
Financial Audit of the Public Library System

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

Report No. 98-8
February 1998



THE AUDITOR
STATE OF HAWAII

The Office of the Auditor

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

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

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.
5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds and existing funds meet legislative criteria.
7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.
8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.
9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



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OVERVIEW

THE AUDITOR
STATE OF HAWAII

Financial Audit of the Public Library System

Summary

The Office of the Auditor and the certified public accounting firm of KPMG Peat Marwick LLP conducted a financial audit of the public library system for the fiscal year July 1, 1996 to June 30, 1997. The audit examined the financial records and systems of accounting and internal controls and tested these for compliance with applicable laws and regulations.

In the opinion of the firm, the financial statements present fairly the library system's financial position and its results of operation for the fiscal year ended June 30, 1997. These statements are in conformity with generally accepted accounting principles.

In their report on compliance and on internal control over financial reporting, the firm noted no matters involving the internal control over financial reporting that they considered to be material weaknesses. KPMG also noted that the results of their tests disclosed that the library system did not comply with applicable laws and regulations related to the expenditure and transfer of funds from the library system's special funds.

Specifically, KPMG and our office found that the state librarian did not comply with Sections 312-3.6 and 312-22, HRS, which require that revenues in the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund be distributed to the individual libraries. Instead, \$2 million was used to pay Baker & Taylor and \$500,000 was transferred into the state's general fund during fiscal years 1995-96 and 1996-97. The transfer did not comply with Section 37-53, HRS, because (1) it was not formally approved by the governor or the director of finance, and (2) the amount transferred was not in excess of fiscal year requirements. No moneys were distributed to the libraries from either special fund.

We also found that the state librarian misrepresented that he would disburse \$1.6 million from these special funds to the individual libraries during FY1996-97. Only one-third of the moneys he claimed he would distribute to the libraries was actually available in the special funds. The fund balances were further reduced when an additional \$590,000 was used to pay Baker & Taylor.

The library system's liberal borrowing rules and inadequate controls over cash receipts increase the risk for abuse, theft, and loss. For example, 516 items were borrowed on one library patron's card within three weeks and not returned. Over \$13,000 in fines remains uncollected for these items.



Contract payments to Baker & Taylor were not subject to contract performance standards, contrary to the library's own guidelines.

Recommendations and Response

We recommended the Legislature require the state librarian to detail the revenues and expenditures for the special funds by individual libraries. We also recommended the governor require the state librarian to document that any transfer from these funds to the general fund is in excess of fiscal year requirements as specified in Section 37-53, HRS.

We recommended the library limit the number of materials a patron may borrow, require patrons to submit a picture identification when borrowing library materials, and barcode all circulating library material.

We made several recommendations to improve fee and fine collections and management of cash. We also recommended all future contracts provide that payments will correlate with performance.

The state librarian agreed with most of the findings and recommendations. The exceptions concerned the distribution and transfers from the special funds. The Board of Education did not submit a response.

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Governor
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the State of
Hawaii

Conducted by

The Auditor
State of Hawaii
and
KPMG Peat
Marwick LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

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Foreword

This report of our financial audit of the Hawaii public library system was prepared in response to Senate Concurrent Resolution No. 171, Senate Draft 1, House Draft 1, Conference Draft 1 of the Regular Session of 1997. The resolution requested the State Auditor to conduct a financial and management audit of the library system. Our report, *Management Audit of the Public Library System*, Report No. 98-3, was issued earlier.

We wish to express our appreciation for the cooperation and assistance extended to us by officials and staff of the Board of Education, the library system, and others whom we contacted during the course of the audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

This is a report of our financial audit of the Hawaii State Public Library System of the Department of Education (library system). The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of KPMG Peat Marwick LLP. The audit was conducted pursuant to Section 23-4 of the Hawaii Revised Statutes (HRS), 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 also conducted pursuant to Senate Concurrent Resolution No. 171, Senate Draft 1, House Draft 1, Conference Draft 1, of the 1997 Regular Session.

Background

According to Section 302A-1120, HRS, the Board of Education, through the state librarian, shall have direct control of the library system, excluding school libraries.

Section 312-1, HRS, describes the Board of Education's duties as follows:

The board of education shall care for, manage, and control all property set apart, donated, loaned to, or in any manner acquired for the use of libraries; receive, care for, expend, and account for any money which may be received for the purpose of erecting buildings for libraries or for any other purposes of the libraries; collect, purchase, receive gifts of, and otherwise acquire all books and other publications proper for libraries, and arrange, classify, and catalogue the same; provide for their safekeeping; expend moneys appropriated by the legislature and otherwise acquired for the development, use, support, and maintenance of libraries; provide ways and means for placing libraries within reach of all residents throughout the State and particularly of all public and private school children; provide and maintain branch libraries, offices, or places for the distribution of books and periodicals throughout the State; make such contracts as may be necessary to carry into effect the general duties herein imposed; appoint such officers and employees as it deems necessary; and make rules for the management and use of libraries, and for the control of the property under its management.

Organization of the Hawaii State Public Library System

The library system is a state-wide public library system comprised of 49 libraries on six islands. The library system is headed by the state librarian. The state librarian and his staff work under the general direction of and report directly to the Board of Education. The state librarian has the overall responsibility for planning, directing, and coordinating the activities of the library system within established laws, policies, and regulations of the State. The Office of the State Librarian is organized into three branches: management information, public libraries, and human resources.

Management Information Branch

The Management Information Branch handles fiscal and administrative matters, support services, and federal grants.

Public Libraries Branch

The Public Libraries Branch oversees the Hawaii State Library, Library for the Blind and Physically Handicapped, and the 47 branch libraries on the islands of Oahu, Hawaii, Maui, Kauai, Molokai, and Lanai.

Human Resources Branch

The Human Resources Branch is responsible for providing centralized personnel services.

Objectives of the Audit

1. To assess the adequacy, effectiveness and efficiency of the systems and procedures for the financial accounting, internal control and financial reporting of the library system; to recommend improvements to such systems, procedures and reports; and to report on the financial statements of the library system.
 2. To 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.
 3. To make recommendations as appropriate.
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Scope and Methodology

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the library system for the fiscal year July 1, 1996 to June 30, 1997. Included in our audit were all fund types and account groups, except the general fixed assets account group. We tested the financial data to provide us with a basis to report on

the financial statements. We also reviewed the library system's transactions, systems, and procedures for compliance with applicable laws and regulations.

In order to examine the accounting, reporting, and internal control structures of the library system, we conducted certain audit procedures at the Hawaii State Library, and the Hilo, Kona, Kahului, Lihue, Pearl City, and Kaimuki public libraries. We made recommendations for improvement including, but not limited to, the forms, records, and accounting and operating procedures of the library system.

The scope of the audit included a review of the procurement process for contracts entered into during the fiscal year under audit. The Baker & Taylor and Ameritech contracts, which were entered into during the previous fiscal year, were not within the scope of the audit performed by KPMG Peat Marwick LLP.

The independent auditor's opinion on the library system's combined financial statements presented in Chapter 3 is that of KPMG Peat Marwick LLP. The audit was conducted from June 1997 through January 1998 in accordance with generally accepted government auditing standards.

Chapter 2

Financial Management and Internal Control Practices

Financial management controls are steps instituted to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial management and internal control practices and procedures of the public library system.

Summary of Findings

1. The state librarian misrepresented to the Legislature that revenues in the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund would be returned to individual libraries for their needs and programs as specified by law. Instead, approximately \$2 million was used to pay Baker & Taylor and an additional \$500,000 was transferred to the state's general fund between fiscal years 1995-96 and 1996-97.
2. Liberal borrowing rules have not protected the library system's collection from abuse, loss, and theft.
3. Inadequate controls over cash receipts increase the risk of fraud and theft. Specifically, cash receipts are not properly safeguarded, reconciliation of cash to daily cash reports is incomplete and untimely, and segregation of duties over cash receipts and over fee and fine waivers is lacking.
4. Procedures to monitor outstanding fines and fees and collection efforts are weak. The library system does not utilize an aging report to monitor delinquent accounts.
5. Failure to verify library patrons' ages and to update this data could result in improper assessment of overdue fines.
6. Contract payments to Baker & Taylor were not subject to contract performance standards. No assurances were made prior to payments that the agreed upon goods would be received or that the contracted services would be performed.

The Library System Did Not Utilize Special Funds Properly

The Legislature authorized the establishment of the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund, and provided that the moneys collected and deposited into these funds be returned to individual libraries for materials and programs. Fines assessed, as authorized under Section 312-3.5, HRS, for overdue materials and for replacement of materials outstanding 30 days after the due date, are deposited into the Libraries Special Fund. Fees collected for the Enhanced Services Program are deposited into the Library Fee for Enhanced Services Special Fund, as authorized under Section 312-21, HRS. Enhanced services include customized research and the rental of videos and library meeting rooms. The offering of enhanced services is at each library's discretion.

To assure that these special fund revenues are used as intended, the Legislature requires the state librarian to submit annual reports identifying the sources of deposits and allocations to individual libraries. However, funds have not been returned to individual libraries as represented in these reports. Instead, the state librarian used the special funds to pay a contractor, Baker & Taylor, for the purchase of books for the library system. He also transferred some of the money to the general fund. This occurred not only in the year under audit, fiscal year ended June 30, 1997, but also in the prior fiscal year.

The state librarian misrepresented special fund allocations to the libraries

On November 15, 1996, the state librarian presented annual reports for the Libraries Special Fund and the Fee for Enhanced Services Special Fund for the fiscal year ended June 30, 1996 to the 1997 Legislature. The reports included a detailed breakdown of the allocations that would be disbursed to each library during FY1996-97. These reports showed \$1,625,000 would be allocated to 49 libraries from the special funds. However, the state librarian knew these funds were not available. The total balance available in both funds as of October 31, 1996 was \$504,686; about one half of that balance was a carryover balance from the previous year. For the 1996-97 fiscal year, no moneys were disbursed to the libraries.

Exhibit 2.1 summarizes the beginning cash balances, the revenues collected, and the various disbursements made during the first four months of FY1996-97—that is, through the month preceding the state librarian's reports to the 1997 Legislature. Disbursements made from the two special funds from July 1, 1996 to October 31, 1997 were for a Baker & Taylor contract payment, monthly overhead assessments, and a transfer to the general fund. An additional \$250,000 was disbursed from these funds to pay Baker & Taylor on November 22, 1996, seven days *after* the state librarian submitted his annual report indicating that he would return

the special funds to the libraries. During January 1997 another \$340,000 was disbursed to pay Baker & Taylor. Thus, by February 1997 the prospects of the libraries receiving the allocations as represented in the state librarian's annual report were even more unlikely.

Exhibit 2.1
Summary of Special Fund Revenues and Expenditures
June 30, 1996 - October 31, 1996

	Library Special Fund	Library Fee for Enhanced Services Special Fund	Total Amount Available
Unencumbered Cash 6/30/96	\$212,931	\$201,077	\$414,008
Revenues 7/1/96 - 10/31/96	221,204	151,437	372,641
Special Fund Overhead Assessments 7/1/96 - 10/31/96	(11,060)	(7,572)	(18,632)
Transfer to General Fund 7/25/96	—	(100,000)	(100,000)
Baker & Taylor Contract Payment 8/14/96	<u>(163,333)</u>	<u>—</u>	<u>(163,333)</u>
Unencumbered Cash 10/31/96	<u>\$259,742</u>	<u>\$244,942</u>	<u>\$504,684</u>

The state librarian made the same misrepresentations in the prior year

The state librarian's annual reports to the 1996 Legislature on the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund for FY1995-96 also misrepresented the allocation of \$1,625,000 to individual libraries. Instead, \$959,252 was paid to Baker & Taylor from the Libraries Special Fund and \$400,000 was transferred into the state's general fund from the Enhanced Services Special Fund. We found no evidence that special fund moneys were distributed to the individual libraries as represented in the annual reports.

Special fund moneys were used to finance the Baker and Taylor book contract

During fiscal years 1995-97 approximately \$1.9 million of the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund were improperly used to pay Baker & Taylor. Exhibit 2.2 summarizes payments to Baker & Taylor that were not distributed to individual libraries as intended by statute.

Exhibit 2.2

Summary of Payments to Baker & Taylor Charged to Special Funds FY1995-96 - FY1996-97

Payment Dates to Baker & Taylor	Charges to Libraries Special Fund	Charges to Library Fee for Enhanced Services Special Fund
April 10, 1996	\$212,397	
May 7, 1996	634,855	
June 3, 1996	112,000	
Subtotal FY1995-96	<u>\$959,252</u>	<u>\$0</u>
August 14, 1996	\$163,333	
November 22, 1996	125,000	125,000
January 17, 1997	170,000	170,000
April 4, 1997	150,000	
Subtotal FY1996-97	<u>\$608,333</u>	<u>\$295,000</u>
Total Payments to Baker & Taylor	<u>\$1,567,585</u>	<u>\$295,000</u>

Section 312-3.6, HRS, authorizes the Library Advisory Committee to direct the state librarian to disburse funds from the Libraries Special Fund for purposes other than returning the moneys to the individual libraries. However, we found no evidence that the Library Advisory Committee approved the expenditure of these funds for payments to Baker & Taylor.

Furthermore, moneys from the Library Fee for Enhanced Services Special Fund which were paid to Baker & Taylor were clearly not used for enhanced services programs in compliance with Section 312-22, HRS.

These funds should have been made available to operate their respective Enhanced Services Programs and to generate additional revenues through the program as intended by the Legislature.

Transfers from the Library Fee for Enhanced Services Special Fund to the State's general fund were not properly authorized

Section 312-22(b), HRS, requires the state librarian to consult with the Library Advisory Committee to determine the allocation amount for each public library from the Library Fee for Enhanced Services Special Fund. The fund is currently scheduled to sunset on June 30, 1999, at which time any remaining balance is to be deposited into the general fund. Section 37-53, HRS, authorizes transfers to the general fund (in effect, prior to the sunset date) provided that the transfer is made with the "portion of moneys determined to be in excess of fiscal year requirements for such special fund." Transfers must also be approved by the governor or the director of finance.

The state librarian transferred \$500,000 (\$100,000 during the fiscal year ended June 30, 1997 and \$400,000 during the prior fiscal year) from the Enhanced Services Special Fund to the state's general fund without meeting the statutory requirements for these transfers. Library system personnel were not able to provide any supporting documentation authorizing the transfers other than a memo dated October 20, 1995 to the state librarian from the governor. This memo, whose primary subject was administrative rule-making, indicates that the governor understood that the state librarian planned to transfer \$500,000 from the Enhanced Services Special Fund; however, it does not appear to constitute a formal authorization by the governor.

Moreover, there is no indication that the amounts transferred into the general fund were based on excess cash in the special fund. To the contrary, the special fund balance was insufficient to cover even the disbursements to the individual libraries projected by the state librarian in his annual reports to the Legislature.

Recommendations

1. The Legislature should amend Sections 312-3.6(d) and 312-22(d), HRS, to require that the state librarian's annual reports to the Legislature include actual accounting of the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund. This should include receipt sources by individual libraries and expenditure of these receipts by individual libraries.
2. Prior to authorizing the transfer of library special funds into the State's general fund, the governor should require the state librarian to document that any transfer from a library special fund into the State's general fund is in excess of the fiscal year requirements as specified in Section 37-53, HRS.

Borrowing Rules Are Too Liberal

The library system's administrative rules attempt to establish controls to protect the system's collection from theft and loss. To reduce such risks, all library patrons must have a library card prior to borrowing any material and fines have been established for materials which are not returned by a specified due date. This allows libraries to track non-returned materials and to hold patrons liable for the late return and loss of these materials. Despite these efforts, the library system is still subject to loss and theft because the rules do not protect the system's collection from the abuse and misuse of library cards. Furthermore, the library automation system's untimely identification of patrons with outstanding fines does not safeguard the library system's collection from potential loss. The automation system's inability to account for magazines on loan also increases the risk of loss.

Administrative rules need to be strengthened

The library system's administrative rules allow residents and non-residents to obtain library cards to borrow library materials. However, library patrons are only required to submit proof of identification when applying for a library card. Therefore, there is no requirement for the patron to provide a picture identification in addition to the library card when borrowing library materials. Requiring both would prevent the unauthorized use of the card.

Although a disclaimer on the back of the library card makes the patron liable for any fines stemming from the unauthorized use of the library card, and the card clearly states that patrons are to report the loss of a card immediately for their protection, these conditions are not always enforced. Patrons may not always be aware of the loss or theft of their library card and the library system does not always hold patrons liable for fines incurred through unauthorized card use.

Furthermore, the risk of substantial loss and theft is high because patrons are allowed to borrow an unlimited number of materials as long as they do not incur a fine of \$10 or more. As a result, a library card may be used to "borrow" a significant amount of library materials without any intent of returning them.

Upon our review of one library patron's record in September 1997, we noted that about \$13,000 in uncollected fines was incurred for 516 various materials that were overdue for almost a year. These materials were borrowed from the Kaimuki, Hawaii State, Waikiki, and McCully public libraries between November 12, 1996 and December 3, 1996. The patron reported his library card was lost in March 1997, about three months after the library system first sent him an overdue notice. The

library system referred this patron's account for collection in May 1997; however, the library system has been unable to recover the fines and replacement value for these items as of January 1998.

Exhibit 2.3 shows that between 3 and 150 items were borrowed on 11 separate dates using this library patron's card. On several dates, the number of materials borrowed was excessive and indicated abuse.

Exhibit 2.3

Summary of One Library Patron's Card Borrow Dates, Due Dates, and the Number of Materials Borrowed

Borrow Date	Due Date	Number of Materials Borrowed
November 12, 1996	December 3, 1996	96
November 13, 1996	December 4, 1996	11
November 15, 1996	December 6, 1996	3
November 18, 1996	December 9, 1996	76
November 21, 1996	November 29, 1996	5
November 21, 1996	December 12, 1996	62
November 23, 1996	December 14, 1996	150
November 26, 1996	December 17, 1996	42
November 27, 1996	December 18, 1996	50
November 29, 1996	December 20, 1996	13
December 3, 1996	December 24, 1996	8
Total Number of Materials Borrowed		<u>516</u>

Limiting the number of materials that can be borrowed and requiring picture identification of library patrons can prevent potential loss or theft from any one patron and the unauthorized use of library cards.

Poor monitoring of overdue materials results in substantial loss

State libraries use the Dynix system, an integrated automation system, that provides librarians with important information including overdue fines and fees. However, the Dynix system does not identify overdue materials in a timely manner. Fines and fees are not calculated until either the borrowed material is returned or the material is past 30 days due. Consequently, library patrons may continue to borrow an unlimited number of items until the fines and fees are posted in the Dynix system. This increases the opportunity for theft and loss because only those patrons identified by the Dynix system as having fines and fees amounting to \$10 or more are prohibited from borrowing additional materials.

As shown in the prior referenced Exhibit 2.3, the library patron's card was used to borrow 8 items on December 3, 1996, even though 96 items were due on this date, and an additional 5 items were due on an earlier date and were not yet returned. Since overdue fines and fees are not posted to the patron's account until the materials are delinquent for 30 days, the system did not warn library personnel that 101 items were due. Consequently, library personnel allowed additional items to be borrowed on that same patron's card. None of these materials were returned at the time of our fieldwork and all are probably stolen or lost.

The Dynix system should accrue fines on a daily basis to prevent further loss of library materials. Library personnel can then be informed of the true account balance of the patron, and borrowing privileges can be denied in a more timely and effective manner.

***Borrowed magazines
are not properly
monitored***

Individual libraries are given the authority to decide whether to circulate magazines. However, magazines are not individually bar-coded; therefore, when a patron presents a magazine for checkout, the library worker scans the magazine as an uncataloged pamphlet and stamps the due date on the magazine.

The Dynix system tracks uncataloged items such as magazines only by count and cannot track specific titles or due dates, assess fines or fees, or send out delinquency notices on these items. A patron's account will reflect only the number of uncataloged items outstanding and the date each was borrowed. Consequently, the Dynix system does not tell library personnel which patron has borrowed the uncataloged items once the material leaves the library. Therefore, patrons may keep magazines beyond their due date or never return them without being assessed fines as required by statute and administrative rule.

Recommendations

1. The library system should minimize the risk of theft and loss of library materials by:
 - Limiting the number of materials a patron may borrow and have outstanding at any given time; and
 - Requiring patrons to submit a picture identification when borrowing library materials.
2. The library system should modify the Dynix system to identify and accrue patrons' fines and fees on a daily basis. This information should be used to deny the borrowing privileges of patrons who have fines or fees amounting to \$10 or more, as required by administrative rule.

3. The library should bar-code all circulating materials including magazines in order to properly account for all items in the library's collection.

Guidelines Over Cash are Not Followed

The Management Information Branch established interim guidelines for fiscal matters after the district offices were eliminated in 1995. These interim guidelines provide a general outline of internal procedures, including controls over cash, for the libraries to follow. We found that libraries do not always comply with fiscal procedures requiring daily cash deposits and retention of cash reconciliation records. Furthermore, the incomplete reconciliation of cash reports, the untimely investigation of cash overages and shortages, and the failure to segregate duties over cash receipts and over the waiving of fines and fees place cash receipts at risk of fraud and theft.

Cash deposits are untimely

The interim fiscal guidelines require libraries to deposit cash on a daily basis with an exception allowed for deposits amounting to less than \$50. In these cases, libraries must make a deposit at least once a month or when the total deposit accrues \$50 or more. We found that cash was not consistently deposited within these guidelines at the Hilo and Kahului public libraries.

For example, at the Hilo Public Library, cash is usually deposited every other day. In certain instances, three days' worth of deposits, with an average daily deposit of \$200, were accumulated before being deposited into the bank. At the Kahului Public Library, cash is deposited on a weekly basis. Up to six business days of deposits, often exceeding \$1,000, are kept in the safe. We were informed that deposits are not made in accordance with established policies because of the limited available staff.

Furthermore, undeposited cash is kept in safes that are accessible to all library staff. Safes at the State, Pearl City, Kaimuki, and Kahului public libraries are kept unlocked during normal business hours because library personnel need to access change throughout the day.

A cash box with not more than \$50 should be used for change in lieu of an open safe. All other cash should be kept in a locked safe and deposited on a daily basis in order to minimize the possibility of theft. Only authorized personnel should have access to the key or code used to open the safe.

Cash is not reconciled to the daily circulation report

The reconciliation of cash to cash register tapes and cash collection reports is necessary to ensure that all cash is accounted for. Although the libraries we visited reconciled cash received to cash register tapes as

required by interim fiscal policies, they did not reconcile the cash register tapes to the daily circulation report. Individual libraries can generate a daily circulation report from the Dynix system to provide operational and financial information such as moneys collected and refunded for the current and previous day. However, libraries do not consistently generate the report and have not used this report for cash reconciliation purposes. Use of the report has been limited to obtaining circulation statistics.

Although library policy does not require the daily reconciliation of the cash register tapes with the daily circulation report, it is imperative to do so because this provides assurance that all cash transactions recorded in the Dynix system are accounted for in the cash register. The Dynix system contains individual patron records of fines and fees. Failure to reconcile the daily circulation report to the cash register tape means that there is no assurance that cash collected and credited to individual patron records are accounted for in the cash register.

Inconsistent close-out procedures prevent proper cash reconciliation

Reconciliation of cash to register tapes at the Pearl City Library is incomplete. The Pearl City Public Library performs close-out procedures 10 minutes prior to the close of the library, although library personnel continue to accept cash for fines and video fees. Library personnel note amounts collected on a piece of paper; however, there is no assurance that this is always done. Cash may be collected from patrons but may not be accounted for. This practice jeopardizes proper cash reconciliation procedures because the cash is not reconciled to a register tape identifying *all* transactions.

The Pearl City Public Library should consider performing close-out procedures the following morning to ensure that all transactions are properly recorded in the cash register. This is the procedure at other libraries we visited.

Cash overages and shortages are not investigated in a timely manner

The interim fiscal guidelines require libraries to complete a daily cash summary form. This form reconciles transactions recorded on the cash register tape to actual cash in the register. This allows errors and irregularities to be detected in a timely manner.

However, at the Kahului Public Library, although cash is reconciled to the cash register tape on a daily basis, any cash discrepancies are not investigated daily. Cash overages or shortages are reviewed only on a weekly basis when the cash register tape summary is reconciled to the accumulated deposits for the past six business days and documented on the daily cash summary form. As a result of the weekly rather than daily preparation of the daily cash summary form, large cash overages or shortages may not be detected or investigated in a timely manner.

Failure to retain daily cash summary form at one library hinders timely reconciliation

The daily cash summary form is sent to the Management Information Branch for reporting purposes and the preparation of the treasury deposit receipt. The interim fiscal guidelines require libraries to keep a copy of the form with the accompanying cash register tape for no less than three years.

The Hilo Public Library sends daily cash summary forms to the Management Information Branch Fiscal Office on Oahu but does not retain copies in the library's files as guidelines require. As a result, in the event of a discrepancy in the daily deposits, the Hilo Public Library would not be able to immediately identify the problem.

There is a lack of segregation of duties over cash

Segregation of duties over cash means that the authorization, custody, and recordkeeping functions are segregated to prevent opportunities for an individual to perpetrate and conceal errors and irregularities while performing cash related duties. It provides a system of checks and balances because functions by one individual are subject to review by another individual. We noted a lack of segregation of duties over cash receipts and over the waiving of fines and fees at the libraries we visited.

Cash is received and recorded by the same employee

At the Hilo, Kona and Lihue public libraries the same individual counts the cash, reconciles the cash in the register to the cash register tape, prepares the deposit slip and deposits the cash into the bank. Library staff reported that the lack of segregation of these duties is a result of limited staffing.

Proper cash controls require a segregation of duties over these functions. In the event that segregation of duties is not feasible, a supervisory review of the daily summary report should be performed and documented to ensure the correct amount of cash.

Individuals who receive and record cash are authorized to waive fines and fees

All circulation personnel have been given authorization to waive or adjust fines in the Dynix system in order to correct improper fee assessments by Dynix. This current policy allows library staff to collect cash from patrons and eliminate any record of the cash being owed or collected in the Dynix system. To protect cash receipts from fraud and theft, the responsibility for waiving fees and collecting fees should be segregated. In the event that segregation of duties is not deemed feasible, the library system could develop a standardized form which would document the

patron's name, the name of the employee waiving the fines and fees, the amount of fines to be waived and the reason for waiving the charges. This report should then be reviewed by the supervisor and reconciled to the daily circulation report.

At the Hawaii State Library, a copy of the daily circulation report is generated daily and waived fees are reviewed by library supervisors for reasonableness. However, no review of the daily circulation report for waived fees was performed at the remaining five libraries we visited.

Recommendations

1. Cash should be deposited on a timely basis in accordance with established policies. We also recommend that the library system consider the feasibility of night deposit drops.
2. The library system should properly safeguard its cash by keeping the safe locked during business hours and allowing for access only by authorized personnel. A cash box with not more than \$50 should be used for change in lieu of an open safe.
3. The library system should require libraries to reconcile the cash register tape to the daily circulation report.
4. The Pearl City Public Library should consider performing close-out procedures on the morning following the day of transactions, consistent with the practice of other libraries we visited.
5. All libraries should prepare the daily cash summary form on a daily basis and retain a copy as required by the interim guidelines. In addition, cash overages or shortages should be investigated in a timely manner.
6. The library system should segregate the authorization of transactions, custody of assets, and recordkeeping functions, or implement review procedures when segregation of duties is not feasible. Specifically, the library system should consider using standardized forms to authorize the waiving of fines and fees and implementing supervisory review of forms to ensure propriety of cash receipts.

Procedures to Monitor Receivables Need Improvement

In accordance with Section 8-200.2-3 and 4, Hawaii Administrative Rules (HAR), the loan period for circulating materials is 21 days upon presentation of a library card. Patrons are assessed fines and fees for library materials not returned during this timeframe. As of September 24, 1997, there were approximately 39,000 patrons with delinquent balances exceeding \$50. For those library patrons, the aggregate outstanding

balances amounted to \$4,335,000. With such a large receivable balance for fines and fees, procedures to monitor outstanding receivables are critical.

The library system does not utilize an aging report to monitor its receivables

The library system does not utilize an aging report to monitor its outstanding fines and fees. An aging report is a listing of all receivables categorized by the number of days outstanding. For example, on a June 30 aging report, a March 15 receivable of that same year would be listed in the "90 days and over" category. An aging report enables library personnel to monitor long-outstanding receivables.

Furthermore, the library system does not prepare and use an exception report that highlights patrons with large outstanding receivable balances. Currently the Dynix system posts overdue charges to a patron's account only when the overdue material is returned or outstanding for over 30 days. No distinction is made in the Dynix system for large balances or receivables over 90 days.

Although past due accounts of \$10 or more are transferred to a collection agent, the library system should monitor outstanding receivables from patrons and from its collection agency. Use of aging schedules is a good management tool to accomplish the monitoring of receivables.

Recommendations

1. The library system should prepare an aging report and an exception report of outstanding fines and fees to improve its ability to monitor receivable balances.
 2. The library system should monitor all accounts which have been transferred to its collection agency.
-

**Overdue Fines
May Not Be
Assessed Properly**

The Dynix system calculates fines based on patron category (juvenile, young adult, or adult) and on the number of days an item is overdue. Juvenile patrons are defined as those in sixth grade or below. Young adults are identified as those between the seventh and twelfth grades. Anyone 18 years or older is considered an adult. Fines for juveniles and young adults accrue at \$.15 per day with a maximum amount of \$4.50. Adult fines are higher at \$.25 per day with a maximum fine of \$7.50. The maximum fine is based on a 30 day past due date after which time the library system considers the material "lost" and assesses a replacement fee and processing fine.

Because the age of a patron determines the fee a patron is assessed, it is necessary that the library system accurately identify and update patrons' ages. However, during our site visits, we noted that the birth date of patrons in the juvenile and young adult categories are not verified. Furthermore, the Dynix system does not automatically update a patron's category from young adult to adult upon the 18th birthday. Therefore, fines may be assessed at the wrong rate.

Library personnel do not verify the age of patrons

When a patron file is initially created, a patron's age category is put into the system. Patrons under the age of 18 are asked their birth date; but are not required to submit evidence that the information provided is true and correct. Instead, library staff rely on their visual assessment of the patron's appearance to verify the stated age.

Moreover, all library patrons are provided with similar cards regardless of their age category. This does not prevent adults from using children's cards in order to benefit from the lower fine rate.

Dynix system does not sufficiently update the status of patrons

The Dynix system does have a programming option available to automatically update a patron's status from juvenile to young adult when the patron reaches the age of 14. This may be useful for updating the collection needs of individual libraries but this update does not affect the fine status of these patrons because juveniles and young adults are assessed the same rate. However, adult fines are assessed at a higher rate and patrons who reach the age of 18 should be identified in the system in order to ensure the correct posting of fines. The Dynix system does not currently utilize this feature to update the status of patrons who reach the age of 18. Therefore, outstanding fines may actually be higher than those reported. The library system may be improperly identifying adults as juveniles and as such, their fines assessed may be too low.

Recommendation

The library system should consider requiring patrons under the age of 18 to show evidence of their birth date when applying for a library card. The library system should also consider the feasibility of re-programming the Dynix system so that the patron category is automatically updated at age 18.

Payments Were Made to Baker & Taylor Without Performance Review

In FY1995-96 the library system entered into a five-year, \$7 million contract with Baker & Taylor for the selection, acquisition, cataloging, technical processing and distribution of library materials. This contract allowed Baker & Taylor to select all of the library system's books for a fixed unit price of \$20.94, following a mix of units outlined in the contract. Payments on the contract were to be made in three installments during the fiscal year ended June 30, 1997.

During our review of disbursements for this book contract, we noted that there were no performance standards such as the number and type of units to be delivered by Baker & Taylor before payment was made. Furthermore, the library system did not establish monitoring procedures to review the performance of Baker & Taylor. This poor accounting for contracted goods and services received is contrary to the library's own interim fiscal guidelines which require that libraries ensure the proper receipt of procured goods and services prior to payment approval. Failure to comply with their own policy meant the libraries had no guarantee that they received the contracted goods and services from Baker & Taylor prior to payment for those goods and services.

Recommendation

All future contracts should include provisions requiring that payments made by the library system correlate directly to the performance of the contracted tasks by the vendor or supplier.

Chapter 3

Financial Audit Reports

This chapter presents the results of the financial audit of the Public Library System of the Department of Education, State of Hawaii (Library System), as of and for the fiscal year ended June 30, 1997. This chapter includes the independent auditors' report and the report on compliance and on internal control over financial reporting as they relate to the Library System. It also displays financial statements of all fund types and account groups administered by the Library System, together with explanatory notes and combining financial statements.

Summary of Findings

In the opinion of KPMG Peat Marwick LLP, based on their audit, except for the general fixed assets account group, the combined financial statements present fairly, in all material respects, the financial position of the Library System as of June 30, 1997, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

KPMG Peat Marwick LLP noted that their tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*. Those findings relative to the transfers from the Library Fee for Enhanced Services Special Fund and the utilization of special funds are described in Chapter 2 of this report.

KPMG Peat Marwick LLP noted no matters involving the internal control over financial reporting and its operation that they considered to be material weaknesses.

Independent Auditors' Report

The Auditor
State of Hawaii:

We have audited the following combined financial statements of the Public Library System of the Department of Education, State of Hawaii (Library System):

Combined Balance Sheet – All Fund Types and Account Groups, June 30, 1997 (Exhibit A);

Combined Statement of Revenues, Expenditures and Changes in Fund Balances – All Governmental Fund Types and Expendable Trust Funds, For the year ended June 30, 1997 (Exhibit B); and

Combined Statement of Revenues and Expenditures – Budget and Actual on a Budgetary Basis - General and Special Revenue Funds, For the year ended June 30, 1997
(Exhibit C).

These combined financial statements are the responsibility of the Library System's management. Our responsibility is to express an opinion on these combined financial statements based on our audit.

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

In accordance with the terms of our engagement, the scope of our audit did not include an audit of the general fixed assets account group. As a result, the balance sheet of the general fixed assets account group is included in the accompanying combined balance sheet of the Library System for informational purposes only. It has been prepared from the Library System's fixed asset records without audit and we express no opinion on it.

As discussed in note 1 to the combined financial statements, the combined financial statements of the Library System 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 that is attributable to the transactions of the Library System.

In our opinion, except for the effects of such adjustment, if any, as might have been determined to be necessary had the scope of our audit included the general fixed assets account group, as discussed in the third paragraph above, the combined financial statements referred to above present fairly, in all material respects, the financial position of the Public Library System of

the Department of Education, State of Hawaii, as of June 30, 1997, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 17, 1997 on our consideration of the Library System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

Our audit was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining financial statements (Schedule I through Schedule IV) are presented for purposes of additional analysis and are not a required part of the combined financial statements. Such information has been subjected to the auditing procedures applied in our audit of the combined financial statements and, in our opinion, except for the effects of such adjustment, if any, as might have been determined to be necessary had the scope of our audit included the general fixed assets account group, as discussed in the third paragraph above, is fairly stated, in all material respects, in relation to the combined financial statements taken as a whole.

Honolulu, Hawaii
October 17, 1997, except as to note 9,
which is as of January 15, 1998

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

The Auditor
State of Hawaii:

We have audited the combined financial statements of the Public Library System of the Department of Education, State of Hawaii (Library System), as of and for the year ended June 30, 1997, and have issued our report thereon dated October 17, 1997, except as to note 9, which is as of January 15, 1998. 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, 1997. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Library System's combined financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*. Those findings relative to the transfers from the Library Fee for Enhanced Services Special Fund and the utilization of special funds are described in Chapter 2 of this report.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Library System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to the Auditor, State of Hawaii, in Chapter 2 of this report.

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

Honolulu, Hawaii
October 17, 1997

Descriptions of Combined and Combining Financial Statements

The following is a brief description of the combined and combining financial statements audited by KPMG Peat Marwick LLP, which are located at the end of this chapter.

Combined financial statements

Combined Balance Sheet – All Fund Types and Account Groups (Exhibit A). This statement presents the assets, liabilities and fund equity of all fund types and account groups of the Library System at June 30, 1997.

Combined Statement of Revenues, Expenditures and Changes in Fund Balances – All Governmental Fund Types and Expendable Trust Funds (Exhibit B). This statement presents the revenues, expenditures and changes in fund balances for all governmental fund types and expendable trust funds of the Library System for the year ended June 30, 1997.

Combined Statement of Revenues and Expenditures – Budget and Actual on a Budgetary Basis – General and Special Revenue Funds (Exhibit C). This statement compares actual revenues and expenditures of the Library System's general and special revenue funds on a budgetary basis to the budget adopted by the State Legislature for the year ended June 30, 1997.

Combining financial statements

Combining Balance Sheet – Special Revenue Funds (Schedule I). This schedule presents the assets, liabilities and fund balances of the special revenue funds of the Library System at June 30, 1997.

Combining Statement of Revenues, Expenditures and Changes in Fund Balances – Special Revenue Funds (Schedule II). This schedule presents the revenues, expenditures and changes in fund balances of the special revenue funds of the Library System for the year ended June 30, 1997.

Combining Balance Sheet – Expendable Trust Funds (Schedule III). This schedule presents the assets, liabilities and fund balances of the expendable trust funds of the Library System at June 30, 1997.

Combining Statement of Revenues, Expenditures and Changes in Fund Balances – Expendable Trust Funds (Schedule IV). This schedule presents the revenues, expenditures and changes in fund balances of the expendable trust funds of the Library System for the year ended June 30, 1997.

Notes to Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the combined financial statements and financial condition of the funds administered by the Public Library System of the Department of Education, State of Hawaii (Library System) are discussed in this section.

Note 1 - Financial reporting entity

For financial reporting purposes, the Library System includes all funds and account groups that are controlled by or dependent on the Library System. Control or dependence on the Library System was determined on the basis of statutory authority and monies flowing through the Library System to each fund or account group.

The Library System accounts for and reports only its portion of those fund types and account groups maintained by the State. The State Comptroller maintains the central accounts for all state funds and account groups and publishes financial statements for the State annually. Governmental resources are allocated to and are accounted for in individual funds based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

Note 2 - Summary of significant accounting policies

Basis of presentation

The financial transactions of the Library System are recorded in individual funds and account groups which are reported by type in the combined financial statements and are described in the following sections. Each fund and account group is considered a separate accounting entity, thus related operations are accounted for with a separate set of self-balancing accounts. Account groups are used to establish accounting control and accountability for the Library System's general fixed assets and general long-term obligations. Account groups are not funds as they do not reflect available financial resources and related liabilities. Financial resources are allocated to and are accounted for in individual funds based upon the purposes for which they are spent and the means by which spending activities are controlled.

The total columns on the accompanying combined financial statements are captioned "Memorandum Only" to indicate that they are presented only to facilitate financial analysis. Information in these columns does not purport to present financial position or results of operations of the Library System in conformity with generally accepted accounting principles. Such data is not comparable to a consolidation. Interfund balances and transactions have not been eliminated.

The Library System uses the following fund types, funds and account groups:

Governmental Fund Types:

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

Special Revenue Funds. Account for financial resources obtained from specific revenue sources (other than expendable trusts) and restricted to expenditures for specified purposes.

Fiduciary Fund Type:

Trust Funds. Accounts for transactions related to assets held by the Library System in a trustee capacity. This includes expendable trust funds which account for assets held in trust to be expended for designated purposes.

Account Groups:

General Fixed Assets Account Group. Accounts for all fixed assets of the Library System for use by the Library System in the conduct of its general governmental operations.

General Long-Term Obligations Account Group. Accounts for the long-term portion of accrued wages and employee benefits for governmental fund types.

Measurement focus and basis of accounting

Governmental Fund Types and Expendable Trust Funds. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds and expendable trust funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities generally are included on the combined balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets.

The Library System uses the modified accrual basis of accounting for the general, special revenue and expendable trust funds. Under the modified accrual basis of accounting, revenues and related current assets are recognized in the accounting period when they become both measurable and available to finance operations of the fiscal year or liquidate liabilities existing at year-end. Measurable means that the amount of the

transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after year-end to liquidate liabilities existing at the end of the fiscal year. Revenues susceptible to accrual include federal grants and funds appropriated by the State Legislature and allotted by the Governor. Expenditures are generally recorded when the related fund liabilities are incurred.

Cash. Cash reported on the combined balance sheet consists of cash in the State Treasury.

Investments. Investments include time certificates of deposit in various Hawaii banks and a U.S. government security stated at amortized cost.

Property and Equipment. Property and equipment reported in the general fixed assets account group are recorded at cost. Those assets were acquired or constructed for general governmental purposes and were reported as expenditures in the funds that financed the assets at acquisition. No depreciation is provided on those assets.

Accumulated Vacation and Sick Leave. 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 and is convertible to compensation upon termination of employment. Such accumulated vacation has been recorded as accrued wages and employee benefits payable in the general long-term obligations account group at the balance sheet date. Sick leave is not convertible to pay upon termination of employment and is recorded as an expenditure when taken.

Residual Equity Transfer. Residual equity transfer represents a nonrecurring and nonroutine transfer of equity from the Library Fee for Enhanced Services Special Fund to the State of Hawaii's general fund.

Encumbrances. Encumbrances are recorded obligations in the form of purchase orders and contracts and are recorded in the governmental fund types. The Library System records encumbrances at the time purchase orders or contracts are awarded or executed. Encumbrances outstanding at year-end are reported as reservations of fund balances since they do not constitute expenditures or liabilities.

Reservations of Fund Balances. Portions of the governmental fund type fund balances are reserved for encumbrances outstanding at year-end. Those amounts are generally liquidated in the subsequent fiscal year.

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. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year.

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

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

Expenditure. The actual disbursement of funds for the payment of goods delivered or services rendered with the obligation to pay for such goods or services having previously been incurred against authorized funds.

Employees' Retirement System. Contributions to the Employees' Retirement System of the State of Hawaii (ERS) include current service costs and amortization of the accrued unfunded liability over a period of 50 years from July 1, 1964. The State's policy is to fund its required contribution annually.

Risk Management. Liabilities related to certain types of losses (including torts, theft of, damage to, or destruction of assets, errors or omissions, natural disasters and injuries to employees) are reported when it is probable that the losses have occurred and the amount of those losses can be reasonably estimated.

Use of Estimates. The preparation of combined financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and other debits and liabilities and other credits, as well as disclosure of contingent assets and liabilities at the date of the combined financial statements, and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

Note 3 - Budgeting and budgetary control

The budget of the Library System is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes (1) the programs, services and activities to be provided during the fiscal year, (2) the estimated revenues available to finance the operating plan and (3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented and controlled. Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically throughout the fiscal year. Amounts reflected as budgeted revenues in the combined statement of revenues and expenditures - budget and actual on a budgetary basis - general and special funds are those estimates as compiled by the Library System and reviewed by the Department of Budget and Finance. Budgeted expenditures are derived primarily from acts of the State Legislature and

for other authorizations contained in the State Constitution, the Hawaii Revised Statutes (HRS) and other specific appropriation acts in various Session Laws of Hawaii.

All expenditures of those appropriated funds are made pursuant to the appropriations in the biennial budget as amended by subsequent supplemental appropriations. Budgetary control is maintained at the departmental level. Budget revisions and interdepartmental transfers may be effected with certain executive and legislative branch approvals.

The general fund and certain special revenue funds have legally appropriated annual budgets. The final legally adopted budget in the combined statement of revenues and expenditures—budget and actual on a budgetary basis—general and special revenue funds represent the original appropriations, transfers and other legally authorized legislative and executive changes. To the extent not expended or encumbered, general and special revenue funds appropriations generally lapse at the end of the fiscal year or grant period for which the appropriations were made. The State Legislature or federal government specifies the lapse dates and any other contingencies which may terminate the authorization for other appropriations. Known lapses occurring in the fiscal year of appropriation, if any, are included in the amended budgets, and are netted against revenues in the combined statement of revenues and expenditures - budget and actual on a budgetary basis - general and special revenue funds. Appropriations which lapse in a year subsequent to the fiscal year of appropriations do not affect current fiscal year budgets and are, therefore, excluded from that statement. In addition, transfers of amounts between funds, divisions and departments are not budgeted, and are, therefore, excluded from revenues and expenditures, as applicable, in that statement.

A comparison of budgeted and actual revenues and expenditures of the general and special revenue funds are presented in the combined statement of revenues and expenditures \mathcal{D} budget and actual on a budgetary basis \mathcal{D} general and special revenue funds. Differences between revenues and expenditures reported on the budgetary basis and those reported in accordance with generally accepted accounting principles (GAAP) are mainly due to (1) encumbrances of purchase orders and contract obligations and (2) unbudgeted revenues and expenditures. These differences represent a departure from GAAP.

A summation of the differences between revenues and expenditures reported on the budgetary basis and those reported in accordance with GAAP for the general and special revenue funds for the year ended June 30, 1997 is as follows:

	General	Special Revenue
Excess of revenues and other financing sources over expenditures - actual on a budgetary basis	\$ -	\$425,233
Reserved for encumbrances	168,861	3,487
Expenditures for liquidation of prior fiscal year encumbrances and reservations	<u>(275,067)</u>	<u>(124,604)</u>
Excess of revenues and other financing sources over expenditures - GAAP basis	<u><u>\$(106,206)</u></u>	<u><u>\$304,116</u></u>

Note 4 - Cash and investments

The State maintains a cash pool that is available for all funds. Each fund type's portion of this pool (cash in State Treasury) is reported as "Cash" in the accompanying combined balance sheet and amounted to \$1,243,740 at June 30, 1997. Those funds are pooled with funds from other state agencies and departments and deposited in approved financial institutions by the director of the Department of Budget and Finance. Deposits not covered by federal deposit insurance are fully collateralized by government securities held in the name of the State by third party custodians.

The Library System also maintains time certificates of deposit and a 30 year U.S. Treasury bond with various Hawaii banks, which are held separately from cash in State Treasury. At June 30, 1997, the carrying amount of time certificates of deposit and U.S. Treasury bonds were \$200,000 and \$10,764, respectively. Those deposits not covered by Federal Deposit Insurance are also fully collateralized by government securities held in the name of the State by third party custodians.

Note 5 - Property and equipment

Changes in the Library System's general fixed assets account group (unaudited) for the year ended June 30, 1997 were as follows:

	Balance at July 1, 1996	Additions	Disposals	Balance at June 30, 1997
Land	\$19,915,278	\$3,997	\$ -	\$19,919,275
Building and improvements	<u>84,941,530</u>	<u>1,166,931</u>	<u>1,417,293</u>	<u>84,691,168</u>
	<u><u>\$104,856,808</u></u>	<u><u>\$1,170,928</u></u>	<u><u>\$1,417,293</u></u>	<u><u>\$104,610,443</u></u>

***Note 6 - Retirement
benefits***

Employees' Retirement System

Substantially all eligible employees of the Library System are members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan covering eligible employees of the State and counties. The ERS provides retirement benefits as well as death and disability benefits. Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under social security. Persons employed in positions not covered by social security are precluded from the noncontributory option. The noncontributory option 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 option or to elect the new noncontributory option and receive a refund of previous employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

Prior to June 30, 1997, required employer contributions to the ERS were based upon the frozen initial liability method and included amortization of the accrued unfunded liability over a period of 50 years beginning July 1, 1964. Effective June 30, 1997, the entry age normal actuarial cost method is used to calculate the total employer contribution required. Under this method, the total employer contribution is comprised of the "normal cost" plus the level annual payment required to amortize the unfunded actuarial accrued liability over the remaining period of 19 years from July 1, 1997. The employer normal cost is the level percentage of payroll contribution required to pay all benefits. Actuarial gains and losses resulting from differences between the actual and assumed experience are reflected in the employer unfunded accrued liability. The State's policy is to fund its required contribution annually.

Ten-year historical trend information showing the ERS's progress in accumulating sufficient assets to pay benefits when due is presented in the ERS's annual report.

Measurement of assets and actuarial valuations are made for the entire ERS and are not separately computed for individual participating employers such as the Library System. The disclosures required by Governmental Accounting Standards Board Statement No. 5 are presented in the ERS's Comprehensive Annual Financial Report (CAFR). The following data is provided as of June 30, 1996 for the entire ERS from the disclosures contained in the CAFR for the year then ended, the most recent available information:

Pension benefit obligation:		
Pensioners and beneficiaries currently receiving benefits and terminated members not yet receiving benefits		\$4,091,261,800
Current members:		
Accumulated member contribution		811,649,400
Employer-financed vested		1,538,271,800
Employer-financed nonvested		851,409,400
		<hr/>
Total pension benefit obligation		7,292,592,400
Net assets available for benefits at cost (fair value, (\$6,657,378,000):		
Pension Accumulation Fund	\$5,251,425,250	
Annuity Savings Fund	811,649,360	6,063,074,610
		<hr/>
Unfunded pension benefit obligation		\$1,229,517,790
		<hr/>

The pension benefit obligation is a standardized 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 entire System's actuarially determined employer contribution requirements were met at June 30, 1997.

In November 1994, the GASB issued Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, which establishes a financial reporting framework for defined benefit plans that distinguishes between two categories of information: (a) current financial information about plan assets and financial activities and (b) actuarially determined information, from a long-term perspective, about the funded status of the plan and the progress being made in accumulating sufficient assets to pay benefits when due. The ERS adopted the provisions of this statement effective July 1, 1996.

In November 1994, the GASB also issued Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, which establishes standards for the measurement, recognition, and display of pension expenditures and related liabilities, assets, note disclosures and, if any required, supplementary information in the financial reports of state and local governmental employers. The State anticipates adopting the provisions of this statement effective July 1, 1997.

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 the Library System on or after attaining age 62 with at least 10 years of service or age 55 with at least 30 years of service under the noncontributory option and age 55 with at least 5 years of service under the contributory option. Retirees credited with at least 10 years of service excluding sick leave credit qualify for free medical insurance premiums; however, retirees with less than 10 years must assume a portion of the monthly premiums. All disability retirees who retired after June 30, 1984, with less than 10 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. Retirees covered by the medical portion of Medicare are eligible to receive a reimbursement of the basic medical coverage premiums. Contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued. The Library System's general fund share of the post-retirement health care and life insurance benefits expense for the year ended June 30, 1997 has not been separately computed and is not reflected in the Library System's combined financial statements. The Library System's special revenue fund share of the post-retirement health care and life insurance benefits expense for the year ended June 30, 1997 was not deemed to be material and is included in the special revenue funds' financial statements.

Effective July 1, 1996, certain changes were made to the post-retirement medical benefits offered to employees hired after June 30, 1996. The State will pay 50% of the monthly medical insurance premiums for these retirees with at least 10 years of service but less than 15 years, 75% with at least 15 years of service but less than 25 years, and 100% with 25 or more years of service.

Note 7 - Risk management

The Library System is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees.

Torts

The Library System is involved in various actions, the outcome of which, in the opinion of management, will not have a material adverse effect on the Library System's financial position. Losses, if any, are either covered by insurance or will be paid from legislative appropriations of the State's general fund.

Property and liability insurance

The State has purchased property damage insurance for losses that may occur for substantially all state facilities, including those of the Library System. The policies provide for coverage of \$100,000,000 per occurrence with a \$250,000 deductible. The deductible for windstorm coverage is 2.5% of loss subject to a \$250,000 minimum and \$2,500,000 maximum per occurrence. Included in the property damage insurance is earthquake and flood coverage whose limit of loss per occurrence is \$50,000,000 with a deductible of 5% of loss subject to the \$250,000 deductible. In addition, the State has a \$10,000,000 public employee faithful performance insurance policy with a \$50,000 deductible. The State also has a personal injury and property damage liability, including automobile and public errors and omissions, insurance policy with an annual aggregate of \$23,000,000 per occurrence, subject to a \$2,000,000 deductible. Claims under \$10,000 as well as deductibles under the property insurance are handled by the risk management office of the Department of Accounting and General Services and paid from the risk management revolving fund. Losses not covered by property and liability insurance are paid from legislative appropriations of the State's general fund.

Workers' compensation policy

The State is self-insured for workers' compensation. Expenditures for workers' compensation are appropriated annually from the State general fund. The Library System is covered by the State's self-insured Workers' Compensation Program for medical expenses of injured employees. However, temporary wage loss replacement benefits to these employees are paid by the Library System. Liabilities for temporary wage loss replacement benefits are established if information indicates that it is probable that liabilities have been incurred as of fiscal year-end and the amounts of those benefits can be reasonably estimated. Those liabilities include an amount for benefits that have been incurred but not reported. In the opinion of management, the Library System has adequately reserved for such benefits.

Note 8 - Commitments

Accumulated sick leave

Sick leave for all full-time employees accumulates at the rate of one and three-quarters working days for each month of service without limitation. It may be taken only in the event of illness and is not convertible to compensation upon termination of employment. However, a state employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the System. Accumulated sick leave at June 30, 1997 amounted to approximately \$8,752,900.

Deferred compensation plan

The State has a deferred compensation plan which enables state employees to defer a portion of their compensation. The Department of Human Resources Development has the fiduciary responsibility of administering the plan. Deferred compensation is not available to employees until termination, retirement, death or an 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 value of the deferred account balance for each participant. Deferred compensation payable at June 30, 1996, the most recent available information, for all entities of the State amounted to \$462,531,000. The deferred compensation payable for the Library System at June 30, 1996 is not readily available.

Note 9 - Contingencies - Litigation

The State and the Library System are subject to a number of lawsuits arising out of the conduct of its business, including the following matters relating to the Library System's operations:

Baker & Taylor v. State of Hawaii, et al.

The Library System entered into a 5 year contract with Baker and Taylor, Inc. (Baker and Taylor) effective March 28, 1996 for the selection, acquisition, cataloging, technical processing and distribution of library materials. This contract was terminated by the Library System in July 1997. Baker and Taylor has filed a lawsuit against the State of Hawaii, the Library System and the State Librarian seeking a review of the State Librarian's determination that Baker and Taylor had failed to perform its obligations under its contract with the Library System. Baker and Taylor also seeks damages in an unspecified amount.

The Library System filed a counter lawsuit against Baker and Taylor seeking (1) damages in an unspecified amount for additional costs of purchasing books during the original contract term; (2) damages of approximately \$20,000 for books rejected after termination of the contract; (3) damages of approximately \$130,000 for duplicate books; (4) restitution of \$730,000 because of a failure of consideration; and (5) damages of approximately \$1,348,000 (including the claim for restitution) for undelivered goods. No trial date has been set.

Carl Corp. v. Hawaii State Public Library System

Carl Corp., the unsuccessful competitor for a contract to provide computer automation and other services to the Library System, protested the awarding of the contract to another vendor because of alleged violations in the procurement laws. The Department of Commerce and Consumer Affairs Hearings Officer concluded that the process by which the proposals were evaluated was in violation of the State Procurement Code (Chapter 103D of the Hawaii Revised Statutes).

In a recent decision, the Supreme Court of the State of Hawaii remanded to the Hearings Officer for entry of an order (1) awarding Carl Corp. its cost for preparing its proposal and reasonable attorneys fees in prosecuting its protest and appeal and (2) ratifying or terminating the contract as provided for in the State Procurement Code. The State's motion for reconsideration of the attorney's fee issue was denied and the matter is presently pending before the Hearings Officer for further review.

Hawaii Government Employees Assn. v. Hawaii State Public Library System et al.

The Hawaii Government Employees Assn. (HGEA), a union representing Library System employees, commenced suit against the Library System, members of the Board of Education, the State Librarian (collectively referred to as the State Defendants), Baker and Taylor and Booklines Hawaii, Ltd., alleging that the contract between the Library System and Baker and Taylor is void as against public policy, citing *Konno v. County of Hawaii*. The complaint requests a judgment declaring the contract void, an injunction ordering the Library System to resume operations previously performed by civil servants, an order directing the Library System to collect amounts paid under the contract and to pay them into the public treasury, and damages in an unspecified amount.

Baker and Taylor and Booklines Hawaii, Ltd. cross-claimed against the State Defendants seeking indemnification against any award recovered by the plaintiff, termination expenses (including a reasonable profit prior to termination) and attorney's fees.

The Library System has moved to dismiss the action as moot, since the contract with Baker and Taylor has been terminated. No trial date has been set.

While the ultimate liabilities, if any, in the disposition of these matters are presently difficult to estimate, it is management's belief that the outcomes are not likely to have a material adverse effect on the Library System's financial position. Losses, if any, may be paid from legislative appropriations of the State General Fund. Accordingly, no provisions for any liabilities that might result have been made in the accompanying combined financial statements.

STATE OF HAWAII
HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION
 Combined Balance Sheet - All Fund Types and Account Groups
 June 30, 1997

	Governmental Fund Types		Fiduciary Fund Type	Account Groups		
	General	Special Revenue	Expendable Trust	General Fixed Assets	General Long-Term Debt	Total (Memorandum Only)
Assets						
Cash	\$ 453,318	643,866	146,556	—	—	1,243,740
Investments	—	—	210,764	—	—	210,764
Fixed assets (note 5)	—	—	—	104,610,443	—	104,610,443
Amount to be provided for the retirement of general long-term debt	—	—	—	—	2,595,906	2,595,906
Total assets	<u>\$ 453,318</u>	<u>643,866</u>	<u>357,320</u>	<u>104,610,443</u>	<u>2,595,906</u>	<u>108,660,853</u>
Liabilities and Fund Balances						
Liabilities:						
Vouchers payable	\$ 239,103	—	—	—	—	239,103
Accrued wages and employee benefits	45,354	—	—	—	2,595,906	2,641,260
Deferred revenues	—	30,842	—	—	—	30,842
Total liabilities	<u>284,457</u>	<u>30,842</u>	<u>—</u>	<u>—</u>	<u>2,595,906</u>	<u>2,911,205</u>
Fund equity:						
Investment in general fixed assets	—	—	—	104,610,443	—	104,610,443
Fund balances:						
Reserved for encumbrances	168,861	3,487	1,016	—	—	173,364
Reserved for trust funds	—	—	356,304	—	—	356,304
Unreserved	—	609,537	—	—	—	609,537
Total fund equity	<u>168,861</u>	<u>613,024</u>	<u>357,320</u>	<u>104,610,443</u>	<u>—</u>	<u>105,749,648</u>
Total liabilities and fund equity	<u>\$ 453,318</u>	<u>643,866</u>	<u>357,320</u>	<u>104,610,443</u>	<u>2,595,906</u>	<u>108,660,853</u>

See accompanying notes to combined financial statements.

STATE OF HAWAII
HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION

Combined Statement of Revenues, Expenditures and Changes in Fund Balances –
 All Government Fund Types and Expendable Trust Funds

For the year ended June 30, 1997

	Governmental Fund Types		Fiduciary Fund Type	Total (Memorandum) Only)
	General	Special Revenue	Expendable Trust	
Revenues:				
State allocated appropriations	\$ 18,282,604	—	—	18,282,604
Intergovernmental revenues	—	720,431	—	720,431
Fines and fees	—	1,364,767	—	1,364,767
Other	—	—	19,723	19,723
	18,282,604	2,085,198	19,723	20,387,525
Expenditures:				
Public Libraries	18,699,482	—	—	18,699,482
Libraries Special Fund	—	732,133	—	732,133
Library Fee for Enhanced Services Special Fund	—	328,518	—	328,518
Federal Grant Programs:				
Public Library Services – Library Services & Construction Act Title I	—	380,585	—	380,585
Inter-library Cooperation and Resource Sharing – Library Services & Construction Act Title III	—	200,352	—	200,352
Public Library Construction – Library Services & Construction Act Title II	—	107,053	—	107,053
Miscellaneous federal grant programs	—	32,441	—	32,441
Other	—	—	12,132	12,132
	18,699,482	1,781,082	12,132	20,492,696
Excess of revenues over (under) expenditures	(416,878)	304,116	7,591	(105,171)
Other financing sources – operating transfers in	310,672	—	—	310,672
Excess of revenues and other financing sources over (under) expenditures	(106,206)	304,116	7,591	205,501
Fund balance at July 1, 1996	275,067	408,908	349,729	1,033,704
Residual equity transfer out	—	(100,000)	—	(100,000)
Fund balance at June 30, 1997	\$ 168,861	613,024	357,320	1,139,205

See accompanying notes to combined financial statements.

STATE OF HAWAII
HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION

Combined Statement of Revenues and Expenditures – Budget and Actual on a Budgetary Basis –
 General and Special Revenue Funds

For the year ended June 30, 1997

	General Fund			Special Revenue Funds			Total (Memorandum Only)		
	Budget	Actual on a Budgetary Basis	Variance Favorable (Unfavorable)	Budget	Actual on a Budgetary Basis	Variance Favorable (Unfavorable)	Budget	Actual on a Budgetary Basis	Variance Favorable (Unfavorable)
Revenues:									
State allotted appropriations	\$ 18,729,567	18,330,327	(399,240)	—	—	—	18,729,567	18,330,327	(399,240)
Intergovernmental revenues	—	—	—	1,541,091	720,431	(820,660)	1,541,091	720,431	(820,660)
Fines and fees	—	—	—	1,625,000	1,364,767	(260,233)	1,625,000	1,364,767	(260,233)
	<u>18,729,567</u>	<u>18,330,327</u>	<u>(399,240)</u>	<u>3,166,091</u>	<u>2,085,198</u>	<u>(1,080,893)</u>	<u>21,895,658</u>	<u>20,415,525</u>	<u>(1,480,133)</u>
Expenditures:									
Public Libraries	18,729,567	18,640,999	88,568	—	—	—	18,729,567	18,640,999	88,568
Libraries Special Fund	—	—	—	1,050,000	735,482	314,518	1,050,000	735,482	314,518
Library Fee for Enhanced Services Special Fund	—	—	—	575,000	328,558	246,442	575,000	328,558	246,442
Federal Grant Programs:									
Public Library Services – Library Services & Construction Act Title I	—	—	—	992,900	370,977	621,923	992,900	370,977	621,923
Inter-library Cooperation and Resource Sharing – Library Services & Construction Act Title III	—	—	—	190,388	100,000	90,388	190,388	100,000	90,388
Public Library Construction – Library Services & Construction Act Title II	—	—	—	319,214	103,803	215,411	319,214	103,803	215,411
Other	—	—	—	38,589	21,145	17,444	38,589	21,145	17,444
	<u>18,729,567</u>	<u>18,640,999</u>	<u>88,568</u>	<u>3,166,091</u>	<u>1,659,965</u>	<u>1,506,126</u>	<u>21,895,658</u>	<u>20,300,964</u>	<u>1,594,694</u>
Excess of revenues over (under) expenditures	—	(310,672)	(310,672)	—	425,233	425,233	—	114,561	114,561
Other financing sources – operating transfers in	—	310,672	310,672	—	—	—	—	310,672	310,672
Excess of revenues and other financing sources over expenditures	\$ —	—	—	—	425,233	425,233	—	425,233	425,233

See accompanying notes to combined financial statements.

**HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION**

Combining Balance Sheet – Special Revenue Funds

June 30, 1997

See accompanying independent auditors' report.

STATE OF HAWAII
HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION

Combining Statement of Revenues, Expenditures, and Changes in Fund Balances --
Special Revenue Funds

For the year ended June 30, 1997

	Libraries Special Fund	Library Fee for Enhanced Services Special Fund	Federal Grants	Hurricane Iniki Insurance Proceeds	Total
Revenues:					
Intergovernmental revenues	\$ —	—	720,431	—	720,431
Fines and fees	892,186	472,581	—	—	1,364,767
	<u>892,186</u>	<u>472,581</u>	<u>720,431</u>	<u>—</u>	<u>2,085,198</u>
Expenditures:					
Libraries Special Fund	732,133	—	—	—	732,133
Library Fee for Enhanced Services Special Fund	—	328,518	—	—	328,518
Federal Grant Programs:					
Public Library Services -- Library Services & Construction Act Title I	—	—	380,585	—	380,585
Inter-library Cooperation and Resource Sharing -- Library Services & Construction Act Title III	—	—	200,352	—	200,352
Public Library Construction -- Library Services & Construction Act Title II	—	—	107,053	—	107,053
Miscellaneous federal grant programs	<u>732,133</u>	<u>328,518</u>	<u>720,431</u>	<u>—</u>	<u>1,781,082</u>
Excess of revenues over expenditures	160,053	144,063	—	—	304,116
Fund balance at July 1, 1996	213,894	194,069	—	945	408,908
Residual equity transfer out	—	(100,000)	—	—	(100,000)
Fund balance at June 30, 1997	<u>\$ 373,947</u>	<u>238,132</u>	<u>—</u>	<u>945</u>	<u>613,024</u>

See accompanying independent auditors' report.

STATE OF HAWAII
HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION
Combining Balance Sheet - Expendable Trust Funds

June 30, 1997

Assets	Library of Hawaii Donation and Gifts	Hawaii Public Library Donation and Gifts	Maul Public Library Donation and Gifts	Kauai Public Library Donation and Gifts	Friends of the Library Donation and Gifts	Hawaii Public Library Payroll Collections	Donation for Transcribing Services	Total
Cash	\$ 136,250	5,629	1,018	397	3,044	200	18	146,556
Investments	200,000	10,764	—	—	—	—	—	210,764
Total assets	\$ 336,250	16,393	1,018	397	3,044	200	18	357,320
Fund Balances								
Reserved for encumbrances	\$ 635	—	—	—	381	—	—	1,016
Reserved for trust funds	335,615	16,393	1,018	397	2,663	200	18	356,304
Total fund balances	\$ 336,250	16,393	1,018	397	3,044	200	18	357,320

See accompanying independent auditors' report.

STATE OF HAWAII
HAWAII STATE PUBLIC LIBRARY SYSTEM
OF THE DEPARTMENT OF EDUCATION

Combining Statement of Revenues, Expenditures and Changes in Fund Balances - Expendable Trust Funds
For the year ended June 30, 1997

	Library of Hawaii Donation and Gifts	Hawaii Public Library Donation and Gifts	Maul Public Library Donation and Gifts	Kauai Public Library Donation and Gifts	Friends of the Library Donation and Gifts	Hawaii Public Library Payroll Collections	Donation for Transcribing Services	Total
Revenues	\$ 16,603	875	45	—	2,000	200	—	19,723
Expenditures	8,260	1,226	45	—	2,601	—	—	12,132
Excess of revenues over (under) expenditures	8,343	(351)	—	—	(601)	200	—	7,591
Fund balance at July 1, 1996	327,907	16,744	1,018	397	3,645	—	18	349,729
Fund balance at June 30, 1997	\$ 336,250	16,393	1,018	397	3,044	200	18	357,320

See accompanying independent auditors' report.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted drafts of this report to the Board of Education and state librarian on February 5, 1998. A copy of the transmittal letter to the state librarian is included as Attachment 1. A similar letter was sent to the Board of Education. The state librarian's response is included as Attachment 2. The Board of Education did not submit a response to our draft report.

The state librarian concurred with several of our recommendations and agreed to review the feasibility of implementing many of our other recommendations. However, he also stated that he hoped we would modify our findings and recommendations. We, along with KPMG Peat Marwick, reviewed the state librarian's response and the additional documentation he provided and we jointly stand by our findings and recommendations.

The state librarian disagreed with our finding that he misrepresented to the Legislature that revenues in the Libraries Special Fund and the Library Fee for Enhanced Services Special Fund would be returned to individual libraries as specified by law. The state librarian contends that he did not make "untrue, incorrect, or misleading representation of the sources of the revenue or expenditure allotment of either special fund." We disagree. Our review of the annual reports for these special funds coupled with our review of the expenditures and balances of both funds indicate: (1) revenues were not distributed to individual libraries as required and as represented in the annual reports, and (2) the special fund balances were insufficient to distribute revenues to individual libraries as represented in the annual reports.

Furthermore, the state librarian's response acknowledges that he did not distribute these funds, because he states that doing so would be improper, illegal, and contrary to general principles of accounting and internal control. To the contrary, while Section 312-3.6 requires that revenues in the Libraries Special fund "be disbursed to each public library, the amount commensurate with the moneys received," the intent of law is to ensure that the moneys collected are distributed or allocated back to the libraries to purchase books or other library materials. Revenues to the Libraries Special Fund consist of fines and fees for overdue or unreturned library materials. The state librarian responded that he complied with the statutory requirements, although the funds were used to pay Baker & Taylor, because the funds were used to purchase library books. We do not agree because the failure to allocate the revenues to the public libraries as required by law deprived each library of the right to identify

and purchase materials which would best meet their individual needs. Instead, Baker & Taylor was allowed to make all purchasing decisions and there was no assurance that materials sent to each library would be commensurate with the moneys received from each library as required by law.

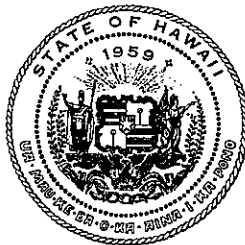
Moreover, the state librarian acknowledges that our 1992 review of the Libraries Special Fund also found that revenues allocated to the libraries were substantially lower than collections and that we recommended that the fund be continued, with the stipulation that allocations to individual libraries be increased. Our current audit indicates that this issue remains unresolved.

The state librarian believes our review of the Library Fee for Enhanced Services was improperly mixed with our review of the Libraries Special Fund and consequently in error. As a reading of our draft would reveal, we reviewed the requirements for each fund separately and found that the respective statutes that established the funds require the revenues from both funds to be distributed or allocated back to the libraries. Moreover, Section 312-22, HRS, clearly states that revenues from the Library Fee for Enhanced Services Special Fund "shall be used by each public library to operate its fee for enhanced services program. Each library shall post in a conspicuous place a list of expenditures made by the library from the special fund during the preceding fiscal quarter." Payments to Baker & Taylor did not comply with these statutory provisions.

The state librarian states that the Office of the Governor and the attorney general disagree with our finding that the transfer of \$500,000 in enhanced services fees into the state's general fund was not in compliance. Again, the law is explicit in establishing the parameters within which transfers from special funds to the state's general fund may occur. According to Section 37-53, "any department may, with the approval of the governor or the director of finance if so delegated by the governor, transfer from any special fund relating to such department to the general revenues of the State all or any portion of moneys determined to be in excess of fiscal year requirements for such special fund, except for special funds under the control of the department of transportation relating to highways, airports, transportation use, and harbor activities, and special funds under the control of the division of community hospitals of the department of health." These requirements were not met. Neither the governor nor the director of finance formally approved the transfers, and the amounts transferred were clearly not in excess of the funds' fiscal year requirements. As we report, the balances in both funds were insufficient to cover the allocations as presented in the annual reports prepared for each fund.

We made a few editorial changes to our draft report for the purposes of clarity, consistency, and style.

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

February 5, 1998

COPY

The Honorable Bartholomew A. Kane
State Librarian
Hawaii State Public Library System
Kekuanao'a Building
465 South King Street, Room B-1
Honolulu, Hawaii 96813

Dear Mr. Kane:

Enclosed for your information are three copies, numbered 20 to 22 of our draft report, *Financial Audit of the Public Library System*. We ask that you telephone us by Monday, February 9, 1998, 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 Friday, February 13, 1998.

The Board of Education, 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,

Marion M. Higa
State Auditor

Enclosures

BENJAMIN J. CAYETANO
GOVERNOR



BARTHOLOMEW A. KANE
STATE LIBRARIAN

STATE OF HAWAII
DEPARTMENT OF EDUCATION
HAWAII STATE PUBLIC LIBRARY SYSTEM

465 SOUTH KING STREET, B-1
HONOLULU, HAWAII 96813

OFFICE OF THE STATE LIBRARIAN

RECEIVED

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OFF. OF THE AUDITOR
STATE OF HAWAII

February 13, 1998

TO: Honorable Marion Higa, State Auditor
Office of the Auditor

FROM: Bartholomew A. Kane
State Librarian

A handwritten signature in cursive script that reads "Bartholomew A. Kane".

SUBJECT: Comments to the Financial Audit
of the Public Library System

Thank you for the opportunity to respond to your draft
Financial Audit of the Public Library System.

I hope the facts and figures I report will cause you to reanalyze your six Summary of Findings and fifteen recommendations. Hopefully, these reanalyses will result in some modification to your findings and recommendations.

Finding #1. "The state librarian misrepresented to the Legislature that revenues in the Libraries Special Fund and Library Fee for Enhanced Services Special Fund would be returned to individual libraries for their needs and programs as specified by law. Instead, approximately \$2 million was used to pay Baker & Taylor and an additional \$500,000 was transferred to the state's general fund between fiscal years 1995-96 and 1996-97."

Black's Law Dictionary (6th ed., 1990) defines misrepresentation as "any manifestation by words or other conduct by one person to another that under the circumstances amounts to an assertion not in accordance with the facts." Commensurate is defined in Bryan Garner's A Dictionary of

Legal Usage (1995) as "(1) co-extensive or
(2) proportionate."

I provided your office with the annual reports to the Legislature on two separate special funds, library fines and lost books special fund and library fee for enhanced services special fund, and my testimony to the Legislature in each of the audited years. In no manner, or words whatsoever, did I make an untrue, incorrect, or misleading representation of the sources of revenue or expenditure allotment of either special fund.

The law for the library fines and lost books special fund states that "the state librarian who shall, unless otherwise directed by the library advisory committee, disburse to each public library, the amount commensurate (emphasis added) with the moneys received from the library under section 312-3.5 over the previous fiscal year."

Your own report in 1992 on your review of special and revolving funds in DCCA, DOE, DOH and DHS to evaluate the appropriateness of special and revolving funds and to recommend whether these funds should be continued, modified, or repeated concluded:

"Recommendation: Continue but increase allocations to libraries. This fund was created in 1989. Its original purpose was to finance some of the cost of books and other library materials purchased by the public libraries. Cash balances indicate the fund has been slow to serve its original purpose. Fines for overdue or lost books are supposed to be used by the individual libraries to purchase books and materials. Expenditures in 1991 were relatively low-of the \$372,000 available, the department expended only \$55,000 and had purchase commitments outstanding of \$211,000. The cash balance will continue to increase as \$350,000 has been allocated to libraries to spend in 1992. This amount is substantially less than the

\$463,000 collected in 1991. There is a direct link between the benefits sought and the charges made upon the users. Individuals who borrow library books are charged fines for overdue library items and the cost of lost or damaged items. The fund should be self-sustaining. The fund meets all three criteria and should be continued. However, in light of the fact, expenditures continue to be less than receipts, allocations to libraries should be increased."

Your management audit of the public library system (98-3) shows legislative appropriations for public libraries fell from \$23,384,867 in FY 93 to \$18,418,895 in FY 97 (p.5). Total revenues for FY 1997 for library fines and lost books was \$885,792.88 and expenditures were \$738,179.00.

The law further provides that "Moneys allocated from the libraries special fund to the public libraries shall be used to purchase books or other library materials." Your finding infers that the approximately \$2 million used to pay Baker & Taylor was used for some purpose other than to purchase books or other library materials. Your inference is false.

The law states the nature, subject, and contents of the annual report to the Legislature and the Governor and has been executed properly since 1989.

You state in your report on page 6: "However, funds have not been returned to individual libraries as represented in these reports." I have attached the delegation of Chief Procurement Officer's Authorities and Duties for Procurement of Goods, Services, and Construction from FY 1995, FY 1996, FY 1997 and FY 1998 and what you infer I should do is improper, illegal, and contrary to general principles of accounting and internal control.

A separate law that established the library fee for enhanced services special fund states: "The special fund shall be administered by the state librarian who, after consultation with the library advisory committee, shall determine the annual amount that each public library shall receive."

(emphasis added) Your office has mixed the two special funds together and erred in your review of the law. The law specifies the nature, subject, and contents of the annual report to the Legislature and the Governor and has been executed properly since 1993.

From the inception of the "Library Special Fund" in 1989, the Fiscal Section had a policy of accumulating the revenues during one year and expending this amount during the second year. This policy was instituted for the following reasons

1. Special funds expenditures and encumbrances cannot exceed total revenues. Under this policy, funds would have been collected and available for expenditures.
2. Each library will have an exact amount to spend during the year. Knowledge of the amount of funding available for the fiscal year would help the library personnel to make decisions on how they will spend the funds. Thus, if they wanted to purchase expensive books or materials, they could use a combination of Special and/or General funds.
3. To minimize errors and misunderstanding. Having a concrete number makes it easier to communicate with library personnel.

This policy was changed for Fiscal Year 1994. From FY 1994, the library system made a projection of revenues for the fiscal year and developed an expenditure plan.

Your management audit of the public library system (98-3) stated: "An additional \$100,000 was improperly transferred to the general fund." (p. 16) The Office of the Governor and the Office of the Attorney General have previously stated that you were wrong in your conclusion that it was improper to transfer \$500,000 in enhanced services fees to the general treasury.

Finding #2. "Liberal borrowing rules have not protected the library systems collection from abuse, loss, and theft."

From an auditor's viewpoint, controlling access to a library collection and tightening borrowing rules may be reasonable; however, from a customer viewpoint and traditional library policy, it may not. Your recommendations will be transmitted to a newly created HSPLS Procedures Review Team that will review them and make a recommendation to the HSPLS' self-directed work teams for a vote. There is no central agency, reference book, nor database for all USA public library policies and procedures; however, there are approximately 15,000 public libraries in the United States, and I will estimate that 95 per cent of them do not limit the number of materials a customer can borrow and have outstanding at any given time, nor require customers to present a picture identification when borrowing library materials. A request will be made to Ameritech DYNIX to determine the feasibility and costs of modifying library software to identify and accrue customer's fines and fees on a daily basis. The HSPLS Procedures Team will review the recommendation to barcode all circulating materials including magazines, which has an exceptionally high staff cost factor.

Finding #3. Inadequate controls over cash receipts increase the risk of fraud and theft. Specifically, cash receipts are not properly safeguarded, reconciliation of cash to daily cash reports is incomplete and untimely, and segregation of duties over cash receipts and over fee and fine waivers is lacking.

Your staff in the financial audit exit interview stated that the HSPLS' interim fiscal guidelines were proper and complete, and that HSPLS' training was appropriate and thorough. HSPLS has established an Internal Audit Team to monitor staff compliance with cash procedures and guidelines. I have attached their reports to this response. We concur with your recommendations and will retrain staff in their proper following of procedures.

Your recommendations #3 and #6 (page 16) will be transmitted to the HSPLS Procedures Review Team for their immediate review and recommendation.

Finding #4. Procedures to monitor outstanding fines and fees and collection efforts are weak. The library system does not utilize an aging report to monitor delinquent accounts.

The use of a collection agency by HSPLS is less than one year in duration. Our current contract does not provide for an aging report or exception report, but this will be transmitted to our contractor for review, cost analysis, and recommendation prior to the contract renewal on March 1, 1999.

Finding #5. Failure to verify library patrons' ages and to update this data could result in improper assessment of overdue fines.

The recommendation to require customers under the age of 18 to show evidence of their birthdate will be transmitted to the HSPLS Procedures Review Team. The recommendation has been already transmitted to Ameritech DYNIX for them to determine the feasibility and costs of reprogramming the DYNIX software for automation age updating.

Finding #6. Contract payments to Baker & Taylor were not subject to contract performance standards. No assurance were made prior to payments that the agreed upon goods would be received or that the contracted services would be performed.

We concur with your recommendation that all future contracts should include provisions requiring that payments made by the library system correlate directly to the performance of the contracted tasks by the vendor or supplier. The Baker & Taylor contract was approved by the Office of the Attorney General and the State Procurement Office. The payment plan as specified in the Baker & Taylor contract would have saved the State approximately \$190,316 in 5-1/4 years.

In conclusion, it was a pleasure for my staff to work with KPMG Peat Marwick LLP. Their audit opinion that no matters involving the internal control over financial reporting and its operation that they considered to be material weaknesses are gratifying. I am pleased that they further found the results of the library system's operations ended in conformity with generally accepted accounting principles.

Thank you for your draft financial audit.

Attach.

