Financial Audit of the Department of Agriculture

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

Report No. 05-02
April 2005

THE AUDITOR
STATE OF HAWAI`I

The Office of the Auditor

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

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

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

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

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

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

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

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

7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.

8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.

9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

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

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OVERVIEW

Financial Audit of the Department of Agriculture

Report No. 05-02, April 2005

Summary

The Office of the Auditor and the certified public accounting firm of Grant Thornton LLP conducted a financial audit of the Department of Agriculture, State of Hawai`i, for the fiscal year July 1, 2003 to June 30, 2004. 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, except for the effects of such adjustments, if any, as might have been determined to be necessary had they been able to examine evidence regarding certain capital asset costs and related accumulated depreciation, the financial statements present fairly, in all material respects, the department's financial position and changes in its financial position for the fiscal year ended June 30, 2004, in conformity with generally accepted accounting principles.

With respect to the department's internal control over financial reporting and operations, we found several deficiencies, including significant reportable conditions considered to be material weaknesses. In the first material weakness, we found that the department lacks formal written policies and procedures for many of its basic processes and management functions, including the administration of agricultural loans, certain accounts receivables, and contract management.

In another material weakness, we found that the department needs to improve its administration of agricultural loans. Our testing of the agricultural loan process revealed deficiencies in the following areas: loan file and loan system maintenance, monitoring and collection of delinquent loans, performing inspections, reconciling internal and external loan reports, and monitoring participation loans.

In another material weakness, we found that the department's calculation of its allowance for agricultural loan losses is not properly supported and does not comply with generally accepted accounting principles. Additionally, the department improperly accrues interest on loans greater than 90 days past due.

In another material weakness, we found that the department's management of its accounts receivables is ineffective. Our testing of accounts receivables revealed that collection procedures at one division are inadequate, while collection procedures at another division, while properly established, are not adhered to. Additionally, the department's allowance for doubtful accounts is not properly calculated or supported.

In another material weakness, we found that the department's year-end financial reporting process is ineffective. Several adjustments and footnote disclosures,

required by generally accepted accounting principles, were not included in the June 30, 2004 draft financial statements submitted to us by the department.

We also found that the department lacks adequate management controls over cash receipts and disbursements and annual inventory counts; has deficient procurement procedures that resulted in noncompliance with certain provisions of the Hawai`i Public Procurement Code; lacks formal policies and procedures to standardize its procurement and contract management practices; and did not file certain federal financial and performance reports on a timely basis.

Recommendations and Response

We recommend that the department establish formal policies and procedures for all functions. These policies and procedures should define the roles, responsibilities, and limitations of personnel and should be approved and periodically reviewed by the Board of Agriculture.

We also recommend that the department improve its administration of agricultural loans; revise its policies and procedures to incorporate a methodology for calculating an allowance for loan losses that is in accordance with generally accepted accounting principles; develop a comprehensive loan monitoring process that involves the participation of the Board of Agriculture; and discontinue accruing interest on loans greater than 90 days past due.

We also recommend that the department review and revise, as appropriate, its policies and procedures over accounts receivable collections, write-offs, and allowances; strengthen management oversight and collection efforts over delinquent accounts; and adhere to established policies and procedures.

We also recommend the department implement a process to ensure accurate and timely year-end financial reporting, including the use of financial statement disclosure checklists. Additionally, the department should maintain adequate support for its capital assets.

We also recommend that the department strengthen management controls over cash receipts and disbursements, and annual inventory counts; and amend policies and procedures and provide staff training to ensure compliance with the Hawai`i Public Procurement Code.

The department generally concurred with most of our findings and recommendations, and provides additional information to explain its current procedures and corrective actions planned, or already taken, to address the internal control deficiencies identified in our report.

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Financial Audit of the Department of Agriculture

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

Conducted by

The Auditor
State of Hawai`i
and
Grant Thornton LLP

Submitted by

THE AUDITOR
STATE OF HAWAI`I

Report No. 05-02
April 2005

Foreword

This is a report of the financial audit of the Department of Agriculture, State of Hawai`i, for the fiscal year July 1, 2003 to June 30, 2004. The audit was conducted pursuant to Section 23-4, Hawai`i 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 Grant Thornton LLP.

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

Marion M. Higa
State Auditor

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Chapter 1
Introduction

This is a report of our financial audit of the Department of Agriculture. The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of Grant Thornton LLP. Section 23-4, Hawai`i Revised Statutes (HRS), requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawai`i and its political subdivisions.

Background

The Department of Agriculture was created by the Hawai`i Legislature pursuant to the Hawai`i State Government Reorganization Act of 1959, Act 1, Second Special Session Laws of Hawai`i 1959.   Section 26-16, HRS, outlines the responsibilities of the department as follows:

- To promote the conservation, development, and utilization of agricultural resources in the state;
- To assist the farmers of the state and any others engaged in agriculture by research projects, dissemination of information, crop and livestock reporting service, market news service, and any other means of improving the well-being of those engaged in agriculture and increasing the productivity of the lands;
- To administer state programs relating to animal husbandry, entomology, farm credit, development and promotion of agricultural products and markets, and the establishment and enforcement of the rules on the grading and labeling of agricultural products; and
- To administer the aquaculture program.

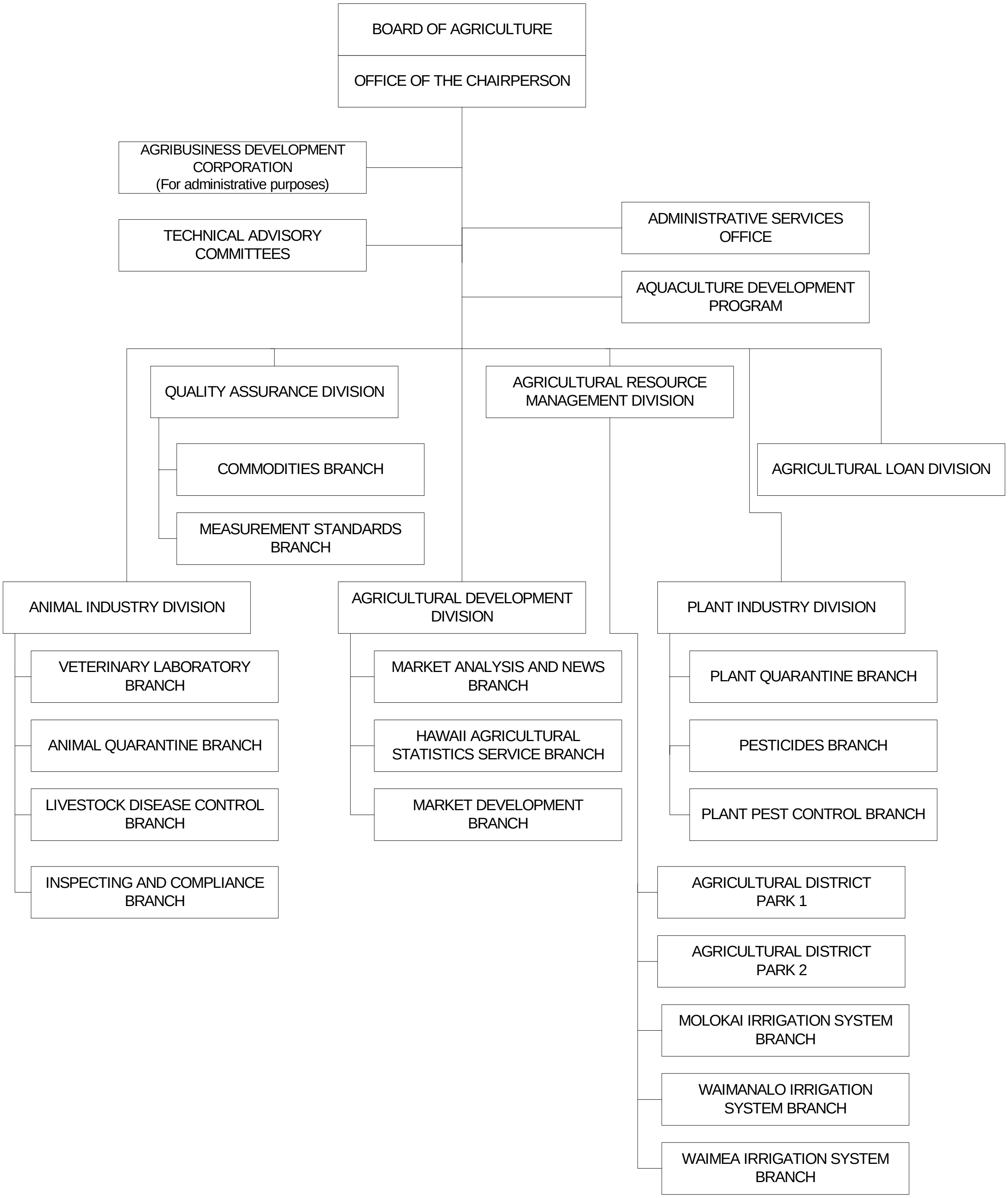
Organization

The department is comprised of the Board of Agriculture, the Office of the Chairperson, the Administrative Services Office, six divisions, and an administratively attached entity. Each is summarized below, along with an organizational chart at Exhibit 1.1.

Board of Agriculture

The Board of Agriculture (board), which was established on May 13, 1903, as the Board of Commissioners of Agriculture and Forestry, then

Exhibit 1.1
Department of Agriculture



Source: Department of Agriculture

under the Territory of Hawai`i, is charged with establishing broad operating policies for the department. The board is an executive board consisting of ten members – one from each of the counties of Hawai`i, Maui, and Kaua`i; four at-large members; the chairperson of the Department of Land and Natural Resources; the director of the Department of Business, Economic Development, and Tourism; and the dean of the College of Tropical Agriculture and Human Resources - University of Hawai`i. The members are appointed by the governor of Hawai`i and confirmed by the Hawai`i State Senate. The chairperson of the Board of Agriculture is also responsible for the day-to-day operation of the Department of Agriculture. Besides providing policy direction for the department, the board also exercises specific authority in such areas as granting permission for the importation of certain animal and plant species which, by regulation, requires such action.

Office of the Chairperson

The office is responsible for planning and developing state agricultural programs, as well as promoting the State's agribusiness development and research.

Planning and development

The department actively seeks to protect existing farming areas and promote increased access to and productive use of the thousands of acres of important agricultural lands and infrastructure vacated by sugar plantations throughout the state. The department, as the principal advocate for agriculture among state agencies, offers consultative input into land use zoning, environmental program implementation, and broader planning and economic development issues that affect agricultural resources and the growth of agricultural businesses.

Agribusiness development and research

To promote a strong and vigorous agricultural industry, the department must have the ability to respond to urgent problems without having to wait for supplemental legislative funds. This program is designed to address critical agricultural research and also marketing and promotional needs to ensure the continued growth of Hawai`i's agricultural industries.

Administrative Services Office

The goals of the Administrative Services Office are to streamline and improve its operations, while providing administrators and program managers with guidance, training, and management tools to enhance their decision-making capabilities in administering their programs.

Operating divisions

The divisions that carry out the programs of the department are as follows:

Agricultural Development Division

The Agricultural Development Division assists in the market research, planning, development, and expansion of Hawai`i's agricultural industries through market research and promotional events, as well as disseminating a collection of production and marketing information.

Agricultural Loan Division

The Agricultural Loan Division administers the Agricultural Loan Program and the Aquaculture Loan Program. These loan programs provide financial assistance to qualifying entities that are unable to obtain financing through conventional sources. In this role, the division contributes to the growth, development, and well-being of the agricultural and aquacultural industries in Hawai`i.

Agricultural Resource Management Division

The Agricultural Resource Management Division works to ensure that the State has adequate and reliable sources of agricultural water, farmland, and infrastructure for farming and agricultural-related processing facilities. The division provides administrative oversight for state agricultural park lots, processing facilities, and several irrigation systems statewide.

Animal Industry Division

The mission of the Animal Industry Division is to protect Hawai`i's livestock and poultry industries and the public health through the prevention of disease introductions and the detection and control of economically important diseases or pests within the State. The division conducts animal disease surveillance, epidemiology, and control; administration of voluntary livestock and poultry disease certification programs; laboratory diagnostic services; dog and cat quarantine to prevent rabies introduction; inspection of all animals and birds entering the state; and livestock brand registration. The primary focus of the division is shifting from mandatory to voluntary disease surveillance and control programs in support of the livestock industry; however, public health and environmental programs aimed at preventing the introduction of the rabies virus and the West Nile virus into the State are important ancillary functions. The development of methods to ensure rapid and appropriate response to incursions of highly contagious diseases, such as foot and mouth disease, is a division priority.

Plant Industry Division

The Plant Industry Division consists of three branches, the Pesticides Branch, Plant Pest Control Branch, and the Plant Quarantine Branch. Together, the branches work to protect Hawai`i's agricultural industries by preventing the entry and establishment of detrimental insects, weeds, and other pests and by assuring the safe and efficient use of pesticides in Hawai`i. The division also works with growers, exporters, and other government agencies to resolve quarantine restrictions in order to allow export of Hawai`i's fresh fruits, vegetables, flowers, and foliage products to markets worldwide.

Quality Assurance Division

The Quality Assurance Division serves both the consumer and producer of agricultural and other products by providing services and enforcing laws and rules designed to improve the market quality of agricultural commodities, promote fair trade and honest business practices, and maintain stability in the dairy industry.

Agribusiness Development Corporation

The Agribusiness Development Corporation was established pursuant to Act 264, Session Laws of Hawai`i (SLH) 1994, to coordinate the development of Hawai`i's agricultural industry and to facilitate its transition from a dual-crop (sugar and pineapple) industry to a diversified, multi-crop and animal industry. More specifically, it is responsible for devising means by which arable sugar and pineapple lands and their production infrastructure can be used again by a diversified agricultural industry and for providing marketing assistance that can lead to the development of local, national, and international markets for Hawai`i grown products.

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 department's financial records and transactions and reviewed the related systems of accounting and internal controls for the fiscal year July 1, 2003 to June 30, 2004. 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.

In addition, we reviewed the extent to which recommendations made in the department's prior external financial audit and in Chapter 2 of the State Auditor's Report No. 94-22, *Financial Audit of the Department of Agriculture*, have been implemented.

The independent auditors' opinion as to the fairness of the department's financial statements presented in Chapter 3 is that of Grant Thornton LLP. The audit was conducted from July 2004 to March 2005 according to auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

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 Agriculture.

Summary of Findings

We found several material weaknesses and several reportable conditions involving the department's internal or management controls. A material weakness is a condition in which the design or operations of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material to the financial statements being audited may occur and not be detected within a timely period by the employees in the normal course of performing their assigned functions.

Reportable conditions, which are less severe than material weaknesses, 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, and report financial data consistent with the assertions of management in the financial statements.

The following matters are severe and considered material weaknesses:

1. The department lacks formal policies and procedures governing many of its basic processes and management functions.

2. The Agricultural Loan Division needs to improve its maintenance of loan files and customer information, collection and inspection procedures, loan system manual, and monitoring of participation loans.

3. The department's calculation of its allowance for agricultural loan losses is not properly supported and does not comply with generally accepted accounting principles.

4. Interest on delinquent loans in the Financial Assistance for Agriculture Fund is improperly accrued.

5. The department's management of its accounts receivables is ineffective.

6. The department's year-end financial reporting process is ineffective.

We considered the following matters to be reportable conditions:

1. The department's internal controls over cash receipts and disbursements are inadequate.

2. A lack of formal policies and procedures led to instances of departmental noncompliance with the Hawai`i Public Procurement Code.

3. The department's contract management process is not standardized.

4. Federal financial reports generated by the department are untimely.

The Department Lacks Formal Policies and Procedures Governing Many of Its Basic Processes and Management Functions

Well-developed policies and procedures form the basis for effective management practices. Policies and procedures should be based on Hawai`i Revised Statutes (HRS) and Hawai`i Administrative Rules (HAR), tailored to meet the specific needs of the department. These policies should be approved by the Board of Agriculture, updated periodically, and made known and available to all personnel. However, during the course of our audit we found that the department did not have established policies and procedures governing many critical functions. Further, of the functions having established policies and procedures, many were either outdated or informal and improperly maintained. Specifically, the department lacked adequate policies and procedures regarding the administration of agricultural loans, certain accounts receivables, and procurement and contract management.

Agricultural loans comprise a significant portion of the department's operations with the receivable balance on these loans accounting for 16 percent of total assets, based on FY2003-04 financial statements. Yet there are several functions within the agricultural loan process that do not have any, or well-developed, policies and procedures guiding their execution. These functions include collection efforts on delinquent loans, maintenance and review of loan payment and customer profile information, reconciliations of internal and external loan reports, and management of participation loans. Another critical component of any loan program involves the establishment of an adequate allowance for inherent losses. Again, the department has failed to formulate an allowance for loan loss policy based on current accounting guidelines.

The department has deficient policies and procedures in place over other important areas. There are no policies directing collection efforts on delinquent accounts receivables at a division that makes up a significant portion of the total account receivables of the department. Further, formal procedures governing certain procurement functions and contract management in general do not exist.

Without formal policies and procedures directing all divisions and functions, management has failed to create a positive control environment and raise the control consciousness of its personnel. This, in turn, opens the door to deficiencies and failures in internal control and is the underlying cause for many of the findings identified during our audit. The significant impact of not having formal policies and procedures in the areas identified above will become evident as subsequent findings are presented throughout this report.

Recommendation

We recommend that the department establish formal policies and procedures for all functions. The board should review and approve the policies and procedures and set a timeframe for required updates. Policies and procedures should clearly define the roles, responsibilities, and limitations of all personnel and should be centrally located and accessible.

The Administration of Agricultural Loans Needs Improvement

The department provides funding to qualified individuals and entities under its agricultural loan program to promote and further develop Hawai`i's agriculture and aquaculture industries with reasonable rates and terms to qualifying individuals or entities. Through the establishment of a revolving loan fund, credit is made available by supplementing private lender sector loan funds or by providing direct funding. The loans help farmers expand their operations and develop their infrastructure, purchase necessary equipment, and assist in the recovery from natural disasters. Considered a "lender of last resort," the program is not intended to compete with private sector lenders. Prospective applicants must inquire with and be denied credit from private sector lenders prior to filing an application. In addition, prospective applicants must fulfill applicable eligibility requirements. At June 30, 2004, the department's loan portfolio included 211 loans with an aggregate outstanding balance of $22.75 million, representing a significant portion (16 percent) of the department's total assets. During the year ending June 30, 2004, the department approved 23 new loans totaling approximately $3.3 million and collected approximately $3.75 million in principal and interest payments.

The volume and scope of fiscal activity within the loan division makes it imperative that sufficient controls are in place and that basic administration and management functions are performed in an efficient manner. During our FY2003-04 audit of the department's agricultural loan program, we found a number of significant areas that need improvement. Some of these deficiencies still exist despite a 1994 financial audit that reported similar deficiencies. We note, however, that the 1994 audit did prompt some changes as monthly payment statements produced by the loan computer program have been improved. Payment statements to borrowers now identify previous payments, outstanding balances, and currently due principal and interest amounts.

Loan files are not properly maintained

The basic foundation of any financial assistance program is the proper maintenance of customer files. We found 26 loan files out of a sample of 30 that were missing at least one required document or signature. Among the items missing were current income tax returns and financial statements, copies of Hawai`i general excise tax licenses, letters of turndown, proof of insurance coverage, loan service reports, and if applicable, accounts receivable aging reports. The following table lists the occurrence of missing documents among the 26 loan files identified.

Missing Documents	Frequency
Two letters of turndown	2
Proof of insurance coverage	2
Accounts receivable aging report	6
Loan service reports	9
Copy of general excise tax license	15
Loan document checklist (unsigned)	16
Current financial statements	20
Current income tax returns	20

Adequate loan documentation provides evidence that loans exist and were analyzed for credit worthiness prior to loan approval. Subsequent to approval, adequate documents provide a basis for analysis of collectibility and the monitoring of collateral. For example, without current financial statements, the division has no way of knowing the financial health of the borrowers. Loan documentation requirements are covered under Chapter 155, HRS, and the division's policies and procedures manual.

Division personnel noted that requests are made for current financial statements and income tax returns through annual requests to borrowers and during annual farm visits. Follow-up requests are made with telephone calls at the loan officers' discretion. However, we did not find any documentation of these calls within the loan files we tested. This finding was reported in a prior audit.

The status of delinquent accounts and history of collection attempts are not adequately documented

Loan officers are required to prepare memos analyzing the status of each delinquent loan, and submit them on a monthly basis to the loan administrator. For FY2003-04, we found that memos were not completed for the months of July to October 2003 and June 2004. Of the remaining seven months, four memos, selected at random, were not completed on a timely basis, defined by division policy as being the end of the subsequent month. To aid in the preparation of these status memos, monthly delinquent loan reports are printed by an account clerk and distributed to the loan officers within the first ten business days of the current month. We also found that four of these monthly delinquent loan reports had not been distributed on a timely basis.

Timely, monthly memos to the loan administrator will assist in assessing the status of all delinquent accounts in a more efficient manner and will also become the basis for calculating an adequate allowance for loan losses. Because the loan administrator does not interact with borrowers on a case by case basis, it is essential that the administrator be updated with status reports such as these memos. As a majority of these monthly loan status reports are not being prepared or are not submitted in a timely manner, the loan administrator cannot assess the credit quality of the department's loan portfolio or the adequacy of the department's allowance for loan losses. The division's policies and procedures manual requires the preparation of these memos and outlines their requirements. While the existing policies in place to address this particular area appear to be sufficient, the failure lies in the adherence to and the enforcement of these policies.

Furthermore, we found six loan files (out of a sample of ten) that did not contain adequate documentation regarding the history of collection attempts. These six in question had a total principal balance due of approximately $1 million and a related accrued interest balance of nearly $55,000. Our sample was based on a population consisting of loans that were greater than 30 days past due. Based on this relatively high accrued interest amount, it is evident that these loans were past due, which makes documentation regarding the history of collection attempts even more important, as these loans may be uncollectible.

Based on inquiries of the loan administrator, we found that there are no formal policies on minimum collection procedures. Loan officers decide when and what method to use to pursue past due balances.

Division personnel noted that because of the unique situation of each borrower, standard collection procedures may not be effective. For example, if a borrower has health or other personal issues, the division may tend to be less aggressive at initial collection than a borrower who chooses not to pay with no reason being given. In any case, the division should have formal policies in place on minimum collection procedures.

Adequate documentation regarding delinquent accounts provides evidence that there were actual attempts at collection. It also aids in further collectibility analyses and provides guidance on how to proceed with problem loans. While the division's policies and procedures manual provides certain guidelines on handling delinquent loans, it fails to specifically address collection procedures.

Department personnel have cited recent turnover in the administrator position as a possible cause for untimely or uncompleted loan status memos. However, division policies and procedures dictate that these memos must be completed. Section 4-8-35, HAR, emphasizes the department's responsibilities by stating that, " The Division shall review delinquent and problem accounts to determine whether or not defaults are being satisfactorily resolved"…. Without timely status memos assisting management with identifying problem loans and other possible issues, and no policies addressing the adequacy of documentation regarding collection attempts, it is difficult to assess the department's fulfillment of this responsibility. Furthermore, non-standardized requirements regarding collection attempts and their documentation expose the division to substandard practices, which lead to inefficiencies in the collection of public money.

Required inspections are not documented

We found 7 out of 30 files selected for testing did not have a loan service report, which is used to document initial and subsequent on-farm visits of loan recipients. Consequently, we were unable to determine whether an initial or subsequent on-farm visit was made for these accounts. These seven loans originally totaled $3.1 million out of a sample of $7.5 million. This finding was reported in a prior audit.

According to the division's policies and procedures manual, initial on-farm visits should be performed within three months of loan disbursement and should be documented with a loan servicing report. Subsequent visits should be performed at least semi-annually, and more often for loans that will potentially become past due. These visits will help determine whether loan proceeds are being used for their intended purposes. Without a loan service report, the division exposes itself to questions regarding the efforts to protect state money after a loan is disbursed, as no evidence exists that on-farm visits were ever performed. Division personnel have noted that required inspections are performed, however, documentation on loan service reports may be lacking due to oversight on their part.

Loan account information and deposits are not reviewed

Based on inquiries made of division personnel, initial loan account information that is entered into the loan master file does not receive any supervisory reviews. This finding was also reported in a prior audit. Furthermore, deposits for loan repayments are not reviewed for propriety of allocation between interest and principal. Supervisory reviews could detect incorrect information that may remain as standing data in the loan computer program. Reviews for deposits could detect an incorrect allocation between interest and principal. Failure to review deposits may lead to incorrect reporting of principal balances to borrowers. The department cannot rely on the customer to identify inaccuracies reported on loan statements, especially if they are in the customer’s favor.

There are no policies in place to require reviews in these situations.

Internal controls over account information are inadequate

Internal controls, such as supervisory reviews and proper segregation of duties, over changes to loan account information are lacking. The department allows the same individual to both authorize and make changes to loan master files. A separate review is not made by another individual. Segregating responsibilities for authorizing, performing, and reviewing changes made to loan account information would help ensure the validity and accuracy of loan account information. Without policies establishing proper segregation of duties, master files containing interest rates and principal balances can be changed by one person and may lead to misappropriation of assets. This finding was also reported in a prior audit.

The division computer system manual is outdated

During our review of APPX, the division computer system set up to handle loan account information, we found that the system manual was over 17 years old. While the basic process remains the same, most of the information contained in the manual would benefit from an update.

Adequate and current software documentation will help to maintain the consistent application of software systems in the event of turnover of key personnel or when major system modifications are attempted. In addition, documentation of software systems provides a basis to facilitate review by supervisory or audit personnel. However, division personnel consider projects of this nature low priority and thus have not updated the manual.

Internal records are not reconciled to FAMIS on a monthly basis

The division's APPX system is capable of producing various monthly reports. We found that these reports are not reconciled to the Financial Accounting and Management Information System (FAMIS) reports produced by the Department of Accounting and General Services on a monthly basis.

Monthly reconciliations are measures to detect improprieties in financial data. When reconciliations are performed monthly, corrections can be made on a timely basis. Untimely reconciliations make it more difficult to resolve any discrepancies that arise. In some extreme cases, reconciliations may help to uncover fraud schemes. Once again, no policies are in place to require monthly reconciliations and corresponding reviews of division and FAMIS reports. Consequently, division personnel perform reconciliations only at the end of the fiscal year.

Participation loans are not adequately documented

A participation loan is a loan in which both the department and a private lender provide funds and have a proportionate share of interest in the loan. As of June 30, 2004, the department participated in 16 loans with various Hawai`i financial institutions with a principal balance due solely to the department totaling approximately $1.2 million. We found that although the loan files contained basic participation agreements, there was no other evidence that the division loan officers were monitoring the private lenders for compliance with applicable statutes.

Participation agreements with private lenders stipulate that the participating institutions are responsible for administering the loans and ensuring compliance with statutes and rules. This, in effect, puts the private institutions in the same position as that of the department. Monitoring of these loans in particular is essential as private institutions may not be familiar with the intricacies of applicable state laws and regulations. There are no formal monitoring procedures in place to determine whether rules are being adhered to. Currently, division loan officers rely on phone calls and email correspondence to stay current with private lenders. This finding was reported in a prior audit.

Recommendations

We recommend that the department:

- Be more diligent in obtaining required loan documents and ensure that the required documents are reviewed and signed off by appropriate personnel. In cases where unsuccessful requests have been made to obtain documents from borrowers, all correspondence should be retained in the respective loan files;

- Prepare monthly delinquent loan status memos on a timely basis. Also, to assist in the timely preparation of these memos, monthly delinquent loan reports should be distributed to the loan officers within the first ten working days of each month;

- Revise the policies and procedures manual to incorporate minimum collection procedures on delinquent loans;

- Retain adequate documentation to provide evidence that collection attempts have been made on delinquent loans. These may include collection letters, email and telephone memos, checklists, and other documents deemed necessary. A collection attempt history form may be developed to standardize the documentation of collection attempts. Also, the department should revise its policies and procedures manual to incorporate requirements for sufficient documentation regarding collection attempts;

- Perform initial and subsequent on-farm visits as required by division policy. Documentation should be made on division loan servicing reports. A tickler system, used by many as a reminder for critical upcoming dates, may be devised to track dates for subsequent on-farm visits;

- Obtain supervisory reviews when new loan account information is entered into the loan master file. Evidence of this review should be documented on the loan document checklist, with a separate sign-off for this particular item. Also, the department should revise the policies and procedures manual to incorporate supervisory review requirements;

- Obtain reviews for transaction journals that provide support for bank deposit slips. Additionally, journals should be initialed for evidence of reviews. At minimum, monthly, reconciled cash receipt journals should be obtained from the department's fiscal office and reconciled to monthly division transaction journals;

- Delegate approvals for changes to loan account information to someone other than the person making the changes to loan master files. Revise policies and procedures manual to include duties and responsibilities for positions within the division;

- Update the APPX system manual to incorporate the following:

    - Program documentation, with data file layouts clearly differentiating applications changes;

  - o Operations documentation, describing the job stream flow, error messages, operator actions, data control procedures, and any special end of month or end of year procedures; and

  - o User documentation, supplementing application menus with narrative as required;

- Reconcile division records to FAMIS reports on a monthly basis. Journal vouchers should be prepared to balance FAMIS and division reports; and

- Update the policies and procedures manual to include procedures on determining whether private lenders are in compliance with applicable laws regarding participation loans. Steps taken to determine compliance should be adequately documented within the loan files.

The Methodologies Used to Determine the Allowance for Loan Losses and to Recognize Interest on Delinquent Loans Are Not in Accordance with Generally Accepted Accounting Principles

The Agricultural Loan Division is responsible for the administration of its loan program. This includes the analysis of the collectibility of each loan and the determination of an adequate allowance for loan losses (allowance). The allowance represents management's best estimate of the uncollectible portion of all outstanding loans at a given point in time. An adequate allowance is essential for the department because of the high risks involved in providing loans under its program. Such risks include credit, environmental, and concentration risk. Credit risk arises because potential borrowers approach the department only as a last resort and only after the borrowers have obtained at least two letters of turndown from private financial institutions. The agricultural sector presents an environmental risk because of its vulnerability to natural disasters, most notably flooding and periods of drought conditions. Concentration risk is due to the department issuing one primary type of loan.

The department's total loan receivable balance and initial related allowance as shown on the financial statements as of June 30, 2004, was $22,755,368 and $1,751,845, respectively. Since management determines the allowance based on subjective as well as objective factors, judgment is often required to estimate the amount shown on the financial statements. Management's judgment should be based on its knowledge and experience about past and current events and assumptions about current conditions, with respect to individual loans, the entire loan portfolio, and the State's economy. Accounting principles generally accepted in the United States of America require that the allowance be reasonable and supported by relevant information and adequate documentation. However, the department's allowance does not meet any of these requirements.

Additionally, the department improperly accrues interest income on loans greater than 90 days delinquent in the Financial Assistance for Agriculture Fund. Generally accepted accounting principals require that interest on loans should be recognized when it becomes both measurable and available to finance expenditures of the fiscal period; however, the department continued to accrue interest on these delinquent loans despite a lack of availability.

The allowance for loan losses has no adequate basis

Management considers a loan to be delinquent if payment is not received within 30 days after the due date. At June 30, 2004, there were 64 past due loan accounts totaling $835,347 in overdue principal, of which $696,405, or 83 percent, had been outstanding for greater than one year. These 64 delinquent accounts also had a related accrued interest balance of $514,112.

The department's methodology in determining the allowance is faulty. In general, management considers a loan seriously delinquent at 180 days past due. At this point, it is the division's policy to submit the account to the Board of Agriculture for approval to forward the account to the Department of the Attorney General for further collection attempts and, if necessary, disposition. When all attempts at collection by the Department of the Attorney General are exhausted, the file is returned to the department for write-off. Only at this point is the loan considered an estimated uncollectible and added to the allowance for loan losses. This treatment contradicts the very purpose of an allowance – to estimate probable *future* losses. Loans at this stage are actual losses and should simply be written-off and removed from the department's books. Moreover, we noted the department has not written-off any loans since November 2000.

The allowance is not supported by sufficient documentation

For the year ending June 30, 2004, the department's initial allowance as adjusted by its contract auditors was $1,751,845, which is approximately $995,000 greater than the amount calculated by department personnel. Those personnel could not provide adequate information and documentation of their methodology in determining either amount, making it impossible to obtain sufficient evidential matter for its allowance account balalnce. Therefore, we initially were unable to determine the adequacy of the allowance account and the accuracy of the financial statements. However, subsequent to our initial review, the department recorded an additional adjustment to increase their allowance for loan losses to $2 million, approximately

$1,243,000 greater than the department's original internal calculation. We further noted that the analyses and calculations of the allowance is performed only at fiscal year end. Because of the volatility of the agricultural sector, the ability of farmers to repay their loans is susceptible to many, sometimes uncontrollable, factors throughout the year. The allowance should be analyzed monthly and used to monitor the status of the loan portfolio.

Failure to properly value the allowance for loan losses may result in improper financial reporting and misrepresents the abilities of the farmers to repay their loans. The underlying cause of this deficiency is a lack of policies and procedures that establish sound methodology for determining the allowance for loan losses. The significance of this finding, if uncorrected, would have led to a "qualified opinion" on the fairness of the department's June 30, 2004 financial statements as it relates to the allowance for loan losses. Further, we noted that although the Board of Agriculture is involved in loan approvals and write-offs, it is not familiar with the ongoing status of loans. The board has a fiduciary responsibility for taxpayer money and cannot execute this responsibility without knowing the condition of its $22 million in outstanding agricultural loans. As "policy directors," the board should be more involved in the operations of its loan program and more informed about the health of the entire loan portfolio.

Interest on loans is accrued beyond its measurable and available period

Interest revenues on loans in the Financial Assistance for Agriculture Fund should be recognized in the accounting period that they become susceptible to accrual. In applying the susceptibility to accrual concept, management should utilize their judgment, and should consider its materiality and consistency of application in determining when revenues become both measurable and available to finance expenditures of the fiscal period. The key element is the availability concept, which is generally held to mean collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period.

We found that the department continues to accrue interest on loans with interest greater than 90 days past due, the point at which revenues are no longer available to finance current period expenditures. The department’s accrued interest receivable on loans greater than 90 days delinquent as of June 30, 2004, is $468,000. In one instance, we found that a single loan with a principal balance of $56,900 had accrued interest totaling $86,000 at June 30, 2004. Continued accrual of interest beyond its measurable and available period is a violation of generally accepted accounting principles. Furthermore, it overstates both the department’s loan portfolio and the interest recognized on the statement of revenues, expenditures, and changes in fund balances.

We recommend the following measures regarding the allowance for loan losses:

Recommendations

- Expand the division's policies and procedures manual to incorporate a methodology to determine a reasonable and adequate allowance in accordance with generally accepted accounting principles;

- Calculate and review the allowance with competent and well-trained personnel;

- Document the calculation, including a detailed analysis, considering all internal and external factors and based on current and reliable data;

- Implement a comprehensive loan monitoring process, complete with monthly analysis and a loan "watch" list. A loan watch list is a listing of loans of particular interest to the department. This could be based on quantitative (large outstanding balance) as well as qualitative (delinquency status, borrowers with more than one outstanding loan) factors. This list should include the borrower's name, outstanding loan balance, collateral value, financial information summary, loss exposure, and any other comments as to performance forecast. This will give the loan administrator and the board a snapshot of the health of the loan portfolio and any possible future issues;

- Require the Board of Agriculture to be more involved with the loan program by reviewing delinquency reports and watch lists, establishing and updating policies and procedures, and issuing recommendations to the division when necessary; and

- Discontinue the accrual of interest on loans with interest greater than 90 days delinquent in the Financial Assistance for Agriculture Fund.

The Department's Management of Its Accounts Receivables Is Ineffective

The department's total accounts receivables have increased over the last three years by an average of $513,398, as illustrated by Exhibit 2.2, despite an average decrease in charges for services of $307,264 during the same period. This trend represents a significant problem and indicates the department's need to more effectively manage and control its accounts receivables. In particular, at the Animal Quarantine Station and the Agriculture Resource Management Division, which together comprise 89 percent of the department's total receivables, the department has failed to establish clear policies over the performance and documentation of monitoring and collection efforts on delinquent accounts. Further, the department has not established and communicated adequate organization-wide policies for the disposition of uncollectible accounts and setting up related allowances.

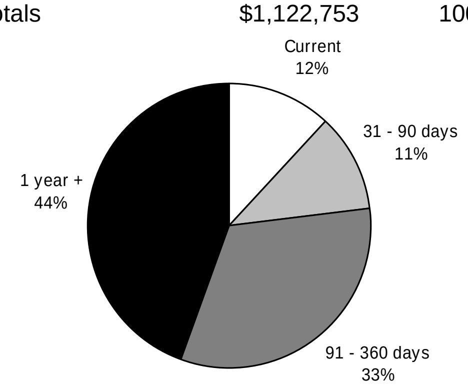
The Animal Quarantine Station's collection procedures are inadequate

The primary purpose of the quarantine station is to keep Hawai`i a rabies free state. Each pet owner is required to remit a quarantine fee depending on the expected length of a pet's stay at the station. As an alternative, a promissory note may be signed to assist residents, visitors, and military families with their financial obligation. Departmental records show the number of pets that entered the quarantine system during the years ended June 30, 2003 and 2004, as 5,440 and 7,276, respectively, an *increase* of 1,836 pets. However, receipts collected at the quarantine station totaled $3.12 million and $2.24 million for the years ended June 30, 2003 and 2004, respectively, a *decrease* of $880,000.

According to the department's aging report, the station's total receivable balance as of June 30, 2004, was approximately $1.1 million, of which approximately $865,000, or 77 percent, was three months or more past due. Exhibit 2.1 illustrates the aging breakdown. This alarmingly large percentage highlights the need for better account maintenance and collection procedures.

Exhibit 2.1
Animal Quarantine Station accounts receivable at June 30, 2004

Accounts receivables days outstanding	Amount outstanding	Percentage of total
Current	$ 135,194	12%
31 – 90 days	122,631	11%
91 – 360 days	366,132	33%
1 year +	498,796	44%
Totals	$1,122,753	100%



Source: June 30, 2004 Animal Quarantine Station aging report

For its delinquent accounts, we found that the quarantine station sends past due notices but does not follow up if the notices do not result in collection. During a site visit to the station, we noted that a copy of the policies and procedures was not available and customer files were difficult to locate. Also, personnel were not aware that accounts should be referred to a collection agency after 30 days from the date of a final notice, as required by station policy. After two years, the account is to be submitted to the Board of Agriculture and the Department of the Attorney General for disposition. As of June 30, 2004, the balance of receivables over two years old was approximately $303,000, or 27 percent of the total balance. Furthermore, there are no policies and procedures dictating how to remove accounts from the station's internal system after approval for disposition.

The Animal Quarantine brochure issued by the department and made available to the general public clearly states that all fees must be paid before release of the pet. This statement contradicts the receivable balance on the books. If payment is required to release a pet, there should be a minimal balance, if any, on the department's records. Some remaining balances may be due to abandonment or death of the pet while still in quarantine.

Departmental personnel have indicated that the problem is due to recent high turnover in the clerical position at the station. They are currently in the process of analyzing all accounts to determine whether there are valid receivables. Department personnel believe that some payments were inadvertently misposted to wrong accounts during the past year as a result of new personnel who were unfamiliar with the system.

The Agriculture Resource Management Division does not adhere to, or document efforts related to, collection policies

The Agriculture Resource Management Division manages leased lands and irrigation water usage at various agricultural lots throughout the state via its agricultural park program. This program seeks to encourage competition within the agricultural industry by providing affordable irrigation water and farmland. At the division, approximately $507,000, or 86 percent, of the $592,000 total receivable balance is over three months old. Similar to the Animal Quarantine Station, except for sending past due notices, the division does not adhere to its policies regarding collection attempts. Based on the severity of the delinquency, the division's policies over collection methods include late notices, collection letters, telephone calls, and field visits. Division personnel are aware of the policies and procedures; however, there were no indications of telephone calls or subsequent actions that are to be taken as required by those policies and procedures. The program manager maintains that many of the substantial delinquent accounts as of the fiscal year ended June 30, 2004, have made considerable payments, are in the process of being granted work-out payment plans, or are in bankruptcy.

Failure by the division to properly manage its accounts receivables deprives the State of realizing its earned revenues and may lead to improper financial reporting as a result of unsupported allowance accounts. Although the division's collection guidelines are clearly written, they are not fully adhered to and not sufficiently documented within the customer files. Oversight over those policies forms the basis for effective management practices. We feel improvement in these areas for the Agriculture Resource Management Division will lead to a higher collection rate for its accounts receivables.

The allowance for doubtful accounts is not supported by sufficient documentation

The department's financial statements present receivable balances in the aggregate, with the majority being comprised of the balances of the Animal Quarantine Station and Agriculture Resource Management Division. Exhibit 2.2 illustrates the department's receivable balances for FY2001-02 to FY2003-04.

Exhibit 2.2
Department of Agriculture accounts receivables for FY2001-02 to FY2003-04

	June 30, 2004	June 30, 2003	June 30, 2002	Average annual increase
Gross receivables	$ 1,869,927	$ 1,154,790	$ 843,131	$ 513,398
Less: Allowance for doubtful accounts	(1,057,659)	(405,500)	(370,000)	343,830
Total net receivables	$ 812,268	$ 749,290	$ 473,131	$ 169,568

Source: Department of Agriculture financial statements for FY2001-02 to FY2003-04

The allowance for doubtful accounts more than doubled from FY2002-03 to FY2003-04. Although this balance does not represent a significant portion of the department's assets, it amounts to nearly 57 percent of total gross receivables at June 30, 2004. As it does with the agricultural loans, the department relies heavily on its contract auditors to determine the allowance for doubtful accounts reported in its financial statements. Currently, all amounts over 90 days are included in the allowance account.

Generally accepted accounting principles require that a sufficient allowance be made to provide for potential losses and that this calculation be adequately documented. The allowance should be based on the department's past experience, as well as other relevant and qualitative matters, and should not be limited to those accounts that are 90 days or more past due. Accounts less than 90 days past due should also be considered for likelihood of collection.

Automatically assessing an account over 90 days as uncollectible may lead to questions of whether the accounts were actually analyzed for collectibility. Again, the underlying cause is a lack of policies and procedures for determining an adequate allowance, as well as a lack of understanding of applicable accounting guidelines.

Attempts to return unclaimed money are weak

When pets are admitted, the Animal Quarantine Station's policy requires fees to be collected on a prepaid basis for the estimated stay of the pet. For example, a customer whose pet is estimated to stay 30 days will be required to pay the full 30 day rate upon entry. Although written into policy, this is not always the case as the implementation of promissory notes has created significant receivable balances. Some of these pets with prepaid quarantine fees will be released prior to the 30 days, and a refund is posted to the system. Because the refund check is processed through the Department of Accounting and General Services, the money due cannot be refunded immediately. Situations may arise, especially with military families passing through the islands, in which the customer cannot be reached.

We found that 471 out of 2,859 accounts included credit balances due to customers totaling approximately $46,000. Of this amount, 246 accounts totaling approximately $20,500 were aged greater than one year. According to Chapter 523A, HRS, *Unclaimed Property Act*, property not claimed by its rightful owners within five years is presumed abandoned and shall be deposited into the State Treasury.

Efforts to return money should take on the same importance as efforts to collect money. We did not find sufficient documentation within customer files regarding refund efforts. In most cases, a simple note was the only evidence of refund efforts. Failure to return money to its rightful owners in a timely manner may raise questions as to the intent of the animal quarantine program and the actual efforts of the Statewide Unclaimed Property Section. Although not material to the department's gross receivables, the credit balances are netted against the receivables, which results in understating the totals shown on the aging reports.

Recommendations

We recommend that the Animal Quarantine Station:

- Consider discontinuing the use of promissory notes, as credit cards are accepted;
- Revise policies and procedures to include account write-offs and determining adequate allowances;
- Strengthen management oversight over delinquent accounts;
- Refer delinquent accounts to a collection agency, the Board of Agriculture, and the Department of the Attorney General for timely disposition;
- Strengthen efforts to return money due to customers and document efforts taken within customer files. Provide better training to new employees regarding the posting of customer payments; and
- Document collection and refund efforts using a standard form to include customer name, contacts, nature, relevant dates, and a history of efforts. This form should be maintained within customer files.

We recommend that the Agricultural Resource Management Division:

- Adhere to collection practices outlined in the policies and procedures;
- Document efforts within customer files using a standard form;
- Revise policies and procedures to include determining adequate allowances; and
- Refer delinquent accounts to a collection agency, the Board of Agriculture, and the Department of the Attorney General for timely disposition.

The Department's Year-End Financial Reporting Process Is Ineffective

Accurate and timely financial reporting is a key factor in management's decision making. Management must have accurate and timely financial information in order to measure an organization's performance, identify opportunities for improvement, and strategically plan for the future. However, we noted significant deficiencies in the department's financial reporting process that hindered its ability to produce timely year-end financial statements that are free from error.

The department's inability to prepare complete, timely, and fairly presented financial statements led to major delays

Although contracted auditors generally provide assistance with the preparation of financial statements, the department is ultimately responsible for ensuring that these financial statements are fairly presented in accordance with accounting principles generally accepted in the United States of America (GAAP). Upon receipt of the department's June 30, 2004 draft financial statements, we noticed several errors and missing disclosures that constituted a departure from GAAP. They are as follows:

- An adjustment to correct a material misstatement of the July 1, 2003 fund balance to record $21,447,442 of loans receivable on the balance sheet of the governmental funds and an adjustment to correct a material misstatement of the July 1, 2003 net assets relating to unrecorded debt obligation of $8.5 million to the State of Hawai`i, Department of Budget and Finance on the statement of net assets.

- An adjustment in the amount of $2,946,182 for payroll fringe benefit costs of certain department employees funded by state appropriations (general fund) that are assumed by the State and not charged to the department's operating funds. The adjustment corrected revenues and expenses on the government-wide statement of activities, and revenues and expenditures on the governmental funds statement of revenues, expenditures, and changes in fund balances in the general fund.

- A disclosure in the notes to the financial statement of the allowance for doubtful accounts of $1,057,659 relating to accounts receivable and details of significant components of accounts receivable that were obscured by aggregation.

- A disclosure in the notes to the financial statements of the details of amounts transferred to/from other funds and a general description of the principal purposes of the interfund transfers which aggregated $1,528,364.

- A disclosure of the nature of the restatements along with the effects on the changes in financial position of the immediately preceding period.

The department subsequently recorded the adjustments and included the disclosures, as described above, in its revised financial statements for the year ending June 30, 2004. However, in our judgment, these errors and omissions would not have been corrected and addressed if not detected by our audit. Additional work that we performed in identifying and evaluating these issues and discussing them with the department resulted in significant delays in the completion of our audit. A lack of adequate management controls over the year-end financial reporting process (i.e., financial statement checklists) is to blame.

The department has not maintained sufficient records to support its capital assets

The department was unable to provide adequate documentation to support certain capital assets costs and related accumulated depreciation. A "qualified opinion" was rendered on the department's June 30, 2004 financial statements, as we were unable to obtain sufficient evidential matter to support the recording of $23,686,133 in capital assets as a result of the retroactive capitalization of infrastructure assets and related accumulated depreciation of $16,143,846 and depreciation expense of $1,579,076.

It is the department's responsibility to maintain sufficient records to support amounts reported in its financial statements. The inability to maintain these records is a material weakness.

Recommendations

We recommend the department utilize resources to assist in detecting improprieties in its reported financial data. These may include the use of financial statement disclosure checklists and reference to various *Governmental Accounting Standards Board* pronouncements. Further, the department should ensure that adequate supporting documentation is maintained to support the propriety of all capital assets.

Inadequate Management Controls, A Lack of Written Policies, and Employee Oversight Have Led to Problems with Cash Receipts and Disbursements, Procurement and Contract Management, and Federal Financial Reporting

A successful organization needs to have adequate management controls. Segregation of duties, account reconciliations, and supervisory reviews are among the most basic controls that must be in place. Formal policies incorporating these types of management controls need to be developed and provide a mechanism for documentation. Management must further demonstrate its commitment to a strong control environment by enforcing these policies and taking appropriate action when they are not adhered to. The lack of one or more of these elements over cash receipts and disbursements, procurement and contract management, and financial reporting has resulted in creating opportunities for potential abuse, violations of the Hawai`i Public Procurement Code, and untimely reporting.

The department's management controls over cash receipts and disbursements are inadequate

For certain functions, such as preparation of treasury deposit receipts and management of petty cash, adequate management controls have not been implemented. For other functions, such as reconciliations of inventory registers, cash receipts journals, and petty cash, management controls are in place; however, their performance is not always documented. Undocumented management controls are controls that lack evidence of being performed. Sufficient evidence may take the form of signatures, correspondence, and calculations to support reconciled amounts.

The department lacks proper segregation of duties

A pre-audit clerk receives validated cash deposit slips each day from an armored courier service. At least once a week, the clerk accumulates the slips and completes a treasury deposit receipt based on allocations that are determined by each division denoted on the deposit slips.

We noted, through inquiries and observation, that the same person who completes treasury deposit receipts also performs reconciliations of validated treasury deposit receipts when they are returned from the Department of Budget and Finance. Through a scan of the cash receipts journal, we noted an average of 371 deposit slips are processed each month. Fiscal personnel estimate that 25 treasury deposit receipts are processed each month by the clerk.

Furthermore, we noted improper segregation of duties as the petty cash custodian performs both custodial and reconciliation functions. Ideally, to obtain maximum benefit from a reconciliation, the reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash. Independent internal verification is vital as misappropriations of cash may go unnoticed. For example, a cashier who prepares the reconciliation can misappropriate cash and conceal the misappropriation by misstating the reconciliation. Although a concurring review may act as a compensating measure, it is an after-the-fact detective control. It is more prudent to maintain preventive controls with cash functions because of the relatively high inherent risk of cash being misappropriated.

Reconciliations and reviews are not documented

During our assessment of management controls within the department, we found that reconciliations and reviews performed lacked documentation. We reviewed the June 30, 2004 Department of Accounting and General Services quarterly inventory transaction register and the Department of Agriculture's AGS Forms 17-A (*Detail Inventory of Property)*. Although Department of Agriculture personnel claimed that reconciliations were performed each quarter, we could not substantiate their claim due to a lack of evidence. The reconciliation between the Department of Accounting and General Services' quarterly inventory register and the Department of Agriculture's AGS Form 17-A was not documented with calculations that supported the results.

We also found that reviews were not performed for reconciliations between petty cash and related bank balances and for reconciliations between the cash receipts journals and related FAMIS reports, which are both performed on a monthly basis. This was noted during our review of the June 30, 2004 petty cash reconciliation and the June 30, 2004 cash receipts journal and through inquiries of fiscal personnel. Petty cash activity totaled approximately $4,800 for the month of June 2004. The significance may increase over the course of one year as petty cash transactions may reach a total of $58,000.

Timely reconciliations help to ensure the accuracy and validity of entries and balances and also help to uncover errors, unintentional or intentional. Supervisory reviews of reconciliations ensure accuracy, promote timely preparation, and facilitate management oversight.

Inventory counts are not documented

Physical inventory counts at year end could also benefit from more documentation. When we reviewed the June 30, 2004 inventory count sheets (the department uses FAMIS MDB 020, *Annual Inventory Report of Property* as count sheets) for a particular division, the sheets were void of any markings to indicate that the item was indeed accounted for. After performing the physical count, branch managers are required to sign an "Annual Physical Inventory Certification" that is retained by the property custodian.

Typical big ticket items that are counted during a year end physical inventory count include vehicles and office equipment, which totaled approximately $6.9 million at June 30, 2004. Inadequate documentation for inventory counts may raise questions as to whether the actual count was ever performed, or may even act as a cover for misappropriated assets. Timely inventory counts are especially vital because inventory items are highly susceptible to misappropriation. The theft of small but expensive items may easily go undetected without timely inventory counts.

The department's policies and procedures governing procurement and contract management are deficient

The Hawai`i Public Procurement Code, Chapter 103D, HRS, sets standards for all state agencies regarding the procurement of goods and services. The code seeks to promote fiscal integrity, accountability, and efficiency in procurement processes among state agencies. The department has failed to develop policies or management controls to ensure total compliance with the code with respect to electronic posting of awards and documenting the justification for exempt contracts. In addition, formal, department-wide procedures have not been developed for the management of all contracts.

Professional services contracts are not posted electronically

The department executes numerous professional services contracts throughout the year. Most prominent are engineering services to continue capital improvements to Hawai`i's agricultural infrastructure. Due to their high demand, professional services contractors are subjected to the rigors of fierce competition within the State's marketplace. Section 103D-304, HRS, regarding contracts for professional services provides, "[C]ontracts awarded under this section shall be posted electronically within seven days of the contract award by the chief procurement officer and shall remain posted for at least one year." During the fiscal year ended June 30, 2004, the department was involved with 159 contracts totaling approximately $25.5 million.

Out of ten professional services contracts tested totaling approximately $1.4 million, we noted four contracts, listed below and totaling $541,855, where contract information was not posted on the State Procurement Office's website.

Contract No.	Description	Contract Amount
50381	Repair and maintenance, Kekaha	$ 194,100
48015	Lower Hamakua Ditch, Paauilo Reservoir	$ 200,000
50340	Lower Kula Watershed	$ 49,885
47918	Lower Hamakua Ditch, Honokaa Reservoir	$ 97,870

No controls are in place, including written procedures, to ensure that professional services contracts are posted electronically and that the department is in compliance with other sections of the code. Failure to post awards exposes the department to complaints from other vendors and raises questions about fair competition and the efficient use of state funds.

Exempt purchases do not have required documentation

By law, certain purchases are exempt from Chapter 103D, HRS, requirements. We selected two contracts totaling $350,500 that were known to be exempt from these requirements. We found that these two instances did not contain references to the applicable statutory exemption as mandated by Section 3-120-4(g), HAR.

Contract No.	Description	Contract Amount
49496	Operation and maintenance, Kekaha	$ 235,000
51120	Electrical transmission systems, Kekaha	$ 115,500

These contracts were executed by the Agribusiness Development Corporation, an administratively attached entity that is exempt from the requirements of Chapter 103D, HRS. Again, the department lacks written policies and procedures to ensure that exempt purchases are supported by sufficient documentation.

Failure to document the reason for exemption questions the validity of the procurement. Department personnel are fully aware of this requirement and claim personnel oversight as the cause of the deficiency, as all contracts should have been reviewed for accuracy and compliance with laws and regulations.

The contract management process is not standardized

The department relies on third party contractors for much of its work. These include construction and engineering services for its drainage systems, agricultural research projects, and other professional services. During the fiscal year ended June 30, 2004, the department was involved with 159 contracts totaling approximately $25.5 million. The magnitude of this amount makes it especially critical for contracts to be effectively managed.

We found the department lacks formal policies and procedures for its contract management process. Due to its relatively small size, the department does not employ a dedicated contract manager. Once a contract is executed, non-fiscal related matters are handled by the respective program personnel. The nature and extent of monitoring and administrative tasks differs among the various programs. For example, for federally-funded contracts, there are no policies in place to ensure compliance with applicable federal requirements. In previous audits, the department failed to determine whether contractors were suspended or debarred from entering into contracts. As a result of its response to these prior audit recommendations, we are pleased to report that the department has resolved this issue, and now has procedures in place to help ensure compliance with this requirement. However, because of the lack of formal policies and procedures for its contract management process, the nature and extent of other contract management procedures are not consistently applied among the various programs and divisions.

Non-compliance with federal requirements may result in the loss of future federal grants. For the year ended June 30, 2004, the department received approximately $3.6 million in federal funding. Failure to develop policies for its contract management process leaves the process open to interpretation and will result in the non-standardized application of monitoring and administrative procedures.

The goal of proper contract management is to ensure that the contract is satisfactorily performed with the efficient use of state money and that the responsibilities of all parties are discharged. An effective policy for contract management may minimize the risk of future problems, potential claims, or possible loss of funding.

Federal financial reports are untimely

We found that the department's financial reporting for certain federal grants is untimely. We tested a sample of 30 financial and performance or special reports from seven different federal grants with federal expenditures totaling approximately $2.2 million, which accounts for about 64 percent of total federal expenditures. We noted three instances where financial reports were not filed by the deadline specified in the respective grant agreement. The following table summarizes the details of our findings.

Awarding Agency	Type	Grant	Deadline	Date submitted	Grant Amount
USDA	Quarter	03-9715-1134	1/31/04	2/11/04	$ 2,652
USDA	Quarter	03-9715-1133	1/31/04	2/11/04	$ 39,990
EPA	Final	E-009159-02-2	12/31/03	4/15/04	$ 231,424

Grant agreements generally allow for extension requests to be made in writing to the affected agencies. No such requests were found in the respective grant files. Fortunately, however, there were no penalties as a result of these late filings. Untimely reporting may result in the loss or reduction of future funding. Department personnel have noted that these deficiencies were a result of personnel oversight. Fiscal personnel keep timetables of all deadlines for the grants they are responsible for and may have simply overlooked some of the deadlines.

Recommendations

We recommend that the department:

- Perform and adequately document reconciliations between department inventory records and those of the Department of Accounting and General Services. Also, cash reconciliations should be reviewed and documented. The department should also have an employee other than the petty cash custodian and an employee other than the employee preparing treasury deposit receipts perform cash reconciliations;

- Ensure that all required professional services contracts are posted on the State Procurement Office's website and that all exempt purchases are documented with a reason for exemption. Controls should be put in place to properly detect instances where adherence to these procurement code sections is required. Such controls may include the development of policies and procedures, training on new laws and regulations, and improved oversight, including small scale internal audits performed by management;

- Establish formal policies and procedures for its contract management process that clearly define the roles, esponsibilities, and limitations of all personnel involved. These should include standards for monitoring contractor activity, identifying progress and possible issues, performing desk reviews, developing progress reports, adherence to key dates, documentation requirements, and compliance with federal and state requirements, including the Hawai`i Public Procurement Code; and

- Establish and enforce formal written procedures that delineate responsibilities and deadlines for completing and submitting required federal reports.

Chapter 3
Financial Audit

This chapter presents the results of the financial audit of the Department of Agriculture, State of Hawai`i, as of and for the fiscal year ended June 30, 2004. This chapter includes the independent auditors' report and the report on internal control over financial reporting and on compliance and other matters 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.

Summary of Findings

In the opinion of Grant Thornton LLP, based on their audit, except for the effects of such adjustments, if any, as might have been determined to be necessary had they been able to examine evidence regarding certain capital asset costs and the related accumulated depreciation that is reflected as a restatement, and the related depreciation expense for the year ended June 30, 2004, reported in the government-wide financial statements, the financial statements present fairly, in all material respects, the respective financial position of the Department of Agriculture, State of Hawai`i, as of June 30, 2004, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America. Grant Thornton LLP noted certain matters involving the department's internal control over financial reporting and its operations that the firm considered to be reportable conditions, including material weaknesses as defined in 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.* Grant Thornton 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 Hawai`i:

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Department of Agriculture, State of Hawai`i, as of and for the year ended June 30, 2004, 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 an opinion on these financial statements based on our audit.

Except as discussed in the second succeeding paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 2, the financial statements of the department are intended to present the financial position and changes in financial position, of only that portion of the governmental activities, each major fund, and the aggregate remaining fund information of the State of Hawai`i 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 Hawai`i as of June 30, 2004, and the changes in its financial position, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We were unable to obtain sufficient evidential matter to support $23,686,133 of $125,404,347 in capital asset costs and related accumulated depreciation of $16,143,846 that is reflected as part of the restatement of $15,982,062 as of July 1, 2003 in the financial statements, and depreciation expense thereon of $1,579,076 in the year ended June 30, 2004. Accordingly, we have not been able to determine the effects of adjustments, if any, that might have been necessary had we been able to examine such evidence.

In our opinion, except for the effects of such adjustments referred to in the preceding paragraph, if any, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Department of Agriculture, State of Hawai`i, as of June 30, 2004, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 14, the net assets and fund balances as of July 1, 2003, have been restated to correct certain errors and to record the retroactive capitalization of infrastructure assets.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 15, 2005, 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. 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.

The 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 has not been presented.

The budgetary comparison information that follows 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.

/s/Grant Thornton LLP

Honolulu, Hawai`i
March 15, 2005

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

The Auditor
State of Hawai`i:

We have audited the financial statements of the Department of Agriculture, State of Hawai`i as of and for the year ended June 30, 2004, and have issued our report thereon which rendered a qualified opinion dated March 15, 2005. 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.

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 financial statements and not to provide an opinion on the internal control over financial reporting. Accordingly, we express no such opinion. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions have been reported to the Auditor, State of Hawai`i, and described in Chapter 2 of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described in Chapter 2 of this report, we consider the lack of policies and procedures governing many of its basic processes and management functions, the improvement needed in the administration of agricultural loans, the methodology used to determine the allowance for agricultural loan losses, the management of accounts receivables, and the significant deficiencies in the financial reporting processes to be material weaknesses that have been reported to the Auditor, State of Hawai`i, and have been described as material weaknesses in Chapter 2 of this report.

Compliance and other matters

As part of obtaining reasonable assurance about whether the department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawai`i Public Procurement Code (Chapter 103D, Hawai`i 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 Hawai`i, and described in Chapter 2 of this report.

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

/s/Grant Thornton LLP

Honolulu, Hawai`i
March 15, 2005

Description of Basic Financial Statements and Required Supplementary Information

The following is a brief description of the department's basic financial statements audited by Grant Thornton 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, 2004. 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 3.3). This statement presents a reconciliation of the department's fund balance reported in the Balance Sheet – Governmental Funds 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 3.4). 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 3.5). This statement presents a reconciliation of the department's net change in fund balances reported in the Statement of Revenues, Expenditures, and Changes in Fund

Balances – Governmental Funds to the change in net assets reported in the Statement of Activities.

Statement of Fiduciary Net Assets – Fiduciary Funds (Exhibit 3.6). This statement presents the assets, liabilities, and net assets of the department's fiduciary funds.

Statement of Changes in Fiduciary Net Assets – Fiduciary Funds (Exhibit 3.7). This statement presents the changes in the net assets of the department's fiduciary funds.

Required Supplementary Information (Unaudited)

Budgetary Comparison Schedule – General Fund (Exhibit 3.8). 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, 2004.

Budgetary Comparison Schedule – Major Funds (Exhibit 3.9). This schedule compares actual revenues and expenditures of the department's major funds on a budgetary basis to the original and final budgets adopted by the State Legislature for the year ended June 30, 2004.

Note to the Budgetary Comparison Schedules (Exhibit 3.10). This note contains a reconciliation for the general fund and the major funds, 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 – Nature of Organization

The mission of the department, State of Hawai`i, is to stimulate growth in agriculture with programs that provide the foundation for agricultural enterprises to build successful businesses. The department administers and oversees programs that include plant quarantine, control of plant diseases and pests, livestock disease control, animal quarantine, agricultural parks, aquaculture development, irrigation systems, inspection and grading of commodities, monitoring the production and processing of milk, measurement standards, collection and dissemination of agricultural statistics and import and export statistics, granting agricultural loans, and market development and promotion of Hawaiian grown products.

The Board of Agriculture (board) is responsible for the direction of the department's activities. The ten-member board is appointed by the governor with the consent of the Senate to serve a term of four years and may be reappointed to an additional term.

Note 2 – Summary of Significant Accounting Policies

Reporting entity

The financial statements reflect only the activities of 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 financial statements to be misleading or incomplete. The Governmental Accounting Standards Board (GASB) has set forth criteria to be considered in determining financial accountability. The department has determined to include in its financial statements the activities of the Agribusiness Development Corporation, a separate public instrumentality affiliated with the department for administrative purposes.

Basis of presentation

The accounting policies of the department utilized in the accompanying financial statements for the year ended June 30, 2004, conform to generally accepted accounting principles (GAAP) in the United States of America as prescribed by the GASB. In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements - and Management's Discussions and Analysis - for State and Local Governments*. The implementation of this statement creates new major reporting requirements for state and local governments throughout the United States of America.

In conjunction with GASB Statement No. 34, other GASB statements were required to also be implemented. These include: Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and Statement No. 38, *Certain Financial Statement Note Disclosures*.

Government-wide financial statements

The statement of net assets and the statement of activities display information about the reporting government as a whole. They include all funds of the reporting entity except for fiduciary funds.

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, generally it is the department's policy to use restricted resources first, then unrestricted resources as they are needed.

Fund financial statements

Fund financial statements of the department are organized on the basis of funds, each of which is considered to be a separate accounting entity. The department used 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. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues, and expenditures. Each major fund is presented in a separate column. Nonmajor funds are aggregated and presented in a single column.

Governmental fund types

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

<u>General fund</u> – The general fund is the general operating fund of the department. It is used to account for all financial activities except those required to be accounted for in another fund. The general fund

presented is a part of the State's general fund and is limited only to those appropriations and obligations of the department.

Special revenue fund – Special revenue funds are used to account for the proceeds of specific revenue sources (other than expendable trust funds) that are legally restricted to expenditure for specified purposes.

Capital projects fund – Capital projects funds are used to account for financial resources to be used for the acquisition or construction of major capital facilities.

Fiduciary funds – Trust and agency funds are used to account for assets held by the department in a trustee or agency capacity. These include expendable trust funds that account for cash collected and expended by the department as trustee and agency funds that account for the cash collected and expended by the department in a custodial capacity.

Major funds

The following are the activities of the major funds accounted for in the fund financial statements:

General
See above for description.

Special revenue funds
Financial assistance for agriculture - Accounts for revenues and expenditures of providing agricultural loans in the State of Hawai`i.

Plant pest and disease control - Accounts for revenues and expenditures of controlling plant pest and disease in the State of Hawai`i.

Agribusiness development and research - Accounts for revenues and expenditures of developing agricultural business and conducting agricultural research.

Capital projects funds
Irrigation and drainage systems - Accounts for resources restricted for the acquisition or construction or irrigation and drainage systems.

Measurement focus, basis of accounting, and financial statement presentation

The governmental-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. With this measurement focus, all assets and liabilities associated with the operation of these activities are included on the statement of net assets. Under the accrual basis of accounting, revenues are recorded when earned and expenses are recorded when the related liability is incurred, regardless of the timing of the related cash flows. Grant and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

The fund financial statements, which include governmental funds, expendable trust funds, and agency funds, are accounted and reported using the current financial resources measurement focus and the modified accrual basis of accounting. With this measurement focus, only current assets and liabilities are generally included on the balance sheet. The revenues and expenditures represent increases and decreases in net current assets. Under 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. Expenditures are generally recognized when the related liability is incurred, except for employee’s vested vacation unpaid and workers compensation benefits, which are recognized as expenditures when paid from expendable available resources.

In applying the susceptible to accrual concept to federal grant revenues, the legal and contractual requirements of the numerous individual programs are used as guidance. Under most of the department's federal programs, moneys must be expended for a specific purpose or project; therefore, revenue is recognized to the extent that expenditures are recognized.

Appropriations

Appropriations are authorizations granted by the legislature of the State of Hawai`i permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended or encumbered at the end of the fiscal year, except for allotted appropriations related to capital improvement projects.

Encumbrances

Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of resources are recorded to reserve that portion of the applicable appropriation. Encumbrances outstanding at fiscal year end are reported as reservations of fund balance since they do not constitute expenditures or liabilities.

Fund balances

Reserved amounts in fund balances represent amounts that are not appropriable for expenditure or legally segregated for a specific future use. Portions of the fund balances are reserved for the following:

- Encumbrances for outstanding commitments which generally are liquidated in the subsequent fiscal year;

- Loan receivables, which are not currently available for expenditure at the balance sheet date;

- Expendable trust fund balances, which are restricted to the purpose of the account; and

- Continuing appropriations for unencumbered allotment balances representing amounts that have been released and made available for encumbrance or expenditures and are legally segregated for a specific use.

Cash and cash equivalents

Cash and cash equivalents include cash in the state treasury and cash in a Hawai`i-based bank. The department's cash is held by the state treasury and pooled with funds from other state agencies and departments and deposited in approved financial institutions by the director of finance. At June 30, 2004, information related to the insurance and collateral of funds deposited into the state treasury was not available, since such information is determined on a statewide basis and not for individual departments. Cash deposits into the state treasury are either federally insured or collateralized with obligations of the State or United States government. All securities pledged as collateral are held either by the state treasury or by the State's fiscal agents in the name of the State.

The Hawai`i Revised Statues (HRS) authorize the director of finance to invest any moneys of the State, which in the director's judgment, are in excess of the amount necessary for meeting the immediate requirements for the State.

Capital assets

Capital assets (primarily land, buildings, improvements, and furniture and equipment) are reported in the government-wide 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
Infrastructure	$100,000
Buildings	$100,000
Land improvements	$100,000
Furniture and equipment	$5,000
Vehicles	$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 assets utilized in the governmental funds are recorded as expenditures in the governmental fund financial statements.

Depreciation is recorded in the government-wide statement of activities. Depreciation is computed using the straight-line method over the following estimated useful lives:

Buildings	30 years
Land improvements	15 years
Furniture and equipment	7 years
Vehicles	5 years

The department began to report and depreciated new infrastructure assets effective for the year ended June 30, 2002. Infrastructure assets include irrigation and drainage systems, etc. Prior to fiscal year ended June 30, 2002, neither their historical costs nor related depreciation has historically been reported in the financial statements. The department has elected to utilize the infrastructure transition option in the implementation of GASB Statement No. 34, in fiscal year ending June 30, 2003, and began to implement the retroactive infrastructure provisions in current fiscal year.

Inter-fund receivables/payables

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

Due to State of Hawai`i

This account consists of reimbursements for expenditures paid by the State of Hawai`i general fund on behalf of the special revenue funds.

Accrued vacation

Vacation pay is accrued as earned by employees. 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 one and two 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 at the end of the calendar year and is convertible to pay upon termination of employment. The employees' accrued vacation is expected to be liquidated with future expendable resources and is therefore accrued in the statement of net assets.

Intra-fund and inter-fund transactions

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

Grant and deferred revenue

Grants are recorded as intergovernmental receivables and revenues when the related expenditures are incurred. Grant funds received in advance prior to the incurrence of expenditures are recorded as deferred revenue.

Use of estimates

In preparing financial statements in conformity with generally accepted accounting principles, 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 expenditures during the reporting period. Actual results could differ from those estimates.

Non-imposed employee fringe benefits

Payroll fringe benefit costs of the department's employees funded by general fund appropriations are assumed by the state and are not charged to the department's operating funds. These costs, totaling $2,939,616, have been reported as revenues and expenditures in the department's financial statements for the fiscal year ended June 30, 2004.

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

Note 3 – Budgeting and Budgetary Control

The budget of the department is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes (1) the programs, services, and activities to be provided during the fiscal year, (2) the estimated revenues available to finance the operating plan, and (3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented, and controlled. Revenue estimates are provided to the Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues in the budgetary comparison statements are those estimates as compiled by the department. Budgeted expenditures are derived primarily from a biennial general appropriations act as amended by any supplemental or other specific appropriations acts.

The department follows these procedures in establishing the budgetary data reflected in the financial statements:

The Budget - Not less than 30 days before the Legislature convenes in every odd-numbered year, the governor submits to the Legislature, and to each member thereof, a budget which contains the program and budget recommendations of the governor for each succeeding biennium. The budget in general contains: the state program structure, statements of statewide objectives; financial requirements for the next biennium to carry out the recommended programs; a summary of state receipts and revenues in the last completed fiscal year; a revised estimate for the fiscal year in progress; and an estimate for the succeeding biennium.

Legislative Review - The Legislature considers the governor's proposed program and financial plan and budget, evaluates alternatives to the governor's recommendation, adopts programs, and determines the state budget. It may, from time to time, request the Department of Budget and Finance and any agency to conduct such analyses of programs and finances in determining the State's programs and financial plan and budget.

Program Execution - Except as limited by policy decisions of the governor, appropriations by the Legislature, and other provisions of law, the agencies responsible for the programs administer the programs and are responsible for their proper management. The appropriations by the Legislature for a biennium are allocated between the two fiscal years of the biennium in the manner provided in the budget or appropriations act and as further prescribed by the director of finance. No appropriation transfers or changes between programs or agencies can be made without legislative authorization. Authorized transfers or changes, when made, should be reported to the Legislature.

A comparison of budgeted and actual (budgetary basis) revenues and expenditures of the general and major special revenue funds are presented in the budgetary comparison statement - general fund and special revenue funds. The final legally-adopted budget in the budgetary comparison statements represents the original appropriations, transfers, and other legally authorized legislative and executive changes.

The legal level of budgetary control is maintained at the appropriation line-item level by department, program, and source of funds as established in the appropriations acts. The Legislature has authorized the governor to transfer appropriations between programs within the same department and source of funds; however, transfers of appropriations between departments generally require legislative authorization. Records and reports reflecting the detail level of control are maintained by and are available at the department.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The Legislature specifies the lapse dates and any other contingencies that may terminate the authorizations for other appropriations.

Differences between revenues and expenditures reported on the budgetary basis and those reported in accordance with GAAP are mainly due to the different methods used to recognize resource uses. For budgeting purposes, revenues are recognized when cash is received and expenditures are recognized when cash disbursements are made or funds are encumbered. In the accompanying financial statements presented in accordance with GAAP, revenues are recognized when they become available and measurable and expenditures are recognized as incurred. A reconciliation of revenues in excess of (less than) expenditures and other financing sources (uses) on a budgetary basis at June 30, 2004, to revenues in excess of (less than) expenditures and other financing sources (uses) presented in conformity with GAAP is set forth in the notes to the required supplementary information.

Funds for the department appropriated from the State's general revenues for the fiscal year ended June 30, 2004 were authorized under the following appropriations:

Act 200, Session Laws of Hawai`i (SLH) 2003, for the operating budget of the department:

Productivity improvement and management assistance	$	5,641,476
Produce development and marketing		2,773,539
General support for agriculture		2,245,467
Agricultural water development and irrigation services		253,401
Pollution control		732,008
Protection of the consumer		677,088
Aquaculture development		490,996
Budget total	$	12,813,975

Note 4 – Cash and Cash Equivalents

At June 30, 2004, the carrying amount of the department's cash and cash equivalents was $30,283,776, which approximates the bank balance.

Note 5 – Loans Receivable

At June 30, 2004, loans receivable consisted of the following:

	Special Revenue	Agency
Hawaii Agriculture Loan Program	$20,877,852	-
Hawaii Aquaculture Loan Program	1,048,676	-
Hawaii Agricultural Products Loan Program	76,214	-
Independent Sugar Growers Loan Program	-	2,114
Emergency Loan Program	-	35,594
Accrued interest	714,918	-
	22,717,660	37,708
Less allowance for doubtful receivables	2,000,000	-
	$20,717,660	37,708

The department grants credit in the form of loans to farmers, all located in the State of Hawai`i. Loans are collateralized by real estate, equipment, crops and other assets of borrowers.

Note 6 – Accounts Receivable

At June 30, 2004, accounts receivable consisted of the following:

Waiahole Water System	$109,500
Lease Rental of Public Land	195,294
Sale of Water	396,397
Quarantine Fee	1,168,736
	$1,869,927
Less allowance for doubtful receivables	1,057,659
	$812,268

Note 7 – Capital Assets

The changes in capital assets for the year ending June 30, 2004, are as follows:

	Balance at July 1, 2003	Adjustments	Beginning Balance as Restated	Additions and Transfers In	Disposals and Transfers Out	Ending Balance June 30, 2004
Capital Assets Being Depreciated						
Land improvements	$19,802,206	32,019,846	51,822,052	962,500	-	$52,784,552
Buildings	20,471,698	6,785,926	27,257,624	-	-	27,257,624
Vehicles	2,410,069	127,410	2,537,479	160,342	(76,192)	2,621,629
Equipment	3,782,804	379,011	4,161,815	143,765	(98,483)	4,207,097
	$46,466,777	39,312,193	85,778,970	1,266,607	(174,675)	$86,870,902
Less accumulated depreciation						
Land improvements	$15,918,559	15,791,609	31,710,168	3,538,490	-	$35,248,658
Buildings	6,238,600	(118,498)	6,120,102	930,906	-	7,051,008
Vehicles	2,036,654	12,741	2,049,395	189,997	(76,192)	2,163,200
Equipment	3,001,050	(219,782)	2,781,268	274,577	(103,794)	2,952,051
	$27,194,863	15,466,070	42,660,933	4,933,970	(179,986)	$47,414,917
Subtotal	$19,271,914	23,846,123	43,118,037	(3,667,363)	5,311	$39,455,985
Capital Assets Not Being Depreciated						
Land	$22,555,327	27,625	22,582,952	-	(85,488)	$22,497,464
Construction in progress	11,371,162	179,252	11,550,414	4,485,567	-	16,035,981
Subtotal	$33,926,489	206,877	34,133,366	4,485,567	(85,488)	$38,533,445
Total capital assets	$53,198,403	24,053,000	77,241,403	818,204	(80,177)	$77,989,430

Depreciation expense for the year ended June 30, 2004, was charged to governmental activities as follows:

Productivity improvement and management assistance	$	674,439
Product development and marketing		71,056
General support for agriculture		235,140
Agriculture water development and		-
Irrigation services		3,191,220
Pollution control		19,086
Protection of the consumer		21,557
Aquaculture development		1,300
Agricultural loans		35,416
	$	4,249,214

The department adopted a new capitalization policy effective July 1, 2001. Furniture and equipment purchases are capitalized when greater than $5,000 and buildings and land improvements are capitalized when greater than $100,000.

Note 8 – General Obligation Bond

Pursuant to Act 111, SLH 1998, reimbursable general obligation bonds of $8,500,000 were issued in 2001 to fund the acquisition of the Waiahole Water System. Section 14, Part IV of Act 111, SLH 1998, requires the Agribusiness Development Corporation to reimburse the general fund in accordance with a schedule determined by the director of finance, with the approval of the governor. The term of the bonds is 34 years and the interest rate is 3.00 percent. The principal repayment is due annually and the accrued interest is due semi-annually.

The changes to the general obligation bond as of June 30, 2004, are as

Balance at July 1, 2003	$8,500,000
Increase	-
Decrease	164,900
Balance at June 30, 2004	$8,335,100

Future bond principal repayment and interest payment for fiscal years ending after June 30, 2004, are as follows:

	Principal	Interest	Total
2005	$170,036	$250,053	$420,089
2006	175,141	244,952	420,093
2007	180,412	239,698	420,110
2008	185,866	234,285	420,151
2009	191,460	228,709	420,169
Thereafter	7,432,185	3,300,964	10,733,149
	$8,335,100	$4,498,661	$12,833,761

Note 9 – Leases

The department, as lessor, has non-cancelable lease agreements for parcels of land at agricultural parks located throughout the State of Hawai`i. The lease agreements have minimum and, where applicable, additional rent based on a percentage of revenues and terms of up to 55 years. Minimum future lease revenue for fiscal years ending after June 30, 2004 is as follows:

2005	$	389,000
2006		369,000
2007		369,000
2008		369,000
2009		368,000
Thereafter		10,325,574
	$	12,189,574

Rental income from leases at the agricultural parks for the fiscal year ended June 30, 2004, approximated $338,700, including $5,200 for additional rent based on percentage of revenues.

Note 10 – Vacation and Sick Leave

Vacation

The changes to the general long-term debt compensated absences as of June 30, 2004 are as follows:

Balance at July 1, 2003	$3,655,383
Increase	57,232
Decrease	-
Balance at June 30, 2004	$3,712,615

Compensated absences liabilities will be liquidated primarily by the general fund. In the past, approximately 80 percent has been paid by the general fund and the remainder by various other governmental funds.

Accumulated sick leave

Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit. It can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a state employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the Employee's Retirement System. Accumulated sick leave at June 30, 2004, was approximately $10,924,000.

Note 11 – Retirement Benefits

Retirement plan description

All eligible employees of the state and counties are required by Chapter 88, HRS, to become members of the ERS, a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS is governed by a Board of Trustees. All contributions, benefits, and eligibility requirements are established by Chapter 88, HRS, and can be amended by legislative action. 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, Hawai`i 96813.

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

Both options 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 vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date is based on the three highest paid years of service, excluding the vacation payment.

Funding policy

Most covered employees of the contributory option are required to contribute 7.8 percent of their salary. Police officers, firefighters, investigators of the departments of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2 percent of their salary. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 27 years from June 30, 2002.

The State's contribution requirements as of June 30, 2004, 2003, and 2002 were approximately $181,614,000, $158,622,000, and $113,984,000, respectively. The state contributed 100 pecent of its required contributions for those years. Changes in salary growth assumptions and investment earnings pursuant to Act 100, SLH 1999, decreased the June 30, 2001 and 2000 required contributions. Act 233, SLH 2002, increased the 2003 contribution by providing a one-time lump-sum pensioner bonus to retirees who were 70 years and older with at least 20 years of credited service as of June 30, 2002. Also Act 284, SLH 2001, provided an increase in the pension benefits effective 2003 to retirees with military service. The department's special revenue funds expended approximately $316,000 in employer contributions for the year.

Post-retirement health care and life insurance benefits

In addition to providing pension benefits, the state, pursuant to Chapter 87, HRS, provides certain health care and life insurance benefits to all qualified employees.

For employees hired before July 1, 1996, the State pays the entire monthly health care premium for employees retiring with ten or more years of credited service, and 50 percent of the monthly premium for employees retiring with fewer than ten years of credited service.

For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50 percent of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the state pays 75 percent of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the state pays the entire health care premium.

There are currently approximately 24,200 state retirees receiving such benefits. 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 reimbursement of the basic medical coverage premium. Contributions are financed on a pay-as-you-go basis. During fiscal 2004, expenditures of $151,851,000 were recognized for post-retirement health care and life insurance benefits, approximately $35,136,000 of which is attributable to the component units.

Note 12 – Commitments and Contingencies

Insurance coverage

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

The department is covered by the State's self-insured workers' compensation program for medical expenses of injured department employees. However, the department is required to pay temporary total and temporary partial disability benefits as long as the employee is on the department's payroll. 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 may be re-evaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors. Workers compensation expenditures for the year ended June 30, 2004, were $17,680.

Deferred compensation plan

The State established a deferred compensation plan pursuant to Internal Revenue Code Section 457 that enables state employees to defer a portion of their compensation. The State of Hawai`i, Department of Human Resources Development, has the fiduciary responsibility of administering the plan. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All amounts of compensation deferred under the plan, all property, or rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employees or other beneficiary) solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject to the claims of the State's general creditors.

Participants' rights under the plan are equal to those of the general creditors of the State in an amount equal to the fair market value of the deferred account for each participant. The assets of the plan and the deferred compensation payable are recorded in the State of Hawaii's Employee Benefits Agency Fund.

Note 13 – Transfers

For the year ended June 30, 2004, transfers by fund were as follows:

Transfer From:	Transfer To:	
State general fund	Irrigation System Revolving Fund	$140,000
State general fund	Hawaii Agriculture Development Revolving Fund	240,558
		$380,958
Waiahole Water System Revolving Fund	State general fund	$400,000
Agricultural Loan Revolving Fund	State general fund	1,000,000
Pesticide Use Revolving Fund	State general fund	128,364
		$1,528,364

The general fund transferred $140,400 to the irrigation system revolving fund pursuant to Section 6 of Act 200, SLH 2003, as amended by Act 41, SLH 2004, and $240,558 to the Hawai`i Agricultural Development Revolving Fund pursuant to Section 7 of Act 200, SLH 2003, as amended by Act 41, SLH 2004; $50,000 of the transfer from the general fund to Hawai`i Agricultural Development Revolving Fund was to be expended for operation and maintenance of the East Kauai Irrigation System. Fixed assets transferred in approximated $211,800.

Note 14 – Prior Period Adjustments

Adjustments were recorded to fund balance and net assets as of June 30, 2003, to recognize the existence of certain assets and correct reporting of certain other transactions. The following are the adjustments:

Government-wide financial statements:

Cost of capital assets	$	39,519,070
Less accumulated depreciation		(15,466,070)
Net adjustment for capital assets	$	24,053,000
Correction to vouchers payable		500,044
Correction to prepaid expenses		(47,569)
Accounts receivable not due in current period		124,972
Loan receivable		(148,385)
Bond payable		(8,500,000)
	$	15,982,062

Fund financial statements:

Long term loans and interest receivable, net of allowance for doubtful accounts of $1,150,000	$	21,447,442
Correction to prepaid expenses	$	(47,569)
Correction to vouchers payable		500,044
	$	452,475

As a result of the restatement, the department’s change in net assets as of June 30, 2003, decreased by $850,193 and the change in fund balances as of June 30, 2003, increased by $2,362,992.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
STATEMENT OF NET ASSETS
JUNE 30, 2004

Exhibit 3.1

		Governmental Activities
ASSETS		
Cash and cash equivalent	$	30,283,776
Receivables, net		812,268
Loans receivable, net		20,717,660
Capital assets		
Land, improvements, and construction in progress		38,533,445
Other capital assets, net of depreciation		39,455,985
Total assets	$	129,803,134
LIABILITIES		
Accounts payable and accrued liabilities	$	1,114,963
Due to state general fund		8,000
Due to agency fund		3,832
Deferred revenues		924,743
Accrued vacation:		
Due within one year		1,332,761
Due in more than one year		2,379,856
Bond payable		
Due within one year		170,036
Due in more than one year		8,165,064
Total liabilities		14,099,255
NET ASSETS (DEFICIT)		
Investment in capital assets		77,989,430
Restricted for:		
Capital projects		14,037,884
Agricultural loan program		28,734,911
Other purpose		5,392,188
Unrestricted		(10,450,534)
Total net assets		115,703,879
Total liabilities and net assets	$	129,803,134

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2004

Exhibit 3.2

Functions/Programs	Expenses	Program Revenues: Charges For Services	Program Revenues: Operating Grants and Contributions	Program Revenues: Captial Grants and Contributions	Net (Expense) Revenue and Changes in Net Assets: Governmental Activities
Departmental Activities:					
Produtivity improvement and management assistance	$ 10,757,522	2,785,828	626,732	-	(7,344,962)
Product development and marketing	3,442,168	292,458	68,507	-	(3,081,203)
General support for agriculture	5,025,330	1,039,525	1,292,813	-	(2,692,992)
Agricultural water development and irrigation services	4,520,511	943,642	28,717	4,044,260	496,108
Pollution control	1,526,725	594,752	283,106	-	(648,867)
Protection of the consumer	773,722	-	-	-	(773,722)
Aquaculture development	569,406	2,765	45,470	-	(521,171)
Agricultural loans	1,636,953	1,064,414	188,114	-	(384,425)
Total departmental activities	$ 28,252,337	6,723,384	2,533,459	4,044,260	(14,951,234)

General Revenues:	
State allotted appropriations	11,984,567
Non-imposed employee fringe benefit	2,939,616
Transfers	(1,316,546)
Total general revenues and transfers	13,607,637
Other Revenue(Loss)	
Loss on disposal of fixed assets	(2,546)
Change in net assets	(1,346,143)
Net assets, July 1, 2003	101,067,960
Prior year adjustment	15,982,062
Net Assets, June 30, 2004	$ 115,703,879

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE, STATE OF HAWAII
BALANCE SHEET
GOVERNMENTAL FUNDS
JUNE 30, 2004

Exhibit 3.3

	General Fund	Irrigation & Drainage System Capital Projects	Financial Assistance for Agriculture	Plant Pest & Disease Control	Agribusiness Development & Research	Other Governmental Funds	Total Governmental Funds
ASSETS							
Cash	$ 1,340,828	$ 14,279,582	$ 8,191,686	$ 381,778	$ 234,630	$ 5,855,272	$ 30,283,776
Loan Receivable	-	-	20,717,660	-	-	-	20,717,660
Total Assets	$ 1,340,828	14,279,582	28,909,346	381,778	234,630	5,855,272	51,001,436
LIABILITIES AND FUND BALANCES							
Liabilities:							
Vouchers Payable	$ 102,461	$ 241,698	$ 428	$ 12,615	$ 23,061	$ 66,871	$ 447,134
Accrued Payroll	438,748	-	23,353	35,632	-	170,096	667,829
Due to State General Fund	8,000	-	-	-	-	-	8,000
Due to Agency Fund	-	-	3,832	-	-	-	3,832
Deferred Revenues	-	-	-	333,531	211,569	379,643	924,743
Total Liabilities	549,209	241,698	27,613	381,778	234,630	616,610	2,051,538
Fund Balances(Deficit):							
Reserved for:							
Encumbrances	1,148,792	4,641,049	120,691	121,225	1,497,377	1,006,645	8,535,779
Continuing appropriation	-	9,396,835	9,751,594	(121,225)	(1,497,377)	4,232,017	21,761,844
Noncurrent assets	-	-	19,009,448	-	-	-	19,009,448
Unreserved:	(357,173)	-	-	-	-	-	(357,173)
Total Fund Balances	791,619	14,037,884	28,881,733	-	-	5,238,662	48,949,898
Total Liabilities and Fund Balances	$ 1,340,828	$ 14,279,582	$ 28,909,346	$ 381,778	$ 234,630	$ 5,855,272	$ 51,001,436

Total governmental fund balances, above	$ 48,949,898
Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds	77,989,430
Receivables in the statement of activities that do not provide current financial resources are not reported in the funds	812,268
Some liabilities, such as compensated absences, are not due and payable in the current period and therefore are reported in the funds	(3,712,617)
Long term liabilities, such as bond payable, are not due and payable in the current period and therefore are not reported in the governmental funds.	(8,335,100)
Net assets of governmental activities	$ 115,703,879

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE, STATE OF HAWAII
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
GOVERNMENTAL FUNDS
FOR THE YEAR ENDED JUNE 30, 2004

Exhibit 3.4

	General Fund	Irrigation & Drainage System Capital Projects	Financial Assistance for Agriculture	Plant Pest & Disease control	Agribusiness development & Research	Other Governmental Funds	Total Governmental Funds
REVENUES							
Allotted appropriation	$ 12,813,975	$ 2,350,000	$ -	$ -	$ -	$ -	$ 15,163,975
Intergovernmental revenues	-	1,894,260	-	519,155	856,416	833,869	4,103,700
Non-imposed employee fringe benefit	2,939,616	-	-	-	-	-	2,939,616
Interest on agricultural loans	-	-	1,060,860	-	-	-	1,060,860
Charges for services	-	-	954	-	-	5,596,007	5,596,961
Investment earnings	-	-	188,114	-	-	135,905	324,019
Other revenue	-	-	2,602	-	-	-	2,602
Total Revenues	15,753,591	4,244,260	1,252,530	519,155	856,416	6,565,781	29,191,733
EXPENDITURES							
Current:							
Productivity improvement and management assistance	6,863,153	-	-	519,155	-	2,963,186	10,345,494
Product development and marketing	3,090,166	-	-	-	-	292,692	3,382,858
General support for agriculture	2,564,999	-	-	-	856,416	1,568,063	4,989,478
Agricultural water development and irrigation services	164,186	-	-	-	-	1,088,881	1,253,067
Pollution control	861,616	-	-	-	-	686,149	1,547,765
Protection of the consumer	746,714	-	-	-	-	-	746,714
Aquaculture development	500,857	-	-	-	-	44,853	545,710
Agricultural loan administration	-	-	1,592,107	-	-	-	1,592,107
Capital Outlay	-	4,485,566	-	-	-	-	4,485,566
Total Expenditures	14,791,691	4,485,566	1,592,107	519,155	856,416	6,643,824	28,888,759
Excess of revenue over(under) expenditure	961,900	(241,306)	(339,577)	-	-	(78,043)	302,974
Other financing sources:							
Lapsed appropriations	(829,408)	(200,000)	-	-	-	-	(1,029,408)
Operating transfers in	-	-	-	-	-	380,958	380,958
Operating transfers out	(380,958)	-	(1,000,000)	-	-	(528,364)	(1,909,322)
	(1,210,366)	(200,000)	(1,000,000)	-	-	(147,406)	(2,557,772)
Excess of revenues and other sources over(under) expenditures and other uses	(248,466)	(441,306)	(1,339,577)	-	-	(225,449)	(2,254,798)
Fund Balances - Beginning	587,610	14,479,190	8,773,868	-		5,464,111	29,304,779
Prior Year Ajustment	452,475	-	21,447,442	-	-	-	21,899,917
Fund Balances - Ending	$ 791,619	$ 14,037,884	$ 28,881,733	$ -	$ -	$ 5,238,662	$ 48,949,898

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE - GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2004

Exhibit 3.5

Net change in fund balances - total governmental funds	$	(2,254,798)
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 as depreciation expense. This is the amount by which capital expenditures exceeded depreciation for the year.		738,025
Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds		62,962
Some expenses reported in the statement of activities, such as compensated absences, do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds		(57,232)
Long term liabilities, such as bond payable, are not due and payable in the current and therefore are not reported in the governmental funds.		164,900
Change in net assets of governmental activities	$	(1,346,143)

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
STATEMENT OF FIDUCIARY NET ASSETS
June 30, 2004

Exhibit 3.6

	Private-Purpose Trusts	Agency
ASSETS		
Cash and cash equivalents	$ 61,933	$ 47,889
Loans receivable, net	-	37,708
Due to special funds	-	3,832
Total Assets	$ 61,933	$ 89,429
LIABILITIES		
Vouchers Payable	$ 2,487	$ 11,768
Accrued Payroll	34,752	-
Due to others	-	36,121
Due to State General Fund	-	41,540
Total Liabilities	37,239	89,429
NET ASSETS	24,694	-
	$ 61,933	$ 89,429

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2004

Exhibit 3.7

	Private-Purpose Trust
REVENUES	
Other revenues	$ 480,117
EXPENDITURES	
Expendable trust funds	449,012
Excess of revenues over expenditures	31,105
Net assets (deficit) at July 1, 2003	(6,411)
Net assets at June 30, 2004	$ 24,694

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
(Budgetary and actual) - General Fund
For the Year Ended June 30, 2004

Exhibit 3.8

	Budgeted Amount Original	Budgeted Amount Final	Actual Amount Budgetary Basis	Variance with Final Budget Positive (Negative)
Budgetary fund balance at July 1, 2003	$ -	$ -	$ -	$ -
REVENUES				
State alloted appropriation	12,813,975	12,813,975	12,813,975	-
Intergovernmental	-	-	-	-
Total Revenues	12,813,975	12,813,975	12,813,975	-
EXPENDITURES				
Productivity improvement and management assistance	5,641,476	5,626,476	5,365,135	261,341
Product development and marketing	2,773,539	2,773,539	2,603,650	169,889
General support for agriculture	2,004,909	2,019,909	1,999,942	19,967
Agricultural water development and irrigation services	113,001	123,001	120,131	2,870
Pollution control	732,008	732,008	666,009	65,999
Protection of the consumer	677,088	677,088	599,530	77,558
Aquaculture development	490,996	480,996	428,138	52,858
Total Expenditures	12,433,017	12,433,017	11,782,535	650,482
Excess of revenue over(under) expenditure	380,958	380,958	1,031,440	650,482
Other financing sources:				
Operating transfers out	(380,958)	(380,958)	(380,958)	-
Excess of revenues and other sources over expenditures and other uses	-	-	650,482	650,482
Lapsed appropriations	-	-	(650,482)	(650,482)
Budgetary fund balance at June 30, 2004	$ -	$ -	$ -	$ -

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
Statement of Revenues, Expenditures, and Changes in Fund Balances
(Budgetary and actual) - Special Revenue Funds
For the Year Ended June 30, 2004

Exhibit 3.9

	Budgeted Amounts Original	Budgeted Amounts Final	Actual Amounts Budgetary Basis	Variance with Final Budget Positive (Negative)
Financial Assistance for Agriculture				
Revenues				
Charge for services and investment income	$ 6,016,965	$ 6,016,965	$ 1,252,530	$ (4,764,435)
Expenditure				
Agricultural Loans	6,016,965	6,016,965	1,576,629	4,440,336
Excess of revenues over (under) expenditures	-	-	(324,099)	(324,099)
Other financing sources				
Operating transfers in (out)	(1,000,000)	(1,000,000)	(1,000,000)	-
Excess of revenues and other sources over (under) expenditures and other uses	$ (1,000,000)	$ (1,000,000)	$ (1,324,099)	$ (324,099)
Plant and Pest Disease Control				
Revenues				
Charges for services and investment income	$ 1,197,718	$ 1,197,718	$ 629,682	$ (568,036)
Expenditure				
Productivity improvement and management	1,197,718	1,197,718	544,018	653,700
Excess of revenues over (under) expenditures	$ -	$ -	$ 85,664	$ 85,664
Agribusiness Development and Research				
Revenue				
Charges for services and investment income	$ 2,889,633	$ 2,889,633	$ 892,004	$ (1,997,629)
Expenditure				
General support for agriculture	2,889,633	2,889,633	899,141	1,990,492
Excess of revenues over (under) expenditures	$ -	$ -	$ (7,137)	$ (7,137)

The accompanying notes are an integral part of these combined financial statements.

DEPARTMENT OF AGRICULTURE
STATE OF HAWAII
Budgetary Comparison Schedule
Budget to GAAP Reconciliation
For the Year Ended June 30, 2004

Exhibit 3.10

	General Fund	Financial Assistance for Agriculture	Plant Pest and Disease Control	Agribusiness development and Research
Excess of revenues and other sources over (under) expenditures and other uses - actual on budgetary basis	$ 650,482	$ (1,324,099)	$ 85,664	$ (7,137)
Reserved for encumberances at fiscal year-end	1,148,793	120,691	-	-
Revenue and expenditure accruals for the year not recognized for budgetary purposes, net of prior year accruals	163,641	7,572	(85,664)	7,137
Lapsed appropriations	(829,408)	-	-	-
Expenditures for prior fiscal years' encumberances	(1,381,974)	(143,741)	-	-
Excess of revenues and other sources over (under) Expenditures and other uses - GAAP basis	$ (248,466)	$ (1,339,577)	$ -	$ -

The accompanying notes are an integral part of these combined financial statements.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Agriculture on April 4, 2005. 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 states that it was given an opportunity to adjust its allowance for loan losses, and thereby believes that a qualifying opinion should be removed. Based on the department's adjusted allowance for loan losses, the related qualification to the opinion in the draft report was removed. However, a material weakness still exists as the department's methodology used to determine its allowance for loan losses for FY2003-04 does not comply with generally accepted accounting principles.

Otherwise, the department generally concurred with our findings and recommendations, and provides additional information to explain its current procedures and corrective actions planned, or already taken, to address the internal control deficiencies identified in our report.

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

April 4, 2005

COPY

The Honorable Sandra Lee Kunimoto
Chair, Board of Agriculture
Department of Agriculture
1428 South King Street
Honolulu, Hawaii 96814

Dear Ms. Kunimoto:

Enclosed for your information are three copies, numbered 6 to 8 of our confidential draft report, *Management and Performance Audit of the Department of Agriculture*. We ask that you telephone us by Wednesday, April 6, 2005, 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, April 13, 2005.

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

Marion M. Higa
State Auditor

Enclosures

LINDA LINGLE
Governor

SANDRA LEE KUNIMOTO
Chairperson, Board of Agriculture

DUANE K. OKAMOTO
Deputy to the Chairperson

State of Hawaii
DEPARTMENT OF AGRICULTURE
1428 South King Street
Honolulu, Hawaii 96814-2512
Phone: (808) 973-9600 Fax: (808) 973-9613

April 13, 2005

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OFC. OF THE AUDITOR
STATE OF HAWAII

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

Dear Ms. Higa:

Thank you for the opportunity to review and provide comments on the Legislative Auditor's (Auditor) draft report of the Management and Performance Audit of the Department of Agriculture. The Department has reviewed the Auditor's draft report and welcomes recommendations to strengthen and improve on the department's financial accounting, internal control and financial reporting systems and procedures.

We would like to provide the following additional background information and response to the Auditor's findings and recommendations:

Findings (bulleted and in bold):

- **The department lacks formal policies and procedures governing many of its basic processes and management functions.** The department lacked adequate policies and procedures regarding the administration of agricultural loans, certain account receivables, and procurement and contract management.

  The department's formal policies for administration of agricultural loans in the Board of Agriculture Policies and Procedures Book (Book) were rescinded by the Board of Agriculture on April 19, 1990 and incorporated in rules and statutes (Chapter 155,HRS). The department's formal policies for the accounts receivables for the Animal Quarantine Branch and the Irrigation System of the Agricultural Resource Management Division are also contained in the Book but as noted by the Auditor are outdated and need to be updated. The Book also contains some formal purchasing policies that are outdated, need to be updated and should include contract management. As stated in the Auditor's draft report, the Board of Agriculture is charged with establishing broad operating policies for the department. As such, the department has been working to remove the specific procedural matters from the Book so that what remains are the broader policy issues and matters for the Board to address and oversee. The department will work to update existing policies and include new policies in the Book.

- **The administration of the agricultural loans needs improvements.** Loan files are not properly maintained. The status of delinquent accounts and history of collection attempts are not adequately documented. Required inspections are not documented. Loan account information and deposits are not reviewed. Internal controls over account information are inadequate. The division computer system manual is outdated. Internal records are not reconciled to FAMIS on a monthly basis. Participation loans are not adequately documented.

In the past year, the Agricultural Loan Division has made significant improvements over the administration of agricultural loans and will continue to institute changes that will strengthen management's ability to effectively administer the program. Business Loan Officers will be reminded to file all required documents in the loan files, to document and retain in the loan files the status of delinquent loans, history of collection attempts, required inspections, and any follow-ups with banks on participation loans, and to review loan account information changes and deposits on a timely basis and as they occur. Since a year ago when a new Division Administrator was appointed, monthly delinquent reports have been distributed to loan officers for their follow-up on delinquent cases. Business Loan Officers are also required to prepare and submit monthly reports on collection efforts for delinquent accounts. The Division recently revised its procedures for account information changes to reflect review and approval by Business Loan Officers to provide better control. In addition to reconciling its internal records to FAMIS on an annual basis, the Division will also begin reconciling on a monthly basis. Policies and procedures will be updated to reflect these changes including minimum collection policies and procedures. The Division Administrator will also conduct periodic reviews to ensure that staff is adhering to the policies and procedures. Once the Division has completed updating its computer system, the computer system manual will be revised and updated.

- **The methodologies used to determine the allowance for loan losses and to recognize interest on delinquent loans are not in accordance with generally accepted accounting principles.** The allowance for loan losses has no adequate basis. The allowance is not supported by sufficient documentation. Interest on loans is accrued beyond its measurable and available period.

  A methodology to determine a reasonable and adequate allowance for loan losses has been developed by the Agricultural Loan Division. The methodology was developed with guidance material from the American Institute of Certified Public Accountants for use by financial institutions in estimating credit losses and in conjunction with the Auditor's external auditor. The loan loss allowance is also now supported with detailed documentation. The methodology will be incorporated into the Division's policies and procedures manual.

  It should be noted that in the last days of the audit the Auditor's external auditor offered the department an opportunity to remove a qualifying opinion if the Division could estimate a reasonable and adequate allowance for its loan losses so that the same allowance amount could be consistently used in the financial statements included in the Auditor's report and the department's financial audit report. The final allowance amount agreed to between the Division and the Auditor's external auditor was $2 million, however, the Auditor's draft report does not reflect the $2 million agreed upon allowance amount or removal of the qualifying opinion.

  The Division is already discontinuing the practice of accruing interest beyond 90 days. It should be noted that the discontinuance of the accrual of interest on loans greater than 90 days delinquent was initiated by the Division as part of their written methodology for determining the loan loss allowance. At that time, the Auditor's external auditors did not disclose to the Division that the accrual of interest beyond 90 days was a problem that would lead to a qualified opinion on the department's June 30, 2004 financial statements.

- **The department's management of accounts receivables is ineffective.** The Animal Quarantine Station's collection procedures are inadequate. The Agricultural Resource Management Division does not adhere to, or document efforts related to collection policies. The allowance for doubtful accounts is not supported by sufficient documentation. Attempts to return unclaimed money are weak.

The Animal Quarantine Branch will update its policies and procedures manual and provide training for staff to instruct them on the policies and procedures. Logs will be modified to improve tracking of delinquent accounts and systematize referrals to collection agencies. The Branch is in the process of compiling older accounts receivable information and will be submitting a request to the Board of Agriculture to refer the accounts to the Office of the Attorney General. Staff will be instructed to document all efforts to return unclaimed moneys.

The Branch will develop and include in its policies and procedures a written methodology for determining allowance for doubtful accounts and support the allowance amount with detailed documentation. At this time, the Branch does not anticipate discontinuing the use of promissory notes because based on experience there have been instances where pet owners have indicated that they do not have a credit card.

The Agricultural Resource Management Division will file all accounts receivable contact information and correspondence in the customer folder, including information retained by the program manager, and refer delinquent accounts to the Board of Agriculture and the Department of Attorney General for timely disposition. The Division is in the process of developing a written procedure and methodology to determine an allowance for doubtful accounts, which will be included with the existing accounts receivable collection guidelines.

- **The department's year-end financial reporting process is ineffective.** The department's inability to prepare complete, timely, and fairly presented financial statements led to major delays. The department has not maintained sufficient records to support its capital assets.

  Both the department and its external auditor lost key personnel during the conduct of the audit resulting in some setbacks for both entities and a period of changes and adjustments. In the future, the department will be more diligent in its review of the financial statements to ensure that amounts are properly reported and disclosed. The department will also attempt to retrieve the documents from the Department of Land and Natural Resources to support the reported value of infrastructure recorded as fixed assets. If unable to locate the supporting documents, the department will require additional funds in order to estimate the value of the infrastructure assets.

- **Inadequate management controls, a lack of written policies, and employee oversight have led to problems with cash receipts and disbursements, procurement and contract management, and federal financial reporting.** The department's management controls over cash receipts and disbursements are inadequate. The department lacks proper segregation of duties. Reconciliation and reviews are not documented. Inventory counts are not documented. The department's policies and procedures governing procurement and contract management are deficient. Professional services contracts are not posted electronically. Exempt purchases do not have required documentation. The contract management process is not standardized. Federal financial reports are untimely.

  The Accountant position in the Fiscal Office will oversee the reconciliation of validated treasury deposit receipts and between the cash receipts journal and related FAMIS reports. Review will be documented by supervising authority's initials and date on the validated treasury deposit receipts and cash receipts journal. A position other than the petty cash custodian will perform the petty cash reconciliation function. The Accountant position in the Fiscal Office will provide the review of the reconciliation between petty cash and related bank balances and will document the review by initialing and dating the respective reconciliation worksheets.

The department has amended its inventory policies and procedures to require the program property custodians to (1) keep a copy of the signed Annual Physical Inventory Certification with the inventory listing as documentation that a physical inventory has been conducted; and (2) certify by initialing and dating the DAGS quarterly inventory transaction register that they have reviewed and reconciled the report to the AGS 17-A.

All departmental programs were notified in writing of the new requirement to electronically post awards of professional service contracts and affected program personnel attended training. The Agricultural Resource Management Division inadvertently forgot to post professional services awards until reminded in FY 2003. Since FY 2004, however, the Division has been diligently posting their professional service awards electronically. The department will include on its contract checklist the requirement for electronically posting awards of professional service contracts as a control to ensure compliance with the procurement code.

The reportable condition regarding exempt purchases by Agribusiness Development Corporation will no longer present itself. Effective January 1, 2005, Agribusiness Development Corporation is no longer exempt from the Hawaii Public Procurement Code codified in Chapter 103D, HRS. The department will remind programs that when a procurement exemption is being utilized references to the applicable statutory exemption is required on contract documents.

The department's contract management process will be standardized by updating the department's existing policies and procedures to make it a requirement rather than optional for programs to submit a completed contract checklist. It is our understanding that the Department of Accounting and General Services is developing checklists with submittal requirements for the various types of contracts. The department will incorporate these checklists into the department's policies and procedures and make these available centrally for programs to access.

The department has reminded staff to submit federal financial reports on a timely basis. To assist in the timely submission of federal financial reports, a list of all federal funds grant agreements and due dates for financial reports will be updated with current required submissions. If the department anticipates delays in meeting the federal financial reporting deadlines, a request for extension will be made in writing to the affected agency.

We would like to thank your staff for their assistance in clarifying certain findings and ensuring that the discrepancies we identified will be corrected in the final report. Thank you again for the opportunity to review and respond to your draft audit report.

Sincerely,

Sandra Lee Kunimoto, Chairperson
Board of Agriculture