Financial Audit of the Department of Health

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

Report No. 04-05
March 2004

THE AUDITOR
STATE OF HAWAII

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
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OVERVIEW

Financial Audit of the Department of Health

Report No. 04-05, March 2004

Summary

The Office of the Auditor and the certified public accounting firm of KPMG LLP conducted a financial audit of the Department of Health, State of Hawaii, for the fiscal year July 1, 2002 to June 30, 2003. The audit examined the financial records and transactions of the department; reviewed the related systems of accounting and internal controls; and tested transactions, systems, and procedures for compliance with laws and regulations.

In the opinion of the firm, the financial statements present fairly the department's financial position and changes in financial position and cash flows for the fiscal year ended June 30, 2003, in conformity with generally accepted accounting principles.

With respect to the department's internal control over financial reporting and operations, we found several deficiencies. Failure to comply with the procurement codes undermines the department's ability to ensure that state funds are spent in a cost effective and beneficial manner. Specifically, in 14 instances out of a sample of 60 small purchases less than $25,000, the department did not comply with the quotation requirements of Chapter 103D and the related procurement circulars. Altogether, the 14 purchases totaled $190,094.

In addition, Chapter 103F and the administrative rules provide procedures for the restrictive purchases of health and human services, similar to those of sole source purchases specified in Chapter 103D. We found three instances of non-compliance with the applicable statutes and rules by the Emergency Medical Services and Injury Prevention System Branch. These three contracts totaled $7.45 million.

We also found that the department lacks formal policies and procedures for its contract management process. In three out of 30 contracts selected, contractors began work prior to the execution of a legally binding contract. These three contracts totaled approximately $22 million. We also found one instance where a contract payment was incorrect and not made in accordance with contractual terms, resulting in an overpayment of $128,689.

Moreover, the department failed to submit certain required federal financial reports on a timely basis. Failure to comply with federal financial reporting requirements can delay the receipt of federal funds and jeopardize the department's ability to receive future funding.

The department lacks formal policies or procedures to identify and lapse invalid encumbrances. As a result, out of a sample of 30 encumbrances, we found four instances, totaling $54,537 between January 1999 and October 2002, where funds were encumbered for contracts that were closed, inactive, or completed.

Finally, we found that the department's controls over petty cash are inadequate. The department did not adhere to the Hawaii Administrative Rules and its own internal policies and procedures requiring periodic, unannounced petty cash counts at least twice a year.

Recommendations and Response

We recommend that the department adhere to the procurement codes and establish policies and procedures for the procurement of goods and services. The department should also establish formal policies and procedures over its contract management functions, provide training, formally execute contracts prior to the commencement of contracted services, and properly review contractor performance and invoices before contract payments.

We also recommend that the department ensure that all required federal financial reports are submitted within required deadlines. The appropriate-level management should monitor each federal program's reporting process. In addition, the department should adhere to the State's policy of unencumbering funds related to contracts/purchase orders that are fulfilled, closed, or become inactive. Finally, the department should have an employee independent of the petty cash process perform periodic and unannounced reviews of each petty cash account.

In its response, the department recognizes our audit as a constructive one that will benefit not only its staff but also the general public. The department acknowledges that the audit findings and recommendations provide an opportunity for the department to continue to improve efficiency and effectiveness in its financial oversight as well as in the procurement procedures. The department also provided additional comments to explain its current procedures and new actions in addressing the internal control deficiencies identified in our report.

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State Auditor
State of Hawaii

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Financial Audit of the Department of Health

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

Conducted by

The Auditor
State of Hawaii
and
KPMG LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 04-05
March 2004

Foreword

This is a report of the financial audit of the Department of Health, State of Hawaii, for the fiscal year July 1, 2002 to June 30, 2003. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of KPMG LLP.

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

Marion M. Higa
State Auditor

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Chapter 1
Introduction

This is a report of our financial audit of the State of Hawaii's Department of Health (department). The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of KPMG LLP pursuant to Section 23-4, Hawaii Revised Statutes (HRS), which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawaii (State) and its political subdivisions.

Background

Section 26-13, HRS describes the department's responsibilities:

> The department shall administer programs designed to protect, preserve, care for, and improve the physical and mental health of the people of the State. Without limit to the generality of the foregoing, the programs shall include the administration and enforcement of matters and laws of public health of the State, including the state hospital, but excluding assistance and care for the indigent and the medically indigent.

Organization

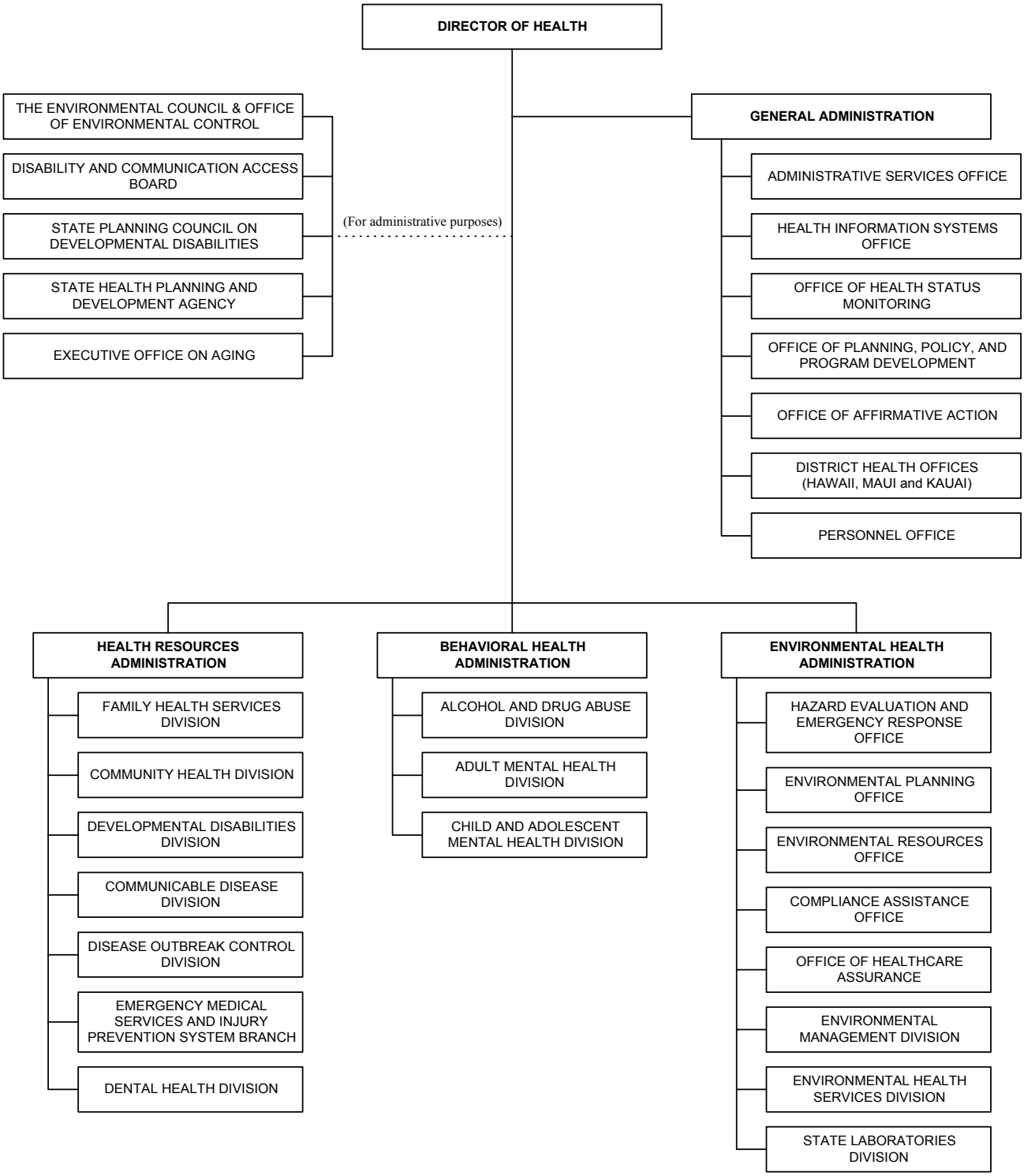
The health director plans, organizes, directs, coordinates, and reports on the department's various activities. The director is supported by deputy directors of health administration, health resources, and environmental health; and by a special assistant in charge of behavioral health. The department is comprised of four administrative areas (consisting of 15 offices/branches and 12 divisions) and five administratively attached agencies. Exhibit 1.1 displays the department's organizational structure. Primary responsibilities of the units follow.

General Administration

The General Administration administers and oversees the Administrative Services Office; Health Information Systems Office; Office of Health Status Monitoring; Office of Planning, Policy, and Program Development; Office of Affirmative Action; District Offices (Hawaii, Maui, and Kauai); and Personnel Office.

The Administrative Services Office provides departmental management of budgets, financial matters, and capital improvements.

Exhibit 1.1
Organizational Structure of the Department of Health



Source: Department of Health

The Health Information Systems Office provides technical assistance and consultation on matters relating to public-health applications of electronic data processing.

The Office of Health Status Monitoring collects, processes, analyzes, and disseminates relevant, population-based data to assess the health status of Hawaii's population. The office also issues and provides a repository for vital event records with the State such as births, deaths, and marriages.

The Office of Planning, Policy, and Program Development develops the department's legislation and administrative rules. It is also responsible for project development, strategic planning, data gathering, research and analysis.

The Office of Affirmative Action monitors, administers, and develops programs to prevent unlawful service and discrimination in the department.

The District Health Offices represent the department in the counties of Hawaii, Kauai, and Maui. The offices provide coordination and administrative support, and are engaged in community organization, planning, and consensus building.

The Personnel Office provides general personnel management and administration, including services to management in attaining program objectives.

Health Resources Administration

The Health Resources Administration administers and oversees the Family Health Services Division; Community Health Division; Developmental Disabilities Division; Communicable Disease Division; Disease Outbreak Control Division; Emergency Medical Services and Injury Prevention System Branch; and Dental Health Division.

The Family Health Services Division ensures all families receive quality prevention and intervention-based health services.

The Community Health Division maximizes and protects healthy lifestyles by improving health practices and access to health concerns through comprehensive and family-centered nursing services.

The Developmental Disabilities Division prevents and minimizes the effects of developmental disabilities and mental retardation on individuals and their families by providing individualized programs of service in the least restrictive environment and continuing long-term active treatment for those unable to return to community living.

The Communicable Disease Division monitors cases of communicable diseases, including tuberculosis, Hansen's disease, AIDS, and other sexually transmitted diseases.

The Disease Outbreak Control Division prevents outbreaks of various diseases through immunizations. The division also plans and implements plans to respond to disease outbreaks.

The Emergency Medical Services and Injury Prevention System Branch minimizes death, injury, and disability due to life-threatening situations by ensuring availability of high quality, emergency medical care through development of a system capable of providing coordinated emergency medical and health services.

The Dental Health Division develops public policy to help assure adequate access to basic dental care.

Behavioral Health Administration

The Behavioral Health Administration administers and oversees the Alcohol and Drug Abuse Division; Adult Mental Health Division; and Child and Adolescent Mental Health Division.

The Alcohol and Drug Abuse Division reduces the debilitating effects related to alcohol and other drug use by ensuring access to an integrated, high quality, public/private community-based system of prevention strategies and treatment services designed to empower individuals and communities to make health-enhancing choices regarding the use of alcohol and other drugs.

The Adult Mental Health Division improves the mental health of Hawaii's people by reducing the prevalence of emotional disorders and mental illness. Services include mental health education, treatment and rehabilitation through community-based mental health centers, and an in-patient state hospital facility for the mentally ill, including those referred through courts and the criminal justice system.

The Child and Adolescent Mental Health Division improves the emotional well-being of children and adolescents and preserves and strengthens their families by ensuring early access to a child and adolescent-centered, family-focused, community-based coordinated system of care that addresses children and adolescents' physical, social, emotional, and other developmental needs.

Environmental Health Administration

The Environmental Health Administration administers and oversees the Hazard Evaluation and Emergency Response Office; Environmental Planning Office; Environmental Resources Office; Compliance

Assistance Office; Office of Health Care Assurance; Environmental Management Division; Environmental Health Services Division; and State Laboratories Division.

The Hazard Evaluation and Emergency Response Office provides risk assessments, responds to the release of hazardous substances, and oversees cleanup of contaminated sites. Activities include evaluating the health effects of air and water pollutants when no standards exist.

The Environmental Planning Office develops strategic plans, supports land use reviews, and helps effectuate new programs. The office has been instrumental in developing the polluted runoff control program and is involved in coordinating watershed management projects.

The Environmental Resources Office handles many grant and administrative responsibilities of the Environmental Health Administration and ensures maximum federal funding is obtained from the U.S. Environmental Protection Agency.

The Compliance Assistance Office provides small businesses with technical support and compliance information subject to state statutes and other environmental program requirements.

The Office of Health Care Assurance manages state licensing and federal certification of medical and health care facilities, agencies, and services provided throughout the State to ensure compliance with established standards of care.

The Environmental Management Division implements and maintains statewide programs to control air and water pollution, ensure safe drinking water, and properly manage solid and hazardous waste; it also regulates the State's wastewater.

The Environmental Health Services Division implements and maintains statewide programs to ensure the safety of food and drugs, control noise and radiation, and improve indoor air quality. The division is also responsible for lead abatement, sanitation, and vector control (rats, mosquitoes, and other public health threats).

The State Laboratories Division provides support, research, and analysis to other health programs, including environmental regulatory and communicable disease control programs. It also provides specialized services to other health-care facilities.

Administratively attached bodies

The Environmental Council and Office of Environmental Quality Control administers the law on environmental impact statements prerequisite to certain types of land use. The office also coordinates efforts for maintaining the State's optimum environmental quality; advises the governor on environmental quality control; directs the attention of government agencies, the community, and the public to environmental problems; and serves as a clearinghouse for environmental impact statements prepared under state statutes.

The Disability and Communication Access Board establishes guidelines for the design of state and county buildings and facilities in accordance with state statutes. The board also approves site-specific alternate designs when they provide equal or greater access; establishes guidelines for utilizing communication access services in state programs and activities; administers statewide programs for disabled persons' parking in accordance with state statutes; serves as a public advocate for persons with disabilities; and coordinates state efforts to comply with the Americans with Disabilities Act.

The State Planning Council on Developmental Disabilities prepares state plans for the developmentally disabled and coordinates services and programs of state departments and private agencies; monitors, evaluates, and comments on public and private agencies' implementation plans relating to developmentally disabled persons and monitors ongoing projects; serves as an advocate for the developmentally disabled; and fulfills other responsibilities specified by law.

The State Health Planning and Development Agency conducts state health planning activities in coordination with sub-area councils, implements the state health plan, determines statewide health needs, and administers the state certificate of need program. The agency also determines the need for proposed institutional health services; periodically reviews the appropriateness of the State's institutional and home health care services; prepares an inventory of health care facilities other than federal ones; and evaluates the physical condition of such facilities.

The Executive Office on Aging provides leadership in programs and polices for older adults, serves as a clearinghouse for information, and partners with the Aging Network to provide home and community-based care for vulnerable seniors.

Objectives of the Audit

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the department; to recommend improvements to such systems, procedures, and reports; and to report on the fairness of the financial statements of the department.

2. To ascertain whether expenses/expenditures or deductions and other disbursements have been made and all revenues or additions and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

3. To make recommendations as appropriate.

Scope and Methodology

We audited the financial records and transactions and reviewed the department's related systems of accounting and internal controls for the fiscal year July 1, 2002 to June 30, 2003. We tested financial data to provide a basis to report on the fairness of the department's financial statements. We also reviewed the department's transactions, systems, and procedures for compliance with applicable laws, regulations, and contracts.

We examined the department's accounting, reporting, and internal control structure and identified deficiencies and weaknesses. We made recommendations for appropriate improvements including, but not limited to, the department's forms and records, management information system, and accounting and operating procedures.

The independent auditors' opinion as to the fairness of the department's financial statements presented in Chapter 3 is that of KPMG LLP. The audit was conducted from July 2003 through December 2003 in accordance with auditing standards generally accepted in the United States of America as set forth by the American Institute of Certified Public Accountants and the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

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Chapter 2

Internal Control Deficiencies

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

Summary of Findings

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

We found the following reportable conditions:

1. The department has failed to comply with procurement codes regarding small purchases and contractual services.

2. The department lacks formal policies and procedures over its contract management process. We found instances where contractors began providing services prior to the execution of a formal contract and one instance where the department made an improper payment to a vendor.

3. The department did not submit certain required federal financial reports to the U.S. Department of Health and Human Services on a timely basis. Failure to comply with federal financial reporting requirements can delay the receipt of federal funds and jeopardize the department's ability to receive future funding.

4. The department lacks formal policies and procedures to monitor outstanding encumbrances. As a result, the department failed to detect several outstanding encumbrances relating to contracts that were closed, inactive, or completed. Those funds could have been used for other state programs.

5. The department's lack of controls over petty cash funds increases the risk of misuse or misappropriation. Duties are not adequately segregated and reconciliations of petty cash accounts are not performed on a timely basis.

The Department Failed To Comply With Procurement Codes

Chapter 103D, HRS (*Hawaii Public Procurement Code*), together with Chapter 103F, HRS (*Purchases of Health and Human Services*), provide standardized policies and procedures for the procurement of goods and services by state agencies. The State established Chapters 103D and 103F, HRS (collectively the "procurement codes"), to promote fiscal integrity, accountability, and efficiency in its procurement processes.

Failure to comply with the procurement codes undermines the department's ability to ensure that state funds are spent in a cost effective and beneficial manner. We found several instances of non-compliance with the codes relating to the department's execution of small purchase procurements and procurement of restricted service contracts. Department personnel indicated they are aware of the procurement codes guidelines. We were informed that the instances of non-compliance were primarily due to department personnel's oversights.

The department violated small purchase requirements

The State's Procurement Circulars Nos. 1997-06 and 2003-01 provide standardized procedures for all purchases of less than $25,000 (called small purchases). In accordance with these circulars, purchases of goods and services greater than or equal to $1,000 require the solicitation of at least three quotations. Verbal quotations must be obtained for purchases between $1,000 and $15,000, while written quotations must be obtained for purchases between $15,000 and $25,000. All quotations must be documented and maintained in a procurement file. The most advantageous quote is selected based on various factors such as quality, warranty, deliverability, and price. If the quote selected is not the lowest submitted, or it is not practical to solicit three quotes, then written justification must be documented in the procurement file.

Failure to properly obtain at least three quotations makes it difficult to determine whether an agency obtained the best possible price for goods and services procured.

We found 14 instances out of a sample of 60 where the department failed to comply with these guidelines. In 11 instances, department personnel did not obtain the required three quotations (either written or verbal) or document their justification for failing to obtain the quotations. Four of these instances related to purchases between $15,000 and $25,000

(requiring three written quotes) and seven to purchases between $1,000 and $15,000 (requiring verbal quotes). Altogether, the 11 purchases ranged from $1,728 to $24,000 and totaled $120,644.

In addition to the instances identified above, we also found three examples relating to purchases between $15,000 and $25,000, in which the department obtained only one quotation because the selected vendor was deemed to be a sole source provider. In these instances, the department properly documented justification for not obtaining three quotations; however, only a verbal quotation was obtained from the respective vendor. A written quotation, as required for purchases between $15,000 and $25,000, was not attached to the sole source approval forms. The three instances related to purchases ranging from $20,000 to $24,950 and totaled $69,450.

The department failed to notify the public when contracting for restrictive services

Chapter 103F, HRS and Section 3-144-203 of the Hawaii Administrative Rules (HAR) allow restrictive purchases of health and human services when only one source is available from which a particular good or service may be obtained. The procedures for executing a restrictive purchase of service are similar to those for sole source procurements specified in Chapter 103D, HRS. A written determination supporting the request for a restrictive purchase of service must be submitted to the State's chief procurement officer for review and approval. If approved, a notice of intent to issue a restrictive purchase of service contract must be published at least once in a newspaper of general circulation on the island or in the locality in which the services are to be provided. Publication of the last newspaper announcement must be at least ten working days prior to the contract's execution.

During the fiscal year ended June 30, 2003, the department executed ten restrictive purchase of service contracts totaling over $8 million. We reviewed all ten contracts and found three instances of non-compliance with Chapter 103F, HRS, and Section 3-144-203, HAR, involving the procurement of medical services contracts by the department's Emergency Medical Services and Injury Prevention System Branch.

In one instance, the department failed to advertise the scope and terms of a $46,000 restrictive service contract prior to execution.

Program	Contract/ PO#	Date Advertised	Date Executed	Amount
EMS & Injury Prevention System	773904	NONE	4/10/03	$46,000

In another, the department failed to advertise the scope and terms of a restrictive service contract at least ten days prior to its execution. Instead, it advertised them on the *same* day the $6.69 million contract was executed.

Program	Contract/ PO#	Date Advertised	Date Executed	Amount
EMS & Injury Prevention System	735857	7/1/02	7/1/02	$6,698,190

We also found an instance where the published notice of intent to issue a restrictive purchase of service contract contained inaccurate information. The notice for this $714,356 contract stated that any objections should be filed by June 25, 2002. However, the notice was not advertised until November 1, 2002—approximately four months after all public objections were due.

Program	Contract/ PO#	Date Advertised	Date Executed	Amount
EMS & Injury Prevention System	50302	11/1/02	12/6/02	$714,356

Failure to properly publish notices of intent to issue a restrictive purchase of service contract in a timely manner deprives the public of its right to object to the restrictive status of vendors. Additionally, it hampers the department's ability to confirm the sole source status of the vendor it has selected and to identify other potential vendors who could provide the required services at a lower cost.

Although the department's fiscal office indicated the instances of non-compliance identified above were made inadvertently, other such examples by the department's Emergency Medical Services and Injury Prevention System Branch were identified in our Report No. 02-14, issued in October 2002.

Recommendations

We recommend that the department adhere to the procurement codes and established policies and procedures for the procurement of goods and services. Specifically, the department should ensure that required verbal or written quotations are obtained prior to executing small purchase procurements and that adequate notification is given to the public before procuring a restrictive purchase of service contract. We also recommend that an appropriate-level management be responsible for overseeing the department's procurement process. This person should ensure compliance with the procurement codes and conduct periodic audits of the department's procurement functions.

The Department Lacks Formal Policies and Procedures Over Its Contract Management Process

Third-party contractors perform a significant portion of the department's functions. During the fiscal year ended June 30, 2003, the department executed 168 contracts totaling approximately $50 million. Of these, 92 contracts worth approximately $31 million were procured in accordance with Chapter 103D, HRS, and 76 contracts of about $19 million were procured in accordance with Chapter 103F, HRS. Given the volume and magnitude of the department's contracts, it is imperative that they be effectively managed. This includes ensuring contractors comply with contractual terms and verifying that performance expectations are achieved.

We found that the department lacks formal policies and procedures for its contract management process. Once a contractor is selected, the department's programs/divisions are responsible for carrying out the various contract management functions. For example, each respective program/division is responsible for monitoring its own contractors' performance and ensuring all payments are made in accordance with contractual terms.

Considering the size and complexity of the health department, it is understandable that the majority of its contract management functions are performed at the program/division level. However, because the department does not have standardized policies and procedures in place, the nature and extent of contract management procedures are not consistently applied among the various programs and divisions. In addition, the department does not conduct formal employee training sessions to communicate uniform contract management requirements and processes. Without standardized policies and procedures for contract execution, performance monitoring, and payment processing, the department has no means of ensuring minimum contract management functions are performed.

We randomly selected 30 contracts totaling approximately $30 million as part of our review of the department's contract management process. The review revealed instances where contractors began providing services before a contract was formally executed and one instance where the department made an improper payment to a vendor.

Services were performed before the execution of legally binding contracts

We found three instances where contractors began work as early as five months prior to the execution of a legally binding contract. These contracts were for recurring services and totaled $22,045,450. Properly executed contracts ensure that the scope of services agreed upon is clearly defined to avoid confusion or misunderstanding. Without an executed contract, the department has no way of ensuring contractors

perform all required tasks in accordance with their contractual terms. Additionally, allowing contractors to provide services prior to establishing contractually defined roles places both the department and contractors at risk should any legal problems arise.

Department personnel informed us that contractors are sometimes required to commence providing services prior to a contract's formal execution because the lead time necessary to process contracts makes it difficult for contractors to meet required completion dates. Therefore, to the extent possible, the department should factor in necessary time requirements for the preparation and execution of contracts when establishing submission deadlines.

Improper contract payment was made

We found one instance where a contract payment was incorrect and not made in accordance with contractual terms. In this instance, the contractor submitted an invoice with an incorrect payment amount and subsequently resubmitted the same invoice with the correct payment amount. The department inadvertently approved and paid both invoices, resulting in an overpayment of $128,689 on a contract worth $714,356. Department personnel indicated this incident was the result of an oversight, and upon identification of the error, the department applied the overpayment against future contract payments.

Recommendations

We recommend that the department:

- Establish formal policies and procedures over its various contract management functions for use by the department's programs/divisions;
- Provide employees with formalized contract management training to familiarize employees with best practice ideas and techniques relating to contract execution, monitoring contractor performance, and contract payment processing;
- Consider the effectiveness of contract management capabilities when conducting employee performance evaluations;
- Formally execute contracts prior to the commencement of contracted services; and
- Ensure that contractor performance and invoices are properly reviewed before contract payments are made.

The Department Failed To Submit Required Federal Financial Reports On a Timely Basis

The department received approximately $92.2 million in federal financial assistance during the fiscal year ended June 30, 2003. As a recipient of federal funds, the department must ensure compliance with reporting requirements set forth in applicable laws, regulations, contracts, and grants. Recipient programs are responsible for the preparation and timely submission of all required reports. Failure to submit federal financial reports on a timely basis can delay the draw-down of additional funds and jeopardize a program's ability to receive future federal funding.

As part of our review of the department's compliance with applicable reporting requirements, we selected six programs with total federal expenditures amounting to approximately $92.8 million (accounting for approximately 68 percent of the department's federal expenditures for the fiscal year ended June 30, 2003). We found that the department's Special Programs for the Aging—Title III, Part B & C program (Special Programs for the Aging Program) did not submit certain financial reports to the U.S. Department of Health and Human Services on a timely basis.

The grant agreement between the Special Programs for the Aging Program and the U.S. Department of Health and Human Services requires that a Federal Cash Transaction Report be submitted on a quarterly basis no later than 45 days after the end of the reporting period. Our testing revealed that three out of four such reports submitted by the Special Programs for the Aging Program during the fiscal year ended June 30, 2003 were not submitted in a timely manner. The department filed these reports between three and 18 days after their required submission deadlines. We note that the department's external auditors reported similar findings relating to the department's failure to comply with federal reporting requirements for fiscal years ended June 30, 2002, 2001, and 2000.

Department personnel informed us that the cash transaction reports were not submitted within required deadlines due to personnel resource issues. Despite the department's inability to submit required federal financial reports on a timely basis, it has not experienced any delays in the receipt of additional funding nor been informed that future funding will be impacted.

Recommendations

We recommend that the department ensure all required federal financial reports are submitted within required deadlines. This can be accomplished by implementing a checklist system to remind personnel of various reporting deadlines. We also recommend that appropriate-level

management be responsible for monitoring each federal program's reporting process to ensure that proper staffing is available and reports are prepared, reviewed, and submitted on a timely basis.

The Department Lacks Formal Policies and Procedures to Identify and Lapse Invalid Encumbrances

Encumbrances are legal commitments related to unperformed purchase orders or contracts for goods and services. They do not become liabilities until an agency actually receives the goods or services. The primary purpose for encumbering funds is to reserve an appropriation (or portion thereof) for future expenditures that an agency will be required to pay. The Legislature requires an accurate accounting of available funds for budgeting purposes. All outstanding encumbrances related to projects that have been closed, inactive, and/or completed are to be promptly unencumbered, and unspent funds made available for other state purposes.

The department does not have formal policies and procedures for monitoring outstanding encumbrances. As a result, we found encumbrances relating to contracts that were closed, inactive, and/or completed. By not lapsing its unneeded encumbrances, the department improperly reserved funds and overstated its reserved fund balance.

The department does not properly unencumber funds

Of 30 encumbrances, we found four instances where funds were encumbered for contracts that were closed, inactive, and/or completed. These totaled $54,537 and should have been unencumbered between January 1999 and October 2002.

The department informed us that there is a lack of communication between divisions/offices and the fiscal office. The division/office originating the contract or purchase order is responsible for notifying the fiscal office when related projects are closed, inactive, and/or completed. Upon such notification, the fiscal office is responsible for unencumbering any unspent funds related to the contract or purchase order. In the instances noted above, department personnel indicated the respective division/office failed to inform the fiscal office of the related inactive contracts. Consequently, the fiscal office did not lapse the remaining unspent balances.

The department lacks a formal process to monitor outstanding encumbrances

The department does not have formal policies and procedures to ensure the validity of outstanding encumbrances. Department personnel indicated they have not performed periodic reviews of outstanding encumbrances to identify and unencumber invalid encumbrances. As a result, unspent balances remain encumbered, even when related contracts are inactive.

The administrator of each division/office should review the outstanding encumbrance report on a periodic basis (e.g., quarterly) to ensure that all encumbrances initiated by the division/office relate to valid future expenditures. If encumbrances relating to fulfilled or closed contacts or purchase orders are detected, the administrator should notify the fiscal office immediately to unencumber those amounts.

The fiscal office should assist in managing encumbrances by periodically scanning the department's outstanding encumbrance report for any old (e.g., outstanding longer than two years) encumbrances, and determine whether these encumbrances are for valid future expenditures. If any relate to contracts or purchase orders that have been fulfilled, the respective division/office should be notified and the unspent funds unencumbered.

Recommendations

We recommend that the department:

- Adhere to the State's policy of unencumbering funds when contracts and purchase orders are fulfilled, closed, or become inactive;
- Establish formal policies and procedures to monitor outstanding encumbrances. Specifically, the department should require that outstanding encumbrances be periodically evaluated by both the fiscal office and each division/office to ensure that all encumbrances relate to valid, ongoing commitments; and
- Promptly identify and unencumber unspent funds related to contracts and purchase orders that are no longer active.

The Department Lacks Controls Over Petty Cash

The department maintains 48 petty cash accounts, which are used for small purchases and employee reimbursements less than $100. Petty cash accounts within the department totaled $46,405 at June 30, 2003, with individual accounts ranging from $100 to $10,000.

Petty cash account balances are authorized based on a respective program's needs. Disbursements from petty cash funds require approval of the petty cash custodian and respective division head, and must be supported by original receipts. Funds are generally replenished on a monthly basis or as necessary. At any point in time, petty cash on hand plus outstanding petty cash vouchers should equal the authorized petty cash balance. We found that the department's controls over petty cash are inadequate.

Established policies and procedures for safeguarding petty cash accounts are not adhered to

Hawaii Administrative Rules and the department's own internal policies and procedures require that periodic, unannounced cash counts of petty cash accounts be performed, and that reconciliations of petty cash accounts be performed at least twice a year and be submitted to the Administrative Services Office. The department has not adhered to these policies and procedures for safeguarding its petty cash accounts.

The department lacks adequate segregation of duties over petty cash functions. The petty cash custodian performs both custodial and reconciliation functions. Ideally, different individuals should perform these functions to minimize the risk associated with the misappropriation of petty cash funds. However, given the limited resources at the program or division level, it may be more feasible to have an individual independent of the petty cash process perform the periodic, unannounced reviews of petty cash reconciliations, including the unannounced cash counts.

We also found that the department's various programs and divisions did not prepare and submit their petty cash account reconciliations as required by department policy. The department informed us that the Administrative Services Office had neither enforced this requirement nor received reconciliations from the various programs and divisions in a timely and consistent manner.

Recommendations

We recommend that the department:

- Perform periodic, unannounced reviews of each petty cash account, including surprise cash counts. An employee independent of the petty cash process should perform these reviews.

- Adhere to established policies requiring programs and divisions to prepare and submit reconciliations of petty cash accounts at least semi-annually. We further recommend that the department consider requiring the preparation and submission of petty cash reconciliations upon each request for replenishment. If reconciliations are not prepared and submitted, the Administrative Services Office should not process the replenishment request.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Department of Health, State of Hawaii (department), as of and for the fiscal year ended June 30, 2003. This chapter includes the independent auditors' report and the report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays the basic financial statements of the department together with explanatory notes and supplementary information required by accounting principles generally accepted in the United States of America (GAAP).

Summary of Findings

In the opinion of KPMG LLP, based on its audit, the basic financial statements present fairly, in all material respects, the financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the department as of June 30, 2003, and the respective changes in financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. KPMG LLP noted matters involving the department's internal control over financial reporting and its operations that the firm considered to be reportable conditions. KPMG LLP also noted that the results of its tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

The Auditor
State of Hawaii:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Department of Health, State of Hawaii (department), as of and for the year ended June 30, 2003, which collectively comprise the department's basic financial statements. These financial statements are the responsibility of the department's management. Our responsibility is to express opinions on these financial statements based on our audit.

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 opinions.

As discussed in Note 1, the financial statements of the department are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State of Hawaii that are attributable to the transactions of the department. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2003, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the department as of June 30, 2003, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The budgetary comparison schedules that follow the notes to the basic financial statements are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

The department has not presented management's discussion and analysis that accounting principles generally accepted in the United States of America require to supplement, although not to be part of, the basic financial statements.

In accordance with *Government Auditing Standards*, we have also issued a report dated December 29, 2003, on our consideration of the department's internal control over financial reporting and on 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.

KPMG LLP

Honolulu, Hawaii
December 29, 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 Hawaii:

We have audited the basic financial statements of the Department of Health, State of Hawaii (department), as of and for the year ended June 30, 2003, and have issued our report thereon dated December 29, 2003. 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.

Compliance

As part of obtaining reasonable assurance about whether the department's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes) and procurement rules, directives, and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are

required to be reported under *Government Auditing Standards,* and which we have reported to the Auditor, State of Hawaii, and described in Chapter 2 of this report.

Internal Control over Financial Reporting
In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on internal control over financial reporting. However, we noted certain matters involving 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 internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the basic financial statements. Reportable conditions have been reported to the Auditor, State of Hawaii, and described in Chapter 2 of this report.

A material weakness is a condition in which the design or operation of one or more 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 basic 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 internal control over financial reporting would not necessarily disclose all matters in 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 Hawaii, and the management of the department and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

Honolulu, Hawaii
December 29, 2003

Description of Basic Financial Statements and Required Supplementary Information

The following is a brief description of the department's basic financial statements audited by KPMG LLP, as well as the unaudited required supplementary information, which are presented at the end of this chapter.

Basic Financial Statements

Government-Wide Financial Statements

Statement of Net Assets (Exhibit 3.1). This statement is prepared using the accrual basis of accounting and is designed to display the financial position of the department at June 30, 2003. This approach is not limited to reporting just current assets and liabilities, but also capital assets and long-term liabilities. The department's net assets are classified as either invested in capital assets, restricted, or unrestricted.

Statement of Activities (Exhibit 3.2). This statement is prepared using the accrual basis of accounting and presents a comparison between direct expenses and program revenues in a format that focuses on the cost of each of the department's functions. Under this approach, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

Fund Financial Statements

Balance Sheet - Governmental Funds (Exhibit 3.3). This statement presents the assets, liabilities, and fund balances of the department's governmental funds and is prepared using the current financial resources measurement focus and the modified accrual basis of accounting. Because the emphasis of this statement is on current financial resources, capital assets and long-term liabilities are not reported.

Reconciliation of the Governmental Fund Balances to the Statement of Net Assets (Exhibit 3.4). This statement presents a reconciliation of the department's fund balance reported in the Governmental Funds – Balance Sheet to the net assets of governmental activities reported in the Statement of Net Assets.

Statement of Revenues, Expenditures, and Changes in Fund Balances - Governmental Funds (Exhibit 3.5). This statement presents the revenues, expenditures, and other financing sources and uses of the department's governmental funds and is prepared using the current financial resources measurement focus and the modified accrual basis of accounting. Under this approach, revenues are recognized when measurable and available while expenditures are recorded when the related fund liability is incurred.

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities (Exhibit 3.6). This statement presents a reconciliation of the department's net change in fund balances reported in the Governmental Funds – Statement of Revenues, Expenditures, and Changes in Fund Balances to the change in net assets reported in the Statement of Activities.

Statement of Net Assets – Proprietary Funds (Exhibit 3.7). This statement is prepared using the accrual basis of accounting and is designed to display the financial position of the department's proprietary funds at June 30, 2003. This approach is not limited to reporting just current assets and liabilities, but also capital assets and long-term liabilities. The department's proprietary fund net assets are classified as either invested in capital assets or restricted for loans.

Statement of Revenues, Expenses, and Changes in Fund Net Assets – Proprietary Funds (Exhibit 3.8). This statement is prepared using the accrual basis of accounting and is designed to display the changes in the department's proprietary fund net assets. Under this approach, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

Statement of Cash Flows – Proprietary Funds (Exhibit 3.9). This statement presents the cash inflows and outflows of the department's proprietary funds. This statement is designed to display the net cash flows provided by or used in operating activities, noncapital financing activities, capital and related financing activities, and investing activities.

Statement of Fiduciary Net Assets – Fiduciary Funds (Exhibit 3.10). This statement presents the assets, liabilities, and net assets of the department's fiduciary funds.

Required Supplementary Information (Unaudited)

Budgetary Comparison Schedule – General Fund (Exhibit 3.11). This schedule compares actual revenues and expenditures of the department's general fund on a budgetary basis to the original and final budgets adopted by the State Legislature for the year ended June 30, 2003.

Budgetary Comparison Schedule – Tobacco Settlement Fund (Exhibit 3.12). This schedule compares actual revenues and expenditures of the department's tobacco settlement fund on a budgetary basis to the original and final budgets adopted by the State Legislature for the year ended June 30, 2003.

Note to the Budgetary Comparison Schedules (Exhibit 3.13). This note contains a reconciliation for the general fund and the tobacco settlement fund, comparing the excess of revenues over expenditures presented on a budgetary basis to the excess (deficiency) of revenues over expenditures presented in conformity with GAAP.

Notes To Basic Financial Statements

Explanatory notes, which are pertinent to an understanding of the basic financial statements and financial position of the department, are discussed in this section.

Note 1 – Summary of Significant Accounting Policies

Financial Reporting Entity and Basis of Presentation

The department is part of the executive branch of the State of Hawaii (the State). The basic financial statements of the department are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State that is attributable to the transactions of the department. They do not purport to, and do not, present fairly the financial position of the State as of June 30, 2003, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with GAAP.

The Department of Health, State of Hawaii (department), administers and oversees statewide personal health services, health promotion and disease prevention, mental health programs, monitoring of the environment and the enforcement of environmental health laws. Federal grants received to support the State of Hawaii's health services and programs are administered by the department.

The department has considered all potential component units for which it is financially accountable and other organizations for which the nature and significance of their relationship with the department are such that exclusion would cause the department's basic financial statements to be misleading or incomplete. The Governmental Accounting Standards Board has set forth criteria to be considered in determining financial accountability. The department has determined, based on the GASB criteria, that it has no component units.

The accompanying basic financial statements of the department have been prepared in conformity with GAAP prescribed by GASB.

Government-Wide and Fund Financial Statements

The government-wide financial statements, which are the statement of net assets and the statement of activities, report information of all of the nonfiduciary activities of the department. Governmental activities, normally supported by state allotments and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. For the most part, the effect of interfund activity has been removed from these government-wide financial statements.

The statement of activities demonstrates the degree to which the direct expenses of a given function are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include charges to customers who purchase, use, or directly benefit from goods or services provided by a given function. Program revenues also include grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. State allotments and other items not properly included among program revenues are reported instead as general revenues. Resources that are dedicated internally are reported as general revenues rather than program revenues.

Net assets are restricted when constraints placed on them are either externally imposed or imposed by constitutional provisions or enabling legislation. Internally imposed designations of resources are not presented as restricted net assets. When both restricted and unrestricted resources are available for use, it is generally the department's policy to use restricted resources first, then unrestricted resources as they are needed.

Separate financial statements are provided for governmental funds, proprietary funds, and fiduciary funds. However, the fiduciary funds are not included in the government-wide financial statements. Major individual governmental funds and major individual enterprise funds are reported as separate columns in the fund financial statements.

Measurement Focus, Basis of Accounting, and Financial Statement Presentation

Government-wide Financial Statements – The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Governmental Fund Financial Statements – The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the department considers revenues to be available if they are collected within 60 days of the end of the current fiscal year-end. Principal revenue sources considered susceptible to accrual include federal grants and interest on investments. Some revenue items that are considered measurable and available to finance operations during the year from an accounting perspective are not available for expenditure due to the State's present appropriation system. These revenues have been accrued in accordance with GAAP, since they have been earned and are expected to be collected within 60 days of the end of the period. Other revenues are considered to be measurable and available only when cash is received by the department.

Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Modifications to the accrual basis of accounting include accrued vacation and workers' compensation liability, which is recorded as an expenditure when due and payable.

Proprietary Funds and Fiduciary Funds – The financial statements of proprietary funds and fiduciary funds are reported using the economic resources measurement focus and the accrual basis of accounting, similar to the government-wide financial statements described above.

In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the department has elected not to apply all Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, unless FASB conflicts with GASB.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services or goods in connection with a proprietary fund's principal ongoing operations. Revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses. The principal operating revenues of the department's enterprise funds are interest income and administrative loan fees on loans made to county governments. Federal grants, state matching funds, and interest income from investments are reported as nonoperating income.

Fund Accounting

The financial activities of the department are recorded in individual funds, each of which is deemed to be a separate accounting entity. The department uses fund accounting to report on its financial position and results of operations. Fund accounting is designed to demonstrate the legal compliance and to aid financial management by segregating transactions related to certain government functions or activities. A fund is a separate accounting entity with a self-balancing set of accounts.

The financial activities of the department that are reported in the accompanying fund financial statements have been classified into the following major and nonmajor governmental and proprietary funds. In addition, a description of the department's fiduciary fund is as follows:

Governmental Fund Types
The department reports the following major governmental funds:

General Fund
This fund is the department's primary operating fund. It accounts for all financial activities of the department, except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted.

Tobacco Settlement Fund
This fund accounts for all tobacco settlement moneys and interest and earnings accruing from the investment of such moneys.

The nonmajor governmental funds are comprised of the following:

Special Revenue Funds
These funds account for the financial resources obtained from specific revenue sources (other than major capital projects) that are legally restricted to expenditures for specified purposes.

Capital Projects Fund
This fund accounts for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds).

Proprietary Fund Type – Enterprise Funds
The major enterprise funds are comprised of the following:

Water Pollution Control Revolving Fund
This fund accounts for federal and state funds used to provide loans in perpetuity to county and state agencies for the construction of wastewater treatment facilities and the repayment, interest and earnings from such loans, and the investment of such moneys.

Drinking Water Treatment Revolving Loan Fund
This fund accounts for federal and state funds used to provide loans and other types of financial assistance to public water systems for drinking water infrastructure and the repayment, interest and earnings from such loans, and the investment of such moneys.

Fiduciary Fund Type

Agency Fund
This fund accounts for assets held by the department in an agency capacity.

Capital Assets

Capital assets, which includes property and equipment, are reported in the applicable governmental or business-type activities in the government-wide financial statements and in the proprietary fund financial statements. Capital assets are defined by the department as those assets with estimated useful lives greater than one year and with an acquisition cost greater than:

Land	All capitalized
Land improvements	$100,000
Building and building improvements	100,000
Equipment	5,000

Purchased and constructed capital assets are valued at cost. Donated assets are recorded at their fair market value at the date of donation.

Capital outlays for items utilized in the governmental funds are recorded as expenditures when incurred in the governmental fund financial statements.

The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized.

Depreciation expense is recorded in the government-wide financial statements, as well as the proprietary fund financial statements. The department utilizes the straight-line method over the assets' estimated useful life. No depreciation is recorded for land. Generally, the useful lives are as follows:

	Governmental Activities	Business-type Activities
Land improvements	15	Not applicable
Building and building improvements	30	Not applicable
Furniture and equipment	5 – 7	5 - 7

Cash and Cash Equivalents

Cash and cash equivalents include short-term investments with original maturities of three months or less. It also includes amounts held in the state treasury. The state director of finance is responsible for safekeeping of all moneys paid into the state treasury (cash pool). The state director of finance may invest any moneys of the State, which in the director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State. Cash is pooled with funds from other state agencies and departments and deposited into approved financial institutions or invested in the State Treasury Investment Pool System. Cash accounts that participate in the investment pool accrue interest based on the average weighted cash balances of each account.

The State requires that the depository banks pledge, as collateral, government securities held in the name of the State for deposits not covered by federal deposit insurance.

Investments can be categorized to give an indication of the level of custodial credit risk assumed by the department. Category 1 includes investments that are insured or for repurchase agreements, collateralized by underlying securities that are so held. Category 2 includes uninsured and unregistered investments for which the securities are held by the broker-dealer in the department's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker-dealer but not in the department's name.

Since all of the department's cash is included in the state cash pool, the category of custodial credit risk is not determinable at the department level.

Deferred Revenues

Deferred revenues at the fund level and government-wide level arise when the department receives resources before it has a legal claim to them. In subsequent periods, when the revenue recognition criteria is met, or when the department has a legal claim to the resources, the liability for deferred revenue is removed from the statement of net assets

or balance sheet and revenue is recognized. Deferred revenues at June 30, 2003 consist primarily of federal grant funds for which all eligibility requirements have not been met.

Compensated Absences

Employees hired on or before July 1, 2001 earn vacation at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn vacation at rates ranging between 1 and 2 working days for each month of service, depending upon the employees' years of service and job classification. Vacation days may be accumulated to a maximum of 90 days each calendar year. Employees are entitled to receive cash payment for accumulated vacation upon termination. Accumulated vacation is not reported in the governmental fund financial statements until it is due and payable, as that amount is otherwise not expected to be paid with current funds. The government-wide financial statements present the cost of accumulated unpaid vacation as a liability. A reconciliation of changes in aggregate liabilities for accumulated vacation is as follows:

	Governmental Activities
Balance at July 1, 2002	$ 17,852,053
Additions	9,967,618
Deletions	(9,316,052)
Balance at June 30, 2003	18,503,619
Less current portion	(6,661,303)
	$ 11,842,316

Employees hired on or before July 1, 2001 also earn sick leave credits at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn sick leave credits at the rate of one and one-quarter or one and three-quarters working days for each month of service, depending upon the employees' years of service and job classification. Sick leave credits may be accumulated without limit. Sick leave can be taken only in the event of illness, and is not convertible to pay upon termination of employment. Accordingly, no liability for unpaid sick leave credits is reported in the accompanying basic financial statements. However, a department employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the Employees' Retirement System of the State of Hawaii. Accumulated sick leave as of June 30, 2003, relating to the department approximated $57,263,000.

Insurance

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

Under the provisions of GASB Statement 10, liabilities related to certain types of losses (including torts, theft of, damage to, or destruction of assets, errors or omissions, natural disasters, and injuries to employees) are reported when it is probable that the losses have occurred and the amount of those losses can be reasonably estimated.

During the year ended June 30, 2003, the department was covered by the State's self-insured workers' compensation program for medical expenses of the injured department employees. However, the department was required to pay Temporary Total Disability (TTD) and Temporary Partial Disability (TPD) benefits for employees on the department's payroll. Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines, and damage awards, the process used in computing claims liability does not necessarily result in an exact amount. Claims liabilities are reevaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors.

The department paid $679,000 for workers' compensation claims during the year. A reconciliation of changes in the department's workers' compensation liability is as follows:

Balance at July 1, 2002	$ —
Current year claims	1,313,373
Claim payments	(679,000)
Balance at June 30, 2003	$ 634,373

Transfers

Transfers are used to move revenues from the fund that statutes require to collect them to the fund that statute requires to expend them. The government-wide statement of activities eliminates transfers within the segregated governmental and business-type activities.

Receivables and Payables

Activities between funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as interfund receivables/interfund payables. Any residual balances outstanding between the governmental activities and the business-type activities are reported in the government-wide financial statements as internal balances.

Use of Estimates

In preparing basic financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Nonimposed Employee Fringe Benefits

Payroll fringe benefit costs of the department's employees are funded by general fund appropriations and are assumed by the State, accordingly, such costs are not charged to the department's operating funds. These costs, totaling $30,535,685, of which $7,334,000 was for retirement benefits, have been reported as revenues and expenditures in the department's basic financial statements for the fiscal year ended June 30, 2003.

Payroll fringe benefit costs related to federally funded salaries are not assumed by the State and are recorded as expenditures in the department's basic financial statements.

Note 2 – Budgeting and Budgetary Control

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated throughout the fiscal year. Budgeted expenditures are derived primarily from acts of the State Legislature and from other authorizations contained in the State Constitution, the Hawaii Revised Statutes (HRS) and other authorizations contained in other specific appropriation acts in various Session Laws of Hawaii. To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations.

For budgeting purposes, the department's budgetary fund structure and accounting principles differ from those utilized to present the basic financial statements in conformity with GAAP. Encumbrances represent

executed but unperformed purchase orders or contracts. Encumbrances are recorded as expenditures for budgetary purposes and as reservations of fund balance for GAAP purposes. Since budgetary basis differs from GAAP, budget and actual amounts in the accompanying Required Supplementary Information – Budgetary Comparison Schedules are presented on the budgetary basis. A reconciliation of the excess of revenues over expenditures on a budgetary basis to the excess (deficiency) of revenues over expenditures presented in conformity with GAAP is set forth in the Note to Budgetary Comparison Schedules.

Note 3 – Loans Receivable

At June 30, 2003, the proprietary fund loans receivable consists of loans to county governmental units for the water pollution control and drinking water treatment programs. The loans are due in annual, semi-annual, or quarterly payments, including interest at 1.55 percent to 3.02 percent, commencing not later than one year after project completion or notice to proceed. Final payment is due not later than 20 years after project completion. Accrued interest receivable on the loans amounted to approximately $1,555,825 at June 30, 2003.

The following is a schedule of principal payments due on loans for projects completed or in progress as of June 30, 2003:

Year ending June 30:	
2004	$ 11,233,023
2005	11,525,840
2006	11,807,261
2007	12,098,068
2008	12,396,571
Thereafter	114,618,713
	$ 173,679,476

Note 4 – Capital Assets

Capital asset activity for the year ended June 30, 2003 was as follows:

	Beginning Balance	Additions	Deletions	Ending Balance
Governmental activities:				
Capital assets not being depreciated:				
Land	$ 1,018,080	$ —	$ —	$ 1,018,080
Total capital assets not being depreciated	1,018,080	—	—	1,018,080
Capital assets being depreciated:				
Land improvements	1,862,927	—	—	1,862,927
Building and improvements	126,113,479	—	(276,000)	125,837,479
Furniture and equipment	12,298,031	930,456	(1,029,979)	12,198,508
Total capital assets being depreciated	140,274,437	930,456	(1,305,979)	139,898,914
Less accumulated depreciation:				
Land improvements	1,475,755	115,023	—	1,590,778
Building and improvements	52,718,719	3,892,465	(276,000)	56,335,184
Furniture and equipment	10,515,309	598,997	(1,012,970)	10,101,336
Total accumulated depreciation	64,709,783	4,606,485	(1,288,970)	68,027,298
Total capital assets of governmental activities, net	$ 76,582,734	$ (3,676,029)	$ (17,009)	$ 72,889,696
Business-type activities:				
Capital assets being depreciated:				
Equipment	$ 459,907	$ 179,743	$ (46,188)	$ 593,462
Less accumulated depreciation for equipment	214,667	73,434	(46,188)	241,913
Total capital assets of business-type activities, net	$ 245,240	$ 106,309	$ —	$ 351,549

Depreciation expense for the year ended June 30, 2003 was charged to functions as follows:

Governmental activities	
General administration	$ 513,091
Environmental health	1,632,877
Behavioral health	1,598,868
Health resources	861,649
Total depreciation expense – governmental activities	$ 4,606,485
Business-type activities:	
Environmental health	$ 73,434

Note 5 – Retirement Benefits

Employees' Retirement System

Plan Description

All eligible employees of the State are required by Chapter 88, HRS, to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

The ERS consists of a contributory plan and a noncontributory plan. Employees covered by Social Security on June 30, 1984 were given the option of joining the noncontributory plan or remaining in the contributory plan. All new employees hired after June 30, 1984, who are covered by Social Security, are generally required to join the noncontributory plan. Both plans provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the payment of salary in lieu of vacation, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after this date is based on the three highest paid years of service excluding the payment of salary in lieu of vacation. Vesting requirements for the contributory and noncontributory plans are five years and ten years, respectively. All contributions, benefits, and eligibility requirements are governed by Chapter 88, HRS.

Funding Policy

Most covered employees of the contributory plan are required to contribute 7.8 percent of their salary. Police officers, firefighters, investigators of the department of the prosecuting attorney and the attorney general, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2 percent of their salary. The actuarial cost or funding method used to calculate the total employer contribution required is the entry age normal actuarial cost method. Under this method, the total employer contributions to the ERS is comprised of normal cost plus level annual payments required to amortize the unfunded actuarial accrued liability over the closed period ending June 30, 2029.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to all employees hired prior to July 1, 1996 who retire from State employment on or after attaining age 62 with at least ten years of service or age 55 with at least 30 years of

service under the noncontributory plan and age 55 with at least 5 years of service under the contributory plan. Retirees credited with at least 10 years of service excluding sick leave credit qualify for free medical insurance premiums; however, retirees with less than 10 years must assume a portion of the monthly premiums. All service-connected disability retirees who retired after June 30, 1984, with less than 10 years of service also qualify for free medical insurance premiums. Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive a reimbursement of a portion of the basic medical coverage premiums.

For employees hired after July 1, 1996 and who retire with fewer than 25 years of service, the State shall pay to a fund a monthly contribution equal to one-half of the retired employee's monthly Medicare or non-Medicare premium for certain medical benefits for retired employees with 10 or more years of service; and 75 percent of the retired employee's monthly Medicare or non-Medicare premium for retired employees with at least 15 but fewer than 25 years of service.

For active employees, the employer's contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued.

Cost of Retirement Benefits

The department's general fund share of the expense for pension and post-retirement benefits for the year ended June 30, 2003, are paid from the state general fund and approximate $7,334,000 (see Note 1(n)). The department's special revenue fund and proprietary fund share of the pension and post-retirement benefits expense for the year ended June 30, 2003, was approximately $3,138,000 and $212,000, respectively, and are included in the department's basic financial statements.

Note 6 – Lease Obligations

The department leases various office facilities and equipment on a long-term basis as provided for in the lease agreements. The following is a schedule of minimum future rentals on noncancelable operating leases at June 30, 2003:

Year ending June 30:		
2004	$	930,870
2005		852,080
2006		949,790
2007		444,680
2008		418,340
	$	3,595,760

Total governmental activities rent expense for the year ended June 30, 2003 was $1,897,390.

Note 7 – Commitments and Contingencies

Deferred Compensation

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

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but does have the duty of due care that would be required of an ordinary prudent investor. Accordingly, the assets and liabilities of the State's deferred compensation plan are not reported in the accompanying basic financial statements.

Litigation

The department is a party to various legal proceedings, most of which normally occur in governmental operations. Although the department and its counsel are unable to express opinions as to the outcome of the litigation, it is their opinion that any potential liability arising there from, will not have a material adverse effect on the financial position of the department, because any judgments against the department are judgments against the State, and would have to be paid by legislative appropriation of the state general fund and not by the department.

Ceded Land

The Office of Hawaiian Affairs (OHA) and the State are presently in litigation involving the State's alleged failure to properly account for and pay to OHA moneys due to OHA under the provisions of the Hawaii State Constitution and Chapter 10, HRS, for use by the State of certain ceded lands. As of June 30, 2003, the outcome of the lawsuit had not been decided.

Note 8 – Transfers

For the year ended June 30, 2003, transfers by fund were as follows:

	Transfers In	Transfers Out
Governmental funds:		
Tobacco settlement fund	$ —	$ 18,722,949
Nonmajor Funds	6,682,711	9,799,541
	$ 6,682,711	$ 28,522,490
Proprietary funds:		
Water pollution control revolving fund	$ 2,094,000	$ —
Drinking water treatment revolving loan fund	1,551,000	—
	$ 3,645,000	$ —

The tobacco settlement fund transferred $18,722,949 to the state general fund and the Department of Budget and Finance pursuant to Chapter 328L, HRS. Transfers out of nonmajor funds included $3,645,000 transferred to the proprietary funds relating to the State's matching of federal funds received from the U.S. Environmental Protection Agency. The remaining transfers in/out of nonmajor funds were made to/from other State agencies to fund various programs and services.

Exhibit 3.1

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Net Assets

June 30, 2003

	Primary Government		
Assets	**Governmental Activities**	**Business-type Activities**	**Total**
Current assets:			
Cash and cash equivalents on deposit with the State of Hawaii	$ 120,590,696	$ 100,202,725	$ 220,793,421
Receivables:			
Accrued interest and loan fees (Note 3)	47,590	2,261,687	2,309,277
Due from federal government	2,561,952	851,517	3,413,469
Internal balances	(395,000)	395,000	—
Current maturities of loans receivables (Note 3)	—	11,233,023	11,233,023
Total receivables	2,214,542	14,741,227	16,955,769
Total current assets	122,805,238	114,943,952	237,749,190
Loans receivable, net of current maturities (Note 3)	—	162,446,453	162,446,453
Capital assets, net (Note 4)	72,889,696	351,549	73,241,245
Total assets	195,694,934	277,741,954	473,436,888
Liabilities and Net Assets			
Current liabilities:			
Vouchers and contracts payable	11,650,441	—	11,650,441
Accrued wages and employee benefits payable	6,449,596	49,082	6,498,678
Accrued vacation, current portion (Note 1)	6,661,303	—	6,661,303
Workers' compensation liability (Note 1)	634,373	—	634,373
Deferred income	330,814	—	330,814
Due to State General Fund	46,805	—	46,805
Total current liabilities	25,773,332	49,082	25,822,414
Accrued vacation, net of current portion (Note 1)	11,842,316	—	11,842,316
Total liabilities	37,615,648	49,082	37,664,730
Commitments and contingencies (Notes 5, 6, and 7)			
Net assets:			
Invested in capital assets	72,889,696	351,549	73,241,245
Restricted for:			
Loans	—	277,341,323	277,341,323
Tobacco prevention and control	27,277,052	—	27,277,052
Capital projects	1,406,017	—	1,406,017
Other purposes	32,449,955	—	32,449,955
Unrestricted	24,056,566	—	24,056,566
Total net assets	$ 158,079,286	$ 277,692,872	$ 435,772,158

See accompanying notes to basic financial statements.

Exhibit 3.2

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Activities

Year Ended June 30, 2003

Functions/Programs	Expenses	Program Revenues: Charges for Services	Program Revenues: Operating Grants and Contributions	Net (Expense) Revenue and Changes in Net Assets, Primary Government: Governmental Activities	Business-type Activities	Total
Primary government:						
Governmental activities:						
General administration	$ 24,935,698	$ 325,164	$ 8,638,481	$ (15,972,053)	$ —	$ (15,972,053)
Environmental health administration	36,287,269	5,893,051	8,388,703	(22,005,515)	—	(22,005,515)
Behavioral health services administration	192,769,198	1,973,307	13,136,150	(177,659,741)	—	(177,659,741)
Health resources administration	249,905,904	1,275,123	56,895,824	(191,734,957)	—	(191,734,957)
Total governmental activities	503,898,069	9,466,645	87,059,158	(407,372,266)	—	(407,372,266)
Business-type activities:						
Environmental health loan programs	2,028,675	5,938,729	10,310,356	—	14,220,410	14,220,410
Total primary government	$ 505,926,744	$ 15,405,374	$ 97,369,514	(407,372,266)	14,220,410	(393,151,856)
General revenues:						
State general fund allotments				317,485,335	—	317,485,335
Nonimposed employee fringe benefits (Note 1)				30,535,685	—	30,535,685
Environmental response tax				1,562,115	—	1,562,115
Deposit beverage container fee				2,091,733	—	2,091,733
Advance glass disposal fee				3,066,777	—	3,066,777
Tobacco settlement funds				43,523,519	—	43,523,519
Other				94,837	—	94,837
Transfers (Note 8)				(21,839,779)	3,645,000	(18,194,779)
Total general revenues and transfers				376,520,222	3,645,000	380,165,222
Change in net assets				(30,852,044)	17,865,410	(12,986,634)
Net assets at July 1, 2002				188,931,330	259,827,462	448,758,792
Net assets at June 30, 2003				$ 158,079,286	$ 277,692,872	$ 435,772,158

See accompanying notes to basic financial statements.

Exhibit 3.3

DEPARTMENT OF HEALTH
STATE OF HAWAII

Balance Sheet - Governmental Funds

June 30, 2003

Assets	General	Tobacco Settlement	Other Governmental Funds	Total Governmental Funds
Cash and cash equivalents	$ 48,206,306	$ 28,033,175	$ 44,351,215	$ 120,590,696
Accrued interest receivable	—	—	47,590	47,590
Due from federal government	—	—	2,561,952	2,561,952
Total assets	$ 48,206,306	$ 28,033,175	$ 46,960,757	$ 123,200,238
Liabilities and Fund Balances				
Liabilities:				
Vouchers and contracts payable	$ 7,867,732	$ 708,048	$ 3,074,661	$ 11,650,441
Accrued wages and employee benefits	4,874,110	48,075	1,527,411	6,449,596
Deferred income	—	—	330,814	330,814
Due to other funds	—	—	395,000	395,000
Due to State General Fund	46,805	—	—	46,805
Total liabilities	12,788,647	756,123	5,327,886	18,872,656
Fund balances:				
Reserved for encumbrances	39,492,554	10,455,938	28,255,839	78,204,331
Unreserved, reported in:				
Major funds:				
General	(4,074,895)	—	—	(4,074,895)
Tobacco settlement	—	16,821,114	—	16,821,114
Nonmajor special revenue funds	—	—	13,377,032	13,377,032
Total fund balances	35,417,659	27,277,052	41,632,871	104,327,582
Total liabilities and fund balances	$ 48,206,306	$ 28,033,175	$ 46,960,757	$ 123,200,238

See accompanying notes to basic financial statements.

Exhibit 3.4

DEPARTMENT OF HEALTH
STATE OF HAWAII

Reconciliation of the Governmental Fund Balances to the Statement of Net Assets

June 30, 2003

Total fund balances – governmental funds	$ 104,327,582
Amounts reported for governmental activities in the statement of net assets are different because:	
Capital assets used in governmental activities are not financial resources and therefore not reported in the governmental funds.	72,889,696
Accrued vacation reported in the statement of net assets do not require the use of current financial resources and therefore are not reported as liabilities in the governmental funds.	(18,503,619)
Workers' compensation liability reported in the statement of net assets does not require the use of current financial resources and therefore is not reported as a liabilities in the governmental funds	(634,373)
Net assets of governmental activities	$ 158,079,286

See accompanying notes to basic financial statements.

Exhibit 3.5

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Revenues, Expenditures, and Changes in Fund Balances - Governmental Funds

Year Ended June 30, 2003

	General	Tobacco Settlement	Other Governmental Funds	Total Governmental Funds
Revenues:				
State general fund allotments, net	$ 311,743,598	$ —	$ 5,741,737	$ 317,485,335
Intergovernmental	—	—	84,623,804	84,623,804
Tobacco settlement	—	43,523,519	—	43,523,519
Nonimposed employee fringe benefits (Note 1)	30,535,685	—	—	30,535,685
Taxes, fees, fines, and other	—	—	16,886,968	16,886,968
Interest income	—	869,904	949,333	1,819,237
Total revenues	342,279,283	44,393,423	108,201,842	494,874,548
Expenditures:				
General administration	17,649,885	—	6,971,885	24,621,770
Environmental health	20,035,354	—	14,398,930	34,434,284
Behavioral health services	172,815,777	—	17,792,185	190,607,962
Health resources	154,713,111	32,207,043	62,323,666	249,243,820
Total expenditures	365,214,127	32,207,043	101,486,666	498,907,836
Excess (deficiency) of revenues over expenditures	(22,934,844)	12,186,380	6,715,176	(4,033,288)
Other financing sources (uses):				
Transfers in (Note 8)	—	—	6,682,711	6,682,711
Transfers out (Note 8)	—	(18,722,949)	(9,799,541)	(28,522,490)
Total other financing uses	—	(18,722,949)	(3,116,830)	(21,839,779)
Net change in fund balances	(22,934,844)	(6,536,569)	3,598,346	(25,873,067)
Fund balances at July 1, 2002	58,352,503	33,813,621	38,034,525	130,200,649
Fund balances at June 30, 2003	$ 35,417,659	$ 27,277,052	$ 41,632,871	$ 104,327,582

See accompanying notes to basic financial statements.

Exhibit 3.6

DEPARTMENT OF HEALTH
STATE OF HAWAII

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities

Year Ended June 30, 2003

Net change in fund balances – total governmental funds	$	(25,873,067)
Amounts reported for governmental activities in the statement of activities are different because:		
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which depreciation exceeded capital outlays for the year.		(3,693,038)
Accrued vacation reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental funds until due and payable.		(651,566)
Workers' compensation liability reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental funds until due and payable.		(634,373)
Change in net assets of governmental activities	$	(30,852,044)

See accompanying notes to basic financial statements.

Exhibit 3.7

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Net Assets – Proprietary Funds

June 30, 2003

Assets (Restricted)	Water Pollution Control Revolving Fund	Drinking Water Treatment Revolving Loan Fund	Total
Current assets:			
Cash and cash equivalents in state treasury	$ 89,528,990	$ 10,673,735	$ 100,202,725
Loan fees receivable	566,544	74,030	640,574
Accrued interest receivable (Note 3)	1,588,748	32,365	1,621,113
Due from other funds	—	395,000	395,000
Due from federal government	400,076	451,441	851,517
Current portion of loans receivable (Note 3)	10,659,371	573,652	11,233,023
Total current assets	102,743,729	12,200,223	114,943,952
Loans receivable, net of current portion (Note 3)	151,795,915	10,650,538	162,446,453
Capital assets, net (Note 4)	19,961	331,588	351,549
Total assets	254,559,605	23,182,349	277,741,954
Liabilities and Net Assets			
Liabilities:			
Current liabilities:			
Accrued payroll and other	41,343	7,739	49,082
Total liabilities	41,343	7,739	49,082
Net assets:			
Invested in capital assets	19,961	331,588	351,549
Restricted for loans	254,498,301	22,843,022	277,341,323
Total net assets	$ 254,518,262	$ 23,174,610	$ 277,692,872

See accompanying notes to basic financial statements.

Exhibit 3.8

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Revenues, Expenses, and Changes in Fund Net Assets – Proprietary Funds

Year Ended June 30, 2003

	Water Pollution Control Revolving Fund	Drinking Water Treatment Revolving Loan Fund	Total
Operating revenues:			
Interest income from loans	$ 3,956,751	$ 158,727	$ 4,115,478
Administration loan fees	1,451,773	371,478	1,823,251
Total operating revenues	5,408,524	530,205	5,938,729
Operating expenses:			
Administrative	1,202,434	272,850	1,475,284
State program management	—	208,956	208,956
Small systems	—	1,858	1,858
Water protection	—	342,577	342,577
Total operating expenses	1,202,434	826,241	2,028,675
Operating income (loss)	4,206,090	(296,036)	3,910,054
Nonoperating revenues:			
Interest income from investments	2,535,929	239,321	2,775,250
Federal contribution	4,428,893	3,105,208	7,534,101
Other	685	320	1,005
Total nonoperating revenues	6,965,507	3,344,849	10,310,356
Income before transfers in	11,171,597	3,048,813	14,220,410
Transfers in (Note 8)	2,094,000	1,551,000	3,645,000
Change in fund net assets	13,265,597	4,599,813	17,865,410
Net assets at July 1, 2002	241,252,665	18,574,797	259,827,462
Net assets at June 30, 2003	$ 254,518,262	$ 23,174,610	$ 277,692,872

See accompanying notes to basic financial statements.

Exhibit 3.9

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Cash Flows – Proprietary Funds

Year Ended June 30, 2003

	Water Pollution Control Revolving Fund	Drinking Water Treatment Revolving Loan Fund	Total
Cash flows from operating activities:			
Interest income from loans	$ 3,865,871	$ 143,010	$ 4,008,881
Administrative loan fees	1,387,937	309,791	1,697,728
Principal repayments on loans	9,687,830	473,601	10,161,431
Disbursement of loan proceeds	(11,279,754)	(2,202,868)	(13,482,622)
Payments to employees	(837,081)	(228,813)	(1,065,894)
Payments to vendors	(345,779)	(535,179)	(880,958)
Net cash flows provided by (used in) operating activities	2,479,024	(2,040,458)	438,566
Cash flows from noncapital financing activities:			
Federal contributions	4,028,817	3,182,157	7,210,974
State contributions	2,094,000	1,551,000	3,645,000
Payments to others	—	(255,013)	(255,013)
Net cash flows provided by noncapital financing activities	6,122,817	4,478,144	10,600,961
Cash flows used in capital and related financing activities:			
Purchase of equipment	(26,002)	(153,741)	(179,743)
Cash flows provided by investing activities:			
Interest from investments	3,016,363	285,281	3,301,644
Net increase in cash and cash equivalents	11,592,202	2,569,226	14,161,428
Cash and cash equivalents at July 1, 2002	77,936,788	8,104,509	86,041,297
Cash and cash equivalents at June 30, 2003	$ 89,528,990	$ 10,673,735	$ 100,202,725
Reconciliation of operating income (loss) to net cash provided by (used in) operating activities:			
Operating income (loss)	$ 4,206,090	$ (296,036)	$ 3,910,054
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:			
Depreciation expense	11,294	62,140	73,434
Change in assets and liabilities:			
Loans receivable	(1,591,924)	(1,729,267)	(3,321,191)
Accrued interest on loans receivable	(90,880)	(15,716)	(106,596)
Loan fees receivable	(63,836)	(61,688)	(125,524)
Accrued wages and other	8,280	109	8,389
Net cash provided by (used in) operating activities	$ 2,479,024	$ (2,040,458)	$ 438,566

See accompanying notes to basic financial statements.

Exhibit 3.10

DEPARTMENT OF HEALTH
STATE OF HAWAII

Statement of Fiduciary Net Assets – Fiduciary Funds

June 30, 2003

Assets		**Agency Fund**
Cash and cash equivalents – on deposit with banks and on hand (Note 1)	$	311,900
Total assets	$	311,900
Liabilities		
Due to others	$	311,900
Total liabilities	$	311,900

See accompanying notes to basic financial statements.

Exhibit 3.11

DEPARTMENT OF HEALTH
STATE OF HAWAII

Required Supplementary Information (Unaudited)

Budgetary Comparison Schedule – General Fund

Year Ended June 30, 2003

	Budgeted Amounts		Actual Amounts (Budgetary Basis)
	Original	**Final**	**(See Note 1)**
Revenues:			
Current year appropriations	$ 359,446,015	$ 333,635,487	$ 318,588,629
Expenditures:			
General administration	14,703,672	10,165,058	15,326,591
Environmental health administration	14,732,549	16,678,377	15,956,453
Behavioral health services administration	185,308,130	157,162,375	146,092,801
Health resources administration	144,701,664	149,629,677	141,212,784
Total expenditures	359,446,015	333,635,487	318,588,629
Excess of revenues over expenditures	$ —	$ —	$ —

See accompanying independent auditors' report and note to the budgetary comparison schedules.

Exhibit 3.12

DEPARTMENT OF HEALTH
STATE OF HAWAII

Required Supplementary Information (Unaudited)

Budgetary Comparison Schedule – Tobacco Settlement Fund

Year Ended June 30, 2003

	Budgeted Amounts		Actual Amounts (Budgetary Basis)
	Original	**Final**	**(See Note 1)**
Revenues:			
Tobacco settlement funds received	$ 50,342,603	$ 50,342,603	$ 44,568,461
Expenditures:			
Health resources administration	50,342,603	50,342,603	43,725,075
Excess of revenues over expenditures	$ —	$ —	$ 843,386

See accompanying independent auditors' report and note to the budgetary comparison schedules.

Exhibit 3.13

DEPARTMENT OF HEALTH
STATE OF HAWAII

Note to the Budgetary Comparison Schedules

Year Ended June 30, 2003

(1) Budget to GAAP Reconciliation

The following reconciles the excess of revenues over expenditures presented on a budgetary basis to the excess (deficiency) of revenues over expenditures presented in conformity with GAAP for the general and tobacco settlement funds.

	General Fund	Tobacco Settlement Fund
Excess of revenues over expenditures – actual on a budgetary basis	$ —	$ 843,386
Reserve for encumbrances at year-end	39,492,554	10,455,938
Expenditures for liquidation of prior year's encumbrances	(64,765,923)	(11,768,087)
Accrual and other adjustments	2,338,525	12,655,143
Excess (deficiency) of revenues over expenditures – GAAP basis	$ (22,934,844)	$ 12,186,380

Response of the Affected Agency

Comments on Agency Response

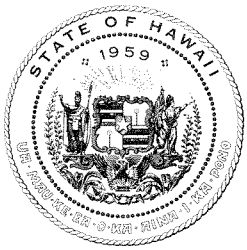
We transmitted a draft of this report to the Department of Health on February 23, 2004. A copy of the transmittal letter to the department is included as Attachment 1. The response of the department is included as Attachment 2.

The department recognizes our audit as a constructive one that will benefit not only its staff but also the general public. The department acknowledges that the audit findings and recommendations provide an opportunity for the department to continue to improve efficiency and effectiveness in its financial oversight, as well as in the procurement procedures.

The department provides numerous corrective actions contemplated and planned and offers its perspectives on how it will implement some modifications of our recommendations.

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

February 23, 2004

COPY

The Honorable Chiyome L. Fukino
Director of Health
Department of Health
Kinau Hale
1250 Punchbowl Street
Honolulu, Hawaii 96813

Dear Dr. Fukino:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Financial Audit of the Department of Health.* We ask that you telephone us by Wednesday, February 25, 2004, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Wednesday, March 3, 2004.

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

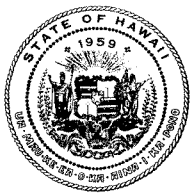
Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
State Auditor

Enclosures

LINDA LINGLE
GOVERNOR OF HAWAII



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In reply, please refer to:
File:
ASO-F-3060

March 1, 2004

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OFC. OF THE AUDITOR
STATE OF HAWAII

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

Dear Ms. Higa:

Thank you for the opportunity to comment on the *Financial Audit of the Department of Health.* The Department has reviewed the auditor's draft report and recognizes and appreciates the need to continuously work towards greater efficiency in its financial oversight of the department as well as in the procedures of the procurement of goods and services. We look upon this review as a constructive one and one that will provide benefit not only to the department 's personnel, but also to the general public as well.

At this time, we would like to provide some additional background information and respond to the report's findings and recommendations.

Findings (bulleted and in bold):

- **The department has failed to comply with procurement codes regarding small purchases and contractual services.**

  Departmental procedures that disseminate from the Administrative Services Office will again remind program staff of the various requirements when obtaining quotes for purchasing of goods and services. In addition, the procedural review process within the Administrative Services Office will also be strengthened to ensure that the program has complied with the applicable requirements for verbal or written quotes. It should also be noted that inherent within the department's organizational structure is an administrative level structure as well as a program level structure that provides the "appropriate-level" oversight to ensure procurement compliance.

- **The department lacks formal policies and procedures over its contract management process. We found instances where contractors began providing services prior to the execution of a formal contract and one instance where the department made an improper payment to a vendor.**

  The department has been discussing the development of policies and procedures with regard to the contract management process. However, one concern over the development of these policies and procedures is that the department felt it would have been too broad to be

effective enough for all programs in the department to benefit. Each program and division has unique requirements and services that are provided to their specific target population. The department does have, however, standard boilerplate language for compensation and payment, general conditions and special conditions, which are used on all contracts.

Training on the contract process by the department's contract specialist has always been provided to new programs. In addition to departmental training, training and workshops on Chapter 103D and 103F contracts are offered by the State Procurement Office (SPO) on a regular basis. This training includes basic procurement and writing of Requests for Proposals. In addition, SPO offers training on related topics such as evaluation of proposals, Administrative Rules changes, and "problem areas".

The department issues memos to all programs and divisions on the timelines that must be followed to execute contracts by July 1st for recurring services. If the deadlines are not met, the department provides a reason for lateness to the Department of the Attorney General. The department will again stress to the programs and divisions the importance of meeting these deadlines.

The duplicate payment of invoices was an inadvertent situation caused by oversight that was primarily attributed to the vacancy of the Public Health Administrative Officer. The position has now been filled and the invoices are being closely scrutinized.

- **The department did not submit certain required federal financial reports to the U.S. Department of Health and Human Services on a timely basis. Failure to comply with federal financial reporting requirements can delay the receipt and jeopardize the department's ability to receive future funding.**

  The Executive Office on Aging (EOA) will develop a checklist system on the reporting deadlines of the financial reports required by the Special Programs for the Aging. If the deadlines cannot be met, the EOA will submit a request for extension.

  The newly hired EOA accountant will be responsible for the timely submittal of the financial reports.

- **The department lacks formal policies and procedures to monitor outstanding encumbrances. As a result, the department failed to detect several outstanding encumbrances relating to contracts that were closed, inactive, or completed. Those funds could have been used for other state programs.**

  In April of each year, the department receives a memorandum from the Comptroller listing contract encumbrances that are still outstanding for five years and had no activity for more than one year. The memo requests that the encumbrances be cancelled if the contracts are completed. The department uses that reminder to monitor outstanding contract balances.

The department will also institute a procedure to review the department's outstanding encumbrance report to identify contract encumbrances that are still outstanding for three fiscal years. These encumbrances will be cancelled if they are no longer needed.

Claims encumbrances or purchase orders for general, special, revolving, and trust funds that are encumbered in the prior fiscal year can only be kept outstanding until June 30th of the next fiscal year. Beyond that date, the outstanding purchase order balances are lapsed by the Department of Accounting and General Services.

- **The department's lack of controls over petty cash funds increases the risk of misuse or misappropriation. Duties are not adequately segregated and reconciliations of petty cash accounts are not performed on a timely basis.**

  Currently, the department does not have sufficient resources to conduct unannounced cash counts or independent reviews of petty cash accounts. However, the department will inform the petty cash custodians that if the petty cash reconciliations, or Statement of Accountability for Petty Cash, are not submitted by the required minimum of twice a year, which will be in April and October, their requests for replenishments will be returned.

The audit findings and recommendations provide an opportunity for the department to continue to strive to improve its efficiency and effectiveness. The department does recognize that in the normal course of conducting business, there will always be areas where improvement can be made. We appreciate the value that the audit findings have provided and also appreciate the opportunity to provide input into the process.

Sincerely,

Chiyome Leinaala Fukino, M.D.
Director of Health