily by the failure of the department to have finalized its June 30, 1995 accounting records and financial statements on a timely basis. Grant Thornton LLP noted matters involving the internal control structure and its operation that they considered to be reportable conditions as defined and described in Chapter 2 on Internal Control Practices. They also noted that with three exceptions, the department has complied in all material respects with laws and regulations applicable to the Department of Defense.

Independent Auditors' Report

To the Auditor
State of Hawaii

We were engaged to audit the following combined financial statements of the State of Hawaii, Department of Defense:

Combined balance sheet - all fund types and account groups, June 30, 1996 (Exhibit A);

Combined statement of revenues, expenditures and changes in fund balances - all governmental fund types and expendable trust funds, Fiscal year ended June 30, 1996 (Exhibit B);

Combined statement of revenues and expenditures - budget and actual - general and special revenue funds, Fiscal year ended June 30, 1996 (Exhibit C).

These combined financial statements are the responsibility of the department's management.

The audit of the department's financial statements as of and for the fiscal year ended June 30, 1995 has not been completed. In accordance with the terms of our engagement, we have not applied audit procedures necessary to satisfy ourselves about the classifications and amounts comprising the accounts reported in the Combined Balance Sheet - All Fund Types and Account Groups as of June 30, 1995 and the Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types and Expendable Trust Funds for the fiscal year ended June 30, 1995. Also, in accordance with the terms of our engagement, the scope of our engagement did not include the audit of the general fixed assets account group as of June 30, 1996.

The financial statements as of June 30, 1996 contain accounting errors which have not been adjusted by the department to be in conformity with generally accepted accounting principles (GAAP). The department did not properly report its pass-through grants that should be recognized as revenues and expenditures in accordance with GAAP. The effect of this error is to overstate revenues and expenditures by \$1,252,299. Also, the department did not accrue amounts due from the federal government and amounts due to subrecipients amounting to \$846,094 and \$765,313, respectively. The net effect of this nonaccrual is to understate revenues by \$80,781.

Since we were unable to apply other auditing procedures to satisfy ourselves about the classifications and amounts comprising the accounts reported in the Combined Balance Sheet - All Fund Types and Account Groups as of June 30, 1995, and the Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types and Expendable Trust Funds for the fiscal year ended June 30, 1995, as discussed in the third paragraph, the scope of work was not sufficient to enable us to express, and we do not express, an opinion on the combined financial statements referred to in the first paragraph.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 19, 1996 on our

consideration of the department's internal control structure and a report dated September 19, 1996 on its compliance with laws and regulations.

/s/Grant Thornton LLP

Honolulu, Hawaii
September 19, 1996

**Independent
Auditors' Report on
the Internal Control
Structure Based on
an Audit of the
Combined Financial
Statements
Performed in
Accordance With
Government
Auditing Standards**

To the Auditor
State of Hawaii

We were engaged to audit the combined financial statements of the State of Hawaii, Department of Defense, as of and for the fiscal year ended June 30, 1996, and have issued our report thereon dated September 19, 1996. Our report contained a disclaimer of opinion on the combined financial statements as, in accordance with the terms of our engagement, we have not applied audit procedures necessary to satisfy ourselves about the classifications and amounts comprising the accounts reported in the Combined Balance Sheet - All Fund Types and Account Groups as of June 30, 1995, and the Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types and Expendable Trust Funds for the fiscal year ended June 30, 1995. Also, in accordance with the terms of our engagement, the scope of our engagement did not include the audit of the general fixed assets account group as of June 30, 1996.

We also identified accounting errors which have not been adjusted by the department as of June 30, 1996.

The management of the Department of Defense is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of combined financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or

irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our engagement to audit the combined financial statements of the State of Hawaii, Department of Defense, for the fiscal year ended June 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of issuing our report on the combined financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our report contained a disclaimer of opinion on the combined financial statements as, in accordance with the terms of our engagement, we have not applied audit procedures necessary to satisfy ourselves about the classifications and amounts comprising the accounts reported in the Combined Balance Sheet - All Fund Types and Account Groups as of June 30, 1995, and the Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types and Expendable Trust Funds for the fiscal year ended June 30, 1995. Also in accordance with the terms of our engagement, the scope of our engagement did not include the audit of the general fixed assets account group as of June 30, 1996. Because of these limitations on the scope of our engagement, it is possible that additional reportable conditions would have come to our attention had our engagement not been so restricted.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the combined financial statements.

The following are the reportable conditions, which are more fully described in Chapter 2:

The department does not fully reimburse the State Treasury for general fund advances to the special revenue fund.

For the past two years, the audit of the department's financial statements was not completed and issued within the required federal statutory time period.

The department does not have procedures in place to ensure that procured goods and services are contracted for timely and in accordance with statutory requirements.

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the combined financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted the first reportable condition previously described involving the internal control structure and its operation that we consider to be a material weakness. This condition was considered in determining the nature, timing, and extent of the procedures to be performed in our engagement to audit the combined financial statements of the Department of Defense for the fiscal year ended June 30, 1996. However, we believe that the second and third reportable conditions described above are not material weaknesses.

We also noted other matters involving the internal control structure and its operation that we have reported to the Auditor, State of Hawaii, and the management of the Department of Defense, which are described in Chapter 2.

This report is intended for the information of the Auditor, State of Hawaii and the management of the Department of Defense. However, this report is a matter of public record and its distribution is not limited.

/s/Grant Thornton LLP

Honolulu, Hawaii
September 19, 1996

**Independent
Auditors' Report
on Compliance
Based on an Audit
of the Combined
Financial
Statements
Performed in
Accordance With
Government
Auditing Standards**

To the Auditor
State of Hawaii

We were engaged to audit the combined financial statements of the State of Hawaii, Department of Defense, as of and for the fiscal year ended June 30, 1996, and have issued our report thereon dated September 19, 1996. Our report contained a disclaimer of opinion on the combined financial statements as, in accordance with the terms of our engagement, we have not applied audit procedures necessary to satisfy ourselves about the classifications and amounts comprising the accounts reported in the Combined Balance Sheet - All Fund Types and Account Groups as of June 30, 1995, and the Combined Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types and Expendable Trust Funds for the fiscal year ended June 30, 1995. Also, in accordance with the terms of our engagement, the scope of our engagement did not include the audit of the general fixed assets account group as of June 30, 1996.

We also identified accounting errors which have not been adjusted by the department as of June 30, 1996.

Compliance with laws, regulations, contracts, and grants applicable to the Department of Defense is the responsibility of the Department of Defense's management. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement, we performed tests of the Department of Defense's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our engagement to audit the combined financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed the following instances of noncompliance, which are more fully described in Chapter 2, that are required to be reported herein under Government Auditing Standards:

The department does not fully reimburse the State Treasury for general fund advances to the special revenue fund.

For the past two years, the audit of the department's financial statements was not completed and issued within the required federal statutory time period.

The department does not have procedures in place to ensure that procured goods and services are contracted for timely and in accordance with statutory requirements.

We considered these instances of noncompliance in preparing our report. This report does not affect our report dated September 19, 1996, on those combined financial statements.

This report is intended for the information of the Auditor, State of Hawaii and the management of the Department of Defense. However, this report is a matter of public record and its distribution is not limited.

/s/Grant Thornton LLP

Honolulu, Hawaii
September 19, 1996

Descriptions and Definitions

This section describes the combined financial statements and provides definitions of technical terms used in this chapter.

Descriptions of financial statements and schedules

The following is a brief description of the combined financial statements that Grant Thornton LLP was engaged to audit, and which are attached at the end of this chapter.

Combined balance sheet - all fund types and account groups (Exhibit A). This statement presents assets, liabilities, and fund equity of all fund types and account groups on an aggregate basis.

Combined statement of revenues, expenditures and changes in fund balances - all governmental fund types and expendable trust funds (Exhibit B). This statement presents revenues, expenditures, and changes in fund equity for all governmental fund types on an aggregate basis. Revenues include state appropriations mandated by various appropriations acts of the State Legislature, and federal grant revenues.

Combined statement of revenues and expenditures - budget and actual - general and special revenue funds (Exhibit C). This statement summarizes revenues and expenditures by source and type on the budgetary basis and compares such amounts to the budget as adopted by the State Legislature.

Definition of terms

Technical terms are used in the combined financial statements and in the notes to the combined financial statements. The more common terms and their definitions are as follows:

Appropriation. An authorization granted by the State Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures.

Allotment. An authorization by the director of finance to a state agency to incur obligations and to make expenditures pursuant to the appropriation authorized by the State Legislature.

Encumbrance. A commitment, related to undelivered goods or unperformed services, in the form of a purchase order or contract which is reserved against an appropriation.

Expenditure. The incurrence of a liability for goods delivered or services rendered.

Reserve. An account used to earmark a portion of the fund balance to indicate that it is not available for expenditure.

Notes to the Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the combined financial statements and financial condition of the funds included in the scope of the engagement are discussed in this section.

Note A - Organization

The State of Hawaii, Department of Defense (department) is an integral part of the government of the State of Hawaii. The department provides for the safety, welfare, and defense of the people of Hawaii by maintaining readiness to respond in the event of war or disaster. Its divisions include the Hawaii Army and Air National Guards, and State Civil Defense.

Note B - Summary of significant accounting policies

The accounting policies of the department utilized in the accompanying combined financial statements for the fiscal year ended June 30, 1996 conform to generally accepted accounting principles (GAAP) as applicable to government entities. The following is a summary of the more significant policies:

Fund accounting

The accounts of the department are organized and operated on the basis of funds and account groups. Each fund and account group is a separate fiscal and accounting entity consisting of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures, as appropriate, which are segregated for the purpose of carrying on specific activities or attaining certain objectives.

The combined financial statements of the department are intended to present the financial position and results of operations of only that portion of the funds and account groups of the State of Hawaii (the state) that is attributable to the transactions of the department. The following fund types are used by the department:

Governmental fund types

Governmental fund types are those through which the acquisition, use and balances of the department's expendable available financial resources and the related liabilities are accounted for. The measurement focus is upon the availability and use of resources and of changes in financial position rather than upon net income determination. The following are the department's governmental fund types:

General fund. The general fund accounts for all financial resources except those required to be accounted for in another fund.

Special revenue funds. Special revenue funds account for the proceeds of special revenue sources (other than expendable trusts, or major capital projects) that are legally restricted to expenditure for specified purposes.

Capital project funds. The capital project fund accounts for financial resources to be used for the acquisition or construction of major capital facilities.

Fiduciary fund type. The fiduciary fund type is used to account for assets held by the department in a trustee capacity or as an agent.

Expendable trust. The expendable trust funds are used to account for cash collected and expended by the department as a trustee.

Account Groups

General fixed assets account group. The general fixed assets acquired for use by the department in the conduct of its general governmental operations are accounted for in the general fixed assets account group

at cost or estimated fair market value at date of donation. Accumulated depreciation is not recorded in the general fixed assets account group.

General long-term obligation account group. The obligation for the long-term portion of accrued vested vacation is recorded in the general long-term obligation account group.

Basis of Accounting

The department's governmental and fiduciary funds are accounted for on the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized when they become available and measurable and expenditures are recognized when incurred.

Encumbrances

Encumbrance accounting is employed in the governmental fund types. Under such accounting, purchase orders and contract commitments for the expenditure of funds are recorded in order to reserve that portion of the applicable allotted appropriation. Open encumbrances are reported as reservations of fund balances since the commitments will be honored when the goods or services are received. Encumbrances do not constitute expenditures or liabilities.

Accumulated vacation and sick leave

Eligible employees are credited with vacation at a rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year end. Liabilities for vacation pay are inventoried at the end of each accounting period and adjusted to current salary levels. The liability is included in the general long-term obligation account group since substantially all of the liability is not expected to be liquidated using expendable available financial resources.

Eligible employees are credited with sick leave at a rate of one and three-quarter days per month of service. Unused sick leave may be accumulated without limit, but can be taken only in the event of illness or other incapacitation and is not convertible to pay upon termination of employment. Accordingly, accumulated sick leave is not included in the department's combined balance sheet. However, an employee who retires or leaves government service in good standing with sixty days or more in unused sick leave is entitled to additional service credit in the Employees' Retirement System of the State of Hawaii. Accumulated sick leave as of June 30, 1996 was approximately \$2,414,000.

Due to State of Hawaii

This account consists of reimbursements for prior year's expenditures paid by the general fund on behalf of the special revenue funds.

Intrafund and interfund transactions

Significant transfers of financial resources between activities included within the same fund are offset within that fund. Transfers of revenues from funds authorized to receive them to funds authorized to expend them have been recorded as operating transfers in the financial statements.

Inventory

Inventories of materials and supplies are recorded as expenditures when purchased.

Grants

Grants are recorded as intergovernmental receivables and revenues when the related expenditures are incurred.

Interfund receivables/payables

Reimbursements for expenditures paid by the general fund on behalf of the special revenue funds are classified as "due from other funds" and "due to other funds" on the balance sheet.

Memorandum only

The total columns on the combined financial statements are captioned Memorandum only to indicate that they are presented only to facilitate financial analysis. Data in those columns do not present financial position, results of operations, or changes in financial position in conformity with GAAP. Neither is such data comparable to a consolidation. Interfund eliminations have not been made in the aggregation of this data.

Note C - Budgeting and budgetary control

Estimated expenditures for the department's general fund and the administration accounts included in the special revenue funds are provided to the State Department of Budget and Finance (B&F) for accumulation with budgeted amounts of the other state agencies and included in the Governor's executive budget which is subject to legislative approval.

A comparison of budgeted and budgetary actual revenues and expenditures of the general and special revenue funds are presented in the combined statement of revenue and expenditures - budget and budgetary

actual - general and special revenue funds (non-GAAP budgetary basis). Amounts reflected as budgeted revenues and expenditures are summarizations compiled by B&F.

To the extent not expended or encumbered, appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse dates.

To provide comparability, actual expenditures in these statements have been adjusted to include encumbrances at year end and exclude current-year expenditures for liquidation of prior-year encumbrances.

Differences between revenues and expenditures reported on the budgetary basis and those reported in accordance with GAAP are mainly due to the different methods used to recognize resource uses. For budgeting purposes, revenues are recognized when cash is received and expenditures are recognized when cash disbursements are made or funds are encumbered. In the accompanying combined financial statements presented in accordance with GAAP, revenues are recognized when they become available and measurable and expenditures are recognized as incurred.

The following schedule reconciles the budgetary-actual amounts to the amounts presented in accordance with generally accepted accounting principles.

	General	Special Revenue
Excess (deficiency of revenues and other financing sources over expenditures and other financing uses - non-GAAP budgetary actual)	\$ -	\$ 1,499,442
Adjustments:		
To adjust for encumbrance	711,893	902,166
To adjust for revenues for accruals	-	(50,637)
To adjust expenditures for accruals	(889,573)	(1,793)
To adjust for lapses and prior year encumbrances	(215,711)	
Expenditures for liquidation of prior-year encumbrances	<u>(657,246)</u>	<u>(2,261,956)</u>
Excess (deficiency of revenues and other financing sources over expenditures and other financing uses - GAAP actual)	<u>\$ (1,050,637)</u>	<u>\$ 87,222</u>

Note D - General fixed assets account group

The changes to the general fixed assets account group for the fiscal year ended June 30, 1996 are as follows:

	Beginning Balance	Additions	Deductions	Ending Balance
Land	\$ 123,687	\$ -	\$ -	\$ 123,687
Land Improvements	9,772,936	-	-	9,772,936
Buildings	21,870,557	-	-	21,870,557
Vehicles	757,390	24,970	4,700	777,660
Equipment	7,121,066	234,621	276,161	7,079,526
Construction in progress	12,006,586	-	-	12,006,586
	<u>\$ 51,652,222</u>	<u>\$ 259,591</u>	<u>\$ 280,861</u>	<u>\$ 51,630,952</u>

Note E - Long-term obligation account group

The changes to general long-term obligation compensated absences for the fiscal year ended June 30, 1996 are as follows:

Balance at July 1, 1995	\$ 1,000,046
Net Increase	<u>3,818</u>
Balance at June 30, 1996	<u>\$ 1,003,864</u>

Note F - Retirement benefits**Employees' Retirement System**

All eligible employees of the state and counties are required by Chapter 88 of the Hawaii Revised Statutes to become members of the Employees' Retirement System (ERS), a cost-sharing, multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits.

Prior to July 1, 1984, the ERS consisted of only a contributory plan. In 1984, legislation was enacted to add a new noncontributory plan for members of the ERS who are also covered under social security. Police officers, firefighters, judges, elected officials and persons employed in positions not covered by social security are precluded from the noncontributory plan. The noncontributory plan provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory plan or to elect the new noncontributory plan and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory plans, respectively.

The ERS's funding policy provides for employer contributions at actuarially determined rates that should provide sufficient resources to

pay member pension benefits when due. The funding method used to calculate the total employer contribution required is the frozen initial liability method.

Under this method, the total employer contribution is comprised of the “normal cost” plus the level annual payment required to amortize the frozen unfunded accrued liability. The employer normal cost is the level percentage of payroll contribution to pay all future benefits, after subtracting expected future member contributions, the unfunded accrued liability, and the assets accumulated as of the valuation date. Actuarial gains and losses resulting from differences between actual and assumed experience are reflected in the employer normal cost rates.

Actuarial valuations are prepared for the entire ERS and are not separately computed for each department or agency. Information on vested and nonvested benefits and other aspects of the ERS is also not available on a departmental or agency basis.

The “pension benefit obligation” which follows is the actuarial present value of credited projected benefits. It is the standardized disclosure measure of the present value of pension benefits adjusted for the effects of projected salary increases estimated to be payable in the future as a result of employee service to date. The pension benefit obligation is independent of the actuarial funding method used to determine contributions to the ERS. The basic purpose of the June 30, 1995 actuarial valuation was to determine the total employer contributions to the ERS, in accordance with the provisions of Chapter 88 of the Hawaii Revised Statutes.

The pension benefit obligation was determined as of June 30, 1995. The actuary employed by the ERS calculated credited projected benefits which include the following:

Future monthly payments to pensioners who are receiving benefit payments on the valuation date and to beneficiaries, including any optional survivors’ benefits.

The potential future monthly service retirement benefits payable to inactive vested members based on their service credit and salary earned up to the date of termination.

The portion of potential future monthly retirement and disability benefits payable to active members attributable to their service credit as of the valuation date and salary as projected to the benefit payment date plus the pro rata portion of certain death benefits.

The actuarial present value of credited projected benefits is the amount determined by the ERS’s actuary by applying actuarial assumptions to adjust the accumulated plan benefits to reflect the time value of money

(through discounts for interest between the valuation date and the expected dates of payment) and the probability of benefit payments (by means of multiple-decrement probability tables for death, disability, retirement and withdrawal). The pension benefit obligation was determined based on an actuarial valuation at June 30, 1995. Significant actuarial assumptions used include: (a) a rate of return on investment of present and future assets of 8 percent per year compounded annually, (b) projected salary increases of 6-1/2 percent of which 5 percent is attributable to inflation and 1-1/2 percent is attributable to seniority and merit, (c) annual post-retirement cost of living increases of 2-1/2 percent, (d) assumed rates of retirement, turnover, disability and mortality based upon the ERS's experience, and (e) unused sick leave credit accumulated by members is 12 days per year. There were no changes in actuarial assumptions from those used in the prior-year valuation.

As of June 30, 1995, the total and unfunded pension benefit obligation for all members were as follows:

Pension benefit obligation:			
Retirees and beneficiaries currently receiving			
benefits and terminated members not yet			
receiving benefits			
			\$ 3,477,479,800
Current employees:			
Accumulated employee contributions			780,674,400
Employer-financed vested			1,655,288,900
Employer-financed nonvested			1,476,465,500
Total pension benefit obligation			7,389,908,600
Net assets available for benefits, at cost			
(market value, \$5,963,630,000):			
Pension Accumulation Fund	\$ 4,818,382,899		
Annuity Savings Fund	780,674,416	5,599,057,315	
Unfunded pension benefit obligation			<u>\$ 1,790,851,285</u>

Included in the pension benefit obligation at June 30, 1995 is an additional liability resulting from increased benefits attributable to employees who retired in 1994 under the Early Retirement Incentive Program. The additional liability attributable to these retirees amounted to \$54,496,400 and will be funded separately (i.e., each employer will be responsible for the additional costs arising from its employees who retired under the program) over a five-year period beginning with the 1998 fiscal year.

The pension benefit obligation at June 30, 1995 does not include the additional liability resulting from increased benefits attributable to employees of the State Department of Education and the University of Hawaii who retired on June 30, 1995 under the Early Retirement

Incentive Program. The additional liability attributable to these retirees amounted to \$59,272,400 and will be funded separately over a five-year period beginning with the 1999 fiscal year.

Contributions for employees accounted for in the department's general fund are paid from the State General Fund and are not reflected in the department's financial statements. The portion of the contributions related to the department's special revenue funds are recorded as an expenditure of the special revenue funds in the combined financial statements. Such contributions approximated \$450,100 for the fiscal year ended June 30, 1996.

Measurement of assets and actuarial valuations are made for the entire ERS and are not separately computed for individual participating employers such as the department.

Ten-year historical trend information designed to provide information about the ERS's progress in accumulating sufficient assets to pay benefits when due is included in the separately issued comprehensive annual financial report of the ERS for the year ended June 30, 1995.

Post-retirement health care and life insurance benefits

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to all employees who retire from State employment on or after attaining age 62 with at least ten years of service or age 55 with at least thirty years of service under the noncontributory plan and age 55 with at least five years of service under the contributory plan. Retirants credited with at least ten years of service excluding sick leave credit qualify for free medical insurance premiums; however, retirants with less than ten years must assume a portion of the monthly premiums. All disability retirants who retired after June 30, 1984, with less than ten years of service also qualify for free medical insurance premiums. Free life insurance coverage and dental coverage for dependents under age 19 are also available. Retirants covered by the medical portion of Medicare are eligible to receive a reimbursement of a portion of the basic medical coverage premiums. For active employees, the employer's contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued.

Note G - Commitments and contingencies

Insurance coverage

Insurance coverage is maintained at the state level. The State is self-insured for substantially all perils including workers' compensation. Expenditures for workers' compensation and other insurance claims are appropriated annually from the State General Fund.

Deferred compensation plan

In 1983, the State established a deferred compensation plan which enables state employees to defer a portion of their compensation. The State Department of Human Resources Development has the fiduciary responsibility of administering the plan. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency. All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject to the claims of the State's general creditors. Participants' rights under the plan are equal to those of the State's general creditors in an amount equal to the fair market value of the deferred account for each participant.

Construction contracts

At June 30, 1996, unbilled balances on construction contracts approximated \$2,281,700.

Compliance with federal grant guidelines

The independent auditors' single audit reports of certain subrecipients (other State of Hawaii and local government agencies) indicate instances of material noncompliance due to a lack of adequate accounting records and documentation to support receipts and expenditures related to disaster survey report (DSR) claims. The subrecipients are presently attempting to collect and organize the supporting documentation to correct the finding, and the grantor agency, the Federal Emergency Management Agency (FEMA), has not made a claim to recover questioned costs. Approximately \$273,000 in questioned costs have been reported in the audit of a subrecipient. Additional questioned costs may be disclosed upon receipt of subrecipient independent auditor reports for the fiscal years ended June 30, 1995 and 1996.

The FEMA Office of the Inspector General (OIG) has audited the public assistance funds awarded to a subrecipient and has proposed a penalty of approximately \$171,000 due to noncompliance with lack of supporting documents, awards exceeding project cost, ineligible administrative cost and awards received for insurable cost. The subrecipient and the State Civil Defense are currently in a disagreement with the OIG assessment. As of June 30, 1996, FEMA has not recouped or deobligated the questioned cost. The OIG has audited public assistance funds awarded to other subrecipients, the outcome of these audits are not determinable as of June 30, 1996.

Note H - Workers' compensation benefit claims liability

Effective December 1, 1994, the department was responsible for certain costs of temporary wage loss replacement benefits for disabled employees under Chapter 386 of the Hawaii Revised Statutes. The department is required to pay temporary total and temporary partial disability benefits as long as the employee is on the department's payroll. As such, a liability for workers' compensation benefits of the department is established when it is probable that a loss has occurred as of June 30, 1996 and the amount of that loss can be reasonably estimated. The liability also includes an estimated amount for workers' compensation benefit claims that have been incurred but not reported because actual claims liabilities depend on such complex factors as inflation, change in legal doctrines, and damage awards. The process is used in computing claims liability and does not necessarily result in an exact amount. Claims liabilities may be re-evaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors at June 30, 1996. The estimated loss for workers' compensation benefits will be expended with currently available resources of the department.

Department of Defense
State of Hawaii

EXHIBIT A

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS

June 30, 1996

	<u>Governmental Fund Types</u>			<u>Fiduciary Fund Type</u>	<u>Account Groups</u>		<u>Total</u>
	<u>General</u>	<u>Special Revenue</u>	<u>Capital Project</u>	<u>Expendable Trust</u>	<u>General Fixed Assets</u>	<u>General Long-term Obligation</u>	<u>(Memorandum only)</u>
ASSETS							
Cash	\$ 814,446	\$1,562,407	\$1,267,204	\$535,735	\$ -	\$ -	\$ 4,179,792
Receivables							
Due from other funds	63,511	-	-	-	-	-	63,511
Due from other government	-	2,040,202	-	-	-	-	2,040,202
Property, plant and equipment	-	-	-	-	51,630,952	-	51,630,952
Amount to be provided for retirement of general long-term obligation	-	-	-	-	-	1,003,864	1,003,864
Total assets	\$ 877,957	\$3,602,609	\$1,267,204	\$535,735	\$51,630,952	\$1,003,864	\$58,918,321
	=====	=====	=====	=====	=====	=====	=====
LIABILITIES AND FUND BALANCE							
Liabilities							
Voucher and contracts payable	\$ 92,553	\$ 452,205	\$ -	\$ -	\$ -	\$ -	\$ 544,758
Due to other funds	-	63,511	-	-	-	-	63,511
Due to State of Hawaii	10,000	520,306	-	-	-	-	530,306
Due to other government	-	19,397	-	-	-	-	19,397
Due to subrecipient	-	1,487,625	-	-	-	-	1,487,625
Accrued payroll	1,213	1,791	-	-	-	-	3,004
Compensated absences	-	-	-	-	-	1,003,864	1,003,864
Total liabilities	103,766	2,544,835	-	-	-	1,003,864	3,652,465
Fund equity							
Investment in general fixed assets	-	-	-	-	51,630,952	-	51,630,952
Fund balance							
Reserved for encumbrances	711,893	902,166	1,935,620	348,118	-	-	3,897,797
Unreserved and undesignated	62,298	155,608	(668,416)	187,617	-	-	(262,893)
Total fund equity	774,191	1,057,774	1,267,204	535,735	51,630,952	-	55,265,856
Total liabilities and fund equity	\$ 877,957	\$3,602,609	\$1,267,204	\$535,735	\$51,630,952	\$1,003,864	\$58,918,321
	=====	=====	=====	=====	=====	=====	=====

The accompanying notes are an integral part of this statement.

Department of Defense
State of Hawaii

EXHIBIT B

COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES -
ALL GOVERNMENTAL FUND TYPES AND EXPENDABLE TRUST FUNDS

Fiscal year ended June 30, 1996

	<u>Governmental Fund Types</u>			<u>Fiduciary Fund Type</u>	<u>Total</u>
	<u>General</u>	<u>Special Revenue</u>	<u>Capital Project</u>	<u>Expendable Trust</u>	<u>(Memorandum only)</u>
Revenues					
State allotments (net of lapses)	\$ 6,477,507	\$ -	\$ 380,000	\$ -	\$ 6,857,507
Intergovernmental	-	27,869,133	1,153,685	310,175	29,332,993
	6,477,507	27,869,133	1,533,685	310,175	36,190,500
Expenditures	7,516,144	27,781,911	2,224,202	69,623	37,591,880
Excess (deficiency) of revenues over expenditures	(1,038,637)	87,222	(690,517)	240,552	(1,401,380)
Other financing sources (uses)					
Operating transfers in	-	-	642,467	-	642,467
Operating transfers out	(12,000)	-	(435,217)	-	(447,217)
	(12,000)	-	207,250	-	195,250
Excess (deficiency) of revenues and other sources over expenditures and other financing uses	(1,050,637)	87,222	(483,267)	240,552	(1,206,130)
Fund balance at July 1, 1995	1,824,828	970,552	1,750,471	295,183	4,841,034
Fund balance at June 30, 1996	\$ 774,191 =====	\$ 1,057,774 =====	\$ 1,267,204 =====	\$535,735 =====	\$ 3,634,904 =====

The accompanying notes are an integral part of this statement.

Department of Defense
State of Hawaii

EXHIBIT C

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

Fiscal year ended June 30, 1996

	<u>General fund</u>			<u>Special Revenue Fund</u>		
	<u>Budget</u>	<u>Actual on budgetary basis</u>	<u>Variance - favorable (unfavorable)</u>	<u>Budget</u>	<u>Actual on budgetary basis</u>	<u>Variance - favorable (unfavorable)</u>
Revenues						
State allotments (net of lapses)	\$6,707,389	\$6,682,483	\$(24,906)	\$ -	\$ -	\$ -
Intergovernmental	-	-	-	11,465,609	27,919,770	16,454,161
	<u>6,707,389</u>	<u>6,682,483</u>	<u>(24,906)</u>	<u>11,465,609</u>	<u>27,919,770</u>	<u>16,454,161</u>
Expenditures	<u>6,707,389</u>	<u>6,670,483</u>	<u>36,906</u>	<u>11,465,609</u>	<u>26,420,328</u>	<u>(14,954,719)</u>
Excess (deficiency) of revenues over expenditures	-	12,000	12,000	-	1,499,442	1,499,442
Other financing sources (uses)						
Operating transfers in	-	-	-	-	-	-
Operating transfers out	<u>-</u>	<u>(12,000)</u>	<u>(12,000)</u>	<u>-</u>	<u>-</u>	<u>-</u>
	<u>-</u>	<u>(12,000)</u>	<u>(12,000)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Excess (deficiency) of revenues and other sources over expenditures and other financing uses	\$ - =====	\$ - =====	\$ - =====	\$ - =====	\$ 1,499,442 =====	\$ 1,499,442 =====

The accompanying notes are an integral part of this statement.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Defense on November 8, 1996. A copy of the transmittal to the department is included as Attachment 1. The department's response is included as Attachment 2.

The department generally disagrees with our findings. It claims that amounts received from the federal government are not "reimbursements" for general fund advances. It claims the moneys are needed to meet the obligations under various federal/state agreements. We disagree. Prior audit reports reflect amounts due to the general fund and our audit revealed not all were transferred to the general fund. The department's transfers of about \$500,000 in federal reimbursements to the general fund in June 1996, support our finding.

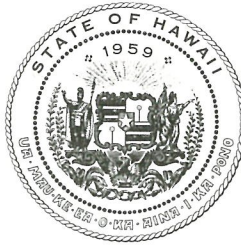
The department does acknowledge the lateness of the single audit reports for the fiscal years ended June 30, 1994 and 1995. The department takes exception to our discussion of the causes of the late reports. It believes that, on balance, its financial records are sufficient for the purposes of effecting internal financial controls and facilitating the completion of annual financial audits. It also disagrees that Federal Emergency Management Agency (FEMA) revenues it receives and then passes on to other agencies and government units as "pass through" moneys should be recorded in its financial records. Regardless of the classification of the moneys, the department is responsible to FEMA for ensuring that these funds are properly accounted for and used. This responsibility should be reflected in its financial accounting records and reports.

With respect to improper procurement practices, the department states that it will move to improve its internal procedures to minimize, if not avoid altogether, instances of noncompliance. The department should strive to comply with procurement laws rather than to simply minimize noncompliance.

The department defended many of its actions we cited in our report. With respect to the issue of parceling, the department contends that the purchase of a lawn mower and lawn mower parts were two unrelated purchases. It does not discuss the alteration of the Summary Vendor Quotation form. It states that our finding on contract services provided prior to execution of contracts is in error. It states these services were provided under existing five year contracts. We found no five year contracts. We did find, however, that the contracts had options for

renewal. The options were exercised and new contracts negotiated and executed—after services were provided. It is questionable whether the department can use renewal options to execute new contracts without competitive solicitation.

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



MARION M. HIGA
State Auditor

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

November 8, 1996

COPY

The Honorable Edward V. Richardson
Adjutant General
Department of Defense
3949 Diamond Head Road
Honolulu, Hawaii 96816-4495

Dear Maj. Gen. Richardson:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Financial Audit of the Department of Defense*. We ask that you telephone us by Wednesday, November 13, 1996, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Thursday, November 21, 1996.

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

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

Sincerely,

A handwritten signature in dark ink, appearing to read "Marion M. Higa".

Marion M. Higa
State Auditor

Enclosures

BENJAMIN J. CAYETANO
GOVERNOR



STATE OF HAWAII
DEPARTMENT OF DEFENSE

OFFICE OF THE ADJUTANT GENERAL

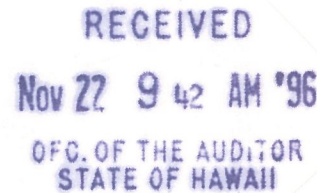
3949 DIAMOND HEAD ROAD, HONOLULU, HAWAII 96816-4495

EDWARD V. RICHARDSON
MAJOR GENERAL
ADJUTANT GENERAL

MICHAEL E. RAWLINS
COLONEL
DEPUTY ADJUTANT GENERAL

November 21, 1996

Honorable Marion M. Higa
State Auditor
State of Hawaii
Office of The Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



Dear Ms. Higa:

This is in response to your letter of November 8, 1996, extending an invitation to the department to review and comment on your draft report, *"Financial Audit of the Department of Defense."* The opportunity to provide comment is welcomed and appreciated. Our comments will be keyed primarily to the major findings of your report.

FAILURE TO TRANSFER MONEYS TO THE GENERAL FUND

The funds which your report identifies as federal reimbursements are, in our view, the federal government's payment for its contractual share of costs to support various departmental activities identified and approved under Act 218, Session Laws of Hawaii (SLH), 1995. All expected federal receipts are planned for, identified, and are part of the budget constructed and approved by the Legislature.

The department's operating budget for fiscal year 1996, as identified in the Appropriations Act, was \$12,800,000. Of this, \$8,100,000 was financed through state general funds and \$4,700,000 was financed by federal funds which was received by way of the various state and federal agreements executed throughout the course of the fiscal year. Additionally, Act 218, SLH, 1995, provided \$2 million in capital improvement funds. The department does not engage in the practice of budgeting general funds for the sole purpose of paying expenses for anticipated federal reimbursements or revenue to build surplus funds. Even in instances where it becomes necessary to use general funds as advance payments for federal expenditures in the course of the fiscal year, all federal receipts for such advance payments would be reprogrammed for expenditures that are planned for the fiscal year--none would be kept as "reimbursements" to finance program expenditures not approved by the Legislature.

The department's special revenue account was established to hold federal moneys received as identified in the department's budget and financial plan. It does not contain federal "reimbursements" for general fund advances. This account is an essential support tool for managing departmental cash flow to meet the obligations incurred under the various federal/state agreements it maintains. It also enables the department to retain federal revenues to maintain its capabilities to service its federal/state agreements that run parallel to the federal fiscal year. Should the department deposit, as recommended, these federal dollars into the State Treasury at the time they are received, the department would be unable to meet its contractual obligations and would be faced with a severe cash flow problem. The impact, moreover, of the report's recommendation would require an increase rather than a decrease in general fund commitment to maintain programmatic effectiveness; i.e., the ability of the department to maintain its readiness to respond to state public safety requirements such as disasters, civil emergencies, etc.

In our view, the fund management practice involving departmental federal revenues does not circumvent the intent of the budget process. Contrary to the report's conclusion, the department's special revenue account balances contain no federal reimbursements for general fund cash advances. Moreover, what is retained in the account are federal revenues which are reflected in the department's budget approved by the Legislature. These funds derive from the department's federal/state agreements and are used for the purpose of meeting the obligations of those agreements. The department retains no excess general fund balances and deposits into the State Treasury any unneeded federal revenues received through its federal/state agreements. Program concerns other than those approved by the Legislature are not funded by moneys in the special revenue account.

The department's annual expenditure was and will continue to be within the limits of the appropriation and purposes set by the Legislature.

FINANCIAL RECORDS ARE NOT SUFFICIENT AND CANNOT BE AUDITED IN A TIMELY MANNER

The department acknowledges the lateness of the single audit reports for fiscal year 1994, which ended on June 30, 1994, and for fiscal year 1995, which ended on June 30, 1995. We are reviewing the findings and recommendations for this area and will be taking action to ensure compliance. Nonetheless, the department does have some observational comments to make on the issues discussed in this section.

After reviewing the findings and conclusions of the independent auditor, Grant Thornton LLP, we believe, on balance, that our financial records are sufficient for the purposes of effecting internal financial controls and facilitating the completion of annual financial audits. The findings, as expressed in your report, are well taken but we believe that the specific conditions to which they point to do not, singularly or together, speak to the adequacy of the department's financial

records. We believe that those conditions speak more to their impact on the length of time it takes to complete an audit rather than on the overall material quality of the department's financial records themselves.

For instance, the report points out that due to the department's record keeping, prior financial auditors had to engage in extended auditing procedures to determine account balances. Here, we believe it should be pointed out that the extra steps taken by the financial auditors were caused more by the need to convert the department's financial information into an auditing format conforming to Generally Accepted Accounting Principles (GAAP) rather than the sufficiency of the records themselves. Our accounting records, which are based on the State Accounting System, are fundamentally not structured to GAAP and therefore require an extra step to convert the financial information into a GAAP format for auditing purposes. We believe that this is a common condition found in other state departments. As an alternative, the department could internally do the conversions but it would take additional staff it currently lacks. Ultimately, it may be more economically prudent, so long as basic financial records are sufficient--as they are now, to continue the current practice of making provisions for contracted auditors to assist departmental staff to make the necessary adjustments to the accounting records for auditing the department's financial statements.

Another instance which the report implies that adds to the length of time it takes to complete the department's financial audit involves the need for prior auditors to prepare and review schedules of certain Federal Emergency Management Agency (FEMA) revenues (Hurricane Iniki disaster aid funds) received and transferred to counties. The purported work related to this task also includes the determination of other amounts due from FEMA and are owed to counties. With regard to this stated condition, the report is not correct since prior auditors did not have to produce such products but, because departmental records are not maintained under GAAP some adjustments had to be made for audit purposes. Here again, the causal factor is more a matter of how records are kept per the State Accounting System rather than the insufficiency of financial records in and of themselves.

As a final comment to this section, we note that the report states that the department did not record FEMA revenues, commonly referred to as pass through funds, passed on to counties as revenues to the department and reported as part of the department's operating budget. Hence, we see in the background statement of your report that the department's fiscal year 1996 operating budget was \$36 million rather than the \$14.8 million budget actually authorized under Act 218, Session Laws of Hawaii (SLH), 1995. The difference that amounts to \$21,800,000 is attributable to FEMA revenues that were received and passed on to various subrecipients--including counties. We believe that because the \$21.8 million does not materially contribute to the department's operation, the inclusion of such revenues as part of the department's operating budget creates a misleading picture. While treating such revenues as part of the operating budget has been required by Government Accountant Principles only since fiscal year 1996 (GASB #24,

June 15, 1995), we find the depiction of the department's operating budget using such pass through funds as inappropriate to maintaining an accurate view of the department's operating budget. In this case it creates an inordinately inflated picture of what is actually available to the department for its operations. It's a picture that requires clarification.

IMPROPER PROCUREMENT PRACTICES

The policy of the department is to follow all laws, rules, and executive directives applicable to the administration of departmental functions--including its procurement functions. In reviewing the findings related to our procurement practices, we believe that there are lessons to be learned and will move to improve the department's internal procedures to minimize, if not avoid altogether, instances of noncompliance--both in appearance and actuality. However, we have a few observational comments to make on the items reported in this section.

With regard to the issue of parceling, the specific transactions, as reported, appear to be parceling but were, in fact, two separate and unrelated purchases in terms of their respective purposes. In the eyes of the requisitioner the purchase of lawn mower parts were for other equipment already purchased and being used. Thus, that purchase was unrelated to the purchase of the Honda tractor with a 52-inch cutting deck. In all other respects, we followed procurement procedures in accordance with §3-122-75 of the Procurement Rules of the Department of Accounting and General Services. This involved getting price quotations from three different vendors and selecting the lowest price and/or bid proposal that's most advantageous to the state.

The auditor's finding concerning bid security and performance bond was essentially correct from the standpoint of the advertised bid notice which was examined. With regard to that instance, we acknowledge that the bid security requirement was advertised in error. In the course of processing the bid that was received, it was found that a bid security and performance bond were not required for bid proposals and contracts for goods and services per §3-122-223 (3) and §3-122-224 (3) of the procurement rules. The requirement for bid security in bid proposals and performance bond in contracting were reviewed with the contracting staff and they are now more cognizant of including the right requirements in future bid notices and contracts.

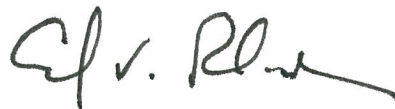
With regard to the issue of increasing the amount of the performance bond to keep pace with change orders changing the face value of a basic contract, we find that it is an insurance industry practice not to issue amended performance bond coverage for change orders when they are made. The industry handles this issue by maintaining that the basic bond policy covers the entire contract--inclusive of all change orders effected throughout the course of the contracts life. Adjustments to the level of bond requirements are made at the end of the contract period. Therefore, for contracts issued by the department, the state will always be covered in the required amounts. This practice is economical to both the construction industry and state.

Honorable Marion M. Higa
November 21, 1996
Page 5

The auditor's finding stating that the department allowed services to be rendered without appropriately executing contracts is not correct. The two situations which the auditor refers were in fact covered by contracts awarded in fiscal years 1994 and 1995 which had renewal options. In each case, the contractors exercised their options to renew and extend the respective contracts for another year. The extensions were granted in accordance to the provisions of the basic contract which has a life of five years. The renewal and extensions were within the life of the contract and there were no instances in which their services were rendered without a contract in force. With regard to the finding that these same renewal options were not in compliance with Executive Memorandum 95-09, Supplement to Executive Memorandum 95-07, we find that the identified contract renewals and extensions were granted prior to the issuance of the Governor's Executive memorandum requiring the approval of contracts and renewals.

Thank you for the opportunity to review and comment on your draft report. Should your staff have any questions, Mr. Jimmy Toyama, Executive Support Officer, may be reached at 733-4260.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ed V. Richardson', with a stylized flourish at the end.

Edward V. Richardson
Major General
Hawaii Air National Guard
Adjutant General

c: Governor's Office