Management and Financial Audit of the Hawai`i Tourism Authority's Major Contracts

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

Report No. 03-10
June 2003

THE AUDITOR
STATE OF HAWAII

The Office of the Auditor

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

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

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds 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.

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

THE AUDITOR
STATE OF HAWAII
Kekuanaoʻa Building
465 S. King Street, Room 500
Honolulu, Hawaii 96813

OVERVIEW

Management and Financial Audit of the Hawai`i Tourism Authority's Major Contracts

Report No. 03-10, June 2003

Summary

Pursuant to Section 23-13, Hawai'i Revised Statutes, our office conducted a management and financial audit of the Hawai'i Tourism Authority's major contracts. A major contractor is one awarded a contract or agreement in excess of $15 million. Three contractors met this criteria: Hawai'i Visitors & Convention Bureau (HVCB), SMG, and the National Football League. We focused exclusively on the two marketing contracts valued at $151.7 million with the Hawai'i Visitors & Convention Bureau, by far the largest of the three contractors.

We found that inadequate oversight by the authority provided HVCB with a blank check to spend state funds for self-serving purposes. For example, we found that HVCB increased the compensation of its state-funded employees by 42 percent over the past three years—from $3.7 million in CY2000 to $5.3 million in CY2002—although the amount of state funding for those same years remained relatively unchanged. The bureau also used state contract funds to pay for exorbitant bonuses and unnecessary severance packages for its employees who were already highly compensated. For example, eight employees were paid between $90,000 and $170,000 with state funds in CY2002. Although it was not obligated to do so, HVCB paid and accrued approximately $202,000 in severance pay using state contract funds. One employee's severance pay was approximately $141,000, nearly the equivalent of that employee's annual salary.

The bureau also expended $191,000 in state contract funds for other inappropriate or questionable expenditures. Such expenditures included paying for an employee's parking and speeding tickets and reimbursing an employee for the employee's family travel expenses. These expenditures violate HVCB's own travel and entertainment policy. We also found an unusual arrangement whereby the state-funded salary of HVCB's vice president in Japan is supplemented by an airline. HVCB asserts that this arrangement does not give that airline an unfair advantage in negotiating favorable cooperative marketing partnerships. However, any arrangement that presents even the *appearance* of a conflict of interest should be avoided so that marketing activities supported by state contract funds are not tainted. Furthermore, we question the propriety of HVCB using its consultant law firm, paid with state funds, to perform legal services that sought to undermine the authority and the State.

The bureau also exercised poor management and oversight over its state-funded contractors. For example, rather than formally evaluating its subcontractors, HVCB relied on personal relationships and oral communication to evaluate its state-funded subcontractors. We also found that HVCB awarded a $242,000 state-funded subcontract to a vice president's firm on the same day she resigned as HVCB vice president for developing international markets. In addition, the bureau did not execute contracts in a timely manner, procured services that were beyond the scope of its state contracts, and maintained contract files that were incomplete and disorganized. We also found questionable arrangements between the former governor's office and HVCB that raise questions about whether the former governor's office used HVCB to circumvent the State Procurement Code.

In what is perhaps our most serious finding, our consultant CPA firm declared a qualified opinion on HVCB's financial statements for the year ending December 31, 2002. The consultant found that HVCB committed funds in one year to pay for future goods and services of another year—a direct violation of generally accepted accounting principles. For example, in November 2001, HVCB accrued approximately $1 million to an advertising company although no related services were provided by December 31, 2001. It appeared that the advertising company pre-billed HVCB for services it had yet to provide. By doing so, HVCB was able to spend exactly up to its state contract limit and circumvent the potential return of unexpended funds to the authority.

We also found that the authority's lax monitoring and enforcement of its contracts with HVCB left little assurance that $151.7 million in state funds were effectively spent. Specifically, we found that poorly constructed contracts and inadequate contract monitoring and enforcement by the authority did not adequately protect the State's interests. For example, the plethora of reports submitted by HVCB contained vague information that failed to tie results to goals and objectives.

We also assessed the actions taken by the authority in response to our previous audit, *Management Audit of the Hawai'i Tourism Authority, Report No. 02-04*. The authority has taken steps to address some of the other management deficiencies discussed in our prior audit. For example, the authority created a marketing department to oversee marketing contracts, drafted contracting policies and procedures, and clarified staff roles and responsibilities. Furthermore, the authority conducted a performance evaluation of both itself and HVCB. However, the authority continues to allow HVCB to provide services without a signed contract.

Recommendations and Response

We recommended that the authority's board of directors and its executive director improve contractor accountability, enforce contract provisions, improve contract language, and maintain and apply contracting policies and procedures. We also recommended that the State and Legislature take appropriate steps to assess the extent to which HVCB violated generally accepted accounting standards during the course of its state marketing contracts.

In written comments on a draft of our report, the authority's board chair and executive director accepted our findings and recommendations. They acknowledged our audit as a tool to improve its operations, respond to legislative questions and concerns, ensure contractor compliance, minimize the state's liability, and optimize the state's expenditures for tourism promotion. Their response also reiterated that the authority takes very seriously its responsibility to the public to be a fiscally accountable organization.

We note that the authority specifically commented on three points in our report. While we take no issue with the authority's comments, we stand by the statements in our report and our strengthened recommendations.

Marion M. Higa
State Auditor
State of Hawaii

Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813
(808) 587-0800
FAX (808) 587-0830

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

Conducted by

The Auditor
State of Hawaii
and
Nishihama &
Kishida, CPA's, Inc.

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 03-10
June 2003

Foreword

This is a report of our management and financial audit of the Hawai‘i Tourism Authority’s major contracts. This audit was conducted pursuant to Section 23-13, Hawai‘i Revised Statutes, which directs the Office of the Auditor to conduct, at least every five years, a management and financial audit of all contracts or agreements awarded by the authority to major contractors to determine if the authority and these contractors are in compliance with all relevant programmatic and financial requirements.

We wish to express our appreciation for the cooperation and assistance extended to us by the Hawai‘i Tourism Authority, Hawai‘i Visitors & Convention Bureau, and others whom we contacted during the course of the audit.

Marion M. Higa
State Auditor

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List of Exhibits

Chapter 1

Introduction

In 2002, the Legislature amended Chapter 23, Hawai`i Revised Statutes (HRS), to direct the Auditor to conduct a management and financial audit of all contracts or agreements awarded by the Hawai`i Tourism Authority to a major contractor every five years. Each audit is to determine if the authority and its major contractors are in compliance with all relevant programmatic and financial requirements. A "major contractor" is defined as any contractor to whom a contract or agreement has been awarded that is valued in excess of $15 million. The Legislature required that the first audit be conducted by July 1, 2003 and include a review of:

- The responsibilities, services, and activities of all major contractors;
- The propriety of expenditures;
- Compliance by all major contractors with any laws and rules that may be in effect;
- The management and oversight of all major contractors by the authority; and
- Any additional issues that the Auditor deems appropriate.

Background

In 1998, the Legislature recognized the importance of coordinating the State's development, marketing, and research of the tourism industry. The Hawai`i Tourism Authority was thus established in Chapter 201B, HRS, as the lead tourism agency for the State of Hawai`i. The authority reports directly to the governor and Legislature and is attached to the Department of Business, Economic Development and Tourism (DBEDT) for administrative purposes. A board of directors heads the authority, and an executive director oversees the authority's staff.

The board is comprised of 15 members—12 public members and three ex-officio members. Of the 12 public members, at least six must have expertise in visitor industry management, marketing, promotion, transportation, retail, entertainment, or visitor attractions. At least one public member must have expertise in Hawaiian cultural practices, and Hawai`i's four counties must be represented on the board. Exhibit 1.1 lists the names of board members as of April 2003.

Exhibit 1.1
Hawai`i Tourism Authority Board Members

Mike McCartney, Chair .... At-large
President and CEO, Hawai`i Public Television

Ron Wright, Vice-Chair .... At-large
Managing Director, Sales and Marketing – Hawai`i,
Continental Airlines

W. David P. Carey, III .... At-large
President and CEO, Outrigger Enterprises, Inc.

Kyoko Kimura .... County of Maui
President and General Manager, Diamond Resort Hawai`i Corporation

Rodney K. Haraga .... Ex-officio
Director, Department of Transportation

Lawrence M. Johnson.. At-large
Chairman of the Board and Chief Executive Officer (retired),
Bank of Hawai`i

Lenny Klompus .... Ex-officio
Director of Communications, Governor's Office, Designated Representative
Department of Business, Economic Development & Tourism

Benjamin A. Kudo .... At-large
Chief Financial Officer and Director, Imanaka Kudo & Fujimoto

Nadine Nakamura.. County of Kaua`i
Principal, NKN Project Planning

Lorrie Lee Stone .... At-large
Attorney-at-Law, Rohlfing and Stone

Sharon Weiner.. City & County of Honolulu
Group Vice-President, Business Development, Public Relations and
Government Affairs, DFS Hawai`i

Keith Vieira .... At-large
Senior Vice-President, Director of Operations – Hawai`i,
Starwood Hotels & Resorts Worldwide, Inc.

Stephen Yamashiro .... County of Hawai`i
Consultant

Peter T. Young.. Ex-officio
Chair, Board of Land and Natural Resources

Source: Hawai`i Tourism Authority

The board's primary purpose is to set broad policy and direction for the authority's activities. This is primarily accomplished through the development and implementation of the authority's tourism strategic plan entitled *Ke Kumu: Strategic Directions for Hawai`i's Visitor Industry*. An executive director reports directly to the board and is responsible for carrying out board policies, board programs, and overseeing the authority's day-to-day operations and staff of 19. Exhibit 1.2 illustrates the authority's current organizational chart.

The Hawai`i Tourism Authority administers statewide tourism

The mission of the authority is:

> To strategically manage the growth of Hawai`i's visitor industry in a manner consistent with our economic goals, cultural values, preservation of natural resources, and community interests.

The authority is responsible for:

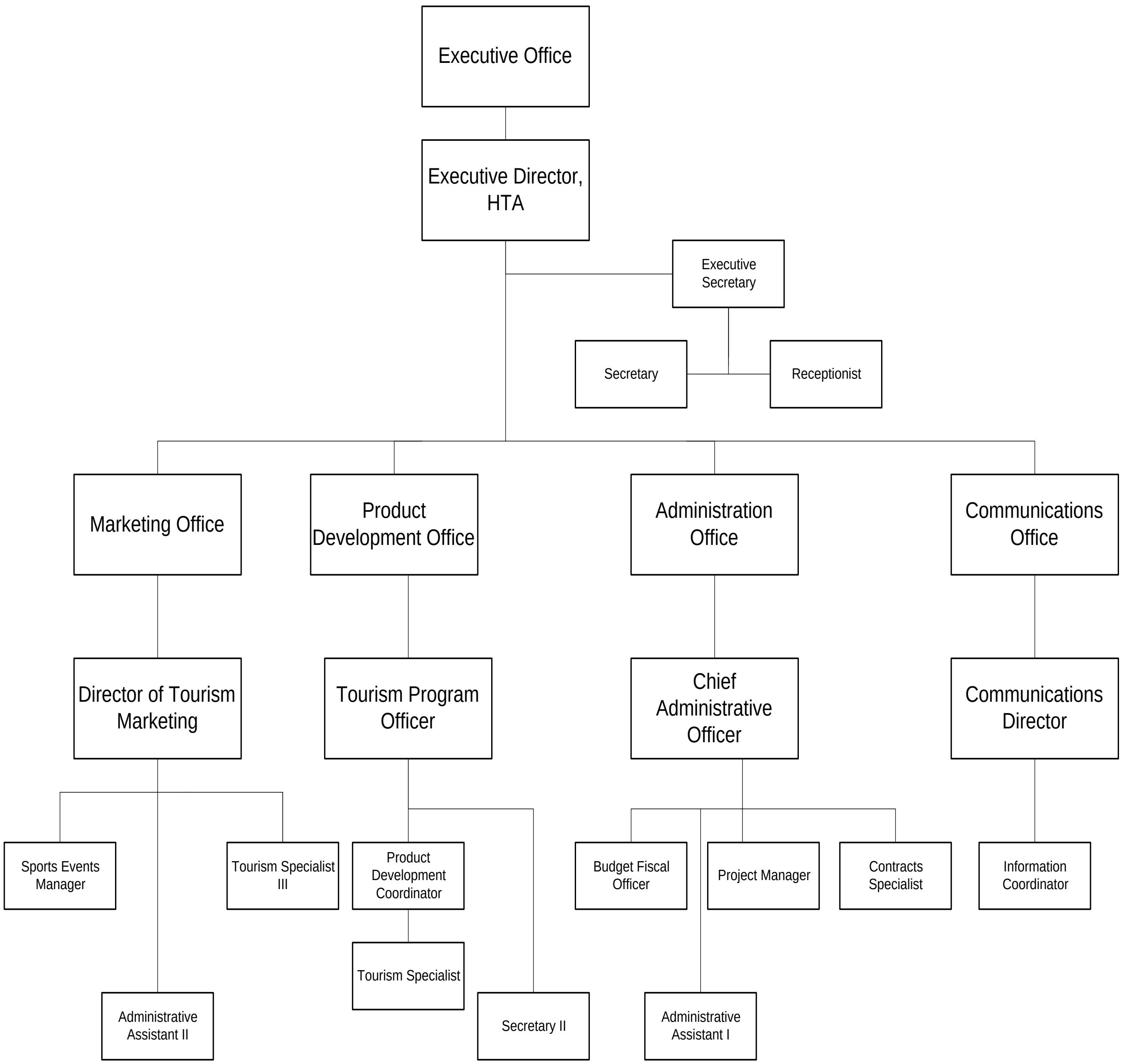
- Promoting, marketing, and developing the tourism industry in the state;
- Arranging for research of the social, economic, and environmental aspects of tourism development in the state;
- Providing technical or other assistance to agencies and private industry upon request;
- Developing and implementing the state tourism marketing plan; and
- Annually reviewing and reporting on tourism promotion, marketing, and development expenditures.

To carry out these responsibilities, the authority, which is exempt from the Hawai`i Public Procurement Code, may enter into contracts and agreements for periods of up to five years. The authority, however, must notify the senate president, house speaker, and governor when it enters into contracts or agreements valued at $25,000 and over.

Funding

The authority receives funding through the Tourism Special Fund. Fund revenues are derived from a portion of the transient accommodations tax; legislative appropriations; and gifts, grants, and other funds accepted by the authority. Currently, the authority receives 32.6 percent of the transient accommodations tax collections. For FY2001-02, the authority reported $131.8 million in total revenues and appropriations. Exhibit 1.3

Exhibit 1.2
Hawai`i Tourism Authority - Organizational Chart



Source: Hawai`i Tourism Authority

illustrates the revenues and appropriations received by the authority from FY1999-2000 to FY2001-02.

Exhibit 1.3
Hawai`i Tourism Authority
Revenues and Appropriations, FY1999-2000 to FY2001-02

	FY1999-2000	FY2000-01	FY2001-02
Revenues:			
Tourism Special Fund	$ 63,887,000	$ 67,145,000	$ 59,743,000
Interest/miscellaneous receipts	$ 248,000	$ 528,000	$ 971,000
Total revenues	$ 64,135,000	$ 67,673,000	$ 60,714,000
Appropriations:			
Regular session	$ 60,000,000	$ 61,000,000	$ 61,057,000
Special session	$ -	$ -	$ 10,000,000
Total Appropriations	$ 60,000,000	$ 61,000,000	$ 71,057,000

Source: Hawai`i Tourism Authority

Major contractors

Section 23-13, HRS, directs the Auditor to conduct a financial and management audit of the authority's "major contractors." A major contractor is a contractor to whom a contract or agreement has been awarded that is valued in excess of $15 million. For this audit, we interpreted the $15 million threshold to include the total compensation a contractor would receive over a multi-year contract and not just the annual compensation. The authority had four contracts with the following contractors that met the $15 million threshold:

1. Hawai`i Visitors & Convention Bureau (HVCB). The authority had two major contracts with HVCB—one for leisure marketing and one for meetings, conventions and incentives. The value of the leisure contract was $129 million; the meetings, conventions and incentives contract was $22.7 million. Both contracts were multi-year contracts beginning January 1, 2000 and ending December 31, 2002.

2. SMG. The authority contracts with SMG to manage and operate the Hawai`i Convention Center. The contract's initial period was June 28, 1996 to June 30, 1999. A first option period extended the contract through June 30, 2003. The authority began operating the convention center on July 1, 2000. Prior to that date, the contract

was managed by the Convention Center Authority. The value of the SMG contract under the authority's management, from July 1, 2000 through June 30, 2003, is about $39.5 million.

3. National Football League (NFL). This contract, which runs from April 1, 2000 through March 31, 2005, is for marketing the NFL Pro Bowl games in Hawai`i. The value of this five-year contract is $23.75 million.

For purposes of this audit, we focused exclusively on the authority's two contracts with HVCB.

The Hawai`i Visitors & Convention Bureau is the State's official tourism marketing agency

As a private, nonprofit, tax-exempt 501(c)(6) corporation, the HVCB promotes leisure and business travel to Hawai`i, including meetings and conventions. HVCB also acts as a catalyst and advocate for improving and expanding Hawai`i's wide-ranging product offerings and experiences, while creating economic opportunities through tourism.

History

Established in 1903, HVCB, then known as the Hawai`i Visitors Bureau, is the oldest tourism organization in the Pacific region and began as a committee of the Honolulu Chamber of Commerce. It received direct territorial appropriations until 1959 when it became a nonprofit corporation. In that same year, the Legislature passed Act 16, which authorized the newly created Department of Planning and Economic Development (now the Department of Business, Economic Development and Tourism) to contract with the bureau for marketing services. In July 1996, the bureau's name was officially changed to the Hawai`i Visitors & Convention Bureau, to reflect a new emphasis on business/meeting travel and responsibility for marketing the Hawai`i Convention Center.

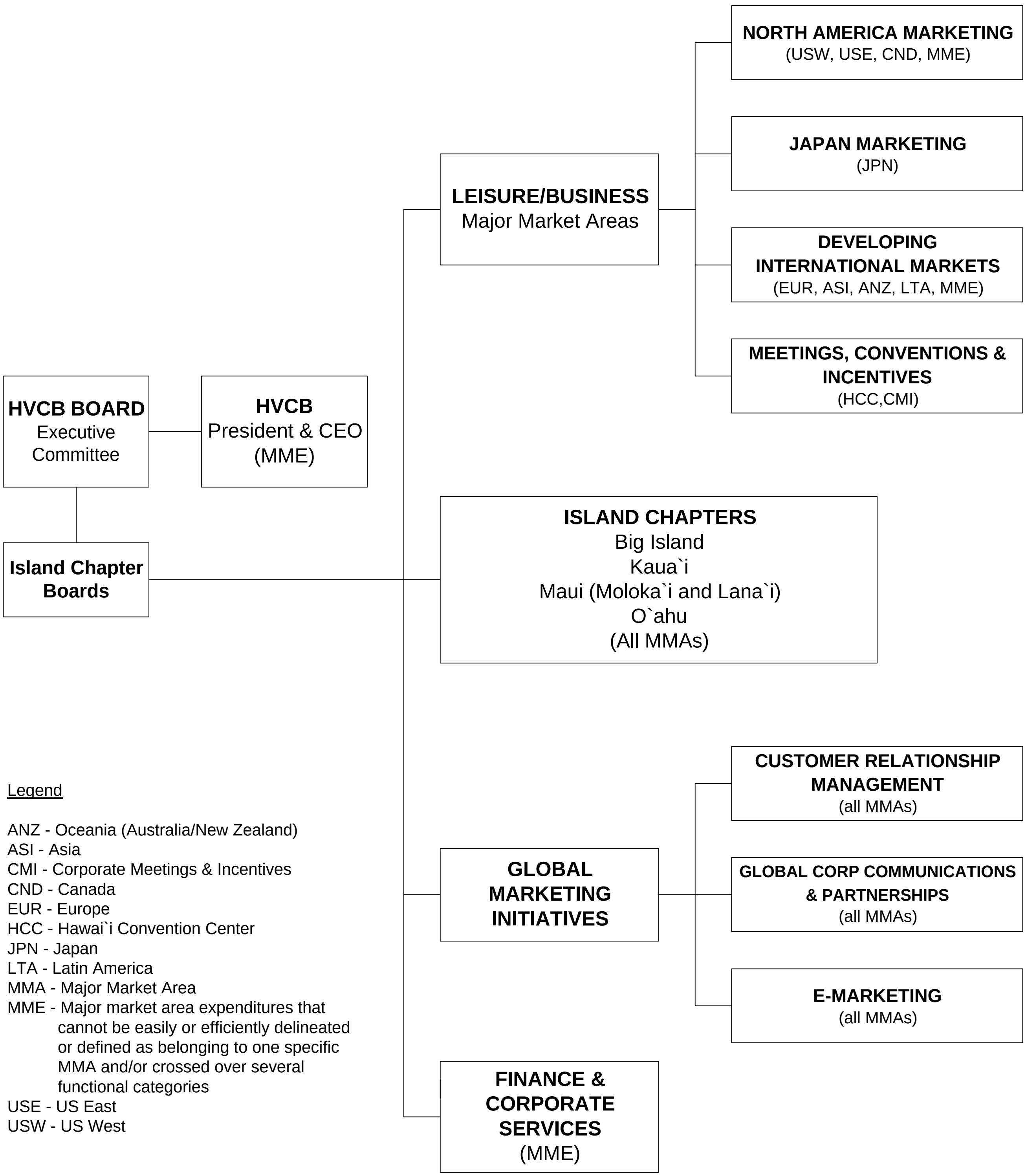
Resources

Today, HVCB has a worldwide presence. In addition to its corporate headquarters in Honolulu, the bureau also maintains offices on each of the major neighbor islands and around the world. In the United States, the bureau maintains offices in Salinas, California; San Diego, California; Chicago, Illinois; and Arlington, Virginia.

The bureau also maintains four foreign offices, two in Japan (Tokyo and Osaka) and two in the People's Republic of China (Beijing and Shanghai).

HVCB representatives can be found in Canada, Germany, United Kingdom, Australia, New Zealand, Korea, Taiwan, Hong Kong, and Uruguay. HVCB's organizational chart is shown in Exhibit 1.4.

Exhibit 1.4
Hawai`i Visitors & Convention Bureau
Organizational Chart



Legend

ANZ - Oceania (Australia/New Zealand)
ASI - Asia
CMI - Corporate Meetings & Incentives
CND - Canada
EUR - Europe
HCC - Hawai`i Convention Center
JPN - Japan
LTA - Latin America
MMA - Major Market Area
MME - Major market area expenditures that cannot be easily or efficiently delineated or defined as belonging to one specific MMA and/or crossed over several functional categories
USE - US East
USW - US West

Source: Hawai`i Visitors & Convention Bureau

For calendar year 2002, HVCB reported a total budget of about $68.8 million, of which $47.9 million, or 70 percent, was derived from state funds and approximately $21 million, or 30 percent, was reportedly derived from private sources. Private fund sources included $2.6 million in membership fees (12 percent), $12 million worth of cooperative marketing (57 percent), and $6 million worth of in-kind contributions (29 percent). Of these amounts, only the $2.6 million in membership fees represents private cash funding. In effect, private sources account for only a fraction of HVCB's overall cash funding. We explain further below.

Cooperative marketing occurs when HVCB and private companies pool funds to leverage buying and marketing power. For example, if HVCB develops a two-page advertising insert for a travel magazine, other companies may opt to add their advertisements to the insert. The insert, which may have grown to four pages, will then strengthen the message of Hawai`i as a travel destination. An example of an in-kind contribution is a hotel sleeping or meeting room made available at no charge to HVCB for a Japanese press tour in Hawai`i. Cooperative marketing and in-kind contributions "revenues" are the estimated *value* of the services, contributions, and support that HVCB receives and do not represent actual cash funding. Therefore, private sources account for only about 5 percent of all cash funding that HVCB receives. State contract funds account for about 95 percent of HVCB's cash funding. Exhibit 1.5 illustrates HVCB's funding sources from 2000 through 2002.

State contracts

The authority's two three-year marketing contracts with HVCB recently ended on December 31, 2002. The $22.7 million meetings, conventions and incentives contract required HVCB to develop and carry out a marketing plan that targeted sales and marketing of the Hawai`i Convention Center and other meeting and convention facilities on all islands. During CY2002, HVCB budgeted $8.0 million to market the convention center and other meeting and convention facilities. Exhibit 1.6 illustrates HVCB's meetings, conventions and incentives expenditures for CY2002.

The $129 million leisure contract required HVCB to develop and implement an annual comprehensive tourism marketing plan in accordance with the authority's tourism strategic plan. The annual tourism marketing plan was to outline how HVCB would increase Hawai`i's promotional presence and brand entity to more globally competitive levels in Hawai`i's nine major market areas: Japan, Canada, Europe, Latin America, Asia, eastern U.S., western U.S., Oceania (including Australia and New Zealand), and other. During CY2002, HVCB spent $35 million in state funds to market Hawai`i in these markets. Exhibit 1.7 reflects these expenditures.

Exhibit 1.5
Hawai`i Visitors & Convention Bureau
Sources of Funding, CY2000 to CY2002

	CY2000	CY2001	CY2002
State Funds			
Leisure			
Marketing	$ 38,400,000	$ 39,000,000	$ 39,000,000
Transfer to Meetings, Conventions & Incentives	-	-	(2,000,000)
Reductions	-	-	(2,000,000)
Proviso	600,000	-	-
Emergency (post 9/11/01 terrorist attack)	-	7,111,840	4,888,160
Total - Leisure	$ 39,000,000	$ 46,111,840	$ 39,888,160
Meetings, conventions & incentives			
Hawai`i Convention Center (HCC)			
Marketing	$ 3,225,531	$ 3,000,000	$ 2,000,000
Supplemental	-	1,000,000	-
Transfer from leisure contract	-	-	2,000,000
Marketing flexibility funds	1,000,000	1,000,000	2,000,000
Proviso/supplemental funds	700,000	-	-
Subtotal HCC	$ 4,925,531	$ 5,000,000	$ 6,000,000
Corporate meetings & incentives (CMI)			
Marketing	$ 1,774,469	$ 2,000,000	$ 2,000,000
Supplemental	-	1,000,000	-
Subtotal CMI	$ 1,774,469	$ 3,000,000	$ 2,000,000
Total - Meeting, conventions & incentives (HCC and CMI)	$ 6,700,000	$ 8,000,000	$ 8,000,000
Total State Funds:	$ 45,700,000	$ 54,111,840	$ 47,888,160
Private Funds			
Co-op Marketing	$ 12,840,855	$ 17,576,003	$ 12,000,000
In-Kind Contributions	7,606,678	6,145,427	6,000,000
Subscriptions (Membership dues)	2,616,711	2,235,809	2,600,000
Interest	74,528	83,282	50,000
Other*	577,809	772,933	332,000
Total Private Funds:	$ 23,716,581	$ 26,813,454	$ 20,982,000
Total Funds – State and Private:	$ 69,416,581	$ 80,925,294	$ 68,870,160

* "Other" private funds include Aloha Concierge Program, consumption tax refund, donations, and friendship contributions

Source: Hawai`i Visitors & Convention Bureau

Exhibit 1.6
Hawai`i Visitors & Convention Bureau
Meetings, Conventions & Incentives Contract Expenditures, CY2002

	Hawai`i Convention Center	Corporate Meetings & Incentives	Total
Advertising	$ 531,970	$ 317,060	$ 849,030
Communications/Promotions	749,633	204,642	954,275
Meeting Trade	265,479	290,965	556,444
Sales	4,362,829	1,011,605	5,374,434
Market Trends	2,960	-	2,960
Administration	153,287	109,570	262,857
Total	$ 6,066,158	$ 1,933,842	$ 8,000,000

Source: Hawai`i Visitors & Convention Bureau

Exhibit 1.7
Hawai`i Visitors & Convention Bureau
Leisure Contract Expenditures, CY2002

Major Market Area	Advertising	Communications/ Promotions	Meeting Trade	Sales	Market Trends	Admin	Total
US West	$ 4,030,238	$ 1,858,657	$ 1,609,153	$ 89,282	$ 11,685	$ 12,415	$ 7,611,430
US East	5,282,630	2,378,119	1,654,044	69,217	11,615	9,833	9,405,458
Canada	343,225	242,473	111,730	67,854	11,600	-	776,882
Japan	4,411,774	2,460,341	822,834	511,472	477	105,133	8,312,031
Europe	87,810	446,963	67,157	156,930	-	-	758,860
Latin America	13,108	22,788	13,358	50,022	-	-	99,276
Asia	16,376	220,440	296,288	157,350	-	160,488	850,942
Oceania	9,309	73,981	28,507	68,901	-	-	180,698
Multi-area	834,681	1,162,013	683,572	1,724,780	216,053	2,383,324	7,004,423
Total	$ 15,029,151	$ 8,865,775	$ 5,286,643	$ 2,895,808	$ 251,430	$ 2,671,193	$ 35,000,000

Source: Hawai`i Visitors & Convention Bureau

Prior audits found numerous deficiencies with both the authority and the bureau

Previous audits revealed the State's history of exercising inadequate oversight of its tourism-related contracts. A previous audit also found that HVCB had failed to fulfill its state contractual responsibilities.

Our most recent audit in 2003, *Financial Audit of the Department of Business, Economic Development and Tourism*, Report No. 03-03, found that the authority did not adequately manage its contracts. As a result, contractors performed services prior to the execution of legally binding contracts, contractors' final reports were not received in a timely manner, contracts were renewed prior to the authority's evaluation of the quality of the work provided, and final payment was made prior to the completion of all required tasks. Our 2002 *Management Audit of the Hawai`i Tourism Authority*, Report No. 02-04, identified serious deficiencies in the authority's contracting process. Specifically, the authority could not justify the contracts it awarded and did not adequately monitor all contracts.

In 1993, the office conducted a *Management and Financial Audit of the Hawai`i Visitors Bureau*, Report No. 93-25. We found that the bureau and the Department of Business, Economic Development and Tourism had fallen short in fulfilling their respective responsibilities for the State's tourism program. The report specifically noted that the bureau had not been submitting reports required under its state contract, and the department had not effectively administered and monitored the bureau's contract.

Objectives of the Audit

1. Assess whether the Hawai`i Tourism Authority adequately manages its major contracts.

2. Assess the compliance of major contractors with contract provisions and the propriety of contract expenditures.

3. Make recommendations as appropriate.

Scope and Methodology

We focused our audit on the authority's two contracts with the Hawai`i Visitors & Convention Bureau to provide marketing for the leisure travel segment and for meetings, conventions and incentives from January 1, 2000 to December 31, 2002. The contracts were judgmentally selected based on their economic significance to the authority and the state economy and their high dollar value.

We reviewed pertinent laws, audits, reports, and studies. We interviewed HVCB and authority personnel including HVCB's president, chief financial officer, human resources manager, and the authority's executive director, chief administrative officer, and director of tourism marketing. We reviewed HVCB's general ledgers, account journals, invoices, contracts, policies and procedures, and personnel information. We also reviewed the authority's contract files and reports, and its policies and procedures. Our fieldwork focused on expenditures made by HVCB's corporate office, Tokyo office, and the Kaua'i Visitors Bureau from January 2002 through October 2002.

Our audit required the services of a technical consultant. We procured the services of Nishihama & Kishida, CPA's, Inc. The consultant conducted a financial audit of HVCB for the calendar year ending December 31, 2002 in accordance with generally accepted auditing standards. The consultant also reviewed contracts entered into by HVCB and the propriety by which HVCB managed those contracts. Finally, the consultant assessed HVCB's existing accounting, reporting and internal controls, and operating procedures.

The audit was conducted from October 2002 through June 2003 in accordance with generally accepted government auditing standards.

Chapter 2

The Hawai`i Tourism Authority Enabled the Hawai`i Visitors & Convention Bureau to Exploit State Contract Funding

The Hawai`i Tourism Authority recently ended two multi-year contracts valued over $150 million with the Hawai`i Visitors & Convention Bureau (HVCB) to market Hawai`i to leisure and business travelers. A review of the authority's contract management and internal controls reveals that the authority failed to safeguard state funds allocated for these marketing efforts. Poorly written contracts and inadequate oversight by the authority resulted in HVCB's exploitation of state contract funds. With Hawai`i facing a potential decline in visitor arrivals of 8.5 percent from 2000 to 2002, it is critical that the moneys allocated to tourism marketing are spent wisely, and those who spend it are held accountable for results. Ultimately, the authority's failure to exert adequate controls allowed HVCB to "run amok" with state contract funds.

Summary of Findings

1. Inadequate oversight by the Hawai`i Tourism Authority provided the Hawai`i Visitors & Convention Bureau with a blank check to spend state funds for self-serving purposes.

2. The authority's failure to monitor and enforce its marketing contracts with the bureau leaves little assurance that $151.7 million in state funds were effectively spent to promote Hawai`i as a visitor destination.

Inadequate Authority Oversight Provided the Hawai`i Visitors & Convention Bureau With a Blank Check to Benefit the Bureau and Selected Entities

The authority's inadequate oversight enabled HVCB to spend a disproportionate amount of state contract funds on its own organization and selected others rather than the state as a visitor destination. Specifically, we found that HVCB significantly increased the number of its state-funded employees over the past three years although the amount of state funding for those three years remained relatively unchanged. HVCB also used state contract funds to pay for exorbitant bonuses and unnecessary severance packages for its employees who were highly compensated. HVCB's corporate office often superseded controls in place and approved inappropriate expenditures of state contract funds, while the bureau's Japan office entered into a salary arrangement for an office executive that creates a potential conflict of interest.

Questionable accounting practices enabled HVCB to circumvent the return of unspent funds to the authority leading to a qualified opinion by our consultant CPA firm. In addition, HVCB's inadequate contract management led to a lack of assurance that its subcontractors appropriately used state contract funds. Finally, we found evidence that HVCB used state contract funds in connection with an unusual arrangement involving the former governor's office.

HVCB's state-funded personnel expenditures dramatically increased over the past three years despite level state contract funding

Despite relatively level state contract funding, HVCB increased its state-funded personnel roster by 20 percent and its state-funded personnel costs by 42 percent from CY2000 to CY2002. HVCB also used state contract funds to pay out large bonuses and severance packages to select employees.

The number of HVCB state-funded employees increased by 20 percent

In CY2000, HVCB had 82 state-funded employees. By CY2002, the number of state-funded employees had increased to 99—a 20 percent increase in personnel over three years. The total compensation of state-funded employees increased more than 42 percent over those same three years—from $3.7 million in CY2000 to $5.3 million in CY2002. HVCB's total state funding, however, remained relatively constant over the 3-year state contract period ($45.7 million for CY2000, $47 million for CY2001, and $43.0 million for CY2002).

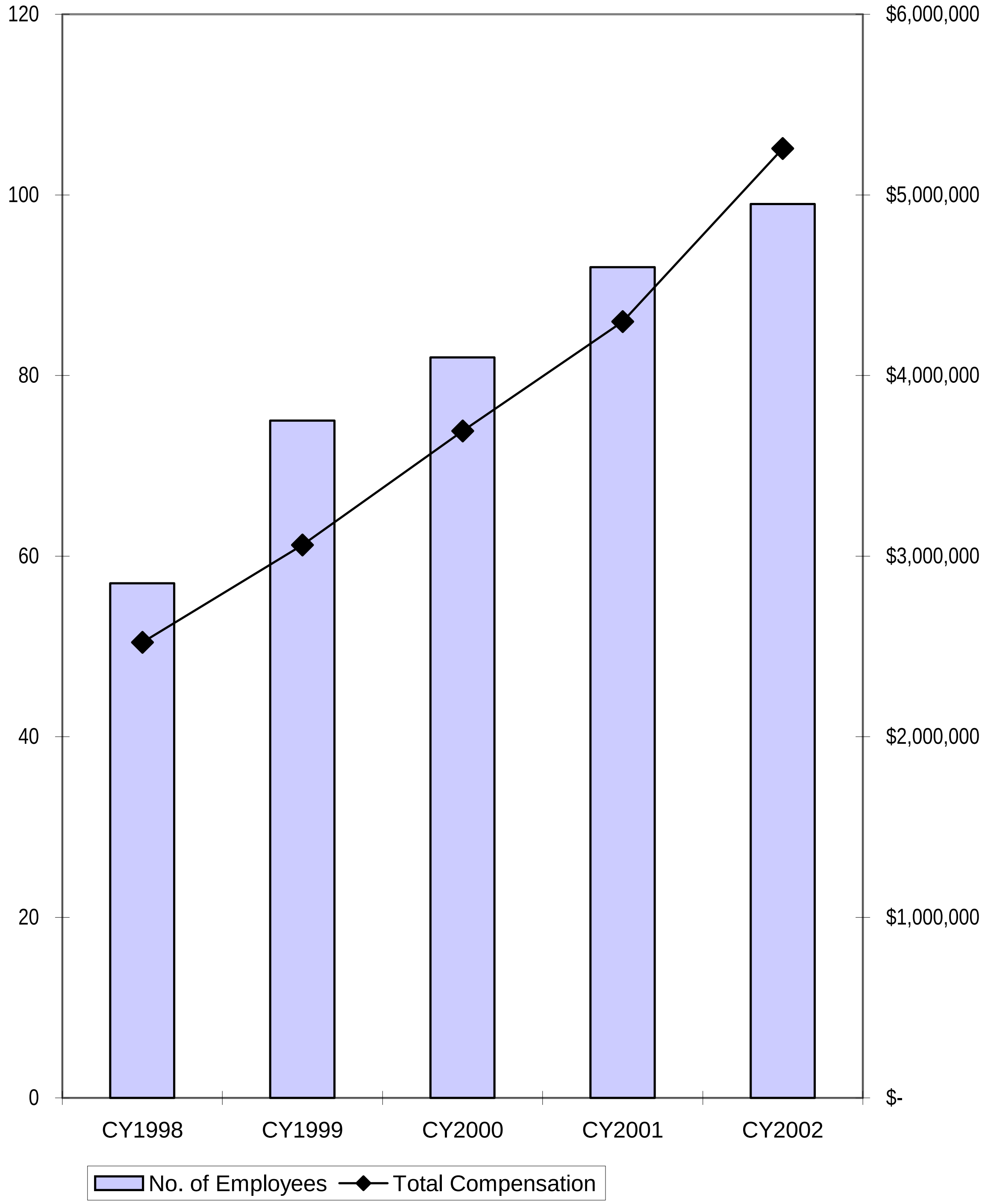
The increase in state-funded HVCB employees over the last five years—from CY1998 to CY2002—is even more alarming. In CY2002, HVCB reported spending about $5.3 million in state-funded personnel—more than double the $2.5 million spent in CY1998. Exhibit 2.1 reflects the number of HVCB employees paid with state contract funds over the last five years from CY1998 to CY2002.

HVCB employees received generous compensation, exorbitant state-funded bonuses, and unnecessary severance packages

Prior to the authority's establishment in 1998, the Department of Business, Economic Development and Tourism (DBEDT) contracted with HVCB to provide state tourism marketing. Under the department contract, HVCB was prohibited from using state contract funds to pay for portions of HVCB employees' salaries in excess of amounts approved by the department.

In 1998, the authority became the State's lead tourism agency and assumed responsibility for the HVCB contract. In comparison to the

Exhibit 2.1
HVCB Staff Paid with State Contract Funds
CY1998 to CY2002



Source: Hawaii Visitors & Convention Bureau department, the authority gave HVCB far more autonomy in establishing salaries and bonus and incentives programs. Unlike the department contract, the authority contract provided little oversight and no constraints on the amounts of HVCB employees' salaries. As a result, HVCB salaries and bonuses increased significantly after the authority assumed responsibility from the department for the HVCB contract.

We found eight HVCB employees who were compensated between $90,000 and $170,000 using state contract funds during CY2002. Three of the highest paid bureau employees experienced more than a 29 percent increase in their total compensation between CY2000 and CY2002.

We also found that HVCB awarded over $500,000 in state-funded bonuses from CY2000 to CY2002. Individual state-funded bonuses over the three-year period ranged from about $100 to $65,000 and were based on performance goals. For example, conventions, meetings and incentives contract employees received a $2,500 bonus if they reached 80 percent of their individual production goals in terms of generating hotel leads, room nights, or bookings. If these employees reached 100 percent of their individual production goals, they earned a $5,000 bonus. Employees were also eligible for additional incentive program bonuses up to $6,000 if they exceeded their production goals. Several HVCB employees received individual annual bonuses in excess of $25,000.

The authority did not assess the appropriateness of the salary levels or the incentive program bonus amounts. The authority's non-involvement and apparent lack of accountability have been exploited by HVCB in establishing compensation thresholds for state-funded bureau employees. Such authority deficiencies have resulted in unfettered increases in the number of HVCB state-funded employees, as well as in the amount of their salaries and bonuses.

In addition, we found that HVCB utilized state contract funds to provide several employees with severance pay. On January 1, 2003, marketing of the Hawai`i Convention Center was transferred from HVCB to the convention center's operator—SMG. As a result, a number of HVCB employees assigned to meetings, conventions and incentives marketing were terminated. Although HVCB was not obligated to provide these employees severance pay, HVCB paid and accrued approximately $202,000 in severance pay using state contract funds. One employee's severance pay was approximately $141,000, nearly the equivalent of that employee's annual salary.

Moreover, one employee who received severance pay was subsequently hired by SMG, the convention center operator that took over after HVCB. In effect, this employee was paid twice with state contract funds at the same time—first upon severance from HVCB and then upon hiring by SMG.

When asked about the severance payments, HVCB responded that payments were intended to ensure a smooth transition from HVCB to SMG. HVCB represented that the severance packages were established with the authority's agreement. The authority disagreed, stating that authority officials had neither requested the severance packages nor had knowledge that the severance pay had been paid with contract funds.

We question whether providing almost a quarter of a million dollars in severance pay was a prudent use of state contract funds. We further question the appropriateness of a single employee being paid both severance pay and salary at the same time by funds intended to market the convention center. Finally, we raise grave concerns regarding the payment by HVCB of over $202,000 in severance pay without the authority's knowledge.

HVCB's Honolulu corporate office approved a plethora of inappropriate state-funded expenditures

Our review of a sample of HVCB state contract expenditures from January 2002 through October 2002 found that HVCB inappropriately spent $191,000 in state contract funds. In some cases, HVCB violated its own policies for reimbursable expenditures. In other cases HVCB did not exercise adequate controls over expenditures that resulted in the misuse of state funds. We also found several instances where HVCB used state contract funds to pay for other state agencies' expenditures under questionable circumstances. Although we reviewed only a sample of HVCB's contract expenditures, we are concerned that HVCB's abuse of state contract funds may be widespread.

Numerous expenditures approved at the corporate level violated HVCB's own travel and entertainment policies

In January 2002, HVCB issued a travel and entertainment policy to: provide guidance to travelers, travel arrangers, approvers, and auditors on cost-effective management of travel, entertainment, and other business expenses; identify reimbursable versus non-reimbursable expenses; and clarify employee responsibility for controlling and reporting travel, entertainment, and other business outlays. In acknowledgement that travel and entertainment costs are two of the largest controllable items in a company's operating budget, HVCB prohibits certain travel and entertainment expenses. For example, airline upgrades, travel for companions or family members, traffic and parking violations, and in-room movies or mini-bar refreshments are non-allowable expenses.

The policy also prohibits using state funds to pay for department parties, holiday parties, employee birthday gifts, or other occasions unless approved by the HVCB president. We agree that using state marketing funds to pay for such expenses is inappropriate.

However, notwithstanding existing policies, we found numerous instances where HVCB's corporate office approved expenditures using state contract funds that violated its own travel and entertainment policy. For example, HVCB used about $2,000 in state contract funds to purchase two first-class airline tickets even though the airline offered to provide HVCB with coach class tickets free of charge. This violated HVCB's policy to use in-kind contributions whenever available. Exhibit 2.2 provides additional examples of HVCB's practice of violating its own travel and entertainment policy.

Some HVCB employees claimed and received excess reimbursement for travel expenses

In addition to HVCB violating its own travel and entertainment policy, we also found instances where employees claimed, and received approval for, excessive reimbursement. Specifically, we found HVCB employees who inflated their mileage and parking expense requests. Even though the amounts involved each time may be small, there appears to be an operant culture of taking advantage of the funding source—public moneys.

For example, we reviewed an expense report submitted by a Chicago-based employee requesting mileage reimbursement for a 25-mile trip. Our research, however, revealed that the actual mileage of the trip is only 6.6 miles. HVCB's corporate office approved the mileage reimbursement. The same employee claimed 21 miles for a roundtrip from the Chicago office to a restaurant. We found, however, that the restaurant is less than 2.5 miles away from the office or approximately five miles roundtrip. This reimbursement was also approved by HVCB's corporate office. Exhibit 2.3 identifies additional examples of excessive reimbursement approved by HVCB's corporate office.

While these overages do not represent a significant amount of money, it is indicative of the HVCB's lack of internal controls and lack of prudent management of contract dollars. It also displays a tendency by HVCB to pay the expenses of privately-funded employees with state contract funds. Greater internal controls must be in place to ensure that state funds do not support privately-funded employees and their expenses.

Expenditures by HVCB's Kaua'i Visitors Bureau and its China and Japan offices indicate varying degrees of improper management of state funds

The Kaua'i Visitor's Bureau has a staff of four state-funded positions and an executive director who is paid through private funds. In CY2002, the Kaua'i Visitors Bureau had a budget of $2,479,248 comprised of

Exhibit 2.2
Examples of Inappropriate Contract-Funded Expenditures

HVCB Policy	Examples of Policy Violations
Traffic and parking violations are not reimbursable.	HTA contract funds were used to pay for the HVCB president's $137 in parking and speeding tickets.
Extravagant meals and alcohol while entertaining staff are not reimbursable.	HVCB's five-year planning meeting on Kauai included a $2,400 employee dinner with $545 in alcoholic beverages.
Upgrades for domestic air travel at the expense of HVCB are not permitted.	The eastern region director of sales upgraded flights on several trips for a total cost exceeding $1,000.
All family member travel expenses are the sole responsibility of the employee.	HVCB's president was reimbursed $174 for his family members' travel expenses.
State funds may not be used for department parties, holiday parties, or other occasions.	• State funds were used to pay for $93 in napkins and refreshments for two HVCB office blessings. • Gifts valued in excess of $800 were purchased for HVCB's outgoing board chair. These gifts included a two-night stay at a Four Seasons Hotel, a massage, and a golf package.
Hotel in-room movies are not reimbursable.	HVCB's president was reimbursed $359 for in-room hotel movies he rented.
Gifts to business associates or clients cannot exceed $25 per person per year.	• HVCB paid for a $600 family vacation for an American Psychiatric Association representative who was instrumental in booking the association's convention at the Hawai`i Convention Center. • An HVCB subcontractor employee received a $110 floral arrangement purchased with contract funds.
Personal convenience is not acceptable justification for car rental.	A Big Island Visitor Bureau employee was reimbursed $340 for a seven-day car rental because the employee shipped a personal car to Maui in anticipation of an imminent relocation to that island.

Source: Office of the Auditor

Exhibit 2.3
Examples of Excessive Reimbursement for HVCB Employees

Type	Examples
Mileage	• An HVCB employee in the Chicago office requested and received reimbursement for a 25-mile trip; however, the actual distance traveled was only 6.6 miles. • The same employee requested and received reimbursement for a 21-mile trip; however, the actual distance traveled was only 4.8 miles.
Parking	• An HVCB employee in the Chicago office was reimbursed multiple times for parking in a structure less than 0.5 miles away from the Chicago office. The same employee is also reimbursed $230 a month for regular employee parking in another parking structure near the office. • Another Chicago employee was reimbursed on 12 separate occasions for parking within blocks of the Chicago office although the employee is reimbursed $175 a month for regular employee parking in a structure within walking distance of the office.
Airfare	• Almost $23,000 in first/business class travel by HVCB's president for several domestic and international trips. • Airfare of about $1,000 for a privately paid HVCB employee to attend a training seminar.
Other	• Bereavement and get-well flowers for the parents of an HVCB executive who is paid with private funds. • Employee parking for an HVCB staff that is privately funded. • Internet service for employees' home computers.

Source: Office of the Auditor

state contract funding and private membership dues. We reviewed expenditures paid and invoices received in CY2002. While we did find instances of inappropriate or questionable expenditures of state contract funds, such as purchasing an office Christmas tree and spending over $100 for less than a pound of coffee for office use, they do not appear to be widespread. Thus, based on our limited review of expenditures, the Kaua'i Visitors Bureau appears to monitor expenditures fairly well and generally complies with policies and procedures.

HVCB's two China offices are located in Beijing and Shanghai. The Beijing office, which is staffed by two state-funded employees, had a CY2002 budget of $239,707. The Shanghai office, which is also staffed by two state-funded employees, had a budget of $221,795 for the same time period. Our limited review of the expenditure files for the China offices did not uncover any examples of improper expenditures made with state funds.

HVCB also has two offices in Japan—one in Tokyo and the other in Osaka. For CY2002, the entire Japan market area was budgeted about $10 million in state contract funds for leisure marketing. We reviewed a sample of 113 expenditures made for the Japan market area representing about 7 percent, or $730,000, of the total $10 million budget. Similar to the China offices, we did not find any examples of improper expenditures made with state funds in the sample we reviewed. We did, however, uncover an unusual salary structure for a Japan office executive that is supported by state contract funds.

The salary structure for a Japan office executive creates a potential conflict of interest

Japanese consumers account for nearly one-fourth (24 percent) of all arrivals to Hawai`i. However, unfavorable market conditions and increased competition required HVCB to intensify its marketing efforts to maintain and strengthen Hawai`i's relationship with Japanese consumers. Therefore, for CY2002, about 27 percent of HVCB's total leisure travel budget, or $10.1 million, was allocated to the Japan market area. A vice president for Japan marketing oversees HVCB's Japan marketing division that is comprised of nine employees in Honolulu, Tokyo, and Osaka. The Japan marketing division is entirely funded with state contract funds.

Although the Japan market area receives a significant portion of the leisure budget, HVCB also works with industry partners to develop cooperative opportunities to ensure continued stability and growth of the Japanese market. Specifically, the bureau has been actively strengthening its relationship with air carriers by implementing promotional programs. Carriers serving the Japanese market include Japan Airlines (JAL), All Nippon Airways (ANA), Northwest, United, and China Airlines.

Under an unusual arrangement, JAL pays a portion of the Japan vice president's salary and provides the vice president with JAL benefits. We believe this arrangement creates the potential for a conflict of interest—or at least the appearance of a conflict of interest.

The vice president, who was hired by HVCB in 1997, was a former JAL employee. When the vice president was hired, HVCB was unable to match his JAL salary. Therefore, HVCB agreed to allow JAL not only to fund the balance of the salary that the employee would have received had he remained with JAL but also to provide the vice president with JAL benefits. Under the arrangement, HVCB submits monthly payments to JAL representing HVCB's portion of the vice president's salary.

Although HVCB asserts that this arrangement does not give JAL an unfair advantage in negotiating favorable cooperative marketing partnerships, it would be reasonable for other air carriers serving the Japanese market to disagree. Any arrangement that presents even the *appearance* of a conflict of interest should be avoided so that marketing activities supported by state contract funds are not tainted.

HVCB violated generally accepted accounting principles to circumvent contract limitations

Under its three-year leisure contract with the authority, the bureau could not expend more than $39 million annually. Although the leisure contract did not contain any provisions for the disposition of unspent contract moneys, any funds that HVCB did not commit or encumber should have been returned to the authority at the end of each of the three calendar years. Additionally, because HVCB is required to prepare its financial statements in accordance with generally accepted accounting principles, funds could be committed only if they were needed to pay for goods to be received, or services to be rendered, by the end of each calendar year. Funds should not be committed to pay for goods or services to be provided in the subsequent year.

For the duration of HVCB's leisure contract with the authority, HVCB has been able to spend exactly up to its annual $39 million expenditure limit. We find it highly suspicious that HVCB has never had unspent state contract funds to return to the authority. Our suspicions prompted a review of HVCB's commitment of funds.

We found that HVCB committed funds to pay for future goods and services—a direct violation of generally accepted accounting principles. For example, in November 2001, HVCB accrued approximately $1 million to an advertising company although no related services were provided by December 31, 2001. It appeared that the advertising company pre-billed HVCB for services it had yet to provide. On another occasion, the bureau accrued approximately $900,000 for various advertising and production services in December 2002, even though the services would be provided or completed in 2003. In Chapter 3 of this report, our consultant CPA firm, Nishihama & Kishida, CPA's, Inc., declares its qualified opinion on the HVCB financial statements for the year ending December 31, 2002.

By adopting this practice that violates generally accepted accounting principles, HVCB was able to spend exactly up to its limit and circumvent the return of funds to the authority. We found that this practice of spending exactly up to its limit existed for the duration of the bureau's leisure contract with the authority.

However, it should be noted that the scope of our financial audit *primarily* focused on the calendar year ending December 31, 2002. Although HVCB conducted its own financial audit for the same period, the State and the Legislature should take additional steps to satisfy themselves that the practice that led to our consultant's qualified opinion did not happen in previous years or under the meetings, conventions and incentives contract. We strongly believe that HVCB's practice of committing funds to pay for future goods and services warrants re-examination.

HVCB's poor contract management results in substandard oversight of its state-funded subcontractors

HVCB generally procures goods or services from third-party vendors (subcontractors) in three ways: (1) a formal contract issued by HVCB; (2) an agreement for services, which is generally issued by the vendor and which may include a proposal; or (3) purchases for food and beverages that do not require proposals. Although HVCB expends a significant amount of its funds on these contracts, agreements, and purchases, we found HVCB's administration and management of them deficient.

Procurement policies and procedures were inadequate and HVCB did not adhere to those that were in place. HVCB failed to adequately and consistently document its contract monitoring and evaluation efforts. Instead, HVCB tended to rely on personal relationships and oral communications as evaluation tools. We also found that HVCB did not execute contracts in a timely manner and that procured services were sometimes beyond the scope of the bureau's leisure contract. Moreover, the bureau expended state contract funds for legal services to develop and advocate positions detrimental to the authority. Finally, HVCB's contract files were incomplete and disorganized.

The process by which subcontracts are procured, monitored, and evaluated is inconsistent

HVCB's current procurement policies and procedures indicate the procedures for issuing requests for proposals and quotations, but are silent as to when these requests should be issued. As a result, we found instances where HVCB procured goods or services using significant amounts of state funds without written contracts or agreements specifying the goods or services to be provided.

For example, although HVCB paid one vendor $2 million for advertising services during CY2002, there was no written agreement as to the type and scope of services the vendor would provide and the payment terms. Another vendor was paid about $700,000 during CY2002; however, we found only a proposal that described some of the services the vendor ultimately provided. Although we found invoices from these vendors, the invoices served as after-the-fact documents of the goods or services that had already been provided. Prudent business practice dictates that a contract or agreement should be in place, specifying HVCB's requirements and expectations in order to protect its and the State's interests.

Although HVCB has written policies and procedures governing contractor evaluations, they do not provide guidelines on documenting the evaluations. We reviewed 25 contracts and noted that HVCB did not document its evaluation of contractor performance for 23 of them. We found that the need for contract evaluations and reports is determined by each contract and on a case-by-case basis.

For example, HVCB had a three-year contract with an advertising firm to provide state-funded marketing and advertising services for a $36,000 monthly fee. The advertising firm was also eligible for bonus payments if it met certain goals. The contract's value over the three years was approximately $1.3 million. However, HVCB has never formally evaluated this advertising firm. According to HVCB, it never conducted a formal evaluation because it is in constant contact with the firm. HVCB explained that its "informal" evaluation system consisted of status meetings on important projects and periodic written and verbal progress reports by the firm. HVCB also remarked that its vice president of North America has a personal relationship with the firm's chief executive officer and that the relationship is built on trust, teamwork, and project fulfillment.

We disagree with HVCB's evaluation methods. While strong relationships with its vendors are important, the lack of formal reporting requirements and contract evaluations means that HVCB is without a mechanism to assess its contractors' performance objectively and to ensure that state contract funds were used efficiently and effectively. In addition, formally documenting that contract expenditures have been monitored provides assurance that costs being incurred agree with contract terms. Documenting contractor performance evaluation is necessary to ensure that the contracts were evaluated according to HVCB guidelines and serves as a basis for determining whether to terminate or renew the contracts.

Contracts were not executed in a timely manner

HVCB does not always execute contracts prior to the commencement of work. Our review of a sample of 25 contracts found that 11 were executed after services were scheduled to commence. In five of the 11 instances, contracts were signed more than one year after the start date of the services. We were unable to determine when five contracts or agreements were executed because the signatory date was blank. Finally, all necessary HVCB representatives did not sign two of the contracts as required by HVCB policy.

Most of the 11 vendors provided services before contracts were finalized because they had previous contracts or agreements with HVCB and expected the continuation of those contracts and agreements. However, this is not in the best interest of the vendors or the authority.

Some subcontractors were procured to perform state-funded services beyond the scope of the bureau's leisure contract

Under HVCB's leisure contract with the authority, HVCB must make every effort to obtain the authority's prior written approval before it engages in projects or programs that will exceed the duration of its contract and are not included in the annual tourism marketing plan. We found at least two occasions where HVCB entered into contracts that exceeded the scope of its contract with the authority. First, HVCB entered into a three-year agreement with Buena Vista Disney to promote the animated movie *Lilo & Stitch*. The contract was effective from April 15, 2002 through April 14, 2005. However, HVCB's contract with the authority ended on December 31, 2002. In effect, HVCB committed $2.2 million in state contract funds that it did not have.

The second instance of HVCB entering into a contract beyond the term of its contract with the authority is a contract with Wish (Wei-Yuan) Company, a Taiwan public relations company. Moreover, the circumstances surrounding the awarding of this contract suggest self-dealing or at least a conflict of interest. Specifically, on the same day that the Wish Company contract was awarded, the president of Wish Company signed a separation agreement with HVCB as its vice president for developing international markets.

Under the contract, Wish Company serves as HVCB's worldwide representative in Taiwan by promoting Hawai'i in Taiwan and improving and maintaining the image of Hawai`i in Taiwan as a primary visitor and convention/incentive destination. The contract was originally effective from May 1, 2002 through December 31, 2005 and committed a total of $242,000 in state contract funds ($44,000 for CY2002, $66,000 for CY2003, $66,000 for CY2004, and $66,000 for CY2005).

On April 30, 2002, just days prior to the execution of the contract, the former HVCB vice president resigned from her HVCB position to "pursue employment elsewhere." Three days later, on May 3, 2002, HVCB executed the contract with the former vice president's company to provide worldwide representative services. At the time the contracts were signed, the former HVCB vice president was Wish Company's president.

The former HVCB vice president's Wish Company not only won the contract award, but also received a contract with an end date extending past 2002. We note, however, that HVCB recently changed the contract's end date to December 31, 2003—the last day of the bureau's extended contract with the authority.

Legal services provided by a state-funded subcontractor sought to undermine state interests

In CY2002, HVCB paid a law firm a total of $300,596 for legal services with state funds intended to market Hawai'i. Moreover, our review of billing statements from the law firm revealed that on several occasions the law firm was engaged to advocate a position adverse to the authority and the State.

For example, the law firm conducted extensive work for HVCB during the 2002 legislative session that included research, bill tracking, drafting testimony, and committee hearing monitoring. One billing entry by the law firm noted that it did work to "review/revise/finalize memo re HB 2451 veto issues." The bill, which was referenced HB 2451, provided the authority with the right to market, operate, manage, and maintain the Hawai`i Convention Center. In addition, the bill provided that convention center management would also include marketing the facility. Public testimony indicated that the authority supported this legislation. Thus, HVCB used state contract funds received from the authority to develop and advocate a position contrary to that of the authority. We question the propriety of utilizing state funds intended to market Hawai`i for legal services designed to undermine the authority.

On a separate occasion, HVCB received state contract funds from the authority to conduct legal research regarding the authority's attendance at HVCB board of directors and marketing advisory committee meetings. Under the terms of the leisure contract, the authority was empowered to attend all such meetings and to receive advance notices of these meetings from HVCB.

Billing statements from HVCB's state-funded attorney revealed that the attorney responded to an e-mail from an HVCB executive "questioning the prudence of HTA member attending meetings." While researching the legality of the authority's attendance may have been legitimate, we again question the appropriateness of using state funds for this purpose.

Other billing entries reviewed read, "review and respond to email regarding strategy for killing SB 3017." Still others requested analysis of campaign finance/public ethics law issues as they relate to dues for a particular political candidate, research regarding gifts of travel to public officials, state ethics law issues, and drafting HVCB testimony for a city council meeting. Even if these are legitimate legal issues facing HVCB, HVCB is not justified in expending over $300,000 in state contract funds for purposes that do not contribute to marketing Hawai`i as a visitor destination.

Contract files are disorganized and incomplete

HVCB's written policies and procedures for bids, quotes, and contracts state that original contracts or copies of contracts for island chapters' contracts are to be centrally filed. Although HVCB employees are aware that contract amendments are an integral part of contracts, we found that contract amendments were not always centrally filed. Instead, HVCB department directors or managers sometimes retained documentation of contract amendments instead of filing the amendments with the original contracts. By filing pertinent contract documents in different locations, HVCB is unable to efficiently research specific contracts and agreements with third parties or be certain whether any amendments were made.

We also found that HVCB does not assign sequential contract numbers. As a general business practice, organizations that manage numerous contracts typically assign contracts sequential numbers to ensure that all contracts are accounted for. As a result, HVCB cannot ensure that it has accounted for all contracts.

During our review of HVCB's contract files, we requested all relevant requests for proposals for third-party services. HVCB however, informed us that it discarded all requests for proposals related to its meetings, conventions and incentives contract because the contract had expired on December 31, 2002 and retaining the documents was not considered necessary. This however, violated HVCB's record retention policy of seven years for expired contracts. Discarding the requests for proposals also violated the record retention requirement of the meetings, conventions and incentives contract. According to the contract, HVCB and any subcontractors are required to maintain the books and records that relate to the meetings, conventions and incentives contract and any cost or pricing data for three years from the date of final payment.

HVCB also amended some of its contracts but failed to formally document the amendments in writing. For one contract, an advertising agency's monthly retainer fee was increased by $4,000 through an oral agreement. A second contract with a website host and development company was revised through electronic mail correspondence, but a copy of the correspondence, which can be legally binding, was not in the contract file and was not made available for our review. Finally, a public relation firm's monthly fee was apparently amended; however, we could not find any documented evidence of the amendment to the contract. It is critical that all contracts, agreements, and amendments be placed in writing to ensure that there are no misunderstandings and to provide a legal basis for enforcement of the agreed-upon terms.

The former governor's office apparently used the bureau and its state contract funds to conceal questionable expenditures

Under the direction of the former governor's office, HVCB entered into two questionable agreements relating to high technology development in Hawai‘i. The arrangements raise questions about whether the former governor's office used HVCB to circumvent the State Procurement Code.

Act 297, Session Laws of Hawai`i 2000, appropriated $200,000 to the Department of Business, Economic Development and Tourism (DBEDT) to promote high technology development. On July 1, 2000, a memorandum of understanding between DBEDT, the High Technology Development Corporation (HTDC), and the former governor's special advisor for technology development specified that the $200,000 would be allocated to: HVCB ($24,000); Honolulu Community College ($72,500); Joan Bennet and Associates, Inc. ($24,000); University of Hawai`i Conference Center ($42,000); Western Governor's Association ($32,000); and miscellaneous ($5,500).

We found that the allocations to HVCB, Honolulu Community College, and Joan Bennet and Associates resulted in questionable contractual arrangements and payments involving HVCB. The $24,000 allocation to HVCB was confirmed through a letter of agreement between the High Technology Development Corporation, DBEDT, and HVCB. The agreement required HVCB to coordinate the logistics of four meetings, submit an initial and four quarterly reports, as well as a final written report. The agreement further stated that payments made to HVCB would be contingent upon receiving the quarterly and final reports. However, we found no evidence that HVCB submitted any reports to DBEDT or the corporation. Instead, we found that HVCB paid for services unrelated to those required by the letter of agreement.

According to HVCB, the $24,000 under the letter of agreement was used to pay for invoices received from the former governor's special advisor for technology development. It was HVCB's understanding that its sole function was to serve as a pass-through for payments to vendors' services procured by the special advisor. Without questioning whether services it was paying for met the letter of agreement's requirements, HVCB paid $12,000 in invoices from a vendor who developed the governor's technology website. We question both the propriety of

HVCB's role as a pass-through for payments under the letter of agreement and also the payments it made on behalf of the former governor's office.

The second allocation of $72,500 to Honolulu Community College also involved a questionable arrangement with HVCB as a subcontractor. In June 2001, the High Technology Development Corporation and DBEDT, under the direction of the former governor's special advisor for technology development, entered into a contract with the college to produce and/or provide certain products and services related to high technology. Specifically, the college agreed to produce collateral material and other creative marketing initiatives related to high technology in Hawai`i; and to provide training programs, workshops, and conferences related to advanced technology.

In November 2001, the Research Corporation of the University of Hawai`i (RCUH), which manages the college's contracts, entered into an agreement with HVCB whereby HVCB would provide the services that the college had agreed to provide under its agreement with the corporation and DBEDT. In addition, the university took a $2,452 fee for managing the contract. We however, found no evidence that HVCB provided the services or deliverables. Again, HVCB's alleged role was to pay invoices it received from the governor's office for services the special advisor procured.

The arrangement between the university and HVCB was also suspect for other reasons. First, we found that HVCB used state contract funds to pay some of the invoices it received from the governor's office because it had not yet received funds from the university. For example, a private vendor invoiced the former governor's office for $20,000 on November 15, 2001 for services it provided. Under the university and HVCB agreement, the invoices should have been paid by funds received from the university. However, HVCB used state contract funds to pay the $20,000 invoice because it had not yet received funds from the university.

Second, we found that some services procured by the former governor's office under the university and HVCB agreement were completed before the agreement was signed. For example, Joan Bennet and Associates, a private vendor, invoiced the governor's office for $23,910 for services it provided as early as July 2001—four months before the university and HVCB agreement was signed in November 2001. Despite this, HVCB paid Joan Bennet and Associates $23,910.

Finally, we found that HVCB still has approximately $26,500 from its agreement with the university. HVCB indicated that it plans to contact DBEDT to determine how it should spend the money.

The flow of expenditures under the $72,500 agreement between the college, the High Technology Development Corporation, and DBEDT is illustrated in Exhibit 2.4.

The third questionable allocation involved a $24,000 letter of agreement between Joan Bennet and Associates, the High Technology Development Corporation, and DBEDT. The scope of services outlined in the agreement are similar to services paid by the HVCB to Joan Bennet and Associates under the separate HVCB/university agreement. The arrangement to pay Joan Bennet and Associates two separate amounts under two separate agreements leads us to question whether use of HVCB as the pass-through entity for payment was designed to evade the State Procurement Code.

HVCB is not a state agency and hence not subject to the State Procurement Code. Had the payments of $23,910 (under the university and HVCB agreement) and $24,000 (under the corporation and DBEDT agreement) been made by a single agency subject to the code, the agency would likely be guilty of parceling, a practice that the code prohibits. Parceling occurs when multiple expenditures are created at the inception of a project or transaction so as to evade the State Procurement Code.

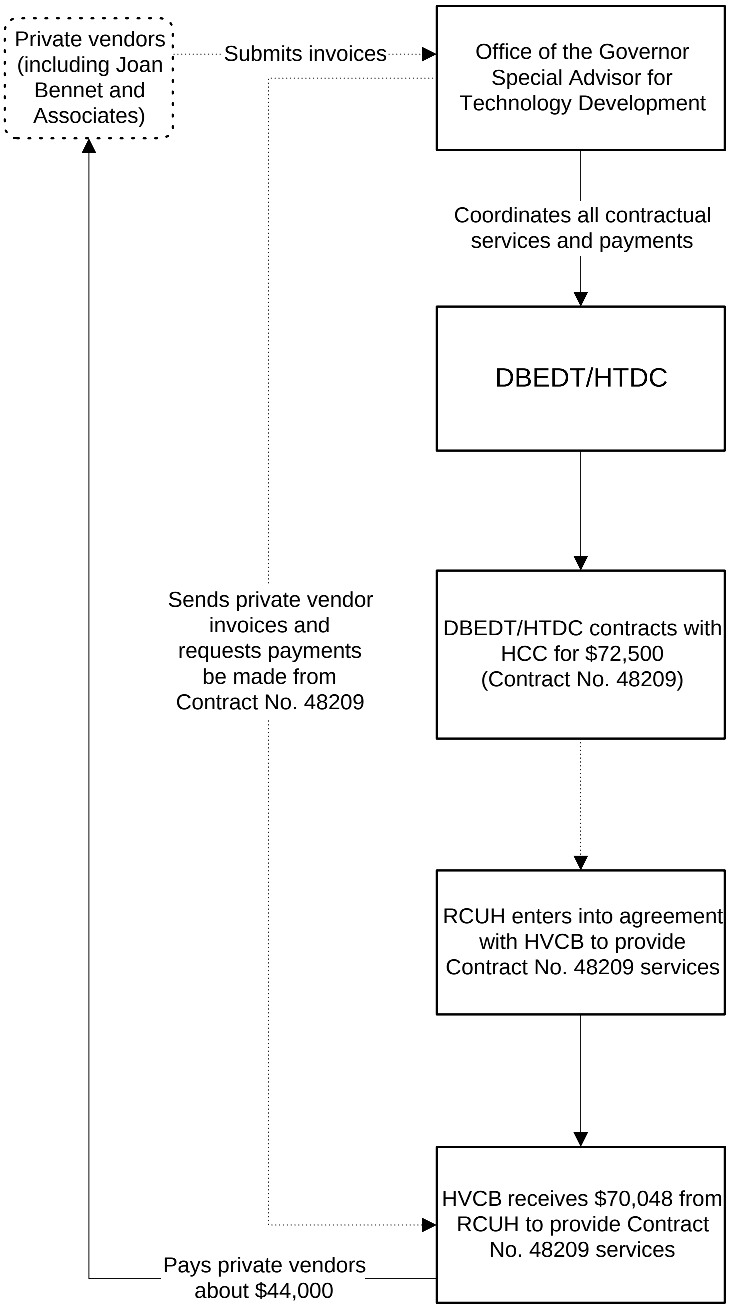
The issue of parceling was entirely avoided by utilizing HVCB as a pass-through for payment. The former special advisor to the governor denies that this arrangement was designed to evade the procurement process. However, the fact remains that the arrangement allowed the former governor's office to use HVCB to funnel $23,910 to Joan Bennet and Associates and a separate agreement to pay Joan Bennet and Associates an additional $24,000, thereby parceling nearly $48,000 of services and circumventing the code's requirement that services over $25,000 be competitively procured.

The Authority's Lax Monitoring and Enforcement of Its Marketing Contracts with the Bureau Leaves Little Assurance that $151.7 Million in State Funds Were Effectively Spent

Sound contract development and monitoring are essential to ensuring that contract funds are used efficiently and effectively. The best-monitored contracts are generally well-written, the expected contract performance spelled out, and those that an organization has a strong incentive to monitor. Most importantly, an organization should adhere to the contract monitoring principle that it has a responsibility to determine whether the contractor's work is faithful to the contract terms and whether the contractor's services are satisfactory.

Our review of the authority's two major contracts with HVCB found that the authority failed to adhere to these principles. The contracts were poorly constructed, and authority monitoring and enforcement were lax.

Exhibit 2.4
Expenditure Flow Under Contract Between HCC and DBEDT/HTDC



DBEDT - Department of Business, Economic Development and Tourism

HTDC - High Technology Development Corporation

HCC - Hawaii Community College

RCUH - Research Corporation of the University of Hawaii

HVCB - Hawai`i Visitors & Convention Bureau

The authority also agreed to contracts that did not have clearly defined goals and objectives. As a result, the authority was unable to adequately assess whether the $151.7 million in state contract funds were effectively spent.

Poorly constructed contracts and inadequate monitoring did not protect the State's interests

The authority's two contracts with HVCB to provide leisure and meetings, conventions and incentives marketing services did not provide either measurable and quantifiable objectives or performance levels to hold HVCB accountable to. Instead, HVCB was basically required to draft annual tourism marketing plans outlining how it would conduct marketing related activities to attract leisure and business travelers to Hawai`i.

Specifically, the leisure contract required that HVCB develop and implement a marketing plan to increase promotional presence and brand entity to more globally competitive levels; develop and execute cooperative programs with travel partners to optimize use of authority resources; and support TV and film initiatives that provide cost-effective, high profile exposure. However, the authority did not provide measurable and quantifiable goals or benchmarks for HVCB to achieve for these three broad contract objectives.

The meetings, conventions and incentives contract's objectives were equally broad. It required that HVCB create a marketing plan to increase revenues by attracting delegates and attendees; enhance Hawai`i's image as a leading business meeting, convention and incentive destination internationally; and create high profile exposure and marketing opportunities.

However, the authority did not identify a specific percentage or dollar amount of the increase in revenues that HVCB's marketing activities should result in. The contract was also silent as to how HVCB would prove that it successfully enhanced Hawai`i's image as a business destination. For example, a possible performance benchmark for HVCB to achieve might have been a target percentage increase in the number of business travelers surveyed who had a better image of Hawai'i after attending a meeting or conference in Hawai`i.

We also found the authority's monitoring philosophy over HVCB to be alarming. According to the authority, HVCB met its entire contractual obligations once it submitted and executed the marketing plans. Accountability for results rested with the authority—not HVCB. In addition, the authority used these plans, and not the actual contracts, to monitor HVCB's services. Moreover, the plans lacked the specificity needed to enable the authority to know exactly what services or benefits the State was receiving for the $151.7 million it provided to HVCB to market Hawai`i. In the end, the authority had no means to assess whether the $151.7 million had been effectively spent, nor could the authority determine whether the expenditures had resulted in enhanced leisure and business travel to Hawai`i.

Contractor submitted a plethora of reports that contained vague information and failed to tie results to goals and objectives

The bureau was required to submit a variety of reports to the authority in accordance with its leisure and MCI contracts; however, the reports did not contain any information analyzing the outcome or impact of HVCB's marketing expenditures and activities. Required reports included annual reports, quarterly reports, monthly variance reports, destination incentive fund reports, and monthly visitor complaint and response reports.

Monthly variance reports prepared by HVCB indicated advertising, communications/promotions, travel trade, sales, marketing trends, and administration expenditures. The reports also compared the current month's and year-to-date expenditures and budget. A list of all HVCB contracts, agreements, and expenses exceeding $150,000 were also included in the monthly report submission. None of HVCB's reports however, identified the impact of expenditures on travel and tourism. The reports also failed to explain expenditures that were either over budget or under budget with any specificity or reliable data.

The bureau maintains an electronic spreadsheet as its database of existing contracts for the purpose of preparing the quarterly report. We found however, that the database was not up-to-date. At times, the department directors or managers failed to inform the finance and corporate division about new or amended contracts. As a result, the reports submitted to the authority were inaccurate by not providing the true extent of HVCB's commitments.

The authority has recognized the inadequacy of the reports submitted by HVCB and intends to correct these inadequacies in future contracts. An authority evaluation found that final reports from contractors resembled "data dumps" of facts about the program without providing a link to measurable program objectives or a rationale for why the program was designed as it was. The evaluation also noted that some contractors, including HVCB, were providing thick binders of data without sufficient interpretation for an uninformed reader to understand the rationale and impact of the contract programs.

Contracts did not stipulate deadlines for the submittal of annual reports

The leisure and meetings, conventions and incentives contracts required HVCB to submit annual reports that contained the following information:

- Goals and objectives as identified by the authority,
- Description and status of promotional projects and programs,
- Analyses of programs and project effectiveness including anticipated and actual results, and
- Program and project funding and costs.

However, the contracts did not specify when HVCB was required to submit these reports. The contracts only required that HVCB use its best efforts to carry out its responsibilities in a timely manner. As a result, the reports for CY2000 and CY2001 were not submitted by HVCB until March 2003. Without the information provided in the annual reports, the authority was unable to review and assess HVCB's contract-funded activities, program effectiveness, and expenditures in a timely manner.

The authority failed to enforce contract terms over Marketing Flexibility Fund expenditures

Under its meetings, conventions and incentives contract, HVCB had the authority to expend funds from a Marketing Flexibility Fund to attract meetings, conventions, and certain trade shows to be competitive with other destinations or to fill spaces during traditionally low booking periods. The fund could be used to attract groups that have the potential for multi-year bookings or large economic impact, or for perception-changing groups. The fund could have also been used to provide special incentives to beat competitors' proposals or to meet groups' special requirements.

Although HVCB had sole discretion to enter into such special incentive commitments, the authority had final approval for any funds that HVCB planned to commit, but would occur after the meetings, conventions and incentives contract period ended on December 31, 2002. HVCB was also required to provide the authority with a monthly report regarding its use of the fund. However, these reports only indicated fund commitments made for future events and did not provide information on actual fund expenditures. We found that HVCB exceeded its CY2001 marketing flexibility fund budget by about 10 percent ($112,216). According to HVCB, an arrangement with the authority permitted it to use funds budgeted for meetings, conventions and incentives to absorb the marketing flexibility fund overage. However, this arrangement raises concerns because marketing flexibility funds have certain criteria for their use. By using operating funds, the bureau is able to co-mingle moneys and create a larger marketing flexibility fund than was intended by contract.

The authority's inadequate reporting requirements allowed HVCB to exceed its budget and to reallocate funds from the meetings, conventions and incentives budget to make up the shortfall. Furthermore, this situation illustrates yet another example where contract terms are not enforced.

Contracts did not contain non-compliance penalties to compel bureau performance

Without non-compliance penalties, the authority was unable to hold HVCB accountable for its shortcomings in meeting contract provisions. For example, HVCB failed to submit CY2000, CY2001 and CY2002 annual reports in a timely manner;, to seek authority approval for marketing flexibility fund commitments beyond the contract term;, and to notify the authority about upcoming board meetings. However, the authority had no viable option to penalize HVCB for non-compliance. A common non-compliance penalty that the authority might have used could have been to withhold contract payments until services were satisfactorily rendered.

The authority continues to allow HVCB to provide services without a signed contract

Despite two recent audit reports that found the authority inappropriately allowed contractors to render services without a fully and properly executed contract, the authority continues this practice. Providing services without contractually defined roles and responsibilities places the State and contractors in jeopardy should any legal problems arise.

When HVCB's three-year leisure and meetings, conventions and incentives contracts with the authority ended on December 31, 2002, the authority did not award new multi-year contracts for state marketing services. Instead, it granted HVCB one-year contract extensions effective January 1, 2003 through December 31, 2003. However, these contract extensions were not signed until June 2003. HVCB provided marketing services for nearly half the contract term before the contract was actually executed.

Authority enforcement of contract provisions was also lax

We found that HVCB did not always comply with the few and relatively benign contract requirements. HVCB failed to get authorization for funds committed beyond its contract terms and did not provide the authority with its fiscal policies. However, the authority did not have a reasonable means of compelling bureau performance due to a lack of non-compliance penalties in the contract. The authority's lax enforcement of contract provisions allowed HVCB to operate outside the contracts' scopes and to commit funds beyond the contracts' terms.

HVCB failed to get authority approval for Marketing Flexibility Fund commitments beyond the contract term

Although HVCB had the sole discretion to enter into commitments utilizing marketing flexibility funds, the authority's approval was required before the bureau made commitments beyond December 31, 2002. However, we found that HVCB did not obtain approval for over $5.4 million in commitments made through 2015. For example, HVCB committed $665,000 for an event to be held in 2005, $187,576 for a function to occur in 2011, and $425,000 for a 2013 gathering. Because HVCB failed to obtain authority approval, the authority is unable to adequately plan for these future commitments made on behalf of the State.

HVCB failed to provide the authority with its most current fiscal policies

The leisure contract required HVCB to provide the authority with a copy of its fiscal policies upon contract execution. The authority needed a copy of HVCB's fiscal policies to ensure that they do not conflict with the authority's own policies. We reviewed a copy of HVCB fiscal policies on file with the authority and found that the policies were outdated and applied to the previous marketing contract under the Department of Business, Economic Development and Tourism (DBEDT).

In essence, HVCB violated the terms of the leisure contract by not having fiscal policies in place. Moreover, by providing the authority a copy of its outdated policies, HVCB gave the authority the impression that fiscal policies were in place. Without such policies, the authority cannot be assured that the HVCB is prudently spending state contract funds. Again, lack of non-compliance penalties in the contract gives the authority no reasonable means of compelling bureau compliance. Accountability by both the authority and HVCB is lacking.

The authority has recently taken steps to address its contract management deficiencies

Our *Management Audit of the Hawai`i Tourism Authority,* Report No. 02-04, recommended that the authority board ensure the development, implementation, and enforcement of written policies and procedures for its contracting, personnel, and organizational management. The audit specifically recommended the revision of its organizational chart and staff positions, implementation of a training program, and regular staff evaluations. Finally, the audit recommended that the board conduct thorough and formal annual evaluations of itself and the authority. We found that the authority has made some progress in adopting some of these recommendations.

The authority created a marketing department to oversee marketing contracts

In response to our finding that the authority had serious contracting deficiencies, a marketing department tasked with the responsibility for all marketing contracts was created. The authority also appointed a tourism marketing director responsible for, among other things, overseeing and evaluating all integrated marketing contracts, and developing and implementing evaluation criteria of all marketing programs, including any program utilizing public funds.

Written contracting policies and procedures have been drafted

The authority developed a *Procurement and Contracting Process* document in response to our finding that the authority failed to establish written policies and procedures for contracting. This document outlines the requirements and criteria used for the authority's contract procurement methods and assigns responsibility of overseeing the procurement steps to various sections. It also specifies that overall responsibility for a contract rests with the section that initiated the contract. Finally, the document establishes a process for contract management that includes maintenance of the contract files, creation of a contract execution schedule, and contract evaluation.

Staff roles and responsibilities have been clarified

The authority has also drafted a *Hawai`i Tourism Authority Personnel Policies and Procedures Manual* in response to our previous audit. The manual was developed to provide staff with written policies and procedures that promote good management and fair treatment, opportunities for training and self-improvement, a safe and healthy work environment, and working conditions that balance work responsibilities and family time and values. The manual includes information related to procedures for filling vacancies, hours and conditions of work, training and employee development, safety and health, employee recognition and awards, benefits, disciplinary action, grievance and complaint procedures, sexual harassment, and reduction in force. The manual also delineates the roles and responsibilities of the authority's executive director, chief administrative officer, various managers and supervisors, and line employees.

The authority conducted a performance evaluation of HVCB

In May 2002, the authority conducted a performance evaluation of HVCB. The evaluation included input of the HVCB board, authority board, authority staff, and industry and community groups. The evaluation found that while visitor industry trends were generally positive, HVCB's marketing plans and reports could be improved. The evaluation also found that marketing objectives needed to be clarified, performance benchmarks needed to be set, and reports should be clarified.

In June 2002, the authority conducted a self-assessment of its existing marketing plans, contractor evaluation procedures, and contract reports. The assessment found that reporting measurements for HVCB and other contractors are not always consistent with the nature of the programs being contracted. It also found that HVCB shifts money between contract programs without providing a rationale for the shifts, and there is no automated "tickler" system for highlighting performance reports that are past due.

The self-assessment also noted that the authority should improve its contracting procedures by:

- Clearly defining what needs to be done and what broad outcomes are expected from its programs in order to accomplish the authority's mission;
- Transmitting performance expectations to potential contractors that are objective, measurable, and related to the nature of the program;
- Requiring final reports for contracts that provide concise data that clearly demonstrate how well the program met performance expectations against defined goals; and
- Assessing performance reports from contractors and correcting deficiencies before reports are accepted and final payments are made.

Conclusion

We found that the authority's inadequate contract management and internal controls failed to safeguard the state funds allocated for marketing Hawai`i as a visitor destination. The visitor industry is a key component of our state's economy, and the marketing contracts issued by the authority play a major role in sustaining the industry's ability to contribute to the state's economic health. For 2002, travel and tourism was expected to produce $7.5 billion, or 16.5 percent, of the gross state product. Tax revenues generated by travel and tourism were also expected to contribute $905 million to state and county governments, or 20.9 percent of all taxes collected.

In addition, poorly written contracts and the authority's inadequate oversight resulted in HVCB's misuse of state contract funds. With Hawai`i facing a potential decline in visitor arrivals (8.5 percent from 2000 to 2002), it is critical that the moneys allocated to tourism marketing are spent wisely, and those who spend it are held accountable for results. Ultimately, the authority's failure to exert adequate controls allowed HVCB to spend $151.7 million in tax dollars with little accountability and no identifiable benefit to the State for those moneys spent.

Recommendations

1. The Hawai`i Tourism Authority Board of Directors and its executive director should:

    a. Improve contractor accountability by:

        i. Holding contractors accountable for complying with their own internal policies and procedures;

        ii. Conducting periodic audits of contract expenditures;

        iii. Placing a limit on the amount of state funds that can be used for contractors' administrative expenditures;

        iv. Placing a limit on the amount of state funds that can be used for contractors' personnel expenses; and

        v. Prohibiting contractors from using contract funds for legal expenses that are unrelated to the contract; and

        vi. Requiring contractors to:

            1) Record expenses in accordance with generally accepted accounting principles;

            2) Limit state-funded expenditures to contract-related purposes;

3) Establish an adequate contract management system that includes appropriate controls and policies and procedures over contract procurement, filing and documentation, amendments, monitoring, and evaluation;

4) Provide specific information on the amount of state funds spent on personnel costs, overhead, and other administrative expenses; and

5) Implement and enforce appropriate policies and procedures over the use of state funds for travel and entertainment expenses.

b. Enforce all contract provisions;

c. Improve its contract language to specify graduated penalties for non-compliance and deadline dates for submission of reports, and to require the submission of reports that contain relevant and reconcilable information that ties contractor performance to measurable objectives and outcomes specified in the contract; and

d. Maintain and apply contracting policies and procedures and continue to conduct performance evaluations of its contractors.

2. The State and Legislature should take appropriate steps to assess the extent to which HVCB violated generally accepted accounting standards under its contracts with the Hawai`i Tourism Authority for leisure marketing and meetings, conventions and incentives marketing.

Chapter 3
Financial Audit

This chapter presents the results of the financial audit of the Hawai`i Visitors & Convention Bureau (HVCB) as of and for the year ended December 31, 2002. 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.* It also displays the financial statements of HVCB together with explanatory notes.

Summary of Findings

In the opinion of Nishihama & Kishida, CPA's, Inc., based on their audit, except for the recognition of expenses in the incorrect accounting year, the financial statements present fairly, in all material respects, the financial position of HVCB as of December 31, 2002, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Nishihama & Kishida, CPA's, Inc. noted certain matters involving HVCB's internal control over financial reporting and its operations that the firm considered to be reportable conditions. Nishihama & Kishida, CPA's, Inc. also noted that the results of its tests disclosed no instances of noncompliance that are required to reported under *Government Auditing Standards.*

Independent Auditors' Report

The Auditor
State of Hawai`i:

We have audited the accompanying statement of financial position of the Hawai`i Visitors & Convention Bureau (HVCB) as of December 31, 2002, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of HVCB's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of HVCB as of December 31, 2001, were audited by other auditors whose report dated March 13, 2002, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In 2002, HVCB recognized certain expenses related to marketing activities prior to such services being provided. In our opinion, such services should be recognized as expenses in the accounting period when incurred to conform with accounting principles generally accepted in the United States of America. If those expenses had been recorded in conformity with U.S. generally accepted accounting principles, current liabilities, revenues, and expenses would have been decreased by $899,779 as of December 31, 2002.

In our opinion, except for the effects of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the Hawai`i Visitors & Convention Bureau as of December 31, 2002, and the change in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included in Exhibit 3.4 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 20, 2003 on our consideration of HVCB’s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

/s/ Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawai`i
May 20, 2003

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 Hawai`i:

We have audited the financial statements of the Hawai`i Visitors & Convention Bureau (HVCB) as of and for the year ended December 31, 2002, and have issued our report thereon dated May 20, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and with 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 HVCB's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered HVCB'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 HCVB's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. 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.

This report is intended solely for the information and use of the Auditor, State of Hawai`i and the board of directors and management of the Hawai`i Tourism Authority and HVCB and is not intended to be and should not be used by anyone other than these specified parties.

/s/ Nishihama & Kishida, CPA's, Inc.

Honolulu, Hawai`i
May 20, 2003

Description of Financial Statements

The following is a brief description of the financial statements audited by Nishihama & Kishida, CPA's, Inc., which are presented at the end of this chapter.

Statements of Financial Position (Exhibit 3.1)

These statements present the assets, liabilities, and net assets of HVCB at December 31, 2002 and 2001.

Statements of Activities (Exhibit 3.2)

These statements present the revenues, expenses and changes in net assets of HVCB for the years ended December 31, 2002 and 2001.

Statements of Cash Flows (Exhibit 3.3)

These statements present the cash flows from operating, investing, and financing activities of HVCB for the years ended December 31, 2002 and 2001.

In-Kind Contributions at Fair Value (Exhibit 3.4)

This unaudited schedule presents the types and amounts of in-kind contributions received by HVCB during the years ended December 31, 2002 and 2001.

Notes to Financial Statements

Explanatory notes that are pertinent to an understanding of the financial statements and financial condition of HVCB are discussed in this section.

Note (1) - Description of Business

The Hawai`i Visitors & Convention Bureau (HVCB), a nonprofit corporation, can trace its origins back to 1892 when business leaders formed the Hawaiian Bureau of Information. That group was disbanded and another was formed in 1902 as a joint committee of the Chamber of Commerce of Honolulu and the Merchants Association. In 1903, the Territorial Legislature recognized the importance of tourism marketing by funding the committee's work. In 1945, the tourism marketing organization became known as the Hawai`i Visitors Bureau. In April 1959, the bureau was incorporated under the laws of the State of Hawai`i (State) for the primary purpose of promoting travel to and among the Hawaiian Islands. In July 1996, the name was officially changed to the Hawai`i Visitors & Convention Bureau.

HVCB's primary source of state funds is derived from contracts with the Hawai`i Tourism Authority (authority). Other revenues are derived primarily from subscription income (e.g., private sector income) from members primarily domiciled in the state, and from cooperative marketing programs.

The accompanying financial statements include the marketing activities and resources of island chapters of HVCB that are funded under HVCB's agreement with the authority.

Note (2) - Summary of Significant Accounting Policies

(a) Financial statement presentation

Net assets, revenues and expenses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of HVCB and changes therein are classified and reported as follows:

Unrestricted Net Assets - Net assets not subject to donor-imposed stipulations.

Temporarily Restricted Net Assets - Net assets subject to donor-imposed stipulations that may or will be met either by actions of the HVCB and/or the passage of time.

(b) Cash equivalents

For purposes of the statements of cash flows, HVCB considers all instruments with original maturities of three months or less to be cash equivalents.

(c) Revenue recognition - State appropriations

State appropriations revenue is recognized when the related expenditures are incurred.

(d) Depreciation and amortization

Leasehold improvements are amortized over the respective lease terms (two through eleven years). Furniture and equipment are depreciated using the straight-line method over their estimated useful lives of three to seven years. The image library is depreciated using the straight-line method over its estimated useful life of five years. The mall tour stage and automobile are depreciated using the straight-line method over their estimated useful lives of three years.

(e) Use of estimates

The preparation of the financial statements requires HVCB management to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include the carrying amount of leasehold improvements, furniture, and equipment; and the valuation allowances for receivables. Actual results could differ from those estimates.

Note (3) - Retirement Plan

HVCB had a noncontributory defined benefit pension plan that covered all full-time employees who had attained the age of 21 and had completed one year of service. Participants in the plan were eligible for normal retirement benefits when they reached age 65. The normal retirement benefit was a percentage for each year of service based on the average final compensation and the social security covered compensation. Participants were fully vested in their accrued benefits under the plan after completing five years of eligible service. HVCB's funding policy was to fund contributions that were actuarially determined as necessary to fund the cost of the plan subject to minimum funding standards as required by the Employee Retirement Income Security Act of 1974. The plan had been curtailed and benefits under the pension plan were frozen as of December 31, 1996. The plan was terminated on July 31, 2000 and all liabilities were settled.

HVCB has a deferred compensation plan under Section 401(k) of the Internal Revenue Code for substantially all regular employees. Participants of the plan may contribute up to 15 percent of their pre-tax salary, or $11,000, whichever is less. The plan provides for matching contributions to be determined by the employer each year. For the years ended December 31, 2002 and 2001, HVCB matched 100 percent of each dollar contributed up to the first $2,000 for each participant's contribution. Matching contributions amounted to $140,438 and $125,371 for the years ended December 31, 2002 and 2001, respectively.

All qualified matching contributions, employee contributions, and rollovers or transfer contributions are 100 percent vested. All other contributions vest under the following schedule:

Years of credit service	Vested percentage
Less than one year	None
Two years	20%
Three years	40%
Four years	60%
Five years	80%
Six years or more	100%

Note (4) - Leasehold Improvements, Furniture, and Equipment

A summary of leasehold improvements, furniture, and equipment at December 31, 2002 and 2001 follows:

	2002	2001
Leashold improvements	$ 826,672	$ 820,110
Furniture and equipment	1,805,071	1,514,887
Automobile	20,911	20,911
	2,652,654	2,355,908
Less accumulated depreciation and amortization	1,639,571	1,084,870
	$ 1,013,083	$ 1,271,038

Note (5) - Short-term Line of Credit

HVCB had a $10,000,000 participative short-term line of credit with two commercial banks that matured on December 31, 2002. The short-term line of credit was secured by accounts receivable from the authority. Interest was payable monthly at 0.25 percent above the bank's base rate (4.75 percent at December 31, 2001) and the principal balance and all accrued interest were due at maturity. Outstanding borrowings under this line of credit amounted to nil and $6,000,000 at December 31, 2002 and 2001, respectively. The line of credit was extended through June 30, 2003, with interest payable monthly at the bank's base rate.

Note (6) - Notes Payable

HVCB had a note payable in the amount of $313,810, which provided for interest at 0.75 percent above the bank's base rate and was payable in monthly installments of $14,445, including interest. All principal and accrued interest on the loan was due on or before May 17, 2002. The note was secured by certificates of deposits, subscriptions receivable, certain furniture and equipment, and various other assets. The outstanding balance of this note payable at December 31, 2001 was $57,026. The note payable was paid off during 2002.

On August 10, 2001, HVCB obtained a note payable in the amount of $125,000, which provides for interest at the bank's base rate minus 0.25 percent (4.00 percent and 4.50 percent at December 31, 2002 and 2001, respectively) and is payable in monthly installments of $3,900, including interest. All principal and accrued interest on the loan is due on or before August 10, 2004. At December 31, 2002, approximate maturities of the note payable amounted to $41,195 in 2003 and $23,913 in 2004. The note payable is secured by a security interest in the Global Trade Show Pavilion. The note payable amounted to $65,108 and $111,602 at December 31, 2002 and 2001, respectively.

Note (7) - Income Taxes

No provisions for income taxes have been made as the Internal Revenue Service has granted HVCB an exemption from normal income taxes under Section 501(c)(6) of the Internal Revenue Code.

Note (8) - Lease

HVCB occupies certain premises under leases that expire on various dates through 2011. Total rent expense for the years ended December 31, 2002 and 2001 was $1,005,381 and $866,617, respectively.

Future minimum lease payments under operating leases as of December 31, 2002 are as follows:

Year Ending December 31,		Amount
2003	$	667,163
2004		508,405
2005		410,877
2006		341,913
2007		327,139
Thereafter		895,961
Total future minimum lease payments	$	3,151,458

Substantially all leases included above provide that HVCB pay taxes, maintenance, insurance, and certain other operating expenses applicable to the leased premises.

It is expected that in the normal course of business, leases that expire will be renewed or replaced by other leases. Any additional future lease rental commitments that may arise from renewals or renegotiations cannot be determined at this time; however, most renewal options provide that the minimum lease rental for the renewal period shall not be less than the minimum lease rental for the preceding period.

Note (9) - Temporarily Restricted Net Assets

The temporarily restricted net assets represents moneys received from the people of Hawaii as a direct response to a tour bus-hijacking incident. All designated moneys collected and interest earned thereon are to remain with HVCB to aid visitors who are victims of crime.

Note (10) - Related Party Transactions

HVCB has various amounts due to and from employees and related parties including affiliated offices on the neighbor islands. At December 31, 2002 and 2001, due from related parties is comprised of the following:

	2002	2001
Island chapters	$ 402,532	$ 281,483
Employees	2,201	78
	$ 404,733	$ 281,561

Due to employees, primarily for expense reimbursements, and related parties are comprised of the following at December 31, 2002 and 2001:

	2002	2001
Island chapters	$ 463,756	$ 561,587
Employees	140,313	154,182
	$ 604,069	$ 715,769

Note (11) - In-Kind Contributions

In-kind contributions consist primarily of donated publications, hotel and meeting rooms, airline tickets, and rental cars and ground transportation. The estimated fair value of these donations were $5,501,999 and $6,145,427 for the years ended December 31, 2002 and 2001, respectively, and are reflected as revenues and expenses in the accompanying statements of activities.

Note (12) - Litigation

HVCB is involved in litigation over a contract dispute with a vendor. In the opinion of management, although the outcome of any legal proceedings cannot be predicted with certainty, the ultimate liability of HVCB in connection with the legal proceedings will not have a material adverse effect on HVCB’s financial position, change in net assets, or cash flows.

Note (13) - Termination Benefits

Due to legislation passed in 2002 and effective January 1, 2003, the responsibilities of marketing the Hawai`i Convention Center (HCC) were transferred from the HVCB to SMG, the management company responsible for the operations of the HCC. As a direct result of this legislation, HVCB terminated the HCC marketing group that was a part of its meetings, conventions, and incentives department in December 2002. Severance pay related to this termination was accrued as of December 31, 2002 and are to be paid throughout 2003.

Exhibit 3.1

Hawai`i Visitors & Convention Bureau
STATEMENTS OF FINANCIAL POSITION
December 31, 2002 and 2001

ASSETS

	2002	2001
Cash	$ 3,085,520	$ 4,075,231
Time certificates of deposit (note 6)	22,500	22,500
Accounts receivable, including State of Hawai`i appropriations of $3,441,000 and $10,612,840 for 2002 and 2001, respectively (note 5)	3,673,230	11,118,039
Subscriptions receivable from members (note 6)	675,683	129,347
Due from employees and related parties (note 10)	404,733	281,561
Prepaid expenses and other	363,607	500,206
Trade-out air coupons	114,164	112,437
Leasehold improvements, furniture, and equipment, net (notes 4 and 6)	1,013,083	1,271,038
Total assets	$ 9,352,520	$ 17,510,359

LIABILITIES AND NET ASSETS

	2002	2001
Liabilities		
Trade accounts payable, including $291,235 due to the State of Hawai`i for 2002	$ 4,399,063	$ 7,225,631
Due to employees and related parties (note 10)	604,069	715,769
Accrued vacation benefits	381,817	330,786
Notes payable (notes 5 and 6)	65,108	6,168,628
Deferred subscriptions	920,136	544,508
Other liabilities (note 13)	790,142	242,928
Total liabilities	7,160,335	15,228,250
Net assets		
Unrestricted	2,158,280	2,248,477
Temporarily restricted (note 9)	33,905	33,632
Total net assets	2,192,185	2,282,109
Commitments and contingency (notes 3,5,6,8,12 and 13)		
Total liabilities and net assets	$ 9,352,520	$ 17,510,359

See accompanying notes to financial statements.

Exhibit 3.2

Hawai`i Visitors & Convention Bureau
STATEMENTS OF ACTIVITIES
Years Ended December 31, 2002 and 2001

	2002			2001		
	Unrestricted	Temporarily Restricted	Total	Unrestricted	Temporarily Restricted	Total
REVENUE						
State appropriations	$ 47,596,925	$ --	$ 47,596,925	$ 54,111,840	$ --	$ 54,111,840
Co-op marketing	13,187,904	--	13,187,904	17,576,003	--	17,576,003
In-kind contributions (note 11)	5,501,999	--	5,501,999	6,145,427	--	6,145,427
Subscriptions	2,615,991	--	2,615,991	2,235,809	--	2,235,809
Interest, net (notes 5 and 6)	54,092	273	54,365	83,282	382	83,664
Miscellaneous	596,610	--	596,610	772,933	--	772,933
Total revenues	69,553,521	273	69,553,794	80,925,294	382	80,925,676
EXPENSES (note 11)						
Advertising	32,126,199	--	32,126,199	45,219,420	--	45,219,420
Communication/promotion	17,107,716	--	17,107,716	16,338,397	--	16,338,397
Sales	9,567,203	--	9,567,203	8,080,045	--	8,080,045
Travel trade	6,410,178	--	6,410,178	6,990,808	--	6,990,808
Administration	3,987,061	--	3,987,061	3,641,878	--	3,641,878
Market trends	445,361	--	445,361	696,615	--	696,615
Total expenses	69,643,718	--	69,643,718	80,967,163	--	80,967,163
Change in net assets	(90,197)	273	(89,924)	(41,869)	382	(41,487)
NET ASSETS AT BEGINNING OF YEAR	2,248,477	33,632	2,282,109	2,290,346	33,250	2,323,596
NET ASSETS AT END OF YEAR	$ 2,158,280	$ 33,905	$ 2,192,185	$ 2,248,477	$ 33,632	$ 2,282,109

See accompanying notes to financial statements.

Exhibit. 3.3

Hawai`i Visitors & Convention Bureau
STATEMENTS OF CASH FLOWS
Years Ended December 31, 2002 and 2001

	2002	2001
Cash flows from operating activities		
Change in net assets	$ (89,924)	$ (41,487)
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation and amortization	554,701	420,455
Decrease (increase) in accounts receivable	7,444,809	(6,270,706)
Increase in subscriptions receivable from members	(546,336)	(9,707)
Increase in due from employees and related parties	(123,172)	(83,755)
Decrease in prepaid expenses and other	136,599	704,326
Increase in trade-out air coupons	(1,727)	(50,492)
Increase (decrease) in trade accounts payable	(2,826,568)	3,618,232
Decrease in due to employees and related parties	(111,700)	(11,757)
Increase in accrued vacation benefits	51,031	31,581
Increase in deferred subscriptions	375,628	183,737
Increase in other liabilities	547,214	234,521
Decrease in deferred sponsorship fee	--	(155,000)
Net cash provided by (used in) operating activities	5,410,555	(1,430,052)
Cash flows from investing activities		
Purchase of leasehold improvements, furniture, and equipment	(296,746)	(351,480)
Net cash used in investing activities	(296,746)	(351,480)
Cash flows from financing activities		
Proceeds from line of credit	--	10,000,000
Payments of line of credit	(6,000,000)	(4,795,668)
Payments of notes payable	(103,520)	(49,652)
Net cash provided by (used in) financing activities	(6,103,520)	5,154,680
NET INCREASE (DECREASE) IN CASH	(989,711)	3,373,148
Cash at beginning of year	4,075,231	702,083
Cash at end of year	$ 3,085,520	$ 4,075,231
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for interest	$ 111,370	$ 181,116

See accompanying notes to financial statements.

Exhibit 3.4

Hawai`i Visitors & Convention Bureau
IN-KIND CONTRIBUTIONS AT FAIR VALUE
Years Ended December 31, 2002 and 2001
(Unaudited)

	2002	2001
Hotels and meeting rooms	$ 2,093,831	$ 1,580,224
Publications	1,121,750	2,452,500
Airline tickets	592,791	607,916
Rental cars and ground transportation	115,144	47,501
Miscellaneous	1,578,483	1,457,286
	$ 5,501,999	$ 6,145,427

See accompanying independent auditors' report.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted drafts of this report to the Board of Directors of the Hawai‘i Tourism Authority, the authority’s executive director, and the Department of Business, Economic Development and Tourism on June 20, 2003. A copy of the transmittal letter to the board chair is included as Attachment 1. Similar letters were sent to the executive director and the Department of Business, Economic Development and Tourism. The joint response of the board chair and executive director is included as Attachment 2. The department did not submit a written response.

In the joint response, the board chair and executive director noted their appreciation of our efforts in conducting a thorough review and thanked us for recognizing the authority’s efforts to address some of the concerns raised in a prior audit. They also noted their support for our audit as a tool to improve its operations, respond to legislative questions and concerns, ensure contractor compliance, minimize the State’s liability, and optimize the State’s expenditures for tourism promotion. The board chair and executive director also stated that they were surprised by many of our findings and consider some of them serious enough to warrant further investigation.

The response outlined additional actions that the authority has undertaken to address identified contract management deficiencies. These actions include a new one-year extension contract with the Hawai‘i Visitors & Convention Bureau that incorporated new accountability measurements and an effort to review contractor performance before considering any possible long-term commitments. The board chair and executive director also noted their concern about the serious nature of some of our findings and indicated that they would take immediate action to address them. Actions include contacting the attorney general’s office to review our findings, holding a special board meeting to publicly discuss report issues, meeting with the Hawai‘i Visitors & Convention Bureau board of directors to discuss our report findings, reviewing its current contract with HVCB to ensure compliance, and developing a plan to implement our recommendations.

While the board chair and executive director were in general support of our report findings, they made three clarifying points. First, they point out that HVCB conducted annual independent financial audits for CY2000-2002, as required by contract, which indicated full compliance with generally accepted accounting principles (GAAP). The response notes that this contradiction with our finding that HVCB violated GAAP requires further investigation. We acknowledge the difference between the two CPA firms' opinions but cannot make a statement as to the work performed by HVCB's financial auditor. However, we agree that the State and Legislature should take the appropriate steps to assess the extent of the violation under the leisure and meetings, conventions and incentives marketing contracts.

Second, the board chair and executive director stated that our claim that, "HVCB represented that the severance packages were established with the authority's approval" is inaccurate and that the authority did not give any approvals for this action. We believe the report language makes it clear that the authority did not request the severance packages and had no knowledge that HVCB paid for severance packages with contract funds.

Lastly, the board chair and executive director characterized our statement, "According to the authority, HVCB met its entire contractual obligations once it submitted and executed the marketing plans," as inaccurate. The response went on to list actions the authority took that contradict our statement. However, in discussions with authority personnel, we found that the authority focused on HVCB's compliance with marketing plans, but failed to also assess HVCB's compliance with the contracts' terms. We believe the findings in our audit support our statement. We do not dispute the actions taken by the authority, particularly in the last year of the contract period, but stand by our statements.

We made some minor changes to the draft report for the purposes of accuracy and clarity. In addition, we added a recommendation that the State and Legislature take appropriate steps to further assess HVCB's violation of generally accepted accounting principles.

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

June 20, 2003

COPY

Mr. Mike McCartney. Chair
Board of Directors
Hawai`i Tourism Authority
Hawai`i Convention Center
1801 Kalakaua Avenue, R-Level
Honolulu, Hawaii 96815

Dear Mr. McCartney:

Enclosed for your information are 15 copies, numbered 6 to 20 of our confidential draft report, *Management and Financial Audit of the Hawai`i Tourism Authority's Major Contracts*. We ask that you telephone us by Tuesday, June 24, 2003, on whether or not you intend to comment on our recommendations. Please distribute the copies to the members of the board. If you wish your comments to be included in the report, please submit them no later than Thursday, June 26, 2003.

The Executive Director of the Hawai`i Tourism Authority, Department of Business, Economic Development and Tourism, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential 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

Hawaii Tourism Authority

LINDA LINGLE
Governor

REX JOHNSON
President and Chief Executive Officer

Hawaii Convention Center, 1801 Kalakaua Avenue, Honolulu, Hawaii 96815
Website: www.hawaii.gov/tourism

Telephone: (808) 973-2255
Fax: (808) 973-2253

June 25, 2003

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813

Dear Ms. Higa:

We have reviewed the draft, "*Financial and Management Audit of the Hawaii Tourism Authority's Major Contracts*," which addressed the period January 1, 2000 – December 31, 2002.

First, we want to thank the Office of the Auditor for conducting this thorough review and recognize the effort put forward by the auditor's staff in preparing the report. We fully support the audit as it is intended to improve our operations, respond to legislative questions and concerns, ensure contractor compliance, minimize the state's liability, and optimize the state's expenditures for tourism promotion. We also want to acknowledge the efforts by the Hawaii State Legislature, which helped to raise awareness and address these issues.

Additionally, we wish to thank the Auditor for recognizing our efforts to address the contract management issues, including those related to the Hawaii Visitors and Convention Bureau (HVCB), raised in the audit conducted in 2001 and presented in February 2002. As noted in the current report, we have created a Marketing Office (January 2003) to oversee and evaluate the marketing contracts, drafted written contract policies and procedures, clarified staff roles and responsibilities, and conducted a performance evaluation of HVCB.

Despite these efforts, we are very concerned about some of the findings in the current audit. Although the HTA has already incorporated stronger control measures into its contract management efforts, the current audit has helped confirm those measures merit our closest scrutiny. While we have been working diligently to address these issues, the current audit demonstrates the full extent of the challenge. We were surprised by many of the findings. Instances cited by the auditor are serious and will be under investigation.

<u>HTA Accepts Audit Findings</u>

Generally, HTA accepts the findings outlined in the audit report. We want to state for the record, that HTA has taken very seriously its responsibility to the public to be a fiscally accountable organization. We acknowledge that, in our role as the lead state agency responsible for Hawaii's number one industry, we must effectively oversee and manage the expenditure of state funds for tourism programs.

There are a few points we want to clarify:

- In carrying out our responsibility to be fiscally accountable for state funds, the HTA has since its inception, required its larger contractors, including the HVCB, to conduct an annual independent financial audit. The reports from KPMG, the accounting firm tasked with the review of HVCB's finances for CY 2000 - 2002, indicated full compliance with Generally Accepted Accounting Principles (GAAP), as required by the HTA contract. Obviously these findings are contrary to the legislative auditor's findings and will require further investigation.

- On page 17, paragraph 1, line 3, the audit states, "HVCB represented that the severance packages were established with the authority's agreement." This statement is inaccurate. The HTA did not give any approvals for this action.

- On page 32, paragraph 4, line 2, the audit states, "According to the authority, HVCB met its entire contractual obligations once it submitted and executed the marketing plans." This statement is inaccurate. As an example, in a review conducted in May 2002 by the HTA, we pointed out issues with HVCB's performance that still needed to be addressed before the contractual obligations were met. The HTA staff also met regularly with HVCB to review programs and accept reports on the progress of marketing plans.

HTA Already Implementing Changes

As mentioned earlier, the audit report points out that HTA has already taken steps to address identified contract management deficiencies. In addition to those steps mentioned in the audit, HTA also has implemented the following key actions:

- In May 2002, HTA conducted a first-ever 360° evaluation of HVCB performance and programs, incorporating industry and community comments. This resulted in the HTA requesting the HVCB to issue an amended marketing plan in 2002. Improvements were also required for, and reflected in the 2003 Annual Tourism Marketing Plan (ATMP). Additionally, the HTA will continue to conduct an annual 360° evaluation of the HVCB.

- On October 31, 2002, the HTA board authorized a one-year extension of HVCB's contracts for Leisure and for Corporate Meetings and Incentives (CMI) marketing for the period of CY 2003, which gave HTA the opportunity to incorporate new accountability measurements into the new contracts and to review HVCB performance in 2003 before considering any possible longer term commitments. In addition, marketing of the convention center was taken out of HVCB's CMI contract in 2003.

- Beginning in November 2002, HTA began drafting HVCB's CY 2003 contract. The new contract has revolutionary changes in comparison to the previous contracts that will result in

HTA having stronger internal controls over its primary marketing contractor. The new contract includes:

- o Accountability research conducted by HTA for leisure marketing programs to measure performance directly related to planned marketing programs.
- o Provisions in the contract relating to standards of conduct, performance standards, and non-compliance penalties.
- o Provisions and conditions requiring budget specificity and reduced flexibility in change orders. Importantly, HTA substantially lowered the ceiling on budget and program changes that HVCB can make without HTA approval.

- In March 2003, the HTA issued a Request for Proposals (RFP) for long-term (2004 – 2007) contracts for Leisure and CMI marketing. The purpose was to ensure that Hawaii had the best, professional expertise to develop and execute programs in these two key areas. This expertise will assist the HTA to achieve the goals for Hawaii as articulated in its Tourism Strategic Plan, "*Ke Kumu* - Strategic Directions for Hawaii's Visitor Industry." The RFP process also provides the HTA with an opportunity to make additional changes as needed in its future marketing contracts.

HTA Leadership Changes Have Occurred Since Audit Period

It is also important to note that the timeframe of this audit was January 1, 2000 – December 31, 2002. Since the previous audit, there have been several significant changes at HTA:

- At the board level, there were several significant changes. Effective July 2002, the board size was increased from 13 to 15 members and the composition of the board was expanded to include a broader representation of Hawaii's community.

- New leadership was elected at the board level along with the creation of new committees.

- At the staff level, a new leadership team was established including the first-time hire of a Director of Marketing (August 2002) and a new Executive Director (September 2002).

HTA's Immediate Actions

In addition to the efforts already taken, HTA will take immediate action to address the issues raised by the audit. The auditor cited several instances which indicated serious abuse of state funds. Therefore, our priority is to fix this current situation while continuing our programs to ensure that marketing for the state continues without interruption. To that end, the following actions are being taken:

- HTA has contacted the State Attorney General's office to review various findings made by the auditor.
- HTA will hold a special, public board meeting in July with the auditor and the HVCB to go over the issues brought forth in this audit.

- HTA will meet with the HVCB board of directors to discuss various findings made by the auditor.
- HTA is reviewing current (2003) contract terms with the HVCB to ensure complete understanding of and compliance with the new terms, and to ensure fiduciary responsibilities. Staff will continue to monitor this new contract, including requiring the submission of all back-up documentation for all invoices.
- HTA agrees with the recommendations outlined by the Auditor and is developing a plan to implement them.

<u>Long-Term Measures May Include Special Master</u>

While we remain focused on confronting these short-term issues, we are already exploring our options to help ensure sound, long-term governance of the HTA marketing contracts. Obviously, the results of HTA's internal investigation will play an important role in determining our future course of action. But measures being considered for board approval include:

- Requiring restitution from the HVCB for any misappropriated spending;
- Requiring a management audit of the HVCB;
- Appointing a special "master" to review the HVCB's operations;
- Enlisting the support of the Ethics Commission and the Attorney General's Office to advise on the audit findings;
- Requesting that the auditor's CPA firm, Nishihama & Kishida CPA's Inc., conduct an audit of HVCB's year-end accounts payable for CY 2000 – 2002;
- Moving forward with the Leisure Marketing and CMI contract review and the RFP process, which presents an opportunity to make further fixes and implement changes to improve our contract monitoring efforts while at the same time instituting meaningful procedures to ensure effective and efficient use of public funds.

Conclusion

HTA remains committed to improving the marketing, promotion, and development of tourism, our largest industry. As we move forward, our efforts will continue to reflect an evolution as an agency that will balance the larger goal of a healthy and vibrant Hawaii tourism industry with the responsibility to be accountable to both government processes and good business practices.

If you have any questions regarding this matter, please call Rex Johnson at (808) 973-2288.

Very truly yours,

Rex Johnson
President & CEO, HTA

Mike McCartney
Chair, HTA