Financial Audit of the Airports Division of the Department of Transportation

A Report to the Governor and the Legislature of the State of Hawai'i

Report No. 99-8
February 1999

THE AUDITOR
STATE OF HAWAI'I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai‘i 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 are 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.

Hawai‘i’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

Financial Audit of the Airports Division of the Department of Transportation

Report No. 99-8, February 1999

Summary

The Office of the Auditor and the certified public accounting firm of KPMG Peat Marwick LLP conducted a financial audit of the Airports Division of the Department of Transportation for the fiscal year July 1, 1997 to June 30, 1998. In the opinion of KPMG Peat Marwick LLP, except for the effects of adjustments (if any) resulting from the Year 2000 issues, the financial statements of the division present fairly the financial position and the results of its operations and cash flow for the year ended June 30, 1998 in conformity with generally accepted accounting principles.

We found significant deficiencies in the Airports Division's procurement process including the failure of the division to ensure competition in the contractor selection process for a new multi-million dollar Airports Management Information System (AIRMIS/2000). Also, one of the contracts to develop and implement this computer system may have been improperly procured as a sole source contract. We found other instances where the division did not comply with the Hawaii Public Procurement Code and administrative rules relating to change orders and small purchases.

We also found that the division did not properly plan for the contracted work relating to the AIRMIS/2000 and contract files for this project were not properly maintained.

We found that ineffective controls over lease renewals and renegotiations and untimely actions on delinquent accounts have resulted in improper billings to lessees and potentially uncollectible lease rents of more than $180,000. Furthermore, the division's ability to monitor and collect outstanding receivables of approximately $50 million is hampered because cash receipts are not applied to specific invoices.

Additionally, controls over the millions of dollars of cash receipts are inadequate. Also, the division needs to evaluate and hasten its Year 2000 remediation efforts. Finally, we found that the division has not formalized an agreement to have Duty Free Shoppers Group LP (DFS) fulfill its original lease fee obligation, and controls over federal grant assurances could be improved.

Recommendations and Response

We recommend that the division maintain competition in the selection of contractors, and adhere to the Hawaii Public Procurement Code and related administrative rules. We also recommend that the division adequately plan for contracted work and maintain an adequate filing system.

We recommend that the division improve its accounts receivable system including its aged accounts receivable ledger. Further, the division needs to enforce collection policies and procedures to minimize past due rents. In addition, the cash receipts function should be properly segregated. We further recommend that the division comply with the State's Year 2000 requirements.

We recommend that the division resolve the delinquent rent from DFS and perform periodic reviews of the bond issuer to ensure that the issuer has the ability to perform under the terms of the concession bond. Finally, we recommend that the division resolve outstanding issues with the U.S. Department of Transportation's Office of the Inspector General, perform thorough reviews of transactions, and maintain closer communications with the Federal Aviation Administration.

The department generally concurs with most of our findings and recommendations. It states that "corrective steps have been initiated or are under discussion." To improve billing and collection practices, the department indicated that it has entered into a contract with the Department of the Attorney General's Civil Recoveries Division to aggressively pursue delinquent accounts. Further, the department stated that the AIRMIS/2000 computer system is anticipated to improve the deficiencies with the aged accounts receivable ledger and will work on segregating the duties over cash receipts. The department acknowledged on-going negotiations with Duty Free Shoppers regarding delinquent rent and promises to review transactions more thoroughly to ensure compliance with grant assurances.

The department disagrees with the finding that the lack of competition in "the contractor selection process may have violated the Hawaii Public Procurement Code." We disagree. This finding did not identify the contractor selection process as violating the Hawaii Public Procurement Code, rather the issue was the division's failure to protect State resources by limiting its contractor selection.

The department also defends its sole source contract with IBM stating that "the current contractor that began the AIRMIS 2000 analysis project, already possessed the background knowledge needed to quickly complete the financial management analysis phase." We disagree with this reasoning. Other contractors could have performed the required assessment for a financial reporting system and provided alternatives for its construction and delivery.

Finally, the department disagrees with our finding that the division has not developed a comprehensive Year 2000 project plan. While we recognize that the division has taken some steps toward Year 2000 compliance, it has yet to complete all critical elements to ensure compliance.

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Financial Audit of the Airports Division of the Department of Transportation

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

Conducted by

The Auditor
State of Hawaii
and
KPMG Peat Marwick LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 99-8
February 1999

Foreword

This is a report of the financial audit of the Airports Division of the Department of Transportation for the fiscal year July 1, 1997 to June 30, 1998. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of KPMG Peat Marwick LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Airports Division and administration of the Department of Transportation.

Marion M. Higa
State Auditor

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Chapter 1
Introduction

This is a report of our financial audit of the Airports Division of the Department of Transportation (Airports Division). 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, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Background

Section 26-19, HRS, requires the Department of Transportation to establish, maintain, and operate transportation facilities of the State, including airports, highways, harbors, and other transportation facilities and activities as may be authorized by law. The department's Airports Division was established on July 1, 1961. The division has jurisdiction over and control of all state airports and air navigation facilities and has general supervision over aeronautics within Hawaii.

The State's airports system consists of sixteen airports which handled 37.3 million passengers during the 1997 calendar year. The Honolulu International Airport, the primary port of entry for Hawaii's international and overseas domestic visitors, was the eighteenth busiest airport in the United States and the thirty-third busiest in the world in 1997. Direct flights from Japan to the Kona International Airport at Keahole began in June 1996. The Airports Division worked with the Barbers Point Naval Air Station Redevelopment Commission to acquire 757 acres at Barbers Point Naval Air Station for use as the Kalaeloa General Aviation Reliever Airport, which is scheduled to commence operation in July 2000.

An economic analysis conducted on the statewide airports system in 1997 estimated that direct revenue generation from airport activities comprised approximately 6.3 percent of the gross state product. Total direct, indirect, and induced impacts accounted for $4.4 billion, or approximately 13.2 percent of the gross state product.

Organization

The Airports Division, headed by the airports administrator, is comprised of four offices and one branch that provide support services and four districts that operate and maintain the airports system. The Oahu, Maui, Hawaii, and Kauai districts are each managed by an airport district manager.

Offices and Branch

Four offices and one branch provide support services for the Airports Division.

The Staff Services Office advises the airports administrator and others on administrative issues and provides coordination and liaison services for legislative matters. In addition, it provides support and guidance through its personnel management; budget; property management and land acquisition; methods, standards, and evaluation; and financial management staff.

The Airports Management Information Systems Office is responsible for planning, designing, and implementing computer systems; operating and maintaining the airport operations control system; providing information systems technology support and training; and developing and administering policies and procedures.

The Aviation Development Office oversees the expansion and diversification of commercial air passenger and cargo services at public airports.

The Airports Operations Office serves as the primary staff for the airports administrator on matters relating to the operations and maintenance of airports and provides advice on compliance with applicable laws, rules, regulations, and standards. This office also provides operational staff support, services, and guidance through its aircraft rescue and firefighting, general aviation, compliance management, certification, and security and safety staff.

The Engineering Branch advises the airports administrator and others on engineering matters and provides engineering support, services, and guidance through its project coordination and control staff, and planning, design, construction, special maintenance, and drafting sections.

Districts

Four districts operate and maintain the State's airports system.

The Oahu District manages, operates, and maintains Honolulu International Airport, Dillingham Airfield and a small airstrip at Ford Island leased from the federal government for general aviation.

The Maui District manages, operates, and maintains Kahului, Hana, West Maui (Kapalua), Lanai, Molokai, and Kalaupapa airports.

The Hawaii District manages, operates, and maintains Hilo International, Kona International at Keahole, Waimea-Kohala, and Upolu airports.

The Kauai District manages, operates, and maintains Lihue and Princeville airports and a general aviation airport at Port Allen.

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 Airports Division; to recommend improvements to such systems, procedures, and reports; and to report on the financial statements of the Airports Division.

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 ascertain the extent to which recommendations contained in Chapter 2 of the State Auditor's *Audit of State Contracting for Professional and Technical Services,* Report No. 95-29, have been implemented.

4. To make recommendations as appropriate.

Scope and Methodology

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the Airports Division for the fiscal year July 1, 1997 to June 30, 1998. We tested financial data to provide a basis to report on the fairness of the presentation of the financial statements. We also reviewed the Airports Division's transactions, systems, and procedures for compliance with applicable laws and regulations.

We examined the existing accounting, reporting, and internal control structure and identified deficiencies and weaknesses therein. We made recommendations for appropriate improvements including, but not limited to, the forms and records, the financial reporting system, and the accounting and operating procedures.

The independent auditors' opinion as to the fairness of the Airport Division's financial statements presented in Chapter 3 is that of KPMG Peat Marwick LLP. The audit was conducted from July 1998 through December 1998 in accordance with generally accepted government auditing standards.

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Chapter 2

Internal Control Deficiencies Persist

Internal controls are steps instituted by management to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Airports Division of the Department of Transportation of the State of Hawaii (Airports Division).

Summary of Findings

We found several reportable conditions involving the Airports Division's internal control over financial reporting and operations. Reportable conditions are significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the division's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

We found the following reportable conditions:

1. Significant deficiencies in the Airports Division's procurement process continue. The failure of the Airports Division to ensure competition in the contractor selection process and to adequately plan for contracted work relating to the new Airports Management Information System (AIRMIS/2000) may cost the State millions of dollars more than originally budgeted. In addition, a possible improper sole source contract was procured for the AIRMIS/2000. We found other instances where the Airports Division did not comply with the Hawaii Public Procurement Code and administrative rules relating to change orders and small purchases.

2. The Airports Division's billing and collection practices need improvement. Ineffective controls over lease renewals and renegotiations and untimely actions on delinquent accounts have resulted in improper billings to lessees and potentially uncollectible lease rents. In addition, the Airports Division's ability to monitor and collect outstanding receivables is hampered because cash receipts are not applied to specific invoices. Further, controls over cash receipts are inadequate as one person deposits, records, and reconciles all cash received by the Financial Management Section of the division.

3. The Airports Division needs to evaluate and hasten its Year 2000 remediation efforts to comply with the State's requirement to process Year 2000 data by September 1999.

In addition to the reportable conditions described above, we found the following:

1. The Airports Division's largest concessionaire, Duty Free Shoppers Group LP (DFS), has not fulfilled its original lease fee obligation. Nonpayment of delinquent lease rent owed by DFS may significantly impact the future operations of the Airports Division.

2. Controls over compliance with federal grant assurances could be improved. The U.S. Department of Transportation's Office of the Inspector General (OIG) reported that the Airports Division did not comply with grant assurances relating to the use of airport revenues for airport purposes. This could result in the return of federal grant moneys and the curtailment of future federal grants.

Weak Controls Result in Continued Procurement Practice and Project Deficiencies

The State Auditor's November 1995 *Audit of State Contracting for Professional and Technical Services*, Report No. 95-29, found that the Airports Division's internal control structure over contractual services was inadequate and failed to safeguard public assets. The State Auditor found that the division did not ensure competition in the contractor selection process and failed to require adequate planning for contracted work. The Auditor recommended that the division follow a competitive negotiation process in selecting contractors and develop and enforce an internal control structure and procedures. However, problems with internal controls and procurement persist. Specifically,

1. The internal controls over the AIRMIS/2000 project are weak. The Airports Division did not ensure competition in the contractor selection process and may have violated the Hawaii Public Procurement Code by entering into a sole source consultant contract. In addition, the division failed to adequately plan for this project and properly maintain contract files.

2. The Airports Division did not comply with the Hawaii Public Procurement Code and related administrative rules on other procurement actions, including price adjustments for contract change orders and small purchase provisions.

Questionable practices over the procurement of the AIRMIS/2000 project

In 1997, the Airports Division began a major initiative to evaluate, consolidate, and reengineer its current information systems into one information system called the Airports Management Information System (AIRMIS/2000). The existing information systems consist of numerous applications developed and enhanced over the years. These aging systems are written in different programming languages, reside on different platforms, and are not Year 2000 compliant.

Undertaking a project of this magnitude requires strong internal controls to ensure that the Airports Division's limited resources are used wisely and that the objectives of the project are met. In addition, Section 103D-301, Hawaii Revised Statutes (HRS), states that unless otherwise authorized by law, all contracts shall be awarded by competitive sealed bidding. Section 3-122-81, Hawaii Administrative Rules (HAR), states that a sole source purchase may be made when there is only one source available from which a particular good or service may be obtained. We found a lack of competition in awarding consultant contracts, possible improper procurement of a sole source contract, and inadequate planning for contracted work. As a result, the AIRMIS/2000 project may cost the Airports Division millions of dollars more than originally budgeted. Although the division has spent more than $3.8 million in consulting fees, it has not begun implementing the most significant component of AIRMIS/2000 and may be forced to repair the existing information subsystems to be Year 2000 compliant.

Lack of competition exists in the contractor selection process

Maintaining competition in the selection of a contractor helps to protect the State's limited resources. Competition provides management with an opportunity to evaluate alternative solutions to meet objectives and to obtain the best solution at a competitive price. However, we found two AIRMIS/2000 contracts totaling more than $3.8 million which lacked competition in the contractor selection process.

In May 1997, the Airports Division solicited proposals for a consulting services project. The project objectives were to: (1) complete a total assessment of the existing information systems, (2) ensure that AIRMIS/2000 is Year 2000 compliant, (3) have at least one of the existing information systems fully integrated and operational in AIRMIS/2000 by the end of the contract period, and (4) provide sufficient training to information systems personnel and end-user staff.

We found that the Airports Division failed to protect State resources by essentially limiting its contractor selection to International Business Machines Corporation (IBM). At the request of the Department of Transportation's administration, the Airports Division specifically required bidders to use the Seer Technologies Integrated Computer Aided Software Engineering (I-CASE) tool and to have extensive experience in the use of the Seer Technologies I-CASE. I-CASE is an automated computer tool used to design, develop, program, and implement software applications. It incorporates a collection of automated and documented methodologies and programs, which allow users to move easily through the complex process of writing applications. In other words, an I-CASE tool simplifies the process of developing computer programs. Since IBM is the only authorized reseller of the Seer Technologies I-CASE tool in Hawaii, the division received only one response to the request for proposal (RFP).

Notably, the Seer Technologies I-CASE tool was procured from IBM by the department as a sole source purchase in April 1997, a month before the division's RFP was issued. The sole source purchase request for the Seer Technologies I-CASE software and user license was projected by the department to cost approximately $150,000. However, our review of two subsequent amendments indicated that this purchase exceeded $450,000.

The State's Information and Communication Services Division requires all application development, requirements/selection, and reengineering projects to adhere to its system development lifecycle methodology tool, Systems Development Methodology (SDM) Structured. However, many consulting firms have successfully shown that their proprietary methodologies are sufficiently similar to SDM Structured and they may use their methodology in lieu of that required by the RFP. In the case of the Airports Division, other consultants were not given the opportunity to demonstrate that their methodologies and I-CASE tools were similar to the required Seer Technologies I-CASE tool.

Other system development tools, such as PowerBuilder and Oracle Developer 2000, along with system development methodologies such as the State's SDM Structured, could have been used to meet the AIRMIS/2000 project objectives. PowerBuilder and Oracle Developer 2000 were previously procured and used to develop the Airports Division's Fiscal Reporting and Cash Management Reporting Systems. It would have been to the division's advantage to allow the proposer to select any suitable I-CASE tool and methodology compatible with the one used by the division. An evaluation of both the I-CASE tool and software solution also should have been part of the contractor selection process. Alternative solutions should have been considered to obtain the best solution at a fair and competitive price.

Possible sole source violation

In February 1998, approximately eight months after it entered into the first contract to develop the AIRMIS/2000, the Airports Division entered into a second contract with IBM for $1.4 million. Terms of this sole source contract required IBM to perform a detailed assessment for a new Financial Management System (FMS) and to provide alternatives for its construction and delivery. However, these services could have been performed by a number of qualified consultants. We were informed that the sole source approval was obtained because the Seer Technologies I-CASE tool was required for the FMS; however, the primary objective of this contract was to assess the existing system and did not require the use of the Seer Technology I-CASE. The contract did not meet the requirements of a sole source contract and should have been subject to competitive bid.

Other procurement violations

The Hawaii Public Procurement Code and the related administrative rules adopted by the Procurement Policy Office establish the compliance requirements that state agencies must follow when purchasing goods and services. We found several instances where the division failed to comply with these procurement provisions and related administrative rules regarding change orders and small purchases.

Noncompliance with provision relating to change orders

Section 3-125-12, HAR, requires that any adjustment in contract price be made in one or more of the following ways: (a) by agreement on a fixed price adjustment before commencement of the pertinent performance or as soon thereafter as practicable, (b) by specified unit prices, (c) by cost attributable to the event, or (d) in such other manner as the parties may mutually agree. We found that the Airports Division did not execute the fixed price adjustments for two change orders in a timely manner as required in (a).

In February 1997, Hawaiian Airlines consolidated its overseas operations with its interisland operations at the Honolulu International Airport's interisland terminal. Due to this consolidation, additional shuttle services were needed to transport Hawaiian Airlines' overseas passengers between the interisland and overseas terminals. Although the Airports Division was notified in October 1992 of Hawaiian Airlines' intention to consolidate its operations, the airline's shuttle service requirements were not included in the division's December 1995 contract for its intra-airport passenger transportation system. Two change orders for the additional shuttle services increased the original contract by $371,763. The first change order for additional shuttle services was for the period August 1, 1996 to July 31, 1997; the second change order was for the period August 1, 1997 to July 31, 1998. These two orders were not prepared and approved until January 1998—seventeen months after the execution of the first change order for additional shuttle services.

The untimely execution of adjustments in contract price exposes the Airports Division to potential litigation and other contractual problems.

Noncompliance with provision relating to small purchases

If expenditures for similar goods or services within a twelve-month period are $10,000 or more (as of the date of procurement), Section 103D-301, HRS, requires the issuance of competitive bids to establish a contract. Furthermore, Section 3-122-74, HAR, states that "small purchases shall not be parceled by dividing the purchase of same, like, or related items of goods or services into several purchases of smaller quantities."

During our review, we found three purchase orders with the same vendor for similar hazardous waste removal services at the Honolulu International Airport on July 23, 1997, July 29, 1997, and August 5, 1997 for $4,478, $6,016, and $4,615, respectively. Because the total of the three purchase orders, $15,109, exceeds the statutory dollar limit, a competitive bid should have been issued to establish a contract.

Section 3-122-75, HAR, also requires the solicitation of at least three written quotations for small purchases at least $1,000 but less than $10,000. Although each of the three purchase orders was supported by copies of solicitations made in the prior year, no price quotations were received and there were no supporting documents in the contract files to explain why the same vendor was awarded all three purchases.

Sound procurement practices require compliance with the Hawaii Public Procurement Code and administrative rules. An estimate of the total cost should have been obtained and an analysis to determine the appropriate form of procurement—small purchase versus competitive bid—should have been performed prior to contracting the hazardous waste removal services.

Inadequate planning of the AIRMIS/2000 project resulted in delays and additional costs

Proper planning for contracted work also helps to protect the State's limited resources and ensures that project objectives are met. The definition of an internal control structure requires that management plan for the proper use of resources. Proper planning entails assessing the need for and priority of a particular project and determining the means to pay for it. It also requires that the scope, outcome, and cost of a project be clearly identified at the outset. We found that the Airports Division has inadequately planned for contract services. Therefore, the division cannot be assured that it receives the required services and deliverables at a fair contract price, and within established deadlines and budgetary constraints.

The Airports Division failed to develop a formal information systems strategic plan for its multi-million dollar AIRMIS/2000 project. An information systems strategic plan includes, but is not limited to, the strategic direction based on the organization's stated goals and objectives, an assessment of existing information technology resources and architecture, and business process reengineering opportunities. A strategic plan also outlines the prioritization, timeline, and cost estimates of all future information technology system implementations.

We also found that the Airports Division did not prepare a formal budget to identify all costs associated with the AIRMIS/2000 project. Without a budget, the division is unable to determine whether the project's objectives can be met within available resources. The lack of a strategic plan and a formal budget has resulted in project objectives not being met and additional costs being incurred beyond those originally expected.

Important subsystem not included in the original project specifications

The Financial Management System (FMS) is the most significant component of AIRMIS/2000 and is critical to the Airports Division's ability to process, report, and analyze financial information. Much of the Year 2000 compliance problems can be attributed to the existing FMS subsystem. However, the assessment of this subsystem was excluded from the scope of the original AIRMIS/2000 contract. The FMS subsystem should have been addressed in the initial planning stages and included in the original contract.

The division's failure to consider the time and cost to implement the FMS has resulted in additional time and expenses incurred to procure a second $1.4 million contract to assess the existing FMS subsystem. We also found that the Airports Division lacked the necessary information to make a prudent decision regarding the second contract. The second contract only included an assessment of the current FMS subsystem and did not include the development and implementation of a new FMS subsystem. The division will need to procure another contract (informally estimated at $7 million) to develop and implement the subsystem. Finally, it is very unlikely that the implementation of the new FMS subsystem will be completed by the Year 2000. The Airports Division may be forced to repair the existing information subsystems to be Year 2000 compliant because of time constraints and the higher than expected cost to implement the FMS subsystem.

Lack of consideration for other software applications

During the systems requirements and selection process, the availability and feasibility of packaged software applications and similar custom developed applications should be studied, documented, and presented for consideration. In general, packaged software applications are more cost effective than custom developments. However, it appears that the Airports Division never considered packaged software applications or applications developed by other airport authorities.

The Airports Division had already decided to custom develop AIRMIS/2000 before the systems requirements and selection process had been determined. Consideration of available packaged software applications and custom applications used by other airport authorities could have saved the Airports Division time, effort, and money.

Proposed contract amendment should have been avoided

Although the second AIRMIS/2000 contract was completed in July 1998 as planned, a contract amendment is currently pending approval. The proposed amendment expands the scope of work to include the design, construction, and delivery of a security application for AIRMIS/2000. The proposed amendment will cost $8,700 for travel expenses and will extend the second contract by five months. However, the contractor's proposal addresses only the delivery of a strategy for the security features and not the actual implementation. The Airports Division's failure to catch this flaw in the proposal will result in additional time and expense to complete the project. Furthermore, the division will be in violation of the Hawaii Procurement Code if it executes the proposed contract amendment. The proposed amendment (to the second contract) actually expands the scope of services of the first contract. We were informed that an amendment to the second contract was proposed because the first contract did not have sufficient funds to cover this amendment. An unrelated amendment to a contract is a violation of the Hawaii Public Procurement Code. The division should have closed the second contract in July 1998 when all its terms had been met.

Contract provision may jeopardize the successful completion of the AIRMIS/2000 project

Proper planning also requires careful review of the terms of a contractual agreement to ensure that the services received will meet the objectives of the project. Our review of the first AIRMIS/2000 contract revealed several areas where the contract's terms were inconsistent with the RFP and do not represent the best interest of the Airports Division.

Although the scope of the contract includes an assessment of the Airports Division's current information system and the design and construction of the Property Management subsystem, the contract also specifies that the completion of the contract could occur when 11,500 hours of work are completed for the project. In other words, the contractor could consider his contractual obligations fulfilled when 11,500 estimated hours of work on this project have passed. The Airports Division has placed itself in a difficult and potentially harmful situation because the contractor may not complete the contracted services before the 11,500 estimated hours is reached.

Contracted scope of services did not address specifications in the request for proposal

Certain requirements specified in the RFP were not addressed in the contract agreement. As discussed earlier, the RFP requested the implementation of a security system, but the contractor's proposal only addressed the delivery of a strategy for the security system. The result was a proposed contract amendment for $8,700 and a five-month extension. The RFP also explicitly required the contractor to provide sufficient training to the end-user staff, but the contractor's proposal indicated that the Airports Division will be responsible for training the end-users. The division will thus incur additional time and money to train its end-users.

The RFP also required that the system have the capability for ad hoc reporting; however, the contractor's Seer Technologies I-CASE tool does not deliver the ad hoc reporting format requested by end-users.

Finally, one of the objectives of the RFP was a Year 2000 compliant system, but the contractor's proposal only promised the design and construction of the Property Management subsystem. These major oversights led to a second contract, a proposed amendment, and additional costs to complete the project. The Airports Division put the State's best interest at risk by failing to thoroughly review and evaluate the contractor's proposal.

Inadequate maintenance of contract files

The Airports Division does not properly maintain its contract files. Maintaining organized and comprehensive contract files enhances the project manager's and other interested parties' ability to access information to ensure compliance with procurement laws and to efficiently monitor contract performance and related contract payments. All contract documents should be maintained and organized in easily accessible contract files.

Our review of various contract files, including the contracts pertaining to the AIRMIS/2000 project, revealed that files are incomplete and decentralized. Contract documents missing from the central files were later found in separate files in the possession of other individuals. We also noted that contract files were located in different areas of the office and were difficult to find. The Airports Division should reassess its contract filing system to ensure that contract files are organized, complete, and easily accessible.

Recommendations

We recommend that the Airports Division:

1. Maintain competition in the selection of contractors;

2. Adhere to the Hawaii Public Procurement Code and related administrative rules;

3. Adequately plan for contracted work by requiring that the scope, outcome, and cost of the project be clearly identified before entering into a contract; and

4. Maintain a filing system that ensures that contract files are organized, complete, and easily accessible.

The Airports Division's Billing and Collection Practices Need Improvement

At June 30, 1998, accounts receivable (net of allowance for uncollectible accounts of $12 million) and operating revenues totaled $45 million and $250 million, respectively. To ensure the accountability over the significant amount of revenue generated by the Airports Division and given the State's current economic situation, the division must implement sound billing and collection procedures.

Problems with deficient billing and collection practices are not new. Previous audits have identified deficiencies in the collection of past due amounts, processing of cash receipts and invoices, and monitoring of new and renewed lease agreements. Although some improvements have been made, certain deficiencies remain and improvements to the Airport Division's billing and collection practices are still needed. The Department of the Attorney General's Civil Recoveries Division has begun to aggressively pursue outstanding accounts of the division and policies and procedures have been revised to expedite the billing process. However, we found a number of instances of improper billings, untimely action on delinquent accounts, ineffective aged accounts receivable ledgers, and inadequate segregation of duties over cash receipts.

Controls over lease renewals and renegotiations are ineffective

The Departmental Staff Manual requires all applications for leases, revocable permits, and other agreements to be processed in a timely manner. When there is a reopening of rent to be paid on a lease, the rental for the ensuing period should be the fair market rental at the time of the reopening. In addition, a tickler file should identify upcoming dates for reopening of rentals and expiration dates of leases. Upon execution of the agreement, the division's Property Management Section should enter billing amounts for new or renewed leases into the accounts receivable system on a timely basis and concurrently notify the division's Financial Management Section of any changes in billing amounts. We found one instance where the expiration of a lease resulted in a tenant not being billed for thirty-eight months and another instance where an increase in rent was not billed to a tenant.

Failure to renew a lease resulted in a tenant not being billed for thirty-eight months

The Property Management Section's tickler file failed to ensure that an expired lease was renewed on a timely basis, resulting in uncollected payments going unnoticed for over two years. In October 1997, the Airports Division's Auditing Unit found that a tenant was not billed for lease rent since October 1994. When the tenant's lease expired in September 1994 the system discontinued billing the tenant. The tenant made rent payments on the expired lease until September 1995, but continued to occupy the space thereafter. In November 1997, a bill for

$64,272 was sent to the tenant for rental charges for the period October 1995 to November 1997 and payment was subsequently received. A revocable permit has since been executed and the tenant is currently being billed on a monthly basis.

An increase in rent was not properly billed

The failure of the division's Property Management Section to update the accounts receivable system resulted in improper billings to a tenant for two years. In a letter dated July 18, 1996, a tenant accepted the Airports Division's increased ground rent proposal of $133,108 annually for the two-year period August 1, 1996 to July 31, 1998. Although the tenant agreed to the new proposal, the Airports Division continued to bill the tenant quarterly lease rents based on the old annual rate of $68,328. The tenant made quarterly payments of less than the accepted $133,108 ground rent proposal but more than the incorrect amount billed by the division. Near the end of this two-year period, the division again changed the annual rent rate to $99,979, retroactive to August 1, 1996. To retroactively amend the lease rent amount near the expiration of a lease period places the State's interest at risk and increases the burden of accurately updating the accounts receivable system.

Although the rent reopening was completed in a timely manner, the Property Management Section failed to update the accounts receivable system to reflect the agreed upon lease rent, resulting in improper billings to the tenant over the two-year period. The division could have identified the incorrect billings by matching rent receipts to billings.

Timely action on delinquent accounts was not taken

Timely termination of leases involving tenants with financial or other problems could reduce the amount of accounts receivable write-offs. On June 30, 1998, approximately $2.5 million of outstanding accounts receivable balances were more than two years past due and considered uncollectible. Our review of outstanding accounts receivable balances revealed two tenants who had outstanding accounts receivable balances and a history of being delinquent but were allowed to continue their tenancy.

The first tenant had delinquent rent payments dating back to 1993. Since then, seven notices of termination were issued and a repayment plan was established in August 1995. However, the tenant was unable to make payments under the repayment plan and has not made a rent payment since September 1995. Two years later, in October 1997, the division sent the tenant a letter requesting compliance with the lease requirements. Finally, in December 1997, another letter was sent requesting compliance and a default and termination notice was issued. When the tenant filed for bankruptcy in March 1998, the outstanding balance was approximately $201,000.

The second tenant had delinquent lease payments from July 1995. Although the tenant became current by July 1996, we found that the Airports Division issued nine notices of termination and agreed to two repayment plans. A recommendation was made by the Financial Management Section to terminate the lease in November 1996 when the outstanding balance was approximately $10,000. When the tenant failed to make payments under either repayment plan, a default and termination notice was issued in November 1997. However, a letter of termination and notice to vacate was not posted until July 1998, shortly thereafter the tenant vacated the premises in July 1998. As of August 1998, the outstanding balance owed by the tenant totaled $81,000.

The Airports Division must strictly enforce collection policies and procedures and take swift action to minimize potential losses from delinquent tenants. Failure to take timely and appropriate action resulted in the accumulation of more than $180,000 of potentially uncollectible rent. The division's untimely action on collecting outstanding balances is imprudent and contributes to the difficult economic situation currently facing the State.

Aged accounts receivable ledger is ineffective

An aged accounts receivable ledger is an effective management tool used to monitor and collect outstanding accounts receivable. However, the Airports Division's aged accounts receivable ledger is programmed to apply all cash receipts to the oldest outstanding balances and does not match receipts to the related invoices. The application of cash receipts to the oldest outstanding balances reduces the effectiveness of the aged accounts receivable ledger and hampers the division's ability to identify, monitor, and collect delinquent accounts. Instead, the division must conduct a time consuming manual review of all billings and cash receipts for a particular account to identify unpaid invoices and the length of time those invoices have been outstanding. Currently, the Airports Division performs a manual review of all signatory airline accounts each month. A manual review is also performed for non-signatory airline accounts at the discretion of the financial management staff, with priority given to accounts that are delinquent and contain large credit balances. Manual reviews of account balances are an inefficient use of the Airports Division's limited staffing resources.

Lack of proper segregation of duties over cash receipts

The Airport Division's Financial Management Section received $27 million in cash receipts in June 1998. One accounting clerk deposits, records, and reconciles all cash received by the section, none of which is reviewed by a supervisor. Improper segregation of duties over depositing, recording, reporting, and reconciling cash receipts increases the possibility of mishandled divisional resources and untimely and inaccurately recorded cash transactions.

Recommendations

We recommend that:

1. The Property Management Section update the accounts receivable system in a timely manner and review its tickler control file to ensure that all billings are properly processed;

2. The Airports Division enforce collection policies and procedures and take immediate action to minimize potential losses from delinquent rents;

3. The Airports Division implement an aged accounts receivable ledger capable of applying cash receipts to the related invoices to effectively identify, monitor, and collect outstanding accounts receivable; and

4. The functions of depositing, recording, reporting, and reconciling cash transactions be segregated in the Financial Management Section to ensure that cash receipts are safeguarded and properly recorded.

The Airports Division Must Evaluate and Hasten Its Year 2000 Remediation Efforts

The Year 2000 is a significant concern that should be addressed as soon as possible to prevent costly and significant application program problems. The Airports Division places heavy reliance on its AIRMIS computer systems and other equipment containing embedded microprocessors to operate the State's airports system and air navigation facilities. The Airports Division must ensure that its information technology systems and other equipment containing embedded microprocessors have the ability to recognize the Year 2000. The Airports Division must also comply with the State's requirement that operating systems be capable of processing Year 2000 data by September 1999.

Ensuring Year 2000 compliance affects the entire Airports Division. Year 2000 compliance not only impacts information technology applications, but also other equipment which may contain embedded microprocessors such as security systems, automated lighting controls, emergency systems, elevators, telephone systems, climate control systems, and automated machinery. Immediate action by the Airports Division is critical because processes that depend on future dates may experience difficulties or failures well in advance of 2000.

We made limited inquiries in connection with the Year 2000 issue, which resulted in several observations. The Airports Division has taken some steps toward Year 2000 compliance, but has yet to complete all critical elements to ensure compliance. The Airports Division must make Year 2000 compliance a top priority. The division has not developed a comprehensive Year 2000 project plan that provides a detailed framework with milestone dates for identification and remediation of all critical information technology and non-information technology applications.

The division has not completed other activities to ensure Year 2000 compliance. A business impact and risk assessment analysis must be performed and documented to assist in identifying all possible sources of potential Year 2000 failures and to prioritize any conflicting remediation tasks. In addition, there must be a complete and accurate inventory of embedded technologies and third party systems, which may be crucial to the uninterrupted operation of the Airports Division's critical business functions. Also, detailed contingency plans must be developed and documented to identify the processes, procedures, and individuals responsible for executing such plans in the event that business-critical systems or vendors providing critical services are not Year 2000 compliant. Finally, a quality assurance and risk management protocol must be developed to confirm that Year 2000 remediation efforts are consistent with the Airports Division's definition of compliance.

Recommendations

To comply with the State's requirement that operating systems be capable of processing Year 2000 data by September 1999, we recommend that the Airports Division:

1. Immediately finalize and adopt a formal Year 2000 project plan to ensure that all assets are compliant. The plan should identify potential Year 2000 failures and risks, milestone dates, methodologies to monitor progress against milestones, expected internal and external resources, testing strategies, and contingency and risk management plans;

2. Inventory and assess all business-critical embedded technologies and third party systems for risk to Year 2000 problems exposure. Confirmation of timely remediation should be made with the appropriate responsible parties and contingency plans developed in the event timely remediation is not achieved;

3. Establish a quality assurance protocol to ensure that risk management issues related to the Year 2000 remediation effort are identified and mitigated on a timely basis and comply with previously established milestone dates; and

4. Establish a Year 2000 executive committee at the administrative level to coordinate the millennium compliance efforts of the Airports Division.

Nonpayment Of Delinquent Concession Fees May Significantly Impact Future Operations

During FY1997-98, approximately $102 million, or 41 percent, of the Airports Division's total operating revenues of $250 million was earned from concession fees under a lease agreement with Duty Free Shoppers (DFS). DFS has not been able to meet its original lease fee obligations since March 1998. Nonpayment of minimum fees owed to the division by DFS will significantly impact the future cash flows of the division and its ability to meet financial requirements contained in revenue bond debt covenants.

In December 1996, the State entered into a concession lease agreement with DFS to operate the in-bond (duty free) concessions at all state airports. The four-year concession lease agreement is effective for the period June 1, 1997 to May 31, 2001 and is secured by a $76.5 million concession bond issued by Royal Hawaiian Insurance Company, Ltd. (RHIC), a wholly-owned subsidiary of DFS. The concession lease agreement stipulates that the annual concession fees paid by DFS be the greater of: (a) a minimum annual guaranty of $102 million for the first year of the lease agreement, $104 million for the second year, $106 million for the third year, and $108 million for the fourth year; or (b) a percentage fee equal to 20 percent of DFS's gross receipts.

DFS is required to make advanced quarterly payments of the minimum annual guaranteed fee on the first day of each June, September, December, and March. If 20 percent of DFS's gross receipts of the preceding quarter exceeds the quarterly amount of the minimum annual guaranty, DFS must pay that amount on or before the twentieth of each June, September, December, and March.

In a letter dated February 19, 1998, DFS requested a deferment of the guaranteed payments. The department granted a 30-day extension and agreed to accept partial payments while it reviewed the request. On March 1, 1998, DFS remitted only $3.5 million of the required $25.5 million minimum fee, which was accepted by the department. DFS has since remitted monthly payments ranging from $4 million to $5 million on its outstanding balance. After considerable discussions, a formal repayment plan has yet to be finalized. The March 31, 1998 deadline has been extended nine times on the condition that DFS continue to remit monthly payments. Between March 1, 1998 and December 1, 1998, DFS has remitted $44 million of the $103.5 million of the minimum fee owed. As of November 1998, a repayment schedule agreement had not been reached. Details regarding interest and additional collateral are still being negotiated and remain unresolved. The deadline has since been extended to December 31, 1998. By December 1, 1998, DFS owed the State approximately $62.4 million in past due concession fees, including $2.9 million in interest and late fees. The Airports Division must continue to monitor this situation carefully and craft an agreement with DFS that protects the interest of the State and ensures that airport operations remain unaffected. Considering the continued moratorium on airport landing fees and significant debt service requirements, the Airports Division should prepare a three-year financial projection to quantify the effects of DFS's deferment on its future operations and cash flows.

It is also incumbent upon the Airports Division to perform periodic reviews of RHIC's financial condition to ensure that RHIC has the financial ability to meet its obligation should DFS be unable to fulfill its lease obligation. Although the Airports Division has obtained the state insurance commissioner's assurances that RHIC is in compliance with captive insurance laws, the Airports Division has yet to formally assess RHIC's ability to perform under the terms of the concession bond.

Recommendations

We recommend that the Airports Division continue to work closely with DFS to resolve this matter. The finalized agreement must contain provisions that meet the Airports Division's cash flow requirements and provide adequate collateral in the event of nonpayment. We also recommend that the Airports Division develop a three-year financial projection to quantify the effects of DFS's deferment and perform periodic reviews of RHIC and its ability to perform under the terms of the concession bond.

Controls Over Compliance With Grant Assurances Could Be Improved

The federal Airport and Airway Improvement Act of 1982, as amended, requires that the Department of Transportation comply with certain grant assurances as a condition precedent to approval of a Federal Aviation Administration (FAA) grant. One of the grant assurance requirements set forth in Section 511(a)(12) of the act requires airport-generated revenues to be used for capital and operating costs of the Airports Division. Failure to comply with grant provisions could result in the return of FAA grant moneys and curtailment of future FAA grants.

The Airports Division is responsible for ensuring that all airport-generated revenues are used for capital and operating costs. This can be accomplished only by performing a thorough review for compliance with grant assurances and obtaining FAA approval prior to executing transactions that may possibly be construed by the U.S. Department of Transportation's Office of the Inspector General (OIG) as unrelated airport transactions. Our review of two OIG audit reports, dated April 28, 1995 and September 19, 1996, disclosed several alleged instances of noncompliance with grant assurance, which could have been avoided if the Airports Division performed a thorough review and obtained prior FAA approval.

In its September 19, 1996 audit, the OIG alleged that the Airports Division used $7.4 million in 1991 to buy land and to widen and expand the Hana Highway. Hana Highway, which is the main state highway near Kahului Airport on Maui, is off-airport and is owned and operated by the Department of Transportation's Highways Division (Highways Division). The State contends that the expansion of Hana Highway was done to compensate for the planned closing of the Haleakala Highway due to the extension of the runway safety zone at the Kahului Airport.

The OIG contended that the widening of Hana Highway was not consistent with grant assurances requiring that airport revenues be used for capital and operating costs of the Airports Division because the expanded portion of Hana Highway may be turned over to the Highways Division and the portion of the Haleakala Highway which is supposed to be closed remains open due to public pressure. The Airports Division anticipates that Haleakala Highway will be closed within two years. The OIG has recommended that the FAA withhold payments on current grants and approval of future grants until the airport revenues used to widen Hana Highway are refunded.

In addition, the Airports Division purchased land for the construction of a new access road and interchange at Kahului Airport. As of December 1995, the cost of the project totaled $7.1 million. When the construction is completed, the Highways Division will assume some control and maintenance of the access road and interchange; however, the specifics of what portion of the project will be transferred to the Highways Division and the purchase thereof have not been finalized.

The OIG contended that the costs associated with this project were not in accordance with grant assurances requiring that airport revenues be used for capital and operating costs of the Airports Division because there was no written agreement stating that the Airports Division would receive equivalent benefit from the airport resources used. The OIG has recommended that the FAA withhold payments on current grants and approval of future grants until such time that the benefit to be received by the Airports Division is determined, and any amounts expended in excess of this benefit are refunded. The department asserts that the road widening and new access road at Kahului Airport are responsive to the airport's need for better access and egress. However, these matters have not been resolved with the OIG.

In its September 19, 1996 audit, the OIG also alleged that the Airports Division did not receive revenue for the use of airport property by six sponsor organizations at eight airport sites. The OIG contended that the Airports Division lost revenues of about $6.5 million during fiscal years 1993 through 1995 and will continue to lose approximately $2.4 million annually.

The OIG also contended that the lost revenues were a diversion of airport revenues to the sponsor organizations and has recommended that the FAA withhold payments on current grants and approval of further grants until the $6.5 million in lost revenues is refunded to the Airports Division. The department has negotiated and drafted a lease acceptable to the FAA for one of the eight airport sites. The department has asserted that the remaining sites are on surplus property and proposed that the Board of Land and Natural Resources withdraw the lands at issue from the airport property. However, this matter has not been resolved with the OIG.

The OIG additionally alleged that the Airports Division received approximately $3 million of ineligible cost reimbursements from several federal grant projects. Specifically, the OIG questioned costs related to landscaping and an off-airport road widening project at the Kahului Airport and maintenance costs at the Honolulu International Airport. The OIG questioned the Airports Division's proration of eligible costs for an energy monitoring and control system at the Honolulu International Airport and for the construction of rescue and firefighting buildings at the Kahului and Lihue Airports. The OIG recommended that the FAA recover the ineligible cost reimbursements.

The department has disputed these findings and believes that it has valid arguments. These matters have not been resolved with the OIG.

Thorough review of transactions for compliance with grant assurances and procurement of prior approval from the FAA by the Airports Division could have prevented the OIG audit findings and the time consuming efforts needed to resolve them. In addition, this lack of review has unnecessarily jeopardized present and future FAA grants.

Recommendations

We recommend that the Airports Division continue its efforts to resolve these matters expeditiously. In the future, the Airports Division should perform thorough reviews of transactions that may be construed by the OIG as improper use of airport revenues and maintain closer communications with the FAA regarding the use of airport revenues.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Airports Division, Department of Transportation, State of Hawaii (Airports Division), as of and for the fiscal years ended June 30, 1998 and 1997. This chapter includes the independent auditors' report and the report on compliance and internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* as they relate to the Airports Division. It also displays financial statements together with explanatory notes and supplementary information.

Summary of Findings

In the opinion of KPMG Peat Marwick LLP, based on their audits, except for the effects of such adjustments, if any, as might have been determined to be necessary had they been able to examine evidence regarding Year 2000 disclosure, the financial statements present fairly, in all material respects, the financial position of the Airports Division as of June 30, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles. KPMG Peat Marwick LLP noted certain matters involving the internal control over financial reporting and its operations that they considered to be reportable conditions. They also noted that the results of their tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

The Auditor
State of Hawaii:

We have audited the balance sheets of the Airports Division, Department of Transportation, State of Hawaii (Airports Division), as of June 30, 1998 and 1997, and the related statements of revenues, expenses and changes in retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Airports Division's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the Year 2000 issue. The Airports Division has included such disclosures in note 14. Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Airports Division's disclosures with respect to the Year 2000 issue made in note 14. Further, we do not provide assurance that the Airports Division is, or will be, Year 2000 ready, that the Airports Division's Year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Airports Division does business will be Year 2000 ready.

As discussed in note 1 to the financial statements, the financial statements present only the activities of the Airports Division and are not intended to present fairly the financial position of the State of Hawaii and the results of its operations, and the cash flows of its proprietary fund type in conformity with generally accepted accounting principles.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding Year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Airports Division as of June 30, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 7, 1998 on our consideration of the Airports Division's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

The supplementary information included in Schedules I through VIII is presented for purposes of additional analysis and is not a required part of the financial statements of the Airports Division. Such information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

/s/ KPMG Peat Marwick LLP

Honolulu, Hawaii
December 7, 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 financial statements of the Airports Division, Department of Transportation, State of Hawaii (Airports Division), as of and for the year ended June 30, 1998, and have issued our report thereon dated December 7, 1998, which was qualified because insufficient audit evidence exists to support the Airports Division's disclosures with respect to the Year 2000 issue. Except as discussed in the preceding sentence, 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 Airports Division's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. However, we noted certain immaterial instances of noncompliance, which we have reported to the Auditor, State of Hawaii, in Chapter 2 of this report.

Internal Control Over Financial Reporting
In planning and performing our audit, we considered the Airports Division's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control

over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Airports Division's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. The issues we consider to be reportable conditions are described in Chapter 2 of this report.

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness. We also noted other matters involving the internal control over financial reporting, which we have reported to the Auditor, State of Hawaii, in Chapter 2 of this report.

This report is intended for the information and use of the Auditor, State of Hawaii, and the management of the Airports Division and is not intended to be and should not be used by anyone other than these specified parties.

/s/KPMG Peat Marwick LLP

Honolulu, Hawaii
December 7, 1998

Description of Financial Statements and Supplementary Information

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

Balance Sheets (Exhibit A). These statements present the assets, liabilities, contributed capital and retained earnings of the Airports Division at June 30, 1998 and 1997.

Statements of Revenues, Expenses and Changes in Retained Earnings (Exhibit B). These statements present revenues, expenses and the changes in retained earnings of the Airports Division for the fiscal years ended June 30, 1998 and 1997.

Statements of Cash Flows (Exhibit C). These statements present cash flows from operating, capital and related financing and investing activities of the Airports Division for the fiscal years ended June 30, 1998 and 1997.

Operating Revenues and Operating Expenses Other Than Depreciation (Schedule I). This schedule presents operating revenues and expenses other than depreciation of the Airports Division for the fiscal year ended June 30, 1998.

Calculations of Net Revenues and Taxes and Debt Service Requirement (Schedule II). This schedule summarizes the excess of net revenues and taxes over debt service requirement for the airports system revenue bonds for the fiscal year ended June 30, 1998.

Summary of Total Debt Service Requirements to Maturity (Schedule III). This schedule summarizes the total debt service requirements to maturity at June 30, 1998 for the outstanding airports system revenue bonds and for the outstanding general obligation bonds which are reimbursable to the State of Hawaii.

Debt Service Requirements to Maturity - Airports System Revenue Bonds (Schedule IV). This schedule summarizes the debt service requirements to maturity for the outstanding airports system revenue bonds at June 30, 1998.

Debt Service Requirements to Maturity - General Obligation Bonds (Schedule V). This schedule summarizes the debt service requirements to maturity for the outstanding general obligation bonds at June 30, 1998 which are reimbursable to the State of Hawaii.

Airports System Charges - Fiscal Year 1995-97 Lease Extension (Schedule VI). This schedule summarizes airline activity and airports system charges for the fiscal year ended June 30, 1998.

Approved Maximum Revenue Landing Weights and Airport Landing Fees - Signatory Airlines (Schedule VII). This schedule summarizes the approved maximum revenue landing weights and adjusted airport landing fees for each of the signatory airlines for the fiscal year ended June 30, 1998.

Approved Maximum Revenue Landing Weights and Airport Landing Fees - Nonsignatory Airlines (Schedule VIII). This schedule summarizes the approved maximum revenue landing weights and adjusted airport landing fees for each of the nonsignatory airlines for the fiscal year ended June 30, 1998.

Notes to Financial Statements

Explanatory notes which are pertinent to an understanding of the financial statements and financial condition of the Airports Division are discussed in this section.

Note 1 - Summary of Significant Accounting Policies

Reporting Entity

The Airports Division, Department of Transportation, State of Hawaii (Airports Division), was established on July 1, 1961 to succeed the Hawaii Aeronautics Commission under the provisions of Act I, Hawaii State Government Reorganization Act of 1959, Second Special Session Laws of Hawaii. The Airports Division has jurisdiction over and control of all State of Hawaii (State) airports and air navigation facilities and general supervision of aeronautics within the State. The Airports Division currently operates and maintains sixteen airports located throughout the State.

Measurement Focus and Basis of Accounting

The accounting policies of the Airports Division conform to generally accepted accounting principles as applicable to enterprise activities of governmental units as promulgated by the Governmental Accounting Standards Board (GASB). In accordance with GASB standards, the Airports Division has elected to apply all applicable Financial Accounting Standards Board pronouncements on accounting and reporting that were issued on or before November 30, 1989.

An enterprise fund is used to account for the acquisition, operation and maintenance of government facilities and services that are entirely or predominantly supported by user charges. The Airports Division's operations are accounted for on the flow of economic resources measurement focus and the accrual basis of accounting is utilized. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Cash and Cash Equivalents

Cash and cash equivalents for the purpose of the statements of cash flows includes all cash and investments (including certificates of deposit, repurchase agreements and U.S. government securities) with original maturities of three months or less.

Investments

Effective July 1, 1997, the Airports Division adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investment Pools* (Statement 31). This statement establishes accounting and financial reporting standards for all investments held by governmental external investment pools and establishes fair value standards for other governmental entities. Accordingly, the Airports Division has stated its investments at fair value. Changes in the fair value of investments are recognized in the statements of revenues, expenses and changes in retained earnings.

The adoption of Statement 31 as of July 1, 1997 had no significant cumulative effect on retained earnings. Accordingly, no restatement of beginning retained earnings has been considered necessary.

Prior to July 1, 1997, investments in certificates of deposit and repurchase agreements were stated at cost and investments in U.S. government securities were stated at amortized cost.

Property, Plant and Equipment

Property, plant and equipment acquired by purchase or construction are recorded at cost. Contributed property is recorded at fair market value at the time received. Depreciation has been provided over the estimated useful lives using the straight-line method.

The estimated useful lives are as follows:

Class of assets	Estimated useful lives
Land improvements	20 years
Buildings and improvements	20 to 45 years
Machinery and equipment	10 years

Disposals of assets are recorded by removing the costs and related accumulated depreciation from the accounts with the resulting gain or loss reflected in operations.

Repairs and maintenance, minor replacements, renewals and betterments are charged against operations for the year.

Major replacements, renewals and betterments are capitalized in the year accrued. Interest cost is capitalized during the period of construction for all capital improvement projects except the portion of projects funded by grants from the federal government.

In accordance with industry practice, depreciation on assets acquired with federal grants is reflected as an offset against contributed capital after first being considered in the determination of net income.

Reserves for Revenue Bond Requirements

As required by the airports system revenue bond indenture, appropriate restricted assets (reserves) have been established for debt service and other required reserve accounts.

Bond Issue Costs and Unamortized Debt Discount

Bond issue costs relating to the issuance of airports system revenue bonds are deferred and are amortized ratably over the terms of the bonds or the sinking fund redemption dates. The unamortized debt discount relating to these bonds is amortized using the effective interest method over the term of the related bonds and is offset against the long-term debt in the balance sheets.

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.

Employees' Retirement System

The Airports Division's contributions to the Employees' Retirement System of the State of Hawaii (ERS) are based on the current contribution rate determined by the State Department of Budget and Finance. The Airports Division's policy is to fund its required contribution annually.

Vacation

Employees are credited with vacation at rates of 168 or 240 hours per calendar year, depending upon their job classification. Accumulation of such vacation credits is limited to 720 or 1,056 hours at calendar year-end and is convertible to pay upon termination of employment. Such vacation credits are recorded as accrued wages at the balance sheet date.

Use of Estimates

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

Note 2 - Cash and Cash Equivalents and Investments

Cash and cash equivalents and investments at June 30, 1998 and 1997 consisted of the following:

	1998	1997
Cash in State Treasury	$ 25,300,499	$ 33,705,896
Certificates of deposit	397,003,755	230,538,417
Repurchase agreements	446,677,174	516,073,639
U.S. government securities	9,021,311	23,310,063
	$ 878,002,739	$ 803,628,015

Such amounts are reflected in the balance sheets at June 30, 1998 and 1997 as follows:

	1998	1997
Cash and cash equivalents:		
Unrestricted	$ 254,432,741	$ 259,910,631
Restricted	100,160,479	75,942,406
Total cash and cash equivalents	354,593,220	335,853,037
Investments:		
Unrestricted	352,273,500	343,470,735
Restricted	171,136,019	124,304,243
Total investments	523,409,519	467,774,978
Total cash and cash equivalents and investments	$ 878,002,739	$ 803,628,015

All cash and cash equivalents are held in the State Treasury. At June 30, 1998 and 1997, information relating to the insurance and collateral of cash deposits was not available since such information is determined on a statewide basis and not for individual departments or divisions. Cash deposits of the State are covered by federal deposit insurance or by collateral held either by the State Treasury or by the State's fiscal agent in the State's name.

Statutes authorize the Airports Division to invest, with certain restrictions, in obligations of the State or the United States, and in federally insured savings accounts, certificates of deposit and repurchase agreements with federally insured financial institutions. Money held as reserves may be invested in obligations of the United States, the State or any subdivision of the State. Investments are insured or collateralized with securities held by the State or by its agent in the State's name.

At June 30, 1998 and 1997, the investments in U.S. government securities, which were purchased through Bank of Hawaii by the State Treasury, were held in custody by Bank of Hawaii for the account of the Airports Division.

The following schedule summarizes the fair value and cost of the Airports Division's investments at June 30, 1998 and 1997:

	1998		1997	
	Fair value	Cost	Fair value	Cost
Certificates of deposit	$ 221,083,946	$ 221,083,946	$ 119,595,162	$ 119,595,162
Repurchase agreements	293,304,262	293,304,262	324,869,753	324,869,753
U.S. government securities	9,021,311	9,020,078	23,259,051	23,310,063
	$ 523,409,519	$ 523,408,286	$ 467,723,966	$ 467,774,978

The fair value of U.S. government securities is based on current market prices. The fair value of nonparticipating certificates of deposit and repurchase agreements are reported using a cost-based measure. The increase in fair value of investments (unrealized gains) at June 30, 1998 amounted to $1,233.

Note 3 - Property, Plant and Equipment

The following is a summary of property, plant and equipment at June 30, 1998 and 1997:

	1998	1997
Land	$ 256,847,853	$ 256,259,382
Land improvements	599,045,559	584,139,371
Buildings and improvements	1,173,914,420	1,148,714,299
Machinery and equipment	146,775,623	130,561,858
Construction in progress	101,939,435	166,645,181
	2,278,522,890	2,286,320,091
Less accumulated depreciation	669,424,204	596,975,698
	$1,609,098,686	$1,689,344,393

During 1998 and 1997, the Airports Division expensed approximately $45,794,000 and $31,274,000, respectively, of costs capitalized as construction in progress to adjust the carrying values to estimated net realizable values. Those adjustments to construction in progress are included in loss on disposal of property, plant and equipment in the accompanying statements of revenues, expenses and changes in retained earnings.

In July 1997, the U.S. government condemned certain airport property for a federal detention center and deposited $9,000,000 with the U.S. District Court for the District of Hawaii. In August 1997, those proceeds, along with interest earnings of $83,967, were transferred to the Airports Division. A gain on disposal of property, plant and equipment amounting to $9,000,000 has been reported in the accompanying 1998 statement of revenues, expenses and changes in retained earnings as a component of loss on disposal of property, plant and equipment.

Note 4 - Airports System Revenue Bonds

In 1969, the Director issued the "Certificate of the Director of Transportation Providing for the Issuance of State of Hawaii Airports System Revenue Bonds" (Certificate) under which $40,000,000 of revenue bonds were initially authorized for issuance. Subsequent issues of revenue bonds were covered by first through twenty-fifth supplemental certificates to the original 1969 Certificate.

These revenue bonds are payable solely from and collateralized solely by the revenues generated by the Airports Division including all aviation fuel taxes levied. The Certificate established an order of priority for the appropriation, application or expenditure of these revenues as follows:

a. To pay when due all bonds and interest. Payment shall be provided from the following accounts:

    1. Interest account
    2. Serial bond principal account
    3. Sinking fund account
    4. Debt service reserve account

b. To pay or provide for the payment of the costs of operation, maintenance and repair of airport properties.

c. To fund the major maintenance, renewal and replacement account.

d. To reimburse the State General Fund for general obligation bond requirements.

e. To provide for betterments and improvements to the airports.

f. To provide such special reserve funds and other special funds as created by law.

g. To provide for any other purpose connected with or pertaining to the bonds or the airports authorized by law.

The Certificate requires that the Airports Division impose, prescribe and collect revenues which will yield net revenues and taxes at least equal to 1.35 times the total interest, principal and sinking fund requirements for the ensuing 12 months. The Airports Division is also required to maintain adequate insurance on its properties.

For purposes of calculating the required amounts to be credited to the interest, serial bond principal, sinking fund, debt service reserve, and major maintenance, renewal and replacement accounts (collectively referred to as revenue bond debt service reserve accounts), the Certificate stipulates that investments be valued at the lower of their face amount or fair value. At June 30, 1998, amounts credited to the revenue bond debt service reserve accounts were in accordance with applicable provisions of the Certificate.

At June 30, 1998 and 1997, the revenue bond debt service reserve accounts (reported as restricted assets in the accompanying balance sheets) consisted of the following:

	1998	1997
Debt service reserve account	$ 123,707,000	$123,804,266
Major maintenance, renewal and replacement account	17,132,408	12,966,953
	140,839,408	136,771,219
Principal and interest due July 1, 1998	76,308,057	—
	$ 217,147,465	$136,771,219

At June 30, 1998, $48,457,443 of airports system revenue bonds were authorized but unissued.

The revenue bonds are subject to redemption at the option of the Department of Transportation (DOT) and the State during specific years at prices ranging from 102% to 100%.

On July 1, 1996, the DOT redeemed $2,040,000 of its outstanding Series of 1972 at 100%, $8,870,000 of its outstanding Series of 1977 at 100% and $27,900,000 of its outstanding Series of 1986 at 102-1/2%.

The following is a summary of airports system revenue bonds issued and outstanding at June 30, 1998 and 1997:

Series	Interest rate	Final maturity date (July 1)	Original amount of issue	Outstanding amount 1998	Outstanding amount 1997
1990	6.45-7.375	2020	$ 100,000,000	$ 92,995,000	$ 94,580,000
1990, second	6.60-7.5	2020	200,000,000	186,375,000	189,470,000
1991	5.70-7.0	2020	200,000,000	190,100,000	193,590,000
1991, second	5.40-7.0	2021	400,000,000	381,490,000	387,995,000
1992, refunding	2.80-5.25	2000	19,400,000	8,995,000	11,570,000
1993, refunding	4.00-6.45	2013	131,035,000	119,895,000	123,610,000
1994, first refunding	4.15-5.60	2004	63,455,000	54,385,000	59,205,000
1994, second refunding	4.40-5.85	2004	79,070,000	58,870,000	67,680,000
1994, third refunding	3.75-5.75	2009	94,045,000	85,045,000	88,045,000
			$1,287,005,000	1,178,150,000	1,215,745,000
	Less unamortized discount			10,656,809	11,813,472
	Less current portion			37,100,000	74,695,000
				$1,130,393,191	$1,129,236,528

On June 30, 1997, principal and interest payments due on July 1, 1997 amounting to $77,815,220 were transferred to a fiscal agent and reported as cash with fiscal agent in the accompanying 1997 balance sheet. The principal and interest payments due on July 1, 1998 were transferred to the fiscal agent on July 1, 1998.

The current portion of airports system revenue bonds at June 30, 1998 and 1997 consisted of the following:

	1998	1997
Maturing July 1, 1998 and 1997, respectively	$ 37,100,000	$37,595,000
Amounts required to be funded currently	—	37,100,000
	$ 37,100,000	$ 74,695,000

Maturities and sinking fund requirements due for airports system revenue bonds, including interest of $963,946,612, in each of the next five years and thereafter, are as follows:

Year ending June 30:	
1999	$ 118,054,000
2000	118,102,000
2001	122,195,000
2002	122,230,000
2003	122,303,000
Thereafter	1,502,112,612
	$ 2,104,996,612

The following is a summary of interest costs incurred for the years ended June 30, 1998 and 1997 and the allocation thereof:

	1998	1997
Expensed as incurred	$ 77,229,759	$ 78,448,623
Capitalized in plant and equipment	3,805,441	4,787,706
	$ 81,035,200	$ 83,236,329

Note 5 - General Obligation Bonds

The Airports Division reimburses the State for the portion of debt service on several general obligation bonds issued by the State, the proceeds of which were used to finance various airport projects.

The following is a summary of such general obligation bonds reimbursable by the Airports Division at June 30, 1998 and 1997:

Series	Interest rate	Final maturity date	Original amount of issue	Outstanding amount 1998	Outstanding amount 1997
BX	5.15 - 6.00	2002	$ 904,241	$ 401,885	$ 502,356
CD	3.85 - 5.00	2003	391,319	244,547	293,471
CF	3.25 - 5.50	2002	1,938,982	1,077,145	1,292,574
CI	4.00 - 5.00	2011	141,392	122,537	131,964
			$ 3,375,934	1,846,114	2,220,365
	Less current portion			374,000	374,000
				$ 1,472,114	$ 1,846,365

Maturities of general obligation bonds, including interest of $258,413, in each of the next five years and thereafter are as follows:

Year ending June 30:	
1999	$ 459,000
2000	442,000
2001	424,000
2002	405,000
2003	285,000
Thereafter	89,527
	$ 2,104,527

The following is a summary of interest costs incurred for the years ended June 30, 1998 and 1997 and the allocation thereof:

	1998	1997
Expensed as incurred	$ 92,509	$136,316
Capitalized in plant and equipment	4,558	6,294
	$ 97,067	$142,610

Note 6 - Leases

Airport-Airline Lease Agreement

The Airports Division had an airport-airline lease agreement with certain major airline carriers (signatory airlines) which expired on July 31, 1992. The expired lease agreement provided the lessees with the nonexclusive right to use the airports system facilities, equipment, improvements and services, in addition to occupying certain premises and facilities. From August 1, 1992 through June 30, 1993, the signatory airlines continued operations under monthly negotiated agreements with the DOT.

In January 1994, the DOT and the signatory airlines executed a letter agreement to extend the expired airport-airline lease agreement to June 30, 1994. Under the terms of the letter agreement, the signatory airlines continued to operate under the terms of the expired airport-airline lease agreement, with an adjustment for terms and provisions relating to airports system rates and charges (adjusted retroactively to July 1, 1993), which included airport landing fees, airports system support charges, nonexclusive joint use premise charges for terminal rentals (overseas terminal, new inter-island terminal and the international arrivals building) and exclusive use premise rentals. The letter agreement further stipulated that the aggregate of all such rates and charges, together with aviation fuel taxes (as adjusted for aviation fuel tax credits), payable to the DOT by the signatory airlines would not exceed $84,175,000.

In June 1994, the DOT and the signatory airlines executed a lease extension agreement to extend the expired airport-airline lease agreement effective July 1, 1994 to June 30, 1997. Under the terms of the lease extension agreement, the signatory airlines would continue to operate under the terms of the expired airport-airline lease agreement, with an adjustment for terms and provisions relating to airports system rates and charges. The nature of these charges were similar to those of the expired letter agreement; however, the lease extension agreement did not stipulate a maximum amount for aggregate airports system charges. Instead, the lease extension agreement's residual rate-setting methodology provided for a final year-end reconciliation containing actual airports system cost data to determine whether airports system charges assessed to the signatory airlines were sufficient to recover airports system costs, including debt service requirements under the Certificate. Annual settlements based on this final reconciliation were made in accordance with the terms of the lease extension agreement. This final reconciliation resulted in a net underpayment by the signatory airlines of $2,299,665 for fiscal year 1998 and a net overpayment of $1,743,522 for fiscal year 1997, which have resulted in a decrease and an increase, respectively, in deferred income in the accompanying balance sheets.

The DOT and the signatory airlines have mutually agreed to continue to operate under the terms of the lease extension agreement which provides for an automatic extension on a quarterly basis unless either party provides 60 days written notice to the other party of termination.

Moratorium On Airport Landing Fees and Airports System Support Charges

In September 1997, the Governor announced the DOT's implementation of a two-year moratorium (effective September 1, 1997) on airport landing fees and airports system support charges assessed to signatory and nonsignatory airlines. The Governor reserved the right to reinstate the airport landing fees and airports system support charges before the two-year period ends. Airport landing fees and airports system support charges aggregated to $3,933,321 and $34,932,362 for fiscal years 1998 and 1997, respectively.

Amendments to the Administrative Rules were approved by the Governor in February 1998 to retroactively suspend airport landing fees and airports system support charges for nonsignatory airlines.

Prepaid Airport Use Charge Fund

In August 1995, the DOT and the signatory airlines entered into an agreement to extend the prepaid airport use charge fund (PAUCF). During fiscal year 1998, the parties agreed to transfer $2,200,000 of the signatory airlines' payments over the required airports system charges for the fiscal years 1997 and 1996 into the PAUCF and the Airports Division then paid $2,200,000 out of the PAUCF to the signatory airlines. During fiscal year 1997, $2,000,000 of the net excess signatory airlines' receipts for fiscal year 1995 was transferred into the PAUCF and the Airports Division paid $4,000,000 out of the PAUCF to the signatory airlines.

Aviation Fuel Tax

The aviation fuel tax amounted to $3,527,963 and $3,674,762 for fiscal years 1998 and 1997, respectively. In May 1996, the State Department of Taxation issued a tax information release that effective July 1, 1996, the Hawaii fuel tax will not apply to the sale of bonded aviation/jet fuel to air carriers departing for foreign ports or arriving from foreign ports on stopovers before continuing on to their final destination.

Airports System Rates and Charges

Signatory and nonsignatory airlines were assessed the following airports system rates and charges:

For fiscal years 1998 and 1997, airport landing fees, net of aviation fuel tax credits of $3,328,679 and $3,500,674, respectively, amounted to $3,854,843 and $34,370,967, respectively, and were established to recover airports system costs allocable to the airfield activity centers. Airport landing fees are based on a computed rate per 1,000 pound units of approved maximum landing weight for each aircraft used in revenue landings. The inter-island airport landing fees for signatory airlines are set at 36% of the airport landing fees for overseas flights for fiscal years 1998 and 1997. The inter-island airport landing fees for nonsignatory airlines are set at 32% of the airport landing fees for overseas flights for fiscal years 1998 and 1997.

Nonexclusive joint use premise charges for terminal rentals amounted to $27,732,606 and $27,600,084 for fiscal years 1998 and 1997, respectively. Overseas and inter-island joint use premise charges were established to recover airports system costs allocable to the overseas and inter-island terminals joint use space based on terminal rental rates and are recovered based on a computed rate per revenue passenger landing.

Effective July 1, 1996, a joint use premise charge for the neighbor isle terminals at Kahului Airport, Kona International Airport at Keahole, Lihue Airport, and Hilo International Airport was established to recover from signatory airlines airports system costs allocable to the baggage claim, baggage tug drive and joint use baggage makeup areas based on terminal rental rates and are recovered based on a computed rate per revenue passenger landing in accordance with the lease extension agreement. Effective March 1, 1997, a blended overseas joint use charge was established to recover costs allocable to Hawaiian Airlines, Inc.'s consolidated terminal operations at the Honolulu International Airport. International arrivals building charges were established to recover airports system costs allocable to the international arrivals area based on terminal rental rates and are recovered based on a computed rate per deplaning international passenger using the international arrivals area.

Exclusive use premise charges amounted to $25,278,608 and $24,823,584 for fiscal years 1998 and 1997, respectively, and are computed using a fixed rate per square footage per year. Exclusive use premise charges for terminal rentals amounted to $15,629,018 and $15,420,096 for fiscal years 1998 and 1997, respectively.

Airports system support charges amounted to $78,478 and $561,395 for fiscal years 1998 and 1997, respectively, and were established to recover all remaining residual costs of the airports system. Airports system support charges were established by Administrative Rules for nonsignatory airlines. Those rates are based on a computed rate per 1,000 pound units of approved maximum landing weight for each aircraft used in revenue landings. The airports system inter-island support charges for nonsignatory airlines are set at 32% of airports system support charges for overseas flights for fiscal years 1998 and 1997.

The following summarizes the rates in effect at June 30, 1998 and 1997:

	1998	1997
Airport landing fees:		
Signatory airlines:		
Overseas flights	$ —	$ 1.930
Inter-island flights	—	.695
Nonsignatory airlines:		
Overseas flights	—	2.980
Inter-island flights	—	.954
Nonexclusive joint use premise charges:		
Overseas and inter-island terminal joint use charges:		
Signatory airlines:		
Overseas terminal	449.016	450.297
Blended overseas	350.045	348.288
Inter-island terminal	67.111	60.757
Nonsignatory airlines:		
Overseas terminal	457.344	457.344
Inter-island terminal	69.375	69.375
International arrivals building charges:		
Signatory airlines	3.038	3.115
Nonsignatory airlines	3.346	3.346

Neighbor isle terminals joint use charges – Signatory airlines	11.853	12.226
Airports system support charges – Nonsignatory airlines:		
Overseas flights	—	.618
Inter-island flights	—	.198

Special Facility Leases and Revenue Bonds

The Airports Division has four special facility lease agreements with Delta Airlines, Inc. (merged with Western Airlines, Inc. in 1987), with Continental Airlines, Inc. in July 1990 and November 1997 and with Caterair International Corporation in December 1990. The construction of the related facilities was financed by special facility revenue bonds issued by the Airports Division in the amounts of $2,300,000, $20,000,000, $25,255,000 and $6,600,000, respectively. These bonds are payable solely from and collateralized solely by certain rentals and other moneys derived from the special facility. Other pertinent information on the aforementioned bonds is summarized hereunder.

$2,300,000 Issue

Bonds with a stated maturity date of June 1, 2005 remain outstanding. The bonds bear interest at 6.50% per annum. The bonds are subject to early redemption, at the option of the Airports Division, at 100% of principal.

The bond maturity dates, including amounts subject to mandatory redemption at par, are as follows:

Maturity date (June 1)	Principal amount
1999	$ 120,000
2000	130,000
2001	140,000
2002	150,000
2003	160,000
Thereafter	355,000
	$1,055,000

$20,000,000 Issue

The bonds are subject to redemption on or after June 1, 2000, at the option of the Airports Division, upon the request of Continental Airlines, Inc., at prices ranging from 102% to 100% of principal depending on the dates of redemption or, if the facilities are destroyed or damaged extensively, at 100% plus interest.

The bond maturity dates, including amounts subject to mandatory redemption at par and the interest rates thereon, are as follows:

Maturity date (June 1)	Interest rate	Principal amount
1999	9.60%	$ 275,000
2000	9.60	300,000
2001	9.60	325,000
2002	9.60	375,000
2003	9.60	400,000
Thereafter	9.60 - 9.70	17,125,000
		$ 18,800,000

$25,255,000 Issue

The bonds are subject to redemption on or after November 15, 2007, at the option of the Airports Division, upon the request of Continental Airlines, Inc., at prices ranging from 101% to 100% of principal depending on the dates of redemption or, if the facilities are destroyed or damaged extensively, at 100% plus interest.

The bonds bear interest at 5.625% per annum. Interest only payments are due semi-annually on May 15 and November 15 of each year until the bonds mature on November 15, 2027, at which time the entire principal amount is due.

$6,600,000 Issue

The bonds are subject to redemption on or after December 1, 2000, at the option of the Airports Division, upon the request of Caterair International Corporation, at prices ranging from 103% to 100% of principal depending on the dates of redemption or, if the facilities are destroyed or damaged extensively, at 100% plus interest.

The bonds bear interest at 10.125% per annum. The bond maturity dates, including amounts subject to mandatory redemption at par, are as follows:

Maturity date (December 1)	Principal amount
1998	$ 200,000
1999	200,000
2000	200,000
2001	200,000
2002	200,000
Thereafter	3,500,000
	$4,500,000

Special facility revenue bonds payable at June 30, 1998 and 1997 consisted of the following:

	Delta (Western)	Continental		Caterair	Total
1998:					
Current portion	$ 120,000	$ 275,000	$ —	$ 200,000	$ 595,000
Noncurrent portion	935,000	18,525,000	25,255,000	4,300,000	49,015,000
	$1,055,000	$18,800,000	$ 25,255,000	$4,500,000	$49,610,000
1997:					
Current portion	$ 110,000	$ 250,000	$ —	$ 300,000	$ 660,000
Noncurrent portion	1,055,000	18,800,000	—	4,500,000	24,355,000
	$1,165,000	$19,050,000	$ —	$4,800,000	$25,015,000

The special facility leases are accounted for and recorded as direct financing leases. The remaining lease payments to be paid by the lessees (including debt service requirements on the special facility revenue bonds) are recorded as an asset and the special facility revenue bonds outstanding are recorded as a liability in the accompanying balance sheets.

Net investments in direct financing leases at June 30, 1998 and 1997 consisted of the following:

	1998	1997
Cash with bond fund trustee	$15,210,338	$ 6,222,342
Receivable from lessees (net of unearned interest of $72,975,691 and $33,635, 515 in 1998 and 1997, respectively)	34,399,662	18,792,658
Interest receivable	372,866	200,418
	$49,982,866	$25,215,418

Other Operating Leases

The Airports Division also leases certain building spaces and improvements to concessionaires, airline carriers and other airport users. The terms of these leases range from 4 to 15 years for concessionaires and up to 35 years for other airport users. Information regarding the cost and related accumulated depreciation of these facilities, which is required to be disclosed by Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, is not provided because the accumulation of such data was not considered practical and because the information, when compared to the future minimum rentals to be received, would not be an accurate indication of the productivity of the property on lease or held for lease, due to the methods by which and the long period of time over which the properties were acquired.

The future minimum rentals from these operating leases at June 30, 1998 are as follows:

Year ending June 30:	
1999	$ 144,443,000
2000	137,113,000
2001	113,307,000
2002	11,366,000
2003	10,764,000
Thereafter	111,469,000
	$ 528,462,000

The leases with concessionaires are generally based on the greater of a percentage of sales or a basic minimum. Percentage rents included in concession fees for fiscal years 1998 and 1997 were approximately $24,237,000 and $24,673,000, respectively.

Concession fees revenues from the DFS Group L.P. (DFS) concession contract accounted for approximately 59% of total concession fees revenues for fiscal years 1998 and 1997.

The DFS concession contract, effective June 1, 1997, provides for payment of 20% of gross sales against minimum guarantee payments aggregating $420,000,387 over the four-year contract. The previous concession contract with DFS, effective from June 1, 1993 through May 31, 1997, provided for payment of 20% of gross sales against minimum guarantee payments aggregating $401,000,387 over the four-year contract. Deferred income related to the DFS concession contract amounted to $17,333,333 and $17,000,000 at June 30, 1998 and 1997, respectively.

In February 1998, DFS requested a deferment of its minimum guaranteed payments. Since March 1998, DFS has been unable to meet its required concession fee payments. The DOT has granted 30 day extensions from March 1998 through December 1998 and has agreed to accept monthly payments while it reviews the request. No formal extension agreement has been executed as of November 1998. The DFS accounts receivable balance (including interest and late fees) amounted to approximately $36,400,000 at June 30, 1998.

During fiscal year 1997, the Airports Division received lease assignment consent fees from DFS and MJR Corporation, amounting to $5,400,000 and $1,318,715, respectively. In October 1997, the Airports Division received an additional $600,000 from DFS as a final settlement. These consent fees are being amortized over the remaining lease terms, and are included in miscellaneous operating revenues in the accompanying statements of revenues, expenses and changes in retained earnings. Deferred income related to the consent fees amounted to $2,313,742 and $3,435,630 at June 30, 1998 and 1997, respectively.

Note 7 - Pension Information

The Airports Division contributes to the ERS, a cost-sharing multiple-employer public employee retirement system established to administer a pension benefit program for all state and county employees. The ERS was established by Chapter 88 of the Hawaii Revised Statutes and is governed by a Board of Trustees. All contributions, benefits and eligibility requirements are established by Chapter 88 of the Hawaii Revised Statutes and can be amended by legislative action.

Members of the ERS belong to either a contributory or noncontributory plan. Prior to June 30, 1984, the ERS consisted of only a contributory plan. In 1984, legislation was enacted to create a new noncontributory plan 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 plan. The noncontributory plan provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory plan or to elect the new noncontributory plan and receive a refund of employee contributions. Both plans provide death and disability benefits and cost-of-living adjustments.

The ERS issues a financial report that includes financial statements and required supplementary information. The report may be obtained by writing to The Employees' Retirement System of the State of Hawaii, City Financial Tower, 201 Merchant Street, Suite 1400, Honolulu, Hawaii, 96813.

Members of the contributory plan are required to contribute 7.8% of their annual covered salary. Measurement of assets and actuarial valuations are made for the entire ERS and are not separately computed for individual participating employers such as the Airports Division. The current contribution rate is approximately 14.5% of annual covered payroll as determined by the State Department of Budget and Finance. The Airports Division's contributions to the ERS for the years ended June 30, 1998, 1997 and 1996 were $4,615,109, $4,389,226 and $3,971,164, respectively, which were equal to the required contributions for each year.

Note 8 - Postretirement 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 Airports Division 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 plan and age 55 with at least 5 years of service under the contributory plan. 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 Airports Division as accrued. The amounts allocated to the Airports Division for fiscal years 1998 and 1997 aggregated approximately $2,099,000 and $1,542,000, respectively.

Effective July 1, 1996, certain changes were made to the postretirement medical benefits offered to employees hired after June 30, 1996. The State will pay 50% of the monthly medical insurance premiums for those 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 9 - Transactions With Other Government Agencies

The State assesses a surcharge of 5% for central service expenses on all receipts of the Airports Division, after deducting any amounts pledged, charged or encumbered, for the payment of bonds and interest during the year. The assessments amounted to $7,142,091 and $10,213,295 in fiscal years 1998 and 1997, respectively.

The Airports Division is assessed a percentage of the cost of the general administration expenses of the DOT. The assessments amounted to $1,544,993 and $2,686,805 in fiscal years 1998 and 1997, respectively. During fiscal years 1998 and 1997, the Airports Division received assessment refunds from the DOT amounting to $1,428,912 and $1,936,652, respectively. Such refunds reduced operating expenses other than depreciation in the accompanying 1998 and 1997 statements of revenues, expenses and changes in retained earnings.

Note 10 - Supplemental Information – Noncash Investing, Capital and Financing Activities

During the years ended June 30, 1998 and 1997, the Airports Division's noncash investing, capital and financing activities included the following:

a. Federal and state grant claims, recorded as contributed capital, amounted to $10,543,120 and $3,021,769 in fiscal years 1998 and 1997, respectively.

b. Principal and interest payments relating to the special facility revenue bonds amounted to $660,000 and $2,954,938, respectively, for fiscal year 1998, and $730,000 and $2,464,000, respectively, for fiscal year 1997. Related accrued interest at June 30, 1998 and 1997 amounted to $372,866 and $200,418, respectively. Special facility revenue bonds of $25,255,000 were issued in 1998 when the Airports Division entered into a special facility lease agreement with Continental Airlines, Inc.

c. Amortization of revenue bond issue costs and bond discount amounted to $1,462,430 and $1,156,663, respectively, for fiscal year 1998, and $1,533,190 and $1,262,706, respectively, for fiscal year 1997.

Note 11 - Commitments

Sick Pay

Sick leave accumulates at the rate of 14 or 20 hours per month of service without limit, depending on the employee's job classification, but can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an Airports Division's 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 with the ERS. Accumulated sick leave at June 30, 1998 and 1997 aggregated approximately $13,907,000 and $13,142,000, respectively.

Deferred Compensation Plan

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

GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans* (Statement 32), was issued October 1997, and is effective for periods beginning after December 31, 1998. Early implementation is required when plan assets are held in trust under the requirements of the Internal Revenue Code (IRC) Section 457, subsection (g). Subsection (g) requires that all amounts of compensation deferred under the plan as well as property and rights purchased with those amounts and income attributable to those amounts, be held in trust for the exclusive benefit of participants and their beneficiaries. Effective July 1, 1997, the State adopted the requirements of the IRC Section 457, subsection (g). Accordingly, the State implemented the provisions of Statement 32 during the year ended June 30, 1998.

Other

At June 30, 1998, the Airports Division had commitments totaling approximately $64,332,000 for construction and service contracts.

Note 12 - Risk Management

The Airports Division 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 Airports Division is involved in various actions, the outcome of which, in the opinion of management, will not have a material adverse effect on the Airports Division's financial position. Losses, if any, are either covered by insurance or will be paid from legislative appropriations of the State General Fund, except as described in note 13.

Property and Liability Insurance

The Airports Division is covered under the statewide insurance program of the State. Under this program, the Airports Division has property damage insurance for losses that may occur from fire, windstorm and other occurrences of $200 million per occurrence. For earthquake and flood, property coverage is for $50 million per occurrence. Deductibles for windstorm losses are 2-1/2% of values at each location with a minimum of $250,000 and maximum of $2.5 million. For other lines of coverage the deductible is $250,000. The program includes a $10 million public employee faithful performance insurance policy with a $50,000 deductible per occurrence.

In addition, the Airports Division has a comprehensive general liability policy with loss coverage of $250 million for each occurrence and in the aggregate, with coverage of $100,000 for fire damage losses.

Workers' Compensation

The State is self-insured for workers' compensation. Accordingly, the Airports Division is liable for all workers' compensation claims filed by its employees. Liabilities for workers' compensation claims are established if information indicates that it is probable that liabilities have been incurred and the amount of those claims can be reasonably estimated. The basis for estimating the liabilities for unpaid claims include the effects of specific incremental claim adjustment expenses, salvage, and subrogation, and other allocated or unallocated claim adjustment expenses. These liabilities include an amount for claims that have been incurred but not reported. At June 30, 1998 and 1997, the workers' compensation reserve amounted to $2,600,000 and $2,300,000, respectively, and is included in other current liabilities (payable from current assets) in the accompanying balance sheets. In the opinion of management, the Airports Division has adequately reserved for such claims.

At June 30, 1998 and 1997, changes in the workers' compensation reserve resulted from the following:

	1998	1997
Workers' compensation reserve at beginning of year	$2,300,000	$2,300,000
Incurred claims	1,279,000	849,000
Payments on claims	(979,000)	(849,000)
Workers' compensation reserve at end of year	$2,600,000	$2,300,000

Note 13 - Contingent Liabilities and Other

Ceded Lands

The lands transferred to the United States by the Republic of Hawaii at Hawaii's annexation to the United States in 1898 are commonly referred to as the ceded lands. Upon Hawaii's admission to the Union in 1959, title to ceded lands still held by the United States and to lands which the United States acquired by exchanges for ceded lands after 1898 was conveyed by the United States to the State. Section 5 of the Admission Act expressly provided that those lands were to be held by the State as a public trust. Portions of lands underlying certain airports (primarily Honolulu International Airport, Hilo International Airport and Kona International Airport at Keahole) are situated on parcels of land which are to be held by the State as a public trust under Section 5.

In 1978, the State Constitution was amended to expressly specify that the lands conveyed to the State as a public trust by the Admission Act were to be held by the State as a public trust for native Hawaiians and the general public, and to establish the Office of Hawaiian Affairs (OHA) to administer and manage the proceeds and income derived from the pro rata portion of the lands held by the State for the betterment of native Hawaiians.

Beginning in fiscal year 1992 and through the third quarter of fiscal year 1996, the Airports Division made payments from airport revenues to OHA for the use of ceded lands which are part of the Airports Division. The Airports Division made payments to OHA equal to 20% of gross proprietary revenues generated by the Airports Division on a site-specific basis.

An audit report dated September 19, 1996, issued by the Office of the Inspector General, U.S. Department of Transportation (OIG), questioned the Airports Division's quarterly payments from airport revenues to OHA, since 1992, for the use of ceded lands, under the Airport and Airway Improvement Act of 1982 (AAIA). In response to the OIG's audit report, the Governor directed the Airports Division to hold payments from airport revenues to OHA for the use of ceded lands until the concerns raised by the OIG were fully resolved. The fourth quarter of fiscal year 1996 payment of $1,876,750 was held and deposited into the Airports Division's trust fund account. Payments for all four quarters of fiscal year 1997 were also held and deposited into the Airports Division's trust fund account. In April 1997, the Federal Aviation Administration (FAA) adopted the OIG's position and referred the matter to the U.S. Department of Transportation.

Subsequently, the State reassessed its earlier position, and determined that the OIG and FAA were correct in concluding that the Airports Division's quarterly payments to OHA since 1992 for the use of ceded lands was barred by the AAIA. In August 1997, the Governor rescinded the earlier directive to hold and deposit payments for OHA in the Airports Division's trust fund account. The entire balance of five quarters' payments for OHA, which had been held and deposited in the trust fund account pursuant to the rescinded directive, was restored to the Airport Revenue Fund.

On October 27, 1997, the Department of Transportation and Related Agencies Appropriations Act, Public Law 105-66 (Act), was enacted. Included among the Act's provisions are:

a. Findings that past payments from airport revenues for the betterment of native Hawaiians constitute illegal diversions of airport revenues;

b. A termination of repayment responsibility for any payment of airport revenues made to native Hawaiians for the use of ceded lands prior to April 1, 1996, including any responsibility to repay the $28,200,000 in ceded land payments the Airports Division made to OHA between 1992 and April 1, 1996 and any lost interest income which resulted from making those payments which the OIG demanded from the Airports Division in the September 19, 1996 audit report; and

c. A prohibition against any further payment of airport revenues for claims related to ceded lands, whether characterized as operating expenses, rent, or otherwise, and whether related to claims for periods of time prior to or after the Act's effective date.

Accordingly, no operating expenses for the use of ceded lands were recorded and no payments were made to OHA by the Airports Division in fiscal years 1998 and 1997. In addition, the Airports Division reversed the fourth quarter payment accrual of $1,876,750, which decreased operating expenses other than depreciation in the accompanying 1997 statement of revenues, expenses and changes in retained earnings.

Litigation

The State is subject to a number of lawsuits arising in the ordinary course of its airport operations, including the matter relating to taxi service described below.

The operator of the taxi management system at the Honolulu International Airport has filed a lawsuit against the State, alleging that the State made certain promises but failed to follow through (e.g., eliminate prearranged taxi service operations, supply electrical service to the taxi operator's office, provide adequate security to oversee taxi operations, and grant the taxi operator the exclusive right to oversee airport taxi operations). The taxi operator is demanding damages in excess of $1,000,000. Trial date in this case is set for July 1999.

The State is vigorously contesting the aforementioned lawsuits. 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 Airports Division's financial position. In addition, the State has not determined whether the ultimate liabilities, if any, will be imposed on the Airport Revenue Fund. Accordingly, no provisions for any liabilities that might result have been made in the accompanying financial statements.

Arbitrage

In compliance with the requirements of Section 148 of the Internal Revenue Code of 1986, as amended, the Airports Division is required to annually calculate rebates due to the U.S. Treasury on the airports system revenue bonds issued since 1986. Rebates are calculated by bond series based on the amount by which the cumulative amount of investment income exceeds the amount that would have been earned had funds been invested at the bond yield. In the opinion of management, rebates payable as of June 30, 1998, if any, are not material to the financial statements. Accordingly, no rebates payable have been recorded in the accompanying financial statements.

Other

In an audit report dated April 28, 1995, the OIG concluded that airport revenues were used to purchase certain parcels of land on the island of Oahu that were not needed for airport purposes. The OIG contended that $64.4 million in airport revenues, excluding lost interest of $6.5 million, were not used for airport purposes. As such, the transaction was found not to be in compliance with grant assurances made by the DOT relating to the use of the Airport Revenue Fund. The OIG recommended that the FAA initiate procedural steps necessary to reach a final determination regarding noncompliance with grant assurances and ensure that the State returns the $64.4 million, along with the $6.5 million in lost interest, to the Airports Division. The State did not contest the OIG's findings and, in January 1997, restored to the Airport Revenue Fund the $64.4 million used to acquire the land.

In March 1998, the State negotiated a reimbursement with the Airports Division to resolve the matter of the lost interest. As of June 30, 1998, the issues relating to the land acquisition and lost interest have been resolved.

In another audit report the Airports Division received from the OIG dated September 19, 1996, which was previously discussed in the section related to ceded lands and the Airports Division's payments to OHA for the use of ceded lands, the OIG also questioned the Airports Division's:

a. Receipt of approximately $3,000,000 of ineligible cost reimbursements;

b. Use of airport revenues to pay approximately $14,500,000 for an off-airport road widening and new access road project near the Kahului Airport without determining whether the Airports Division received an equal benefit; and

c. Nonreceipt of approximately $6,500,000 in rental revenues from six sponsor organizations for the use of airport property from 1993 to 1995.

With respect to these questioned items, the OIG recommended that the FAA: (1) recover approximately $3,000,000 for ineligible cost reimbursements, (2) ensure that only eligible projects receive Airport Improvement Program funds, (3) ensure that the Airports Division is reimbursed $6,500,000 for sponsor occupied airport property, (4) review the road widening and new access road at Kahului Airport to ensure that airport revenues are recovered as appropriate, (5) ensure that airport revenues are used only for airport purposes, and (6) ensure that the sponsor pays market rental rates for use of airport property.

The matter of airport revenues used to pay OHA for ceded land payments has been resolved with the federal legislation enacted on October 27, 1997, as described previously. The DOT has disputed the OIG's claims relating to ineligible cost reimbursements, and has asserted that the road widening and new access road at Kahului Airport are responsive to the airport's need for access and egress. Because the findings of the OIG are in dispute and because the Airports Division's management believes that it has valid arguments, no liability arising from the OIG's audit findings has been recorded in the accompanying financial statements. The DOT is presently discussing these matters with the FAA.

Note 14 - Year 2000 (Unaudited)

The Airports Division is currently in the process of evaluating and correcting its potential Year 2000 issue and has created a project team to address both its information technology (IT) systems and other equipment containing embedded microprocessors. The Airports Division's goal is to be Year 2000 ready by July 31, 1999.

The Airports Division has substantially completed the awareness stage and has established a project plan to complete the assessment, remediation and testing stages for its IT systems and other equipment containing embedded microprocessors. The inventory and assessment of the IT hardware, infrastructure, and application software have been completed. The hardware and software from IT systems are currently being updated or replaced for Year 2000 readiness. The testing and validation of the IT systems are in progress. Infrastructure providers, servicers and others whose Year 2000 compliance could affect the Airports Division are being solicited for information regarding the status of their Year 2000 issues. Preparation of contingency plans are also in process.

A matrix has been developed for equipment containing embedded microprocessors to assist in the prioritization of the Airports Division's Year 2000 efforts. The Airports Division is in the process of inventorying its equipment containing embedded microprocessors. Essential systems under remediation include the video monitoring and access control system, the fire annunciation system, the energy monitoring control system, the flight information display system, the air conditioning, the people mover systems and the public address system.

At June 30, 1998, the Airports Division had commitments totaling approximately $1,681,000 relating to its Year 2000 remediation efforts.

Any failure by the Airports Division or by third parties on which the Airports Division relies upon to be Year 2000 ready could adversely affect the operations of the Airports Division. Accordingly, management cannot provide assurances that all matters associated with Year 2000 issues will be identified and cured.

Exhibit A

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Balance Sheets

June 30, 1998 and 1997

Assets	**1998**	**1997**
Current assets:		
Cash and cash equivalents (including certificates of deposit and repurchase agreements of $234,656,892 in 1998 and $233,099,545 in 1997) (note 2)	$ 254,432,741	$ 259,910,631
Investments (note 2)	352,273,500	343,470,735
Receivables:		
Accounts receivable (net of allowance for uncollectible accounts of $11,783,000 in 1998 and $13,050,000 in 1997) (note 6)	45,400,675	12,087,652
Interest	8,660,116	8,365,493
Claims receivable – federal grants	1,449,417	224,331
Due from State of Hawaii	698,404	—
Aviation fuel tax	287,537	274,275
Total receivables	56,496,149	20,951,751
Inventory of materials and supplies, at cost	233,654	233,158
Total current assets	663,436,044	624,566,275
Restricted assets:		
Current:		
Cash and cash equivalents (including certificates of deposit and repurchase agreements of $94,635,829 in 1998 and $69,047,596 in 1997) (note 2):		
Revenue bond debt service (note 4)	46,011,446	12,966,976
Revenue bond construction	51,895,590	60,846,729
Security deposits	2,253,443	2,128,701
Total cash and cash equivalents – restricted	100,160,479	75,942,406
Investments (note 2):		
Revenue bond debt service (note 4)	171,136,019	123,804,243
Revenue bond construction	—	500,000
Total investments – restricted	171,136,019	124,304,243
Cash with fiscal agent	—	77,815,220
Total restricted current assets	271,296,498	278,061,869
Net investments in direct financing leases (note 6)	49,982,866	25,215,418
Total restricted assets	321,279,364	303,277,287
Property, plant and equipment, at cost, less accumulated depreciation (notes 3, 4, 5 and 13)	1,609,098,686	1,689,344,393
Bond issue costs (net of accumulated amortization of $9,918,792 in 1998 and $8,456,362 in 1997)	14,970,482	16,432,912
	$ 2,608,784,576	$ 2,633,620,867

(Continued)

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Balance Sheets

June 30, 1998 and 1997

Liabilities, Contributed Capital and Retained Earnings	**1998**	**1997**
Current liabilities (payable from current assets):		
Vouchers payable	$ 1,853,749	$ 2,935,031
Contracts payable (including retainage of $1,988,335 in 1998 and $1,644,930 in 1997)	6,888,454	6,603,773
Current portion of general obligation bonds (note 5)	374,000	374,000
Deferred income (note 6)	20,294,532	25,582,752
Accrued wages (including vacation of $5,358,625 in 1998 and $5,083,479 in 1997)	8,889,917	5,453,871
Prepaid airport use charge fund (note 6)	114,000	114,000
Due to State of Hawaii	—	1,163,048
Other (note 12)	6,677,438	4,905,108
Total current liabilities (payable from current assets)	45,092,090	47,131,583
Current liabilities (payable from restricted current assets):		
Contracts payable (including retainage of $2,502,504 in 1998 and $2,636,280 in 1997)	3,177,345	4,916,603
Current portion of:		
Airports system revenue bonds (note 4)	37,100,000	74,695,000
Special facility revenue bonds (note 6)	595,000	660,000
Accrued interest	39,621,638	40,420,639
Security deposits	2,253,443	2,128,701
Total current liabilities (payable from restricted current assets)	82,747,426	122,820,943
Total current liabilities	127,839,516	169,952,526
Long-term liabilities (net of current portion):		
General obligation bonds (note 5)	1,472,114	1,846,365
Airports system revenue bonds (net of unamortized discount of $10,656,809 in 1998 and $11,813,472 in 1997) (note 4)	1,130,393,191	1,129,236,528
Special facility revenue bonds (note 6)	49,015,000	24,355,000
Total liabilities	1,308,719,821	1,325,390,419
Contributed capital:		
Federal grants (net of accumulated depreciation of $106,994,066 in 1998 and $96,590,174 in 1997)	238,956,455	238,817,227
State of Hawaii grants	4,949,287	4,949,287
Airport lessees	5,038,146	5,038,146
Total contributed capital	248,943,888	248,804,660
Retained earnings:		
Reserved for revenue bond requirements:		
Debt service reserve account	123,740,035	123,740,035
Major maintenance, renewal and replacement account	15,000,000	15,000,000
Total reserved	138,740,035	138,740,035
Unreserved	912,380,832	920,685,753
Total retained earnings	1,051,120,867	1,059,425,788
Commitments and contingencies (notes 6, 7, 8, 11, 12 and 13)		
	$ 2,608,784,576	$ 2,633,620,867

See accompanying notes to financial statements.

Exhibit B

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Statements of Revenues, Expenses and Changes in Retained Earnings

Years ended June 30, 1998 and 1997

	1998	1997
Operating revenues (notes 4 and 6):		
Concession fees	$ 174,111,548	$ 170,484,774
Aeronautical rentals:		
Nonexclusive joint use premise charges	27,732,606	27,600,084
Exclusive use premise charges	25,278,608	24,823,584
Nonaeronautical rentals	9,217,126	11,570,000
Airport landing fees	3,854,843	34,370,967
Aviation fuel tax	3,527,963	3,674,762
Airports system support charges	78,478	561,395
Miscellaneous	6,148,372	6,324,147
Total operating revenues	249,949,544	279,409,713
Operating expenses other than depreciation (notes 7, 8, 9, 11, 12 and 13)	125,158,064	119,248,811
Operating income before depreciation	124,791,480	160,160,902
Depreciation	73,512,592	72,630,158
Operating income	51,278,888	87,530,744
Nonoperating revenues (expenses):		
Interest income:		
Certificates of deposit, repurchase agreements and U.S. government securities	44,043,117	38,533,124
Investments in direct financing leases (note 6)	3,127,386	2,458,081
Other	85,200	19,946
Interest expense:		
Revenue bonds:		
Airports system (note 4)	(77,229,759)	(78,448,623)
Special facility (note 6)	(3,127,386)	(2,458,081)
General obligation bonds (note 5)	(92,509)	(136,316)
Loss on disposal of property, plant and equipment (note 3)	(36,793,750)	(31,287,577)
Total nonoperating expenses, net	(69,987,701)	(71,319,446)
Net income (loss)	(18,708,813)	16,211,298
Add depreciation expense on assets acquired with federal grants transferred to contributed capital	10,403,892	10,457,206
Retained earnings at beginning of year	1,059,425,788	1,032,757,284
Retained earnings at end of year	$ 1,051,120,867	$ 1,059,425,788

See accompanying notes to financial statements.

Exhibit C

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Statements of Cash Flows

Years ended June 30, 1998 and 1997

		1998		1997
Cash flows from operating activities:				
Operating income	$	51,278,888	$	87,530,744
Adjustments to reconcile operating income to net cash provided by operating activities:				
Depreciation		73,512,592		72,630,158
Provision for uncollectible accounts		(1,267,000)		150,000
Decrease (increase) in assets:				
Accounts receivable		(32,046,023)		(604,432)
Aviation fuel tax receivable		(13,262)		251,762
Inventory of materials and supplies		(496)		(1,735)
Increase (decrease) in liabilities:				
Vouchers payable		(1,081,282)		348,310
Contracts payable		(1,454,577)		3,655,170
Deferred income		(5,288,220)		3,345,754
Accrued wages		3,436,046		446,899
Prepaid airport use charge fund		—		(2,000,000)
Due to Office of Hawaiian Affairs (note 13)		—		(1,876,750)
Due to/from State of Hawaii		(1,447,983)		1,523,328
Other		1,817,217		(463,185)
Security deposits		124,742		(662,975)
Net cash provided by operating activities		87,570,642		164,273,048
Cash flows from capital and related financing activities:				
Proceeds from federal grants		8,904,565		3,686,838
Acquisition and construction of capital assets		(35,250,636)		(31,679,772)
Proceeds from disposition of land (notes 3 and 13)		9,000,000		64,400,000
Principal paid on general obligation bonds		(374,251)		(474,469)
Interest paid on airports system revenue and general obligation bonds		(39,309,290)		(80,591,814)
Principal paid on airports system revenue bonds		—		(37,595,000)
Net cash used in capital and related financing activities		(57,029,612)		(82,254,217)
Cash flows from investing activities:				
Proceeds from sale and maturities of investments		1,036,299,493		800,074,713
Purchases of investments		(1,092,031,300)		(929,637,206)
Interest received:				
Investments		43,845,760		35,198,191
Other		85,200		19,946
Principal received on note receivable		—		630,054
Net cash used in investing activities		(11,800,847)		(93,714,302)
Net increase (decrease) in cash and cash equivalents		18,740,183		(11,695,471)
Cash and cash equivalents at beginning of year		335,853,037		347,548,508
Cash and cash equivalents at end of year (note 2)	$	354,593,220	$	335,853,037

See accompanying notes to financial statements.

Schedule I

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Operating Revenues and Operating Expenses Other Than Depreciation

Year ended June 30, 1998

	Total	Statewide	Airports: Honolulu International	Hilo International	Kona International at Keahole	Kahului	Lihue	All others
Operating revenues:								
Concession fees	$ 174,111,548	$ —	$ 148,191,680	$ 5,382,228	$ 2,144,772	$ 12,919,175	$ 5,205,009	$ 268,684
Aeronautical rentals:								
Nonexclusive joint use premise charges	27,732,606	—	26,508,166	147,569	451,393	397,726	227,752	—
Exclusive use premise charges	25,278,608	—	21,943,346	644,758	717,368	1,196,588	606,886	169,662
Nonaeronautical rentals	9,217,126	—	5,750,883	389,691	503,837	1,977,072	564,862	30,781
Airport landing fees	3,854,843	—	2,192,795	182,276	337,624	797,701	249,055	95,392
Aviation fuel tax	3,527,963	—	3,511,972	1,201	186	8,312	5,281	1,011
Airports system support charges	78,478	—	58,149	3,637	2,999	6,801	3,144	3,748
Miscellaneous	6,148,372	—	4,919,931	286,872	234,303	341,953	296,123	69,190
Total operating revenues	$ 249,949,544	$ —	$ 213,076,922	$ 7,038,232	$ 4,392,482	$ 17,645,328	$ 7,158,112	$ 638,468
Operating expenses other than depreciation:								
Salaries and wages	$ 45,660,755	$ 6,053,082	$ 21,197,439	$ 3,122,416	$ 3,362,044	$ 6,201,968	$ 4,001,302	$ 1,722,504
Other personnel services	27,778,417	3,568,581	15,698,837	1,210,391	2,202,431	2,716,512	1,476,324	905,341
Utilities	14,766,797	28	10,596,866	670,724	721,628	1,599,982	932,750	244,819
Repairs and maintenance	15,884,218	312,969	11,115,711	865,795	233,589	1,712,330	606,000	1,037,824
State of Hawaii surcharge on gross receipts (note 1)	7,142,091	7,142,091	—	—	—	—	—	—
Materials and supplies	4,002,333	223,346	2,102,779	487,652	262,840	495,942	227,342	202,432
Department of Transportation general administration expenses	1,544,993	1,544,993	—	—	—	—	—	—
Claims and benefits	1,278,822	57,422	765,424	48,412	113,300	207,507	83,004	3,753
Insurance	788,468	788,468	—	—	—	—	—	—
Communication	331,966	92,865	88,432	17,256	25,707	57,147	28,827	21,732
Rent	227,365	25,114	131,987	2,903	6,164	34,764	19,042	7,391
Travel	215,694	43,153	47,910	24,651	29,858	26,784	30,229	13,109
Dues and subscriptions	156,085	139,868	5,431	2,100	3,678	1,068	3,038	902
Printing and advertising	19,072	8,186	4,762	1,836	240	1,861	1,733	454
Miscellaneous	277,471	155,167	35,416	21,771	14,986	22,745	16,259	11,127
	120,074,547	20,155,333	61,790,994	6,475,907	6,976,465	13,078,610	7,425,850	4,171,388
Allocation of statewide expenses (note 2)	—	(20,155,333)	12,464,250	1,306,296	1,407,266	2,638,169	1,497,915	841,437
Total operating expenses other than depreciation for net revenues and taxes	120,074,547	—	74,255,244	7,782,203	8,383,731	15,716,779	8,923,765	5,012,825
Disbursements out of major maintenance, renewal and replacement account not included above	5,083,517	—	3,072,332	107,693	425,852	87,133	84,930	1,305,577
Total operating expenses other than depreciation for statement of revenues, expenses and changes in retained earnings	$ 125,158,064	$ —	$ 77,327,576	$ 7,889,896	$ 8,809,583	$ 15,803,912	$ 9,008,695	$ 6,318,402

Notes:

1 State of Hawaii surcharge on gross receipts consists of transfers to the State General Fund to defray central service expenses as required by HRS Section 36-28.5.

2 Statewide expenses are allocated to the airports based upon their respective current year operating expenses to total current year operating expenses for all airports.

See accompanying independent auditors' report.

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Calculations of Net Revenues and Taxes and
Debt Service Requirement

Year ended June 30, 1998

Revenues:				
Concession fees			$	174,111,548
Aeronautical rentals:				
Nonexclusive joint use premise charges				27,732,606
Exclusive use premise charges				25,278,608
Interest income, exclusive of interest on investments in direct financing leases and including interest income of $21,608,611 on capital improvement projects				44,128,317
Nonaeronautical rentals				9,217,126
Airport landing fees				3,854,843
Aviation fuel tax				3,527,963
Airports system support charges				78,478
Miscellaneous				6,148,372
				294,077,861
Deductions:				
Operating expenses other than depreciation for net revenues and taxes (schedule 1)	$	120,074,547		
Amounts required to be paid into the State General Fund for general obligation bond requirements:				
Principal		374,251		
Interest		97,067		
Annual reserve required on major maintenance, renewal and replacement account		4,461,486		125,007,351
Net revenues and taxes				169,070,510
Debt service requirement:				
Airports system revenue bonds:				
Principal		37,100,000		
Interest (note 1)		78,416,108		
		115,516,108		
Less available funds deposited into the Airport Revenue Fund for credit to the interest account (note 2)		39,000,000		
		76,516,108		
Debt service coverage percentage	x	135%		103,296,746
Excess of net revenues and taxes over debt service requirement			$	65,773,764

(Continued)

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Calculations of Net Revenues and Taxes and
Debt Service Requirement, Continued

Notes:

1. For purposes of calculating the debt service requirement, interest payments for airports system revenue bonds exclude the amortization of bond issue costs and debt discount, which are reported as interest expense for financial statement reporting purposes.
2. On June 30, 1997, the Airports Division deposited $39,000,000 of available funds into the Airport Revenue Fund for credit to the interest account for fiscal year 1998. The available funds reduced the amount of funds required pursuant to the provisions of Section 6.01 to be paid or credited during such year to the interest account as required in the "Certificate of the Director of Transportation Providing for the Issuance of State of Hawaii Airports System Revenue Bonds."

See accompanying independent auditors' report.

Schedule III

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Summary of Total Debt Service Requirements to Maturity

June 30, 1998

Year ending June 30	Annual principal and interest requirements: Airports system revenue bonds	General obligation bonds	Total
1999	$ 118,054,390	$ 459,066	$ 118,513,456
2000	118,102,023	441,922	118,543,945
2001	122,194,950	424,154	122,619,104
2002	122,229,979	404,909	122,634,888
2003	122,302,644	284,842	122,587,486
2004	123,740,035	12,702	123,752,737
2005	100,744,435	12,290	100,756,725
2006	100,723,400	11,871	100,735,271
2007	100,696,232	11,442	100,707,674
2008	100,656,845	11,004	100,667,849
2009	91,123,352	10,558	91,133,910
2010	80,953,697	10,111	80,963,808
2011	80,957,346	9,656	80,967,002
2012	80,973,518	—	80,973,518
2013	80,981,100	—	80,981,100
2014	75,390,160	—	75,390,160
2015	75,381,700	—	75,381,700
2016	75,382,130	—	75,382,130
2017	75,379,255	—	75,379,255
2018	75,385,540	—	75,385,540
2019	75,386,265	—	75,386,265
2020	75,383,953	—	75,383,953
2021	32,873,663	—	32,873,663
Total	$ 2,104,996,612	$ 2,104,527	$ 2,107,101,139

See accompanying independent auditors' report.

Schedule IV

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Debt Service Requirements to Maturity – Airports System Revenue Bonds

June 30, 1998

	Principal											
Year ending June 30	Series of 1990, 6.45% to 7.38%	Second Series of 1990, 6.60% to 7.50%	Series of 1991, 5.70% to 7.00%	Second Series of 1991, 5.40% to 7.00%	Refunding Series of 1992, 2.80% to 5.25%	Refunding Series of 1993, 4.00% to 6.45%	First Refunding Series of 1994, 4.15% to 5.6%	Second Refunding Series of 1994, 4.40% to 5.85%	Third Refunding Series of 1994, 3.75% to 5.75%	Total principal	Interest	Total requirements
1999	$ 1,810,000	$ 3,545,000	$ 3,925,000	$ 7,300,000	$ 3,660,000	$ 4,105,000	$ 4,425,000	$ 7,260,000	$ 5,675,000	$ 41,705,000	$ 76,349,390	$ 118,054,390
2000	1,940,000	3,795,000	4,165,000	7,745,000	1,850,000	4,325,000	6,645,000	7,695,000	5,960,000	44,120,000	73,982,023	118,102,023
2001	2,080,000	4,070,000	4,425,000	8,225,000	—	8,585,000	8,950,000	8,170,000	6,265,000	50,770,000	71,424,950	122,194,950
2002	2,220,000	4,365,000	4,710,000	8,740,000	—	9,080,000	9,425,000	8,680,000	6,600,000	53,820,000	68,409,979	122,229,979
2003	2,385,000	4,690,000	5,010,000	9,300,000	—	9,590,000	9,960,000	9,230,000	6,965,000	57,130,000	65,172,644	122,302,644
2004	2,550,000	5,040,000	5,340,000	9,905,000	—	10,145,000	10,765,000	10,965,000	7,330,000	62,040,000	61,700,035	123,740,035
2005	2,735,000	5,420,000	5,695,000	10,560,000	—	10,735,000	—	—	7,725,000	42,870,000	57,874,435	100,744,435
2006	2,935,000	5,825,000	6,095,000	11,265,000	—	11,370,000	—	—	8,155,000	45,645,000	55,078,400	100,723,400
2007	3,150,000	6,260,000	6,520,000	12,055,000	—	12,055,000	—	—	8,610,000	48,650,000	52,046,232	100,696,232
2008	3,375,000	6,730,000	6,975,000	12,900,000	—	12,785,000	—	—	9,100,000	51,865,000	48,791,845	100,656,845
2009	3,625,000	7,235,000	7,465,000	13,790,000	—	4,065,000	—	—	9,625,000	45,805,000	45,318,352	91,123,352
2010	3,890,000	7,780,000	7,990,000	14,740,000	—	4,335,000	—	—	—	38,735,000	42,218,697	80,953,697
2011	4,180,000	8,360,000	8,545,000	15,755,000	—	4,625,000	—	—	—	41,465,000	39,492,346	80,957,346
2012	4,485,000	8,990,000	9,145,000	16,845,000	—	4,935,000	—	—	—	44,400,000	36,573,518	80,973,518
2013	4,815,000	9,665,000	9,785,000	18,005,000	—	5,260,000	—	—	—	47,530,000	33,451,100	80,981,100
2014	5,170,000	10,390,000	10,470,000	19,270,000	—	—	—	—	—	45,300,000	30,090,160	75,390,160
2015	5,540,000	11,170,000	11,205,000	20,615,000	—	—	—	—	—	48,530,000	26,851,700	75,381,700
2016	5,950,000	12,005,000	11,985,000	22,060,000	—	—	—	—	—	52,000,000	23,382,130	75,382,130
2017	6,380,000	12,905,000	12,825,000	23,605,000	—	—	—	—	—	55,715,000	19,664,255	75,379,255
2018	6,850,000	13,875,000	13,725,000	25,255,000	—	—	—	—	—	59,705,000	15,680,540	75,385,540
2019	7,350,000	14,915,000	14,685,000	27,025,000	—	—	—	—	—	63,975,000	11,411,265	75,386,265
2020	7,880,000	16,035,000	15,715,000	28,850,000	—	—	—	—	—	68,480,000	6,903,953	75,383,953
2021	—	—	—	30,795,000	—	—	—	—	—	30,795,000	2,078,663	32,873,663
Total	$ 91,295,000	$ 183,065,000	$ 186,400,000	$ 374,605,000	$ 5,510,000	$ 115,995,000	$ 50,170,000	$ 52,000,000	$ 82,010,000	$ 1,141,050,000	$ 963,946,612	$ 2,104,996,612

Note: For purposes of this schedule, the above debt service requirements are set forth based upon funding requirements. Principal and interest payments are required to be funded in the 12-month and 6-month periods, respectively, preceding the date on which the payments are due. Accordingly, this schedule does not present the principal and interest payments due on July 1, 1998.

See accompanying independent auditors' report.

Schedule V

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Debt Service Requirements to Maturity – General Obligation Bonds

June 30, 1998

Year ending June 30	Series BX 5.15% to 6.00% due 2002	Series CD 3.85% to 5.00% due 2003	Series CF 3.25% to 5.50% due 2002	Series CI 4.00% to 5.00% due 2011	Total principal	Interest	Total requirements
1999	$ 100,471	$ 48,909	$ 215,429	$ 9,427	$ 374,236	$ 84,830	$ 459,066
2000	100,471	48,909	215,429	9,427	374,236	67,686	441,922
2001	100,471	48,909	215,429	9,427	374,236	49,918	424,154
2002	100,472	48,910	215,429	9,427	374,238	30,671	404,909
2003	—	48,910	215,429	9,427	273,766	11,076	284,842
2004	—	—	—	9,427	9,427	3,275	12,702
2005	—	—	—	9,425	9,425	2,865	12,290
2006	—	—	—	9,425	9,425	2,446	11,871
2007	—	—	—	9,425	9,425	2,017	11,442
2008	—	—	—	9,425	9,425	1,579	11,004
2009	—	—	—	9,425	9,425	1,133	10,558
2010	—	—	—	9,425	9,425	686	10,111
2011	—	—	—	9,425	9,425	231	9,656
Total	$ 401,885	$ 244,547	$ 1,077,145	$ 122,537	$ 1,846,114	$ 258,413	$ 2,104,527

See accompanying independent auditors' report.

Schedule VI

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Airports System Charges – Fiscal Year 1995-97 Lease Extension

Year ended June 30, 1998

	Airline Activity			Airports System Charges								
						Nonexclusive joint use premise charges						
	Approved maximum revenue landing weights (1,000 pound units)	Revenue passenger landings	Deplaning international passengers	Airport landing fees	Airports system support charges	Joint use charges – overseas terminal	Joint use charges – blended OST terminal	Joint use charges – interisland terminal	Joint use charges – neighbor island terminal	International arrivals building charges	Exclusive use premise charges – terminal space	Total
Signatory airlines:												
Air Canada	51,054	179	8,410	$ 9,727	$ —	$ 34,574	$ —	$ —	$ 1,209	$ 25,550	$ —	$ 71,060
Air New Zealand, Ltd.	429,707	898	73,253	133,373	—	402,767	—	—	12	222,543	239,503	998,198
Aloha Airlines, Inc.	7,988,029	67,071	6,443	983,482	—	—	—	2,049,570	433,002	19,603	1,877,079	5,362,736
American Airlines, Inc.	1,079,811	2,967	—	292,369	—	1,004,898	—	—	8,641	—	865,376	2,171,284
American International Airways	357,378	24	—	109,850	—	10,327	—	—	12	—	—	120,189
American Trans Air	514,136	1,555	11	186,548	—	396,032	—	—	7,977	33	32,112	622,702
Canadian Airlines International, Ltd.	297,787	810	72,474	76,355	—	363,703	—	—	—	220,176	331,188	991,422
China Airlines, Ltd.	234,645	431	108,782	73,909	—	193,526	—	—	—	330,480	169,632	767,547
Continental Airlines, Inc.	435,517	1,088	—	129,010	—	488,529	—	—	—	—	1,288,060	1,905,599
Continental Micronesia	407,070	913	231,269	137,879	—	409,952	—	—	—	702,595	114,185	1,364,611
Delta Airlines, Inc.	1,388,692	3,849	—	389,892	—	1,404,522	—	—	8,546	—	1,101,399	2,904,359
Federal Express Corporation	205,079	—	—	69,364	—	—	—	—	—	—	—	69,364
Garuda Indonesia Airlines	180,600	420	8,136	73,861	—	188,587	—	—	—	24,717	—	287,165
Hawaiian Airlines, Inc.	6,419,357	50,149	34,625	1,030,122	—	—	1,010,230	1,470,536	300,485	105,191	1,667,537	5,584,101
Island Air	716,958	—	—	87,271	—	—	—	—	—	—	189,194	276,465
Japan Air Lines Company, Ltd.	2,203,483	4,122	1,096,587	681,343	—	1,707,608	—	—	3,781	3,331,431	1,087,236	6,811,399
Japan Air System Company, Ltd.	—	—	—	—	—	—	—	—	—	—	206,052	206,052
Korean Airlines Company, Ltd.	200,542	343	86,699	94,452	—	154,013	—	—	—	263,392	235,544	747,401
Mahalo Air	180,149	1,888	—	125,204	—	—	—	—	22,378	—	104,236	251,818
Northwest Airlines, Inc.	1,770,058	3,792	547,467	651,387	—	1,702,669	—	—	—	1,663,205	770,647	4,787,908
Philippine Airlines, Inc.	256,739	266	23,783	68,923	—	119,438	—	—	—	72,253	267,180	527,794
Phoenix Air Group, Inc.	3,463	88	160	1,390	—	—	—	—	1,043	486	14,720	17,639
Polar Air Cargo	115,290	—	—	44,120	—	—	—	—	—	—	—	44,120
Qantas Airways, Ltd.	389,347	364	59,255	125,382	—	163,442	—	—	—	180,017	445,788	914,629
Sun Country Airlines, Inc.	341,327	939	—	108,663	—	237,080	—	—	4,872	—	3,554	354,169
Trans World Airlines, Inc.	169,214	393	—	99,055	—	176,502	—	—	—	—	290,532	566,089
United Airlines, Inc.	2,531,725	6,301	274,220	872,182	—	1,825,699	—	—	26,492	833,080	3,378,382	6,935,835
United Parcel Service Co.	283,302	—	—	56,707	—	—	—	—	—	—	3,354	60,061
Nonsignatory airlines	1,198,294	1,071	211,746	378,920	78,478	489,815	—	—	—	708,502	946,528	2,602,243
Total airports system charges billed	30,348,753	149,921	2,843,320	7,090,740	78,478	11,473,683	1,010,230	3,520,106	818,450	8,703,254	15,629,018	48,323,959
Fiscal year 1998 underpayment (overpayment) of airports system charges				92,782	—	420,146	43,944	353,254	166,708	1,222,831	—	2,299,665
Adjusted airports system charges based on final reconciliation				$ 7,183,522	$ 78,478	$ 11,893,829	$ 1,054,174	$ 3,873,360	$ 985,158	$ 9,926,085	$ 15,629,018	$ 50,623,624

(Continued)

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Reconciliation of Airport Landing Fees

Year ended June 30, 1998

	Signatory airlines	Nonsignatory airlines	Total
Gross airport landing fees billed	$ 6,711,820	$ 378,920	$ 7,090,740
Plus net underpayment of airport landing fee	92,782	—	92,782
	6,804,602	378,920	7,183,522
Less aviation fuel tax credit	3,302,530	26,149	3,328,679
Total	$ 3,502,072	$ 352,771	$ 3,854,843

(Continued)

Schedule VI-3

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Overpayment of Airports System Charges – Signatory Airlines

Year ended June 30, 1998

Fiscal Year 1997 Overpayment

In fiscal year 1997, the signatory airlines overpaid total airports system charges by $1,743,522. In accordance with the Fiscal Year 1995-97 Lease Extension, the airports system support charges for fiscal year 1998, if any, would be reduced by the net excess signatory airlines' receipts for fiscal year 1997.

Fiscal Year 1998 Underpayment

In fiscal year 1998, the signatory airlines underpaid total airports system charges (as defined in the Fiscal Year 1995-97 Lease Extension) by $2,299,665. The fiscal year 1998 underpayment and the transfer to the PAUCF (see note 6) were used to reduce the signatory airlines' payments over the required airports system charges for the fiscal years 1997 and 1996.

See accompanying independent auditors' report.

Schedule VII

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Approved Maximum Revenue Landing Weights
and Airport Landing Fees – Signatory Airlines

Year ended June 30, 1998

	Approved Maximum Revenue Landing Weights (1,000 pound units)				Honolulu International Airport and Hilo International Airport: Gross airport landing fees					All other airports			
	Honolulu International Airport	Hilo International Airport	All other airports	Total	Honolulu International Airport	Hilo International Airport	Total	Aviation fuel tax credit	Adjusted airport landing fees	Gross airport landing fees	Aviation fuel tax credit	Adjusted airport landing fees	Total adjusted airport landing fees
Air Canada	22,158	—	28,896	51,054	$ 4,910	$ —	$ 4,910	$ (789)	$ 4,121	$ 4,817	$ —	$ 4,817	$ 8,938
Air New Zealand, Ltd.	429,387	—	320	429,707	133,373	—	133,373	—	133,373	—	—	—	133,373
Aloha Airlines, Inc.	3,668,225	756,170	3,563,634	7,988,029	450,284	93,234	543,518	(399,833)	143,685	439,964	—	439,964	583,649
American Airlines, Inc.	860,644	—	219,167	1,079,811	251,311	—	251,311	(383,547)	(132,236)	41,058	—	41,058	(91,178)
American International Airways	237,720	46,420	73,238	357,378	88,726	8,131	96,857	(84,176)	12,681	12,993	—	12,993	25,674
American Trans Air	296,562	—	217,574	514,136	106,121	—	106,121	(126,502)	(20,381)	80,427	—	80,427	60,046
Canadian Airlines International, Ltd.	297,787	—	—	297,787	76,355	—	76,355	—	76,355	—	—	—	76,355
China Airlines, Ltd.	234,645	—	—	234,645	73,909	—	73,909	—	73,909	—	—	—	73,909
Continental Airlines, Inc.	435,517	—	—	435,517	129,010	—	129,010	(158,500)	(29,490)	—	—	—	(29,490)
Continental Micronesia	407,070	—	—	407,070	137,879	—	137,879	—	137,879	—	—	—	137,879
Delta Airlines, Inc.	1,129,534	—	259,158	1,388,692	332,355	—	332,355	(475,227)	(142,872)	57,537	—	57,537	(85,335)
Federal Express Corporation	205,079	—	—	205,079	69,364	—	69,364	—	69,364	—	—	—	69,364
Garuda Indonesia Airlines	180,600	—	—	180,600	73,861	—	73,861	—	73,861	—	—	—	73,861
Hawaiian Airlines, Inc.	3,467,829	473,364	2,478,164	6,419,357	643,630	61,337	704,967	(602,069)	102,898	325,155	—	325,155	428,053
Island Air	285,515	—	431,443	716,958	34,783	—	34,783	—	34,783	52,488	—	52,488	87,271
Japan Air Lines Company, Ltd.	2,023,567	—	179,916	2,203,483	639,979	—	639,979	—	639,979	41,364	—	41,364	681,343
Korean Airlines Company, Ltd.	200,542	—	—	200,542	94,452	—	94,452	—	94,452	—	—	—	94,452
Mahalo Air	86,205	615	93,329	180,149	59,913	427	60,340	—	60,340	64,864	—	64,864	125,204
Northwest Airlines, Inc.	1,770,058	—	—	1,770,058	651,387	—	651,387	(268,725)	382,662	—	—	—	382,662
Philippine Airlines, Inc.	256,739	—	—	256,739	68,923	—	68,923	—	68,923	—	—	—	68,923
Phoenix Air Group, Inc.	446	—	3,017	3,463	—	—	—	—	—	1,390	(851)	539	539
Polar Air Cargo	115,290	—	—	115,290	44,120	—	44,120	—	44,120	—	—	—	44,120
Qantas Airways, Ltd.	389,347	—	—	389,347	125,382	—	125,382	—	125,382	—	—	—	125,382
Sun Country Airlines, Inc.	191,928	—	149,399	341,327	50,883	—	50,883	—	50,883	57,780	—	57,780	108,663
Trans World Airlines, Inc.	169,214	—	—	169,214	99,055	—	99,055	(86,851)	12,204	—	—	—	12,204
United Airlines, Inc.	1,869,928	—	661,797	2,531,725	659,697	—	659,697	(648,480)	11,217	212,485	—	212,485	223,702
United Parcel Service Co.	219,732	—	63,570	283,302	56,707	—	56,707	(66,980)	(10,273)	—	—	—	(10,273)
Total	19,451,268	1,276,569	8,422,622	29,150,459	$ 5,156,369	$ 163,129	$ 5,319,498	$ (3,301,679)	$ 2,017,819	$ 1,392,322	$ (851)	$ 1,391,471	$ 3,409,290
Summary of revenue landing weights:													
Overseas				13,577,647									
Interisland				15,572,812									
				29,150,459									

Aviation fuel tax of $3,527,963 was paid by the users for the year ended June 30, 1998. Of this amount, $3,328,679 was credited against the airport landing fees in accordance with Article V.E. of the Airport-Airline Lease Agreement as follows:

Signatory airlines	$ 3,302,530
Nonsignatory airlines	26,149
	$ 3,328,679

Note: The above schedule presents airport landing fees billed to signatory airlines for the year ended June 30, 1998.

See accompanying independent auditors' report.

Schedule VIII

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
AIRPORTS DIVISION

Approved Maximum Revenue Landing Weights
and Airport Landing Fees – Nonsignatory Airlines

Year ended June 30, 1998

	Approved Maximum Revenue Landing Weights (1,000 pound units)				Honolulu International Airport and Hilo International Airport: Gross airport landing fees					All other airports			
	Honolulu International Airport	Hilo International Airport	All other airports	Total	Honolulu International Airport	Hilo International Airport	Total	Aviation fuel tax credit	Adjusted airport landing fees	Gross airport landing fees	Aviation fuel tax credit	Adjusted airport landing fees	Total adjusted airport landing fees
Air Pacific Limited	11,520	—	—	11,520	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
Air Service Corp.	21,889	583	18,545	41,017	16,676	—	16,676	—	16,676	8,302	—	8,302	24,978
All Nippon Airways Co., Ltd.	214,320	—	—	214,320	104,205	—	104,205	—	104,205	—	—	—	104,205
Asiana Airlines	55,040	—	—	55,040	59,123	—	59,123	—	59,123	—	—	—	59,123
Big Island Air, Inc.	7	14	10,031	10,052	7	—	7	—	7	2,417	—	2,417	2,424
Canada 3000 Airlines, Limited	48,909	—	32,872	81,781	5,310	—	5,310	—	5,310	5,310	—	5,310	10,620
Century Aviation, Inc.	8,169	371	14,083	22,623	3,654	230	3,884	(4,990)	(1,106)	5,288	(594)	4,694	3,588
Circle Rainbow Air, Inc.	3,144	—	6,018	9,162	658	—	658	—	658	1,282	—	1,282	1,940
Circle Rainbow Aviation	17,279	23	10,857	28,159	7,389	—	7,389	(5,454)	1,935	4,965	(436)	4,529	6,464
Corporate Air	12,092	9,080	12,909	34,081	2,314	1,909	4,223	—	4,223	2,833	—	2,833	7,056
Emery Air Freight Corp.	12,670	—	—	12,670	3,290	—	3,290	(494)	2,796	—	—	—	2,796
Eva Airways Corporation	51,747	—	1,260	53,007	25,216	—	25,216	—	25,216	—	—	—	25,216
Evergreen International Airlines, Inc.	136,665	—	—	136,665	(4,023)	—	(4,023)	—	(4,023)	—	—	—	(4,023)
Genavco Corp.	—	—	18,850	18,850	—	—	—	—	—	3,101	—	3,101	3,101
Gerardin Corporation, The dba Alexair	—	—	14,265	14,265	—	—	—	—	—	1,124	—	1,124	1,124
Hawaii Air Ambulance	13,277	34	466	13,777	1,771	6	1,777	(760)	1,017	116	—	116	1,133
Hawaii Helicopters, Inc.	—	6,231	15,553	21,784	—	1,539	1,539	—	1,539	2,543	(1,729)	814	2,353
Helicopter Consultants of Maui dba South Sea Helicopter	—	40,269	42,134	82,403	—	7,712	7,712	(956)	6,756	7,072	(3,161)	3,911	10,667
Island Helicopters Kauai, Inc.	—	—	13,456	13,456	—	—	—	—	—	2,123	(799)	1,324	1,324
Japan Air Charter Co., Ltd.	20,150	—	—	20,150	10,808	—	10,808	—	10,808	—	—	—	10,808
Kamaka Air	1,194	—	11,806	13,000	215	—	215	—	215	1,542	—	1,542	1,757
Molokai/Lanai Air Shuttle	3,893	—	6,491	10,384	3,714	—	3,714	—	3,714	6,193	—	6,193	9,907
Oahu Northshore Aviation	—	—	15,715	15,715	—	—	—	—	—	3,260	—	3,260	3,260
Ohana Aviation, Inc. dba Ohana Helicopter Tours	—	—	18,965	18,965	—	—	—	—	—	3,370	(1,131)	2,239	2,239
Safari Aviation	—	9,626	12,259	21,885	—	2,098	2,098	—	2,098	1,850	(188)	1,662	3,760
South Sea Helicopters	—	—	11,974	11,974	—	—	—	—	—	1,758	(521)	1,237	1,237
Squyres, Will Helicopter, Inc.	—	—	15,339	15,339	—	—	—	—	—	2,032	—	2,032	2,032
Sunshine Helicopters, Inc.	—	—	34,634	34,634	—	—	—	—	—	5,792	(1,663)	4,129	4,129
Trans Air	4,581	—	9,181	13,762	433	—	433	(1,373)	(940)	571	(64)	507	(433)
Miscellaneous	95,894	10,114	41,846	147,854	38,567	4,032	42,599	(440)	42,159	9,223	(1,396)	7,827	49,986
Total	732,440	76,345	389,509	1,198,294	$ 279,327	$ 17,526	$ 296,853	$ (14,467)	$ 282,386	$ 82,067	$ (11,682)	$ 70,385	$ 352,771
Summary of revenue landing weights:													
Overseas				750,629									
Interisland				447,665									
				1,198,294									

See accompanying independent auditors' report.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Transportation on January 14, 1999. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2. The department generally concurs with most of our findings and recommendations. It states that "corrective steps have been initiated or are under discussion" based on the findings in this report. With regard to improvements in the billing and collection practices, it states that the division entered into a contract with the Department of the Attorney General's Civil Recoveries Division to aggressively pursue delinquent accounts. The department further states that the AIRMIS/2000 computer system is anticipated to improve the deficiencies with the aged accounts receivable ledger. The department will segregate the duties over cash receipts to improve on internal controls.

The department also states that negotiations with Duty Free Shoppers Group LP (DFS) regarding the rent delinquency are in process, and it is diligently working to finalize the repayment agreement with DFS. The department also concurs that it needs to do a better job of reviewing transactions that may be construed by the U.S. Department of Transportation's Office of the Inspector General as improper use of airport revenues. It plans to seek approvals from the Federal Aviation Administration before transactions are executed.

The department disagrees with our finding that the lack of competition in "the contractor selection process may have violated the Hawaii Public Procurement Code." We disagree. Our finding did not identify the contractor selection process as violating the Hawaii Public Procurement Code. The issue was the division's failure to protect State resources by limiting its contractor selection. Given the requirements of the AIRMIS/2000 project and the State's limited resources, it would have been in the State's best interest to encourage competition to obtain the best solution at the best price.

The department also maintains that the audit incorrectly stated that the division issued two sole source contracts for the procurement of the AIRMIS 2000 contracts. However, our report clearly indicates that the division solicited proposals for the first AIRMIS/2000 contract, and that there were two contracts totaling more than $3.8 million which lacked competition in the contractor selection process.

The department disagrees with our assessment that the second IBM contract for the AIRMIS/2000 project violated the sole source requirements of the procurement law. The department states that "IBM, as the current contractor that began the AIRMIS 2000 analysis project, already possessed the background knowledge needed to quickly complete the financial management analysis phase." While the request for sole source was submitted to the State Procurement Office for its review and approval, we do not agree with this reason for a sole source selection. This sole source contract required the contractor to perform a detailed assessment for a financial reporting system and provide alternatives for its construction and delivery. While the Hawaii Public Procurement Code allows for awarding of contract without competition, it generally requires that there be only one source for the required service. The service was not unique to one vendor and other contractors could have performed this assessment and provided alternatives. Thus, the spirit of open competition was violated and the State has no assurance that it received the best value for the price.

The department also disagrees with our finding that the division has not developed a comprehensive Year 2000 project plan that provides a detailed framework with milestone dates for identification and remediation of all critical information technology and non-information technology applications. It indicates that a formal Year 2000 Project Team was organized during the Summer 1998 to manage the readiness effort from initial awareness through inventory, assessment, remediation, and testing stages, to final Year 2000 readiness. The department further states that a number of tasks have been completed, other tasks are currently being performed, and exercises are planned for the end of the 1999 year to ensure the division's readiness. While we recognize that the division has taken some steps toward Year 2000 compliance, it has yet to complete all critical elements to ensure compliance. Further, we were not provided with a comprehensive Year 2000 project plan that meets the required elements identified in our report.

The department did not address the other procurement violations regarding change orders and small purchases. In addition, the department did not respond to the finding regarding the inadequate planning over the AIRMIS/2000 project, and the inadequate maintenance of the division's contract files.

ATTACHMENT 1

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

January 14, 1999

COPY

The Honorable Kazu Hayashida, Director
Department of Transportation
Aliiaimoku Hale
869 Punchbowl Street
Honolulu, Hawaii 96813

Dear Mr. Hayashida:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Financial Audit of the Airports Division of the Department of Transportation*. We ask that you telephone us by Tuesday, January 19, 1999, 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 Monday, January 25, 1999.

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

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

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

BENJAMIN J. CAYETANO
GOVERNOR

KAZU HAYASHIDA
DIRECTOR

DEPUTY DIRECTORS
BRIAN K. MINAAI
GLENN M. OKIMOTO

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
869 PUNCHBOWL STREET
HONOLULU, HAWAII 96813-5097

IN REPLY REFER TO:
AIR-A
99.007

January 22, 1999

RECEIVED
JAN 25 4 13 PM '99
OFC. OF THE AUDITOR
STATE OF HAWAII

TO: MARION M. HIGA, STATE AUDITOR

FROM: KAZU HAYASHIDA K.H.
DIRECTOR OF TRANSPORTATION

SUBJECT: RESPONSE TO THE FINDINGS OF THE FINANCIAL AUDIT OF THE AIRPORTS DIVISION

Thank you for the opportunity to comment on your audit findings which provide a useful management tool to improve upon the operations of the Airports Division. In general, we concur with most of the recommendations and corrective steps have been initiated or are under discussion. We provide the following responses:

<u>Questionable Practices Over the Procurement of the AIRMIS/2000 Project</u>

We do not agree with the finding that the contractor selection process may have violated the Hawaii Public Procurement Code. The audit incorrectly states that the Airports Division issued two sole source contracts for the procurement of the AIRMIS 2000 contracts. The first contract was procured through the Request for Proposal (RFP) process which underwent the review and approval of the Department of Accounting and General Services/Information and Communication Services Division (DAGS/ICSD). DAGS/ICSD also participated in the RFP evaluation and award process for the contractor selection. The second contract was procured by a non-competitive sole source process.

In accordance with State procurement procedures, the request for sole source was submitted to the State Procurement Office for their review and approval. We requested the sole source as IBM, being the current contractor that began the AIRMIS 2000 analysis project, already possessed the background knowledge needed to quickly complete the financial management analysis phase. As procurement procedures were adhered to and all appropriate approvals secured, we do not agree with the view that the Procurement Code may have been violated.

The AIRMIS 2000 project specifically required the use of the Seer Technologies Integrated Computer Aided Software Engineering (I-Case) tool. The Seer Technologies I-Case tool was established as a Departmental application development standard and procured by a sole source contract issued by the Department's Computer Services and Support Office. While there were other automated computer tools besides Seer at that time that could be used to design, develop, program and implement software applications, Seer Technologies I-Case tool also supported cross-platform application development, integrated forward engineering, and application program executable support that the other I-Case tools did not support. The sole source purchase request was revised from $150,000 to $450,000 because additional licenses were required to support the AIRMIS 2000 Project.

The goal of the AIRMIS 2000 project was to create an Enterprise Definition for the Airports Division which would develop the formal information systems strategic plan. Due to the turnovers in management at the division within the last four years and the many new information needs, the project helped to establish the baseline for an integrated information system and identify the business process reengineering opportunities for the division. Initially it was decided that the best solution was to develop an application to accommodate the business needs without changing the way the end-users did their business due to the many requirements for processing of data that packaged software solutions did not appear to offer. With the knowledge that the financial management system is estimated to cost $7.0 million to develop and implement, research of applications are being made and will continue in order to determine whether it will be more cost effective to change the business practices to accommodate a software package solution or to develop an application to support the current business practices.

The Airports Division Must Evaluate and Hasten Its Year 2000 Remediation Efforts

The audit findings state that the Airports Division has yet to develop a comprehensive Year 2000 project plan. We respectfully beg to differ. A formal Year 2000 Project Team led by Airports Administrator Jerry Matsuda was organized during the summer of 1998 to manage the readiness effort from initial awareness, through inventory, assessment, remediation, and testing stages, to final Year 2000 readiness.

The Division is in the process of developing a complete inventory of its embedded systems and has separately identified, assessed, and begun remediation of the key embedded systems essential to airport operations. The embedded systems effort is 50% complete with Year 2000 readiness expected by June 1999. Inventory and assessment of information technology (IT) hardware, infrastructure, and application software have been completed. The hardware and software from IT systems are currently being updated or replaced for Year 2000 readiness. The testing and validation of the IT systems are in progress, and are expected to be completed by the fall of 1999.

The division also has contingency plans similar in format to disaster and emergency plans to address any unforeseen problems or failures. Exercises are planned for October and November, 1999 to prepare and have staff ready for the end of the year. Operational and headquarters staff will be pre-positioned on the evening of December 31, 1999 to ensure that the airports system is operational and ready to handle any unanticipated problems and to continue air transportation services at statewide airports.

Airports Division's Billing and Collection Practices Need Improvement

We agree that improvements are needed to correct deficiencies in billing and collection practices. We have entered into a contract with the Department of the Attorney General's Civil Recoveries Division to aggressively pursue delinquent accounts. Having a dedicated unit within the Attorney General's Office to support the division in its collection efforts means that enforcement and legal actions can be followed through on a more timely basis.

We concur with the observation that the aged accounts receivable ledger is ineffective as this was one of the foremost improvements that was being sought in the AIRMIS 2000 project. The financial system requirement analysis which was completed in July 1998 specifically addressed this issue in the functional requirements. The new or enhanced financial management system will require matching cash receipts by invoice.

To address the finding regarding the lack of proper segregation of duties over cash receipts, we will segregate functions of recording, depositing and reconciling cash received.

Duty Free Shoppers Group LP (DFS) Rent Delinquency

Please be assured that we are diligently working with DFS to finalize the repayment agreement. As negotiations are still in process, I am unable to provide any further comments at this time.

Controls Over Compliance With Grant Assurances Could be Improved

We concur that more thorough reviews of transactions that may be construed by the Office of the Inspector General (OIG) as improper use of airport revenues should be done and approvals sought from FAA before transactions are made. Since the last audit performed by the OIG in 1996, the division has been seeking FAA's prior input on transactions which may raise revenue diversion issues. We shall continue to work closely with FAA on these matters.

Thank you for the opportunity to provide comments.