Financial Audit of the Department of Human Resources Development

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

Report No. 07-09
December 2007

THE AUDITOR
STATE OF HAWAI‘I

Office of the Auditor

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

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

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

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

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

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

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

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

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

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

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

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

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OVERVIEW

Financial Audit of the Department of Human Resources Development

Report No. 07-09, December 2007

Summary

The Office of the Auditor and the certified public accounting firm of Accuity LLP conducted a financial audit of the Department of Human Resources Development, State of Hawai'i, for the fiscal year July 1, 2005 to June 30, 2006. The audit examined the financial records and transactions of the department; reviewed the related systems of accounting and internal controls; and tested transactions, systems, and procedures for compliance with laws and regulations.

In the opinion of the firm, the financial statements present fairly, in all material respects, the department's financial position of its general fund and human resources development special fund as of June 30, 2006, and the respective changes in financial position and the respective budgetary comparison for the general and major special revenue funds for the year then ended in conformity with accounting principles generally accepted in the United States of America. However, the firm was not able to apply auditing procedures to satisfy themselves regarding the amounts reported as workers' compensation liability and the related workers' compensation expense in the statement of net assets and statement of activities. Additionally, the firm disclaimed opining on the workers' compensation and unemployment insurance interdepartmental accounts in the governmental funds.

With respect to the department's internal control over financial reporting and operations, we found two material weaknesses. First, we found that accounting personnel and accurate financial reporting are not a priority of the department. While the department is proficient with day-to-day tasks, it lacks a formal internal financial reporting process. The department also does not produce financial statements and is not subject to annual financial audits. Collectively, these factors contributed to certain account balances being misstated as of June 30, 2006. Further, external stakeholders, including the public, are left with no means to evaluate the financial performance of the department.

The second material weakness is that the department has not taken functional ownership of the Workers' Compensation Program. The department is responsible for planning and administering the Workers' Compensation Program for a majority of state agencies and the Legislature; however, it does not systematically calculate, track, and report the approximately $29 million in related liabilities. Additionally, the department has not established formal policies over processing related claims to avoid potential exposure to related litigation. As a result, we found that workers' compensation expenditure and liability balances were significantly misstated as of June 30, 2006.

Recommendations and Response

We recommend that the department train current accounting staff and enable them to, or hire personnel with the experience necessary to, perform advanced financial accounting functions that include preparing financial statements, designing systems of internal controls and financial reporting, providing training to other staff, and reviewing financial reports to identify discrepancies.

We also recommend that the department establish formal, written policies and procedures governing workers' compensation claims that include, among other things, guidelines for initial estimates, updates, and reviews of reserves.

The department expressed its appreciation of the value of audits but disagreed with many of our findings and conclusions. The department provided detailed explanations supporting its disagreement with our findings. However, the department's responses either do not specifically address, or demonstrate a lack of understanding of, the actual findings. We stand by our conclusions presented in the final report and believe our audit report presents a balanced and accurate analysis of the department's financial operations.

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State of Hawai'i

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Financial Audit of the Department of Human Resources Development

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

Conducted by

The Auditor
State of Hawai‘i
and
Accuity LLP

Submitted by

THE AUDITOR
STATE OF HAWAI‘I

Report No. 07-09
December 2007

Foreword

This is a report of the financial audit of the Department of Human Resources Development, State of Hawai'i, for the fiscal year July 1, 2005 to June 30, 2006. 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 Accuity LLP.

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

Marion M. Higa
State Auditor

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Chapter 1

Introduction

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

Background

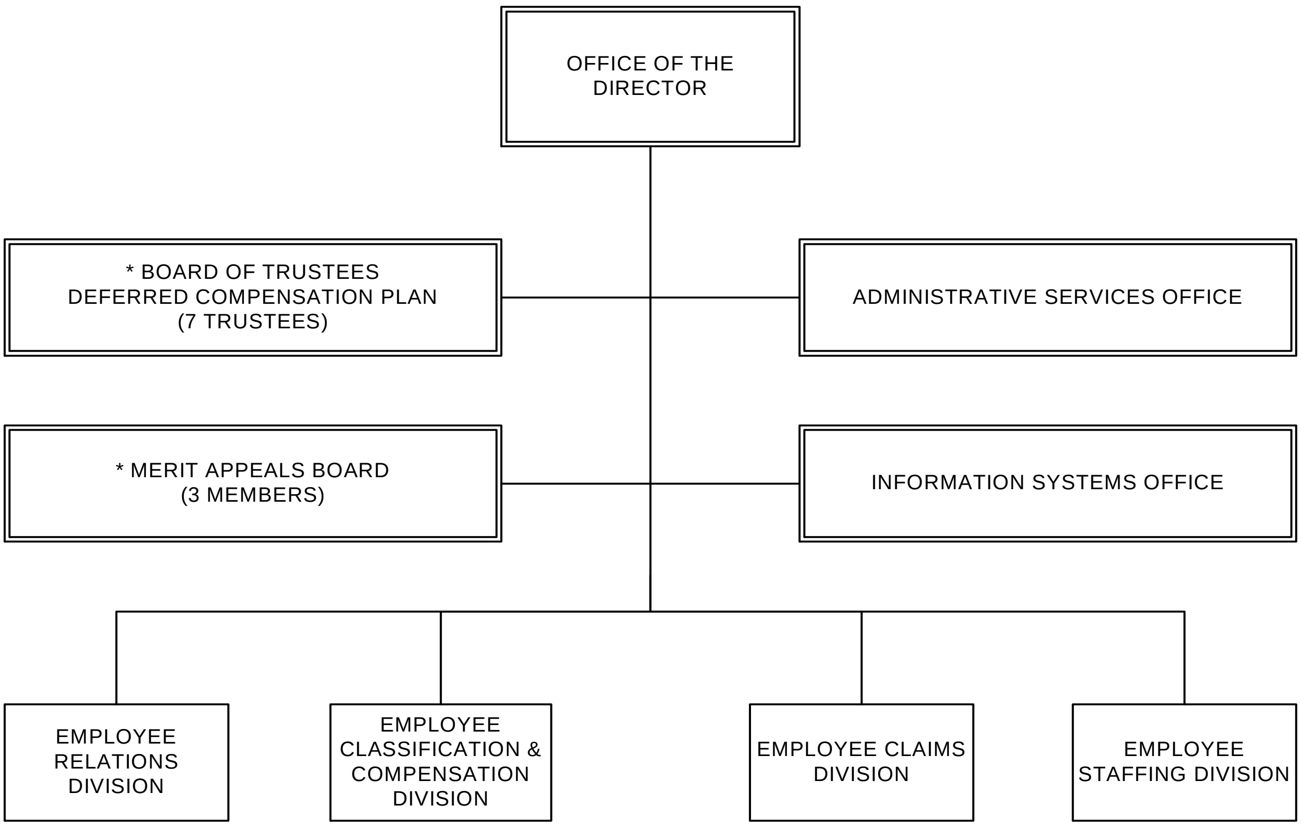
The Department of Human Resources Development is part of the executive branch of the State of Hawai‘i. The department administers the state personnel program, provides administrative support services to statutorily and executively assigned commissions or boards, and represents the State on other commissions and committees.

The Territorial Legislature established the Territorial Civil Service Commission in 1939 and the Department of Civil Service in 1951. In 1959, the Department of Civil Service was renamed the Department of Personnel Services (DPS) as part of the statehood reorganization. The Legislature established positions and funds for a new centralized workers' compensation unit within DPS, which began operations in 1985. In 1992, the Legislature changed the Department of Personnel Services to the Department of Human Resources Development to support concepts of human resources as more than personnel processing work as well as the employment-long development of people into productive and motivated workers for the public service.

Organization

The department is headed by the director of human resources development. The Office of the Director plans, organizes, directs, and coordinates the various activities of the state personnel program in personnel development and training, recruitment, examination, position classification, pay administration, workers' compensation payments, and labor relations within the scope of laws, rules, and established policies. Exhibit 1.1 displays the department's organizational structure.

Exhibit 1.1
State of Hawai‘i
Department of Human Resources Development
Organizational Chart



Source: Department of Human Resources Development

Administrative Services Office

This central office coordinates the development and maintenance of a comprehensive accounting system and control of expenditures for the department's finances; compiles and analyzes fiscal and budget data for preparation of financial reports and submission of the departmental budget; provides administrative support services to the department; administers Unemployment Insurance Benefits; and provides personnel services to employees of the department.

Information Systems Office

The Information Systems Office directs efforts to implement the departmental plan for computerization of personnel functions and development and maintenance of an automated Human Resources Management System.

Divisions

The **Employee Relations Division** establishes and maintains statewide policies, procedures, programs, and services that provide guidance and support to the line departments of the Executive Branch with regard to employee relations issues. The division is comprised of three branches: Labor Relations, Employee Assistance, and Personnel Transactions and Training.

The **Employee Classification and Compensation Division** develops and administers classification and compensation systems for civil service positions, including the establishment and maintenance of classes and their experience and training requirements; the pricing of classes; and the assignment of positions to classes, bargaining units and other administrative units. This division develops and administers position management standards and information, develops new classification methods and systems, and develops the compensation component by formulating and implementing new systems and programs to compensate employees appropriately and to fulfill other statutory requirements.

The Employee Classification and Compensation Division also develops and administers statewide human resource programs for employees exempt from civil service and excluded from collective bargaining. Functions include the development of programs, monitoring their implementation and effectiveness in meeting needs, and the provision of direct services. Finally, the division develops statewide policies, methods, and practices and legislative proposals affecting program activities.

The **Employee Claims Division** plans and administers the statewide Workers' Compensation Program (except for the Department of Education and the University of Hawai‘i, which have separate funds), claims management, and Return to Work Priority Program. It focuses new emphasis on enhancing customer service delivery, financial accounting, cost management, audit and Department of Labor and Industrial Relations compliance reports. This division also provides a centralized management of workers' compensation claims for 18 departments and agencies within the executive branch of State government as well as the Legislature. This includes administering the funds that have been appropriated for the purpose of paying workers' compensation benefits for employees occupying general funded and certain federally funded positions.

The **Employee Staffing Division** conducts statewide staffing and consultative advisory services, including human resource research and development projects, to forecast, plan for, and effectuate effective staffing strategies before staffing issues become acute or impact public services. The division also researches, develops, and implements strategies to attract and retain efficient and effective employees by competitively filling positions.

Other agencies

Two agencies are attached to the department for administrative purposes. The **Merit Appeals Board** (formerly **State Civil Service Commission**) accepts and hears appeals from job applicants and civil service employees regarding classification and pricing, and disciplinary or other adverse employment actions, which are not covered by Hawai'i's collective bargaining law and contractual agreements.

The **Board of Trustees Deferred Compensation Plan** administers a tax-sheltered saving and investment program for state employees with authority to engage services to establish, administer, or maintain the plan under its direction.

Prior Financial Audit

The Office of the Auditor and the certified public accounting firm of Deloitte & Touche LLP conducted a financial audit of the Department of Personnel Services for FY1991 pursuant to Section 23-4, HRS. In the opinion of Deloitte & Touche LLP, the department's financial statements presented fairly its financial position, the results of its operations, and the changes in its proprietary fund as of June 30, 1991. There were no instances in which the department did not comply with applicable laws and regulations, nor did the firm find weaknesses in the department's control measures that would affect an opinion on the financial statements.

Our audit did find, however, that the department had reorganized without obtaining the necessary approvals as required by administrative directive. Our audit also found differences between the department's records and those of the Department of Accounting and General Services (DAGS), as the department had not been reconciling its accounting records to those of DAGS. We recommended that the department take steps to ensure that all organizational changes follow applicable administrative directives and that the organizational structure be authorized by the governor. We further recommended that the department periodically reconcile its accounting records with DAGS's records. The department generally agreed with our findings and recommendations.

Objectives of the Audit

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

2. Ascertain whether 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. Make recommendations as appropriate.

Scope and Methodology

We audited the financial records and transactions and reviewed the related systems of accounting and internal controls of the department for fiscal year July 1, 2005 to June 30, 2006. We tested financial data to provide a basis to report on the fairness of the presentation of the 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 therein. We made recommendations for appropriate improvements including, but not limited to, the department's management and administration of claims, forms, and records; accounting and operating procedures; and financial reporting process.

The independent auditors' opinion as to the fairness of the department's financial statements presented in Chapter 3 is that of Accuity LLP. The audit was conducted from September 2006 through January 2007 in accordance with auditing standards generally accepted in the United

States of America as set forth by the American Institute of Certified Public Accountants and the standards 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 safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Department of Human Resources Development.

Summary of Findings

We found two material weaknesses involving the department's internal control over financial reporting and operations. A material weakness is a reportable 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.

The following matters are considered material weaknesses:

1. Accounting personnel and accurate financial reporting are not a priority.

2. No functional ownership of the Workers' Compensation Program exists.

Accounting Personnel and Accurate Financial Reporting Are Not a Priority

Financial information should be accurately communicated to both internal and external users. Internal financial reporting should be designed to meet management's needs, which include monitoring performance and strategic planning, while external reporting should be designed to meet the general needs of those with an interest in a government's finances. Qualified accounting personnel should be employed to record and report financial transactions and results as well as to design and monitor a system of internal control over the process to ensure the reliability of the process and accuracy of the reports. These components are especially critical to state agencies as they receive and expend public moneys.

The Department of Human Resources Development is responsible for administering the State's personnel program and during FY2006 received approximately $14,539,000 in general funds to fulfill that purpose. This included $7 million in general funds for the department's Workers' Compensation Program. However, our audit revealed weaknesses in the department's internal financial reporting process and further found that the department has no external financial reporting process. Recognizing that the department is capable at an operational level, we found that it lacks technical accounting skill and an understanding of the importance of consistent monitoring and reporting of financial performance, which resulted in significant misstatements of the department's FY2006 financial balances and results.

Internal financial reporting and oversight are insufficient

We found that the department does not have formal procedures over internal financial reporting that specify what types of data should be reported, how frequently it should be prepared, or who is responsible for reviewing it. We further found that the department does not have accounting staff that understand accounting principles, particularly those relative to government entities.

We do emphasize that the department's current fiscal staff is proficient with day-to-day tasks and responsibilities, such as recording the state-allotted appropriations and requests for payments. This is evidenced by the fact that our audit revealed few discrepancies on a transactional level. However, without formal internal reporting procedures or skilled accounting personnel, the department may not be able to get the most benefit out of available data, recognize significant and relevant accounting issues, or accurately report financial transactions and results to management and stakeholders. Further, without qualified accounting personnel, the department does not have a full understanding of the value of establishing, monitoring, and evaluating internal controls over financial reporting functions.

In addition to properly recording transactions, effective internal controls are crucial in providing assurance that transactions are executed with proper authorization and accountability is maintained over the department's assets. Sound internal controls will help protect government resources against waste, mismanagement, or misappropriation. Although we noted no instances of abuse, we did note several accounting errors and misstatements as discussed below.

The department is unable to accurately report financial results to external stakeholders

On an annual basis the department neither prepares financial statements in compliance with generally accepted accounting principles, nor is it audited by a certified public accounting (CPA) firm. As a state agency that receives and expends taxpayer moneys, the department should be accountable to the Legislature and citizenry of Hawai‘i. However, without audited annual financial statements, legislators and taxpayers have no readily available means to judge whether the department is meeting its fiscal responsibilities.

Audited financial statements and qualified accounting staff deemed unnecessary

Historically, the department has not been required by the State to generate annual financial statements or be audited, and the department believes that the generation of internal financial statements and the retention of qualified accounting personnel are not necessary. Instead, the department relies on the Financial Accounting and Management Information System (FAMIS), which is the State's general ledger system maintained by the Department of Accounting and General Services (DAGS), to generate all reports used for reviewing or reporting its account balances.

For fiscal years 2004 and 2005, DAGS took the initiative to assist the department in preparing financial statements and footnotes in accordance with generally accepted accounting principles (GAAP), with the intent that the department would be able to continue this on its own going forward. However, due to turnover of the personnel involved, both within the department and at DAGS, any gains achieved were subsequently lost and the department was unable to prepare its own financial statements for FY2006. The department did hire another CPA firm to compile its FY2006 financial statements; however, this was done only in preparation for our current audit. The department still lacks the accounting expertise to understand the information presented in its own financial statements.

External reporting is limited to legislative budgetary reports

Legislators receive some financial reports from the department in the form of budget requests. However, this information is taken straight from FAMIS, which is based on governmental fund accounting and does not incorporate the requirements of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. GASB Statement No. 34 sharpens the focus of government financial statements by bringing in some new information, most notably the use of government-wide financial statements, prepared using accrual accounting. This is important to users of financial statements because accrual accounting measures current assets and liabilities, plus also takes into account long-term assets and liabilities. Accrual accounting requires the reporting of *all* revenues and *all* costs of providing services each year, not just those received or paid in the current year or soon after year-end. In short, the reports required by GASB Statement No. 34 should give government officials a new and more comprehensive way to demonstrate their stewardship in the long term in addition to the way they currently demonstrate their stewardship in the short term and through the budgetary process.

Because of the overreliance on DAGS and FAMIS, the department's fiscal staff has not found it necessary to become familiar with financial reporting requirements applicable to the department. As previously noted, the department was unable to prepare its financial statements, trial balances, or account balance analyses for our current audit, and it contracted with another CPA firm to perform these functions. While it is not uncommon for departments to receive assistance in compiling their financial statements, the department should be able to prepare the supporting audit schedules and be knowledgeable of, and responsible for, the information presented in the financial statements; otherwise, the department may not be in a position to detect misstatements and other accounting errors.

Citizens and other external stakeholders are left in the dark

None of the department's fiscal reports (budget reports, fund financial statements, or government-wide financial statements) are currently made available to those to whom the department is ultimately accountable—the taxpaying public. Governmental Accounting Standards Board Concepts Statement No. 1, *Objectives of Financial Reporting*, identifies citizens as one of the primary users of a government's financial reports. The concepts statement further states that financial reporting helps fulfill a government's duty to be publicly accountable and that it should help to satisfy the needs of users who have limited authority, ability, or resources to obtain information and who therefore rely on the reports as an important source of information. Currently, the public has no means of evaluating the fiscal performance of the Department of Human Resources Development.

Misstatements are prevalent across the department's accounts

The department's informal financial reporting processes have led to misstatements and errors that impact more than just external reports. We found that fund balances were overstated and did not lapse back into the general fund as prescribed; fund balances reserved for encumbrances were overstated; and intergovernmental revenues were not recognized in the proper period.

First, the Workers' Compensation Interdepartmental (S302) fund balance and Unemployment Insurance Interdepartmental (S304) fund balance were overstated by approximately $1,494,000 and $861,000, respectively, as these fund balances should have lapsed back to the State's general fund at June 30, 2006. The *General Appropriations Act of 2005,* Act 178, Session Laws of Hawai‘i 2005, which provides appropriations and authorizations for the fiscal biennium 2005-2007, designates both these funds as "U" funds—that is, as a means of financing they enable interdepartmental transfers. The funds are not established statutorily to maintain excess cash. Therefore, the fund balances should lapse at fiscal year-end and not carry over to the next fiscal year.

Ordinarily, upon notice from a department, a journal voucher to lapse the funds is initiated and prepared by DAGS. However, the DHRD journal voucher was not processed until September 29, 2006, by DAGS on its own accord. The department failed to recognize an adjustment was needed and did not notify DAGS of the adjustment or request that the CPA firm adjust its financial statements as of June 30, 2006.

Second, we found that the June 30, 2006 fund balance reserved for encumbrances was overstated by approximately $202,000 because the department included balances from expired contracts in the reserved for encumbrances balance. Out of 14 items selected for testing, we found five contracts expired prior to June 30, 2006, as noted in Exhibit 2.1.

Exhibit 2.1
Expired Contracts

Contract Number	Vendor	Expired Amount	Expiration Date
4787101	Child & Family Service	$52,000	June 30, 2002
4787102	Child & Family Service	18,000	June 27, 2003
4787103	Child & Family Service	92,000	June 28, 2004
4787104	Child & Family Service	20,000	June 28, 2005
5347001	Child & Family Service	20,000	June 28, 2006
	TOTAL	$202,000	

Source: Department of Human Resources Development

We were informed by the department that this vendor was contracted to provide counseling services for the Project REACH program, a state initiative, but the actual amount of services provided was less than the estimated contract amount resulting in the expired amount. Although the Employee Assistance Office within the Employee Relations Division had previously monitored the expirations of encumbered contracts, the responsibility for this function was not explicit in any formal policies and procedures. Therefore, over time, the review process simply did not occur, resulting in this overstatement.

Third, revenues, receivables, and net assets were understated in the government-wide financial statements by approximately $5,000, $110,000 and $105,000, respectively. Government accounting standards require that financial statements be reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are to be recorded when earned, regardless of the timing of its related cash flows. During the period of our audit, we found that intergovernmental revenues were not recognized in the proper period. We tested 91 percent of the revenues and noted seven out of 60 transactions tested in which the department failed to accrue for certain revenues earned during the period from June 16 through June 30 and for other services performed in the proper period.

Finally, and most significantly, the department grossly misstated workers' compensation expense and liability balances as of June 30, 2006. The severity of this issue resulted in a separate material weakness that is discussed in detail below.

Recommendations

The department should train current staff and enable them to, or hire qualified accounting personnel with the relevant expertise and experience necessary to, perform the following functions:

- prepare accurate and complete GAAP financial statements,
- design, monitor, and evaluate the internal controls and financial reporting functions of the department,
- provide periodic training (at least annually) to the appropriate personnel for new accounting pronouncements and changes to the reporting requirements, and
- review the FAMIS reports on a timely basis to identify any discrepancies or adjustments required.

No Functional Ownership of the Workers' Compensation Program Exists

While the lack of accounting knowledge has led to the department's inability to produce accurate financial statements, a failure to take ownership of workers' compensation raises further questions of stewardship. The department is responsible for the processing of claims and administering of workers' compensation funds; however, it does not systematically calculate, track, and report approximately $29 million in related liabilities. Additionally, there are no formal, written policies and procedures governing the entire function.

Given that the department is responsible for the majority of the State's employees and that the average amount of loss expense is $7.6 million over the last two years, it is irresponsible to not have clear guidance. While the duties of initial reserve setting and claims processing have evolved over time, management opts to not formalize this in fear of potential liability. No clear review process exists, and often claims processing is subjective. This has led to errors in processing that could otherwise have been prevented. Moreover, in much the same way that accurate financial reporting is not a priority, accuracy in claims processing data is also lacking.

The State's workers' compensation responsibilities include establishing and updating reserves

The Employee Claims Division within the department is responsible for planning and administering the State's Workers' Compensation Program for 18 executive branch agencies and the Legislature. The only entities specifically excluded are the Department of Education and the University of Hawai'i. Additionally, the department administers the claims for the Department of Transportation and the Stadium Authority but does not receive appropriations for, and is not responsible to pay, related benefits. The department's responsibilities include the administering of funds appropriated for the purpose of paying workers' compensation benefits for employees in general funded and certain federally funded positions. During FY2006, 560 new workers' compensation claims were opened, which are part of the $6.6 million in claims and benefits expenditures. At June 30, 2006, there were approximately 1,680 total active claims being administered by the department.

The department's responsibilities for workers' compensation are not limited to the processing of claims and making related payments. Equally important is estimating all future payments that will need to be made on individual cases and establishing reserves for the total liability. These reserves must be periodically reviewed and updated because, as claim information changes, the estimated future liability changes.

At the end of each reporting period, another reserve is necessary to capture the possibility of future claims. Incurred But Not Reported (IBNR) reserves represent estimated liabilities for employees who were injured during the reporting period but who do not file the related claims with their respective departments until after the end of the period. As provided in Section 386-82, Hawai'i Revised Statutes (HRS), an employee is entitled to compensation within two years after the date at which the effects of the injury for which the employee is entitled to compensation have become manifest, and within five years after the date of the accident or occurrence which caused the injury. Therefore, it is common for employees to sustain injuries during a fiscal year and report them to their department long after the fiscal year ends, thus requiring a reserve liability. Governmental Accounting Standards Board Statement

No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 22, instructs that a "liability for unpaid claims costs, including estimates of costs related to incurred but not reported claims, should be accrued when insured events occur."

A systematic process for establishing, reviewing, and updating reserves is critical in ensuring accurate workers' compensation reserves, including IBNR. In addition to satisfying accounting and reporting requirements, accurate workers' compensation reserves allow the State to plan for this significant liability and ensure funds will be available to meet these legal obligations as they become due.

The department does not recognize its $29 million workers' compensation liability

Ultimately, the department does not think it is important to track over $29 million related to workers' compensation claims that it, and the State, will be liable for paying. The department does not feel it is responsible for calculating or reporting the total reserves on claims it is responsible for, including IBNR, on an ongoing basis, as these amounts are reported in the statewide Comprehensive Annual Financial Report (CAFR). While it is true that workers' compensation reserves are reported in the State's CAFR, we believe that this does not absolve the department of its responsibility to report the reserves as well as to maintain accurate records.

Workers' compensation data is maintained in the Human Resource Management System but the department does not track or report the total related reserves. The department did generate a workers' compensation reserve report as of June 30, 2006, which was then recorded by the CPA firm it hired to compile its financial statements. However, the reserve report was generated only in anticipation of our audit, and the department-hired CPA firm found that the reserve report understated the related expense and liability by approximately $672,000. Further, based on our audit work, we found additional, significant errors with the reserve report, as delineated in Exhibit 2.2 and explained further below. We emphasize that the misstatements discovered during our audit and presented below are based on testing of only a sample of the total claims, and that the total actual misstatement could be much larger if the entire population was reviewed or if known errors were extrapolated over the entire population.

Exhibit 2.2
Workers' Compensation Expense and Reserve as of, and for the Year Ending June 30, 2006

	Workers' Comp Expense	Workers' Comp Reserve	Incurred But Not Reported
Reported by DHRD (per CPA-prepared trial balance)	$6,550,000	$0	$0
Adjustments posted by another CPA firm:			
Per Workers' Compensation Reserve run report	0	28,553,000	0
Additional adjustments	672,000	672,000	0
Unaudited balances (per CPA prepared trial balance)	7,222,000	29,225,000	0
Misstatements found by our audit:			
Changes made to claims reserve balance after year-end but not properly recorded	(1,567,000)	(439,000)	0
Reserves closed after year-end but not updated to reflect actual payments	(278,000)	(364,000)	0
Payments per claims detail did not agree to actual payments made	(372,000)	(372,000)	0
Unrecorded IBNR	(528,000)	0	1,201,000
Total misstatements	(2,745,000)	(1,175,000)	1,201,000
Corrected balance, for known misstatements	$4,477,000	$28,050,000	$1,201,000

Source: Compiled by Accuity LLP

The department is responsible for providing centralized management of workers' compensation claims for most of the State's employees, including administering the funds appropriated for the purpose of paying workers' compensation benefits. As the responsibility for the processing and administering of funds is held within the department, the department should also report the liability for the Workers' Compensation Program, including IBNR.

Workers' compensation claims reserve records are inaccurate

Reporting responsibilities aside, the department should maintain accurate workers' compensation records so that the *amount* of the liability reported is proper. Currently, DAGS calculates the workers' compensation reserve related to claims handled by the department, which is subsequently audited and reported in the State's Comprehensive Annual Financial Report (CAFR). However, this calculation is based on historical payroll and insurance data and does not rely on claims specific data. While this approach may satisfy applicable accounting and auditing standards, it confirms our finding that the department does not maintain accurate workers' compensation claims records.

As noted in the most recent State of Hawai'i *Report on Internal Control over Financial Reporting and on Other Matters* as of June 30, 2005 (issued in conjunction with the CAFR audit), "the claims reserves report accumulated [by the Department of Human Resources Development] in the current year continues to be inaccurate and unreliable for purposes of determining the State's estimated workers' compensation liability." The internal control report further recommends that the department "should maintain adequate documentation in claims files to support its estimates of future expected costs for all open claims (case reserves)" and "should perform an actuarial analysis of the required reserve estimate using generally accepted actuarial techniques."

Impact of unrecorded IBNR is not understood

In addition to the responsibilities of maintaining accurate records, the department must understand the importance of recognizing these liabilities as soon as it can be reasonably estimated. Recording the IBNR is an integral responsibility when administering workers' compensation since it recognizes the potential that a claim may come in years after an incident occurs and provides a mechanism for the department to meet GASB standards requiring the recordation of the impact.

The department currently records the workers' compensation claims and benefits expenditures as the claims are paid, identifying them with the related cash flows. IBNR claims represent additional expenses related to workers' compensation claims that the department is liable for as of the fiscal year end but unaware of until subsequent to that fiscal year end. Since IBNR requires analysis of potential claims and workers' compensation claims are tracked based on the cash flows, IBNR had never been recorded. Therefore, recording the IBNR reserve based on a historical loss analysis and future projections will allow the department and the State to adequately budget and plan for these future obligations.

Staff are not equipped to calculate a reasonable IBNR reserve

The department's staff neither understands the need to record IBNR, nor are they well equipped to perform these calculations. The calculation of IBNR reserves is complex, relying on a combination of assumptions and estimates, which can be subjective, and case file information provided by the department. Due to the complexity of the task of calculating the IBNR reserve, the calculation is usually performed by a loss reserve specialist using various statistical models.

Currently the department does not have staff qualified to perform these calculations, nor is a specialist contracted to perform this analysis. As noted by the American Institute of Certified Public Accountant's Audit Guide, *Audit of Property and Liability Insurance Companies*, Chapter 4.70, "the absence of involvement by a loss reserve specialist in the determination of management's estimate may constitute a reportable condition and possibly a material weakness in the entity's internal control." However, until the department can resolve its problems with accurate recording and reporting of its financial and workers' compensation information, using a loss reserve specialist would be ineffective.

We estimated the IBNR reserve based on a ten year historical loss analysis using workers' compensation payment reports generated by the department. As Section 386-82, HRS, provides for a five year time frame after the date of injury for liability purposes, we calculated the average percentage of claims paid within five years. Using these percentages and actual claims payments, we estimated the amount of claims to be reported in the years subsequent to June 30, 2006 for injuries occurring as of June 30, 2006, shown as Exhibit 2.3.

Exhibit 2.3
Workers' Compensation Claims – Incurred But Not Reported Reserves

Year of Injury	Claims Paid as of June 30, 2006	Incurred But Not Reported Reserves
2002	$12,451,000	$21,000
2003	6,731,000	11,000
2004	8,476,000	28,000
2005	6,588,000	191,000
2006	4,962,000	950,000
Total		**$1,201,000**

Source: Compiled by Accuity LLP using claims paid data from reports generated from the department's Human Resource Management System

Based on a lack of understanding of the importance of recording IBNR, the staff's inability to calculate IBNR, and inaccurate or incomplete data to rely on, the department does not calculate or record an IBNR reserve.

Unclear responsibilities, polices, and procedures contribute to errors

The department has no formal policies and procedures with respect to either the workers' compensation reserve or the IBNR. The process of initial creation and subsequent closure of reserves has evolved over time, with certain key individuals driving the function. The department elects not to adopt formal policies over the processing of workers' compensation claims; however, this has led to errors and significant misstatements of related balances.

The workers' compensation claims process is informal

No formal policies exist over the approval of workers' compensation claims, establishment of reserves, processing of payments, and reporting and reviewing claims activity. For example, when claims are first received by the department, the personnel program manager establishes the initial reserve. However, the reserve calculation is not based on any established or documented criteria, as the personnel program manager relies on her 30 plus years of experience. Additionally, there is no systematic process for reviewing and updating the reserve to coincide with and reflect significant activity, such as when claim payments are made. The entire Workers' Compensation Program is governed by informal procedures that have evolved over time to meet the department's needs. These informal procedures do include checks to ensure that incoming claims are accompanied with appropriate forms and that claim payments are proper. However, if these procedures are not documented there is no assurance that they are consistently applied, greatly increasing the likelihood of errors. Moreover, the turnover or extended absences of key personnel could compromise the continuity of the entire program.

Lack of rules intended to avoid potential liability

Surprisingly, the department claims it was advised by the Department of the Attorney General not to have formal, written policies regarding workers' compensation claims that could subject the department or State to potential administrative proceedings if it failed to comply with such policies. However, the department was unable to provide any record or documentation of this guidance received from the Department of the Attorney General.

In addition to not establishing procedures over the Workers' Compensation Program, the department does not concern itself with accurate reporting of claims activity. The department feels that its primary concern is to pay the claims timely, while the reporting of workers' compensation reserves is not a priority. However, as stewards of the Workers' Compensation Program, claims data, and allocated funds, the department needs to take ownership of the entire process, especially considering the magnitude of dollars.

A lack of written policies feeds into the department's current practice of reporting and recording workers' compensation data when convenient to its employees' schedules. In effect, this leads to large misstatements which affect the workers' compensation reserve balance. Misstatements noted in our current audit arose from adjustments to claims balances after year-end that were not properly recorded; claim reserves closed subsequent to year-end but not updated to reflect actual, final payments; case reserves details excluding previous payments; and under-reserving or over-reserving on claims due to simple typographical errors with no oversight.

Lax policies result in significant errors and misstatements

Gross misstatements to the department's workers' compensation expense and liability accounts are the result of no formal policies, as the department failed to identify and record certain adjustments to the reserve liability and related expense account in the proper fiscal year end. Due to the nature and significance of the department's workers' compensation reserve balance, we tested a sample of 225 and 176 claims reserve balances at June 30, 2006 and 2005, respectively. We obtained the claim files and compared the payments to supporting documentation, noting several errors that resulted in various misstatements to the reserve balances.

We noted deficiencies in the department's process to ensure the State's workers' compensation liability was properly analyzed and reported for the year ended June 30, 2006. Many of the misstatements could have been avoided if clear guidance had been available to employees. Misstatements were caused by time lags between posting of payments and when payments were made. Duplication of payments occurred and was not readily identified by the department. Previous payments made by other state departments were not properly communicated to prevent duplication at a later date. In addition, no process is in place for the calculation and recording of IBNR.

For example, changes or adjustments to the claims balances after the year-end were not properly recorded by the department, which resulted in the reserve balance being overstated by approximately $439,000 at June 30, 2006 and understated by approximately $1.1 million at June 30, 2005. Losses should be reflected in the year the injury occurred or based on other known factors, and the reserve balance should be adjusted for changes to the estimates. According to GASB Statement No. 10, paragraph 22, "A liability for unpaid claims costs, including estimates of costs relating to incurred but not reported claims, should be accrued when insured events occur . . . that liability should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience."

In addition, we identified 60 workers' compensation claim reserves that were closed subsequent to year-end, but the actual claim reserves were not updated to reflect the final payments, resulting in an overstatement of the reserve balance of $242,032. Additional procedures performed on reserves not selected for testing increased the overstatement to approximately $364,000 and $86,000 at June 30, 2006 and 2005, respectively. Based only on our sample testing, we noted an overstatement of reserves, as shown by type in Exhibit 2.4.

Exhibit 2.4
Overstatement of Reserve Type

Reserve Type	Instances	Overstated
Permanent partial disability	10	$106,680
Medical expense	20	98,083
Administrative expense	20	25,177
Temporary total disability	6	7,025
Temporary partial disability	2	4,642
Disfigurement	2	425
Total	**60**	**$242,032**

Source: Compiled by Accuity LLP's testing from Department of Human Resources Development summary warrant vouchers

The department generally reviews claims files on a quarterly basis and will "zero out" any remaining reserve balance for closed claims. However, the department had not performed the quarterly review from June 30, 2006 through our testing date of October 23, 2006, and therefore the above errors related to closed claims were not identified by the department.

Further, the amount reflected as paid according to the workers' compensation reserve detail as of June 30, 2006 did not agree with the actual payments for the following reserves, resulting in the net overstatement reflected in Exhibit 2.5.

Exhibit 2.5
Claims Misstatements

Claim Number	Reserve Type	Misstatement
19710013	Permanent total disability	$(1,074)
29840831	Permanent total disability	(1,089)
20241027	Temporary total disability	(1,046)
20440208	Temporary total disability	(869)
20540216	Temporary total disability	(150)
28941329	Temporary total disability	(652)
29740281	Temporary total disability	(1,074)
29840831	Temporary total disability	69,685
20440611	Administrative expense	(8)
29840831	Administrative expense	234
20441065	Medical	(117)
70210162	Medical	(619)
	Total, Net	**$63,221**

Source: Compiled by Accuity LLP's testing according to the Department of Human Resources Development's reserve detail report and summary warrant vouchers

The errors noted above could have been avoided had there been a clear written policy detailing employees' responsibilities with respect to recording workers' compensation transactions. A time lag exists between the date the payments are posted to the workers' compensation reserve report by the department and the date the payments are actually made by DAGS, resulting in an understatement of the reserve balance. The department recorded the payment when authorized, as of June 30, 2006, but the payment was not processed until after June 30, 2006. We identified five case reserves with a net understatement of approximately $1,800.

Additionally, the amount identified as paid on the workers' compensation reserve detail improperly included duplicate amounts that were not paid. Corrections were made after June 30, 2006, rather than as of June 30, 2006. We identified five case reserves with a net understatement of approximately $4,900. Amounts identified as paid on the workers' compensation reserve detail improperly excluded previous payments made by the respective state departments prior to the department processing the workers' compensation claims. We identified two case reserves with a net overstatement of approximately $69,900.

We also noted that one claim reviewed was over-reserved by $339,000 and another claim was under-reserved by $30 due to key stroke inputting errors by the department personnel at June 30, 2006. Additional errors may exist, but they would likely not be discovered without an adequate review of the workers' compensation reserve listing by appropriate department personnel.

These errors and misstatements further underscore the department's lack of understanding of the importance of accurate reporting and record maintenance. As the workers' compensation liability is the most significant account balance for the department, it is essential that the reserve balance be accurately reported in the financial statements and reported to the State. However with no clear guidance it is unrealistic to expect more than minimal reporting and record maintenance.

Recommendations

Formal, written policies and procedures should be established related to workers' compensation claims. The policies should include the following:

- guidelines for estimating the initial reserves;
- required documentation and level of detail to support the estimate;
- requirements to update claim information on a periodic basis;
- requirements to review adequacy of reserves on a periodic basis;
- requirements to record claim payments based on actual payments by DAGS rather than when authorized; and
- requirements to institute a checklist for all claim files to ensure necessary procedures are performed and documented.

When the policies are established and approved, they should be distributed, acknowledged, and enforced by those employees involved with workers' compensation claims. Additionally, formal training should be conducted to ensure these policies and procedures are properly implemented and monitored to ensure the workers' compensation claims are properly accounted for.

The department should also consider contracting a loss reserve specialist to actuarially evaluate and calculate the IBNR reserve due to the complexity of the analysis. In addition to assumptions and estimates, the analysis also involves using historical loss data in conjunction with statistical models to estimate the IBNR reserve. Therefore, it is essential that the underlying historical loss data maintained by the department be accurate, as the specialist is not responsible for the accuracy of the data.

Chapter 3
Financial Audit

This chapter presents the results of the financial audit of the Department of Human Resources Development (department) as of and for the fiscal year ended June 30, 2006. This chapter includes the independent auditors' report and the report on internal control over financial reporting and compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays the department's financial statements together with explanatory notes.

Summary of Findings

In the opinion of Accuity LLP, based on its audit, the financial statements present fairly, in all material respects, the financial position of the general fund and human resources development special fund for the department as of June 30, 2006, and the respective changes in financial position and the respective budgetary comparison for the general and major special revenue funds for the year then ended in conformity with accounting principles generally accepted in the United States of America. However, Accuity LLP was not able to apply auditing procedures to satisfy themselves regarding the amounts reported as workers' compensation liability and the related workers' compensation expense in the statement of net assets and statement of activities. Additionally, Accuity LLP disclaimed opining on the workers' compensation and unemployment insurance interdepartmental accounts in the governmental funds. Accuity LLP noted certain matters involving the department's internal control over financial reporting and its operations that the firm considered to be 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.* Accuity 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

To 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 Human Resources Development, State of Hawai'i (department), as of and for the year ended June 30, 2006, which collectively comprise the department's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the department's management. Our responsibility is to express opinions on these financial statements based on our audit.

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

As discussed in Note 1, the financial statements of the department are intended to present the financial position and the changes in financial position 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, 2006, 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.

The department's accounting for workers' compensation liability of $29,225,000 and the related workers' compensation expense of $7,221,978 do not provide sufficient evidence to support the amounts that should be reported in the statement of net assets and the statement of activities as of and for the year ended June 30, 2006. In addition, the workers' compensation and unemployment insurance interdepartmental account fund balances of $1,493,879 and $860,846, respectively, should have been reflected as lapsed appropriations in the governmental funds balance sheet and statement of revenues, expenditures and changes in fund balances as of and for the year ended June 30, 2006.

Because we were not able to apply auditing procedures to satisfy ourselves regarding the amounts reported as workers' compensation liability, the related workers' compensation expense and the workers' compensation and unemployment insurance interdepartmental accounts, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the statement of net assets, statement of activities and the workers' compensation and unemployment insurance interdepartmental account major funds as of and for the year ended June 30, 2006.

In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the general fund and human resources developmental special fund—major funds and the aggregate remaining fund information for the department as of June 30, 2006, and the respective changes in financial position and the respective budgetary comparison for the general and major special revenue funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 43 through 53 is not a required part of the basic financial statements but is 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.

In accordance with *Government Auditing Standards,* we have also issued our report dated January 19, 2007, 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 considered in assessing the results of our audit.

/s/ Accuity LLP
Honolulu, Hawai‘i
January 19, 2007

Report of Independent Auditors 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*

To the Auditor
State of Hawai‘i:

Except as discussed in the following paragraph, we have audited the financial statements of the governmental activities, each major fund and the aggregate remaining fund information of the Department of Human Resources Development, State of Hawai‘i, as of and for the year ended June 30, 2006, which collectively comprise the department's basic financial statements and have issued our report thereon dated January 19, 2007, which includes a disclaimer of opinion on the statement of net assets, statement of activities and the workers' compensation and unemployment insurance interdepartmental account major funds of the department. 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.

As described more fully in Chapter 2 of this report, the department's accounting for workers' compensation liability and the related workers' compensation expense do not provide sufficient evidence to support the amounts that should be reported in the statement of net assets and the statement of activities as of and for the year ended June 30, 2006. In addition, the workers' compensation and unemployment insurance interdepartmental account fund balances should have been reflected as lapsed appropriations in the governmental funds balance sheet and statement of revenues, expenditures and changes in fund balances as of and for the year ended June 30, 2006.

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 opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the 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 reportable 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 we reported to the Auditor, State of Hawai'i, and described in Chapter 2 of this report, we consider the matters regarding the accounting personnel and accurate financial reporting are not a priority of the department and that substantial misstatements were identified related to the workers' compensation liability to be material weaknesses, which 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 grant agreements, 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 or other matters 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 those specified parties.

/s/ Accuity LLP
Honolulu, Hawai‘i
January 19, 2007

Description of Basic Financial Statements

The following is a brief description of the department's basic financial statements audited by Accuity LLP, which are presented at the end of this chapter.

Management's discussion and analysis (Exhibit 3.1)

Management's discussion and analysis introduces the basic financial statements and provides a narrative overview and analysis of the department's financial activities for the fiscal year ended June 30, 2006.

Basic financial statements

Government-wide financial statements

Statement of Net Assets (Exhibit 3.2). This statement presents assets, liabilities and net assets of the department at June 30, 2006 using the accrual basis of accounting. This approach includes reporting not just current assets and liabilities, but also capital assets and long-term liabilities. The department's net assets are classified as invested in capital assets or unrestricted.

Statement of Activities (Exhibit 3.3). This statement presents revenues, expenses and changes in net assets of the department for the year ended June 30, 2006, using the accrual basis of accounting and presents a comparison between direct expenses and program revenues. Direct expenses are those that are specifically associated with a service or program and are therefore clearly identifiable to a particular function. Program revenues include charges paid by the recipients of the goods or services offered by the programs. State allotted appropriations are reported as general revenues. The comparison of program revenues and expenses identifies the extent to which each program or business segment is self-financing. 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 3.4). This statement presents assets, liabilities and fund balances by major governmental fund and the aggregate remaining fund information using the current financial resources measurement focus and 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.

Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds (Exhibit 3.5). This statement presents revenues, expenditures and changes in fund balances by major governmental fund and the aggregate remaining fund information using the current financial resources measurement focus and 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 Governmental Funds Balance Sheet to the Statement of Net Assets (Exhibit 3.6). This reconciliation identifies the types of differences between the fund balance of total governmental funds and net assets of governmental activities, as reported in the statement of net assets.

Reconciliation of the Governmental Funds Statement of Revenues, Expenditures and Changes in Fund Balances to the Statement of Activities (Exhibit 3.7). This reconciliation identifies the types of differences between the net changes in governmental funds and changes in net assets of governmental activities, as reported in the statement of activities.

Budgetary Comparison Statements (Exhibit 3.8 and Exhibit 3.9). These statements compare actual revenues and expenditures of the department's general and major special revenue funds on a budgetary basis to the budget adopted by the State Legislature for the year ended June 30, 2006.

Notes to Basic Financial Statements

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

Note 1 – Financial statement presentation

Reporting entity

The Department of Human Resources Development, State of Hawai‘i, is an agency of the executive branch of the State of Hawai‘i (State). The department administers the State’s personnel program, provides administrative support services to statutorily and executively assigned commissions or boards, and represents the State on other commissions and committees.

The financial statements of the department present the financial position and the changes in financial position of only that portion of the governmental activities, each major fund and the aggregate remaining fund information of the State that are attributable to the transactions of the department. The State comptroller maintains the central accounts for all State funds and publishes comprehensive financial statements for the State annually, which include the department’s financial activities.

Note 2 – Summary of significant accounting policies

Measurement focus, basis of accounting and financial statement presentation

The accounting policies of the department conform to accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB) through its statements and interpretations. The government-wide statement of net assets and statement of activities are accounted for on a flow of 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.

The accounts of the department are organized and operated on a fund basis. Each fund is a separate fiscal and accounting entity, consisting of self-balancing accounts that comprise its assets, liabilities, fund balance, revenues and expenditures, as appropriate. The funds are segregated for the purpose of carrying on specific activities or attaining certain objectives. The department uses 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. 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. The following are the department's governmental-fund types:

General Fund – accounts for all financial activities of the department, except those required to be accounted for in another fund. The general fund presented is part of the State's general fund and is limited only to those appropriations and obligations of the department.

Special Revenue Funds – account for the proceeds of specific revenue sources that are legally restricted to be expended for specified purposes. Revenues are primarily from interdepartmental payroll assessments and fees. The department's major special revenue funds are as follows:

Human Resources Development Special Fund – The purpose of this fund is to support and facilitate the department's entrepreneurial initiatives, training activities and programs for government employees. The fund covers expenses related to developing and conducting employee training programs and entrepreneurial activities such as providing workers' compensation claims management and premium conversion plan administration services to other agencies. The fund receives participant fees for in-service training, fees for services provided under entrepreneurial initiatives and from other sources such as grants and awards.

Workers' Compensation Interdepartmental Account – This fund is used to pay workers' compensation benefits for certain federally funded employees of the State. Revenues of the fund are primarily from payroll assessments from other State departments that have employees in federally funded positions. At June 30, 2006, the remaining funds in this account of $1,493,879 should have been reflected as lapsed appropriations in the governmental funds balance sheet and statement of revenues, expenditures and changes in fund balances.

Unemployment Insurance Interdepartmental Account – This fund is used to pay unemployment insurance benefits to former State employees who worked in federal or special funded positions. Revenues of the fund are primarily from payroll assessments from other State departments that have employees in federal or special funded positions. At June 30, 2006, the remaining funds in this account of $860,846 should have been reflected as lapsed appropriations in the governmental funds balance sheet and statement of revenues, expenditures and changes in fund balances.

All governmental-fund types are accounted for using the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recorded when susceptible to accrual, that is, both measurable and available, usually when the appropriations are allotted. Expenditures are generally recognized when the related liability is incurred, as under accrual accounting. Exceptions include employees' vested annual leave which is recorded as an expenditure when utilized. The amount of accumulated annual leave unpaid at June 30, 2006 of approximately $1,435,000 has been reported only in the government-wide financial statements.

Encumbrances

Encumbrance accounting is employed in the governmental-fund types, 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 year-end are reported as reservations of fund balances since the commitments will be honored when the goods or services are received.

Cash and short-term investments

Cash and short-term investments reported in the statement of net assets and the governmental funds balance sheet consist of cash and short-term investments held in the State Treasury.

The State maintains a cash pool that is available for all funds. Each fund type's portion of this pool is displayed on the statement of net assets and the governmental fund balance sheet within cash and short-term investments. Those funds are pooled with funds from other State agencies and departments and deposited in approved financial institutions by the State director of finance. Deposits not covered by federal deposit insurance are fully collateralized by government securities held in the name of the State by third party custodians. Interest income from this cash pool is allocated to the various departments and agencies based upon their average cash balance for the period.

The Hawai‘i Revised Statutes (HRS) authorizes the State director of finance to invest in obligations of or obligations guaranteed by the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit and repurchase agreements with federally-insured financial institutions.

Capital assets

Capital assets, which include buildings, improvements, furniture and equipment, are reported in the government-wide financial statements.

Capital assets are defined as assets with an initial individual cost of $5,000 or more for furniture and equipment and $100,000 for buildings and improvements at the date of acquisition. Donated assets are recorded at their fair market value at the date of donation. Capital assets acquired by the department are recorded as expenditures in the governmental fund financial statements. Capital assets are capitalized and depreciated in the government-wide financial statements on the straight-line method over the following estimated useful lives:

Buildings and improvements	30 years
Furniture and equipment	5-12 years

Departments sharing the same building and improvements with other departments of the State report their respective allocated share of the cost as determined by the State's Department of Accounting and General Services.

Workers' compensation liability

The department is assigned responsibility for the administration, processing and payment of workers' compensation claims and benefits for certain State departments. The workers' compensation liability represents the estimated ultimate net cost of all reported losses incurred through the date of the financial statements. The department has established a liability for the estimated workers' compensation claims and benefits which the department expects to pay in future periods. The obligation is expected to be liquidated through appropriations through the State's general fund.

As of June 30, 2006, the workers' compensation liability of $29,225,000 and the related workers' compensation expense of $7,221,978 did not include incurred but not reported (IBNR) reserves which represent estimated liabilities for employee injuries that have occurred during the fiscal year, but the claims have not been reported to the department until after the fiscal year. In addition, the department did not adjust the June 30, 2006 workers' compensation liability and related expense accounts for certain closed claims and adjustments to claims as of fiscal year end. Therefore, the workers' compensation account balances do not accurately reflect the amounts that should be reported in the statement of net assets and the statement of activities as of and for the year ended June 30, 2006.

Accrued vacation and sick leave

Eligible employees are credited with vacation at a rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year-end and is convertible to pay upon termination of employment. The governmental fund financial statements record expenditures when employees are paid for leave. The government-wide financial statements present the cost of accumulated vacation leave as a liability. Liabilities for vacation pay are inventoried at the end of each accounting period and adjusted to current salary levels.

Eligible employees are credited with sick leave at a rate of one and three-quarter days per month. Unused sick leave may be accumulated without limit but can be taken only in the event of illness or other incapacitation and is not convertible to pay upon termination of employment. Accordingly, accumulated sick leave is not included in the department's statement of net assets or governmental fund balance sheet. However, an employee who retires or leaves government service in good standing with 60 days or more in unused sick leave is entitled to additional service credit in the Employees' Retirement System of the State of Hawai'i (ERS). Accumulated sick leave as of June 30, 2006 was approximately $5,911,000.

Appropriations

An authorization granted by the State Legislature permitting a state department, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year.

Program revenues

The department charges fees that include training and registration fees and assessments for workers' compensation claims and unemployment compensation benefit payments.

Employee benefit costs

Costs for pension, health, social security and workers' compensation benefits for governmental funds are recorded in the respective funds. These costs relating to the general fund are not charged to the department by the State whereas costs applicable to the special revenue funds are reflected as expenditures in the respective funds.

Intrafund and interfund transactions

Significant transfers of financial resources between activities and appropriations included within the same fund are eliminated. 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. All interfund transfers are reflected in the governmental fund financial statements but are eliminated in the government-wide financial statements.

Use of estimates

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

Note 3 – Budgeting and budgetary control

The department's annual budget is prepared on the cash basis utilizing encumbrance accounting. Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected by the department as budgeted revenues are those estimates as compiled by the State director of finance. Budgeted expenditures for the department's general fund are provided to the Department of Budget and Finance, State of Hawai‘i, for accumulation with budgeted amounts of the other state agencies and included in the governor's executive budget that is subject to legislative approval.

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 State Legislature specifies the lapse dates and any other contingencies that may terminate the authorizations for other appropriations.

For purposes of budgeting, the department's budgetary fund structure and accounting principles differ from those utilized to present the financial statements in conformity with accounting principles generally accepted in the United States of America. Since the budgetary basis differs from accounting principles generally accepted in the United States of America, budget and actual amounts in the statements of revenues and expenditures - budget and actual, are presented on the budgetary basis. 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 accounting principles generally accepted in the United States of America, revenues are recognized when they become available and measurable, and expenditures are recognized as incurred.

A reconciliation of the general and major special revenue funds' revenues in excess of expenditures on a budgetary basis for the year ended June 30, 2006, to the general and major special revenue funds' revenues in excess of expenditures presented in conformity with accounting principles generally accepted in the United States of America (GAAP basis), is set forth below.

	General Fund	Human Resources Development Special Fund	Workers' Compensation Inter-departmental Account	Unemployment Insurance Inter-departmental Account
Excess of revenues over expenditures — actual (budgetary basis)	$ 1,542,193	$ 16,673	$ 1,493,879	$ 860,846
Reserved for encumbrances at year-end	283,794	-	-	-
Expenditures for liquidation of prior year encumbrances	(110,926)	(3,783)	-	-
Net adjustments for accrued expenses	(29,261)	24,481	-	-
Excess of revenues and other financing sources over expenditures and other financing uses — actual (GAAP basis)	$ 1,685,800	$ 37,371	$ 1,493,879	$ 860,846

Note 4 – Cash and short-term investments held in State Treasury

Cash and short-term investments include monies in the State Treasury. The State Treasury maintains an investment pool for all state monies. Hawai'i law authorizes the state director of finance to invest any monies of the State which in the director's judgment are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of or guaranteed by the U.S. government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit and repurchase agreements with federally-insured financial institutions.

Information relating to the bank balance, insurance and collateral of cash deposits is determined on a statewide basis and not for individual departments or divisions.

As of June 30, 2006, the carrying amount, which approximates the bank balance of the department's cash and short-term investments, was $3,646,951 for its governmental funds.

Note 5 – Capital assets

The changes to capital assets as of June 30, 2006 were as follows:

	Balance July 1, 2005	Additions	Disposals/ Retirements	Balance June 30, 2006
Buildings and improvements	$ 10,124,368	$ -	$ -	$ 10,124,368
Furniture and equipment	1,991,013	50,183	(50,215)	1,990,981
Total capital assets	12,115,381	50,183	(50,215)	12,115,349
Less: accumulated depreciation	6,061,945	615,176	(50,215)	6,626,906
Capital assets - net	$ 6,053,436	$ (564,993)	$ -	$ 5,488,443

Depreciation expense for the year ended June 30, 2006 was charged to the department's functions as follows:

General administration	$ 82,269
Employee claims	149,348
Employee classification and compensation	92,929
Employee relations	140,539
Employee staffing	150,091
Total depreciation expense	$ 615,176

Note 6 – Long-term obligations

The changes in long-term obligations as of June 30, 2006 were as follows:

	Balance July 1, 2005	Increase	Decrease	Balance June 30, 2006	Due Within One Year
Workers' compensation liability	$ 28,553,000	$ 7,221,978	$ (6,549,978)	$ 29,225,000	$ 6,500,000
Accrued vacation	1,415,530	461,162	(441,990)	1,434,702	582,000
Capital lease obligations	58,210	12,300	(21,198)	49,312	24,800
Total	$ 30,026,740	$ 7,695,440	$ (7,013,166)	$ 30,709,014	$ 7,106,800

The activity in the workers' compensation liability for the year ended June 30, 2006 is summarized as follows:

Balance at beginning of year	$ 28,553,000
Incurred related to	
Current year	5,021,486
Prior year	2,200,492
Total incurred	7,221,978
Paid related to	
Current year	(1,005,112)
Prior year	(5,544,866)
Total paid	(6,549,978)
Balance at end of year	$ 29,225,000

Obligations for the workers' compensation liability and accrued vacation are generally liquidated by appropriations from the State's general fund.

The department leases various office equipment under noncancelable leases expiring at various dates through December 2010. These leases meet the criteria for capitalization established by Financial Accounting Standards Board Statement No. 13, as amended. The leases are financed from general government resources. The estimated value of the leased equipment at the inception of the capital leases aggregated approximately $110,300. The future minimum payments under capital leases as of June 30, 2006 are as follows:

Fiscal year ending June 30,		
2007	$	28,800
2008		17,400
2009		4,900
2010		2,900
2011		1,500
Total minimum lease payments		55,500
Less: Amount representing interest at 7.2% to 17.7%		(6,188)
Obligation under capital leases	$	49,312

Capital lease expenditures for the year ended June 30, 2006 approximated $21,200 and $6,100 for principal and interest, respectively.

Note 7 – Retirement benefits

Employees' Retirement System

Substantially all eligible employees of the department are members of the Employees' Retirement System of the State of Hawai'i (ERS), a cost-sharing, multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and service-connected disability benefits. All contributions, benefits and eligibility requirements are established by Chapter 88, HRS, and can be amended by legislative action.

The ERS is composed of a contributory retirement option and a noncontributory retirement option. Prior to July 1, 1984, the ERS consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under social security. Persons employed in positions not covered by social security are precluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of 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 and prior to January 1, 2003, is based on the three highest paid years of service, excluding the vacation payment. Effective January 1, 2003, the AFC is the highest three calendar years or highest five calendar years plus lump sum vacation payment, or highest three school contract years, or last 36 credited months or last 60 credited months plus lump sum vacation payment. Contributions for employees of the department are paid from the State general fund.

Most covered employees of the contributory option are required to contribute 7.8 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 amortize the unfunded actuarial accrued liability over the remaining period of 27 years from June 30, 2002.

Actuarial valuations are prepared for the entire ERS and are not separately computed for each department or agency. Information on vested and nonvested benefits, and other aspects of the ERS is also not available on a departmental or agency basis.

The department's general fund share of the retirement system expense for the year ended June 30, 2006, was included in the Supplemental Appropriations Act as an item to be expended by the Department of

Budget and Finance and is not reflected in the department's general fund financial statements. No contributions were required by the department's special revenue funds.

ERS issues a Comprehensive Annual Financial Report (CAFR) that includes financial statements and required supplementary information, which may be obtained from the following address:

Employees' Retirement System of the State of Hawai'i
201 Merchant Street, Suite 1400
Honolulu, Hawai'i 96813

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 those retiring with ten or more years of credited service, and 50 percent of the monthly premium for those retiring with fewer than ten years of credited service. For employees hired after June 30, 1996, and retiring with fewer than ten years of service, the State makes no contributions. For those retiring with at least ten 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 retiring 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; and for those retiring with over 25 years of service, the State pays the entire health care premium. There are currently approximately 24,600 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 a reimbursement for the basic medical coverage premium. Contributions are financed on a pay-as-you-go basis. The department's general fund share of the expense for post-retirement health care and life insurance benefits for the year ended June 30, 2006 was paid from the State's general fund and is not reflected in the department's financial statements. There was no expense for the department's special revenue funds.

Effective July 1, 2003, the Hawai'i Employer-Union Health Benefit Trust Fund (EUTF) replaced the Hawai'i Public Employees Health Fund under Act 88, SLH 2001. The EUTF was established to provide a single delivery system of health benefits for state and county employees, retirees and their dependents.

Note 8 – Commitments and contingencies

Litigation

The department is involved in several lawsuits and complaints which the department believes arose in the normal course of operations. Based on discussion with counsel, management has ascertained that lawsuits and complaints against the State of Hawai‘i are typically paid through an appropriation from the State’s general fund. Accordingly, the department is of the opinion that the outcome of these lawsuits and complaints will not have a material adverse effect on the financial position of the department.

Insurance

Insurance coverage is maintained at the state level. The State is self-insured for substantially all perils including workers’ compensation. The State is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; and workers’ compensation; however, the State has property, crime and other liability insurance policies in force through various outside insurance carriers to mitigate this risk. The State generally retains the risk of losses up to deductible amounts per occurrence, and for amounts over the coverage limits. Losses not covered by the insurance policies are paid by the State’s general fund or through legislative appropriation.

Deferred compensation plan

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

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but has the duty of due care that would be required of an ordinary prudent investor. The department has the fiduciary responsibility of administering the plan; however, the plan’s assets are not reflected in the department’s or State’s financial statements.

Note 9 – Related party transactions

As the administrator of the State’s Workers’ Compensation Insurance Program, the department is required to pay to the State Workers’ Compensation Insurance Special Compensation Fund amounts prescribed by the fund’s director in accordance with Sections 386-151 and -152, HRS. During the year ended June 30, 2006, the department paid $464,461 to the State Workers' Compensation Insurance Special Compensation Fund.

Although the department administers the State's unemployment insurance funds, unemployment insurance claims are paid by the State Department of Labor and Industrial Relations (DLIR). Accordingly, during the year ended June 30, 2006, the department transferred $1,299,177 to DLIR for payment of unemployment insurance claims.

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GOVERNOR OF HAWAII

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235 S. BERETANIA STREET
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MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2006

The Department of Human Resources Development (Department) was established on November 25, 1959 by Act 1, Session Laws of Hawaii, Second Special Session 1959. The Department administers the State of Hawaii's (State) personnel program, provides administrative support services to statutorily and executively assigned commissions or boards, and represents the State on other commissions and committees. The Department is also responsible for handling workers' compensation claims filed by Executive Branch employees (not including the University of Hawaii and State Department of Education), Charter School employees pursuant to statute, and the Legislature who suffer injuries or illnesses arising out of and in the course of their employment. This includes authorizing benefits for payment of lost wages and medical expenses relating to the injury or illness. As management of the Department, we offer readers of the accompanying financial statements this narrative overview and analysis of the financial activities of the Department for the fiscal year ended June 30, 2006. This discussion and analysis is designed to assist the reader in focusing on the Department's financial issues and activities. We encourage readers to consider the information presented here in conjunction with the basic financial statements as a whole.

Financial Highlights

- The liabilities of the Department exceeded its assets at June 30, 2006 by $23,075,767 (net assets).

- The deficit in unrestricted net assets decreased by $1,801,081 (6%) from the prior year.

- The Department's liabilities reported in the statement of net assets increased during the current fiscal year to $32,211,161, an increase of $709,824 (2%) from the prior year.

- At June 30, 2006, the Department reported combined ending fund balances of $2,144,804. Of this amount, $1,658,844 constitutes the unreserved fund balance.

Overview of the Basic Financial Statements

This discussion and analysis is intended to serve as an introduction to the Department's basic financial statements. The Department's basic financial statements are comprised of three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to basic financial statements.

Government-Wide Financial Statements

The government-wide financial statements are designed to provide readers with a broad overview of the Department's finances. These statements include current assets and liabilities as well as capital assets and long-term liabilities, and are prepared using the full accrual basis of accounting. All of the fiscal year's revenues and expenses are recorded as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, assets, liabilities, and expenses are reported in these statements for some items that will result in cash flows in future fiscal periods.

The *Statement of Net Assets* presents all of the Department's assets and liabilities, with the difference reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator to determine whether the financial position of the Department is improving or weakening.

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. State allotted appropriations not included among program revenues are reported as general revenues. This statement shows the extent to which the various functions depend on general revenues for support.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives.

The governmental funds financial statements focus on near-term inflows and outflows for spendable resources as well as on balances or spendable resources available at the end of the fiscal year. Such information may be useful in evaluating the Department's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities of the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Department's near-term financing decisions. Both the governmental funds balance sheet and the governmental funds statement of revenues, expenditures, and changes in fund balances provide reconciliations to facilitate this comparison between governmental funds and governmental activities.

The Department maintains several individual governmental funds. Information is presented separately in the governmental funds balance sheet and in the governmental funds statement of revenues, expenditures, and changes in fund balances for each of the major funds.

The Department adopts an annual appropriated budget for its General Fund. A budgetary comparison statement has been provided to demonstrate compliance with this budget.

Notes to Basic Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Government-Wide Financial Analysis

The following is a financial analysis on the governmental activities of the Department. Net assets are a useful indicator of a government's financial position. For the Department, total liabilities exceeded assets by $23,075,767, and net assets increased by $1,244,986 (5%) over the course of this fiscal year's operations.

The following table was derived from the government-wide statements of net assets.

Summary of Statement of Net Assets

June 30, 2006 and 2005 (unaudited)

	2006	2005	Increase (Decrease)
Assets:		(unaudited)	
Cash and short-term investments held in State Treasury	$ 3,646,951	$ 1,127,148	$ 2,519,803
Capital assets, net	5,488,443	6,053,436	(564,993)
Total assets	9,135,394	7,180,584	1,954,810
Liabilities:			
Vouchers payable	501,776	505,570	(3,794)
Accrued payroll and employee benefits payable	316,891	273,566	43,325
Due to other agencies	677,480	689,461	(11,981)
Due to State General Fund	6,000	6,000	-
Long-term liabilities:			
Due within one year -			
Workers' compensation liability	6,500,000	6,550,000	(50,000)
Accrued vacation	582,000	442,000	140,000
Capital lease obligations	24,800	21,200	3,600

Due in more than one year -			
Workers' compensation liability	22,725,000	22,003,000	722,000
Accrued vacation	852,702	973,530	(120,828)
Capital lease obligations	24,512	37,010	(12,498)
Total liabilities	32,211,161	31,501,337	709,824
Net Assets:			
Invested in capital assets,			
net of related debt	5,439,131	5,995,226	(556,095)
Unrestricted	(28,514,898)	(30,315,979)	1,801,081
Total net assets	$ (23,075,767)	$ (24,320,753)	$ 1,244,986

Analysis of Net Assets

The Department had a deficit in net assets at the end of 2006 and 2005. Net assets was comprised of investment in capital assets less any related debt to acquire those assets that is still outstanding and unrestricted net assets. The capital assets are used by the Department to provide services to other state departments and agencies and would not be available for future spending. Although the Department's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. Capital assets decreased by $564,993 in 2006 primarily due to depreciation expense.

Unrestricted net assets had a deficit balance in 2006 and 2005 primarily due to the workers' compensation liability of $29,225,000 and $28,653,000, respectively. This liability is paid from current year and future appropriations and accordingly, results in the deficit in net assets.

Total assets increased by $1,954,810 (27%) from the prior fiscal year. The increase is primarily due to cash balances in the workers' compensation interdepartmental account ($1,493,879) and the unemployment insurance interdepartmental account ($860,846). These cash balances resulted from interdepartmental payroll assessments being greater than the compensation amounts paid to state/former state employees in federally funded positions. Cash balances in the interdepartmental accounts cannot be retained by the Department and accordingly, were transferred to the State General Fund in September 2006, after the fiscal year 2006 was closed.

Total liabilities increased by $709,824 (2%) primarily due to increases in the reserve for workers' compensation claims and benefits.

Changes in Net Assets

The following financial information was derived from the government-wide statement of activities and reflects how the Department's net assets changed during the fiscal year.

Statement of Activities

Years Ended June 30, 2006 and 2005 (unaudited)

	2006	2005 (unaudited)	Increase (Decrease)
General Revenues:			
State allotted appropriations, net of lapsed appropriations	$ 14,539,215	$ 14,073,074	$ 466,141
Program Revenues:			
Charges for services	3,023,402	726,800	2,296,602
Total revenues	17,562,617	14,799,874	2,762,743
Expenses:			
General administration	1,395,670	1,473,568	(77,898)
Employee claims	1,623,426	2,145,420	(521,994)
Employee classification and compensation	1,096,666	1,169,198	(72,532)
Employee relations	2,025,389	1,951,235	74,154
Employee staffing	1,648,299	1,554,455	93,844
Merit appeals board	7,026	6,156	870
Unemployment insurance claim payments	1,299,177	1,208,787	90,390
Workers' compensation claims and benefits	7,221,978	7,976,339	(754,361)
Total expenses	16,317,631	17,485,158	(1,167,527)
Change in net assets	1,244,986	(2,685,284)	3,930,270
Net assets, beginning of year	(24,320,753)	(21,635,469)	(2,685,284)
Net assets, end of year	$ (23,075,767)	$ (24,320,753)	$ 1,244,986

Analysis of Changes in Net Assets

The Department's net assets increased by $1,244,986 (5%) due primarily to the increase in revenues for the workers' compensation and unemployment insurance interdepartmental transfer accounts that come from payroll assessments to other State departments who have employees in federally funded positions and decreases in employee claims and workers' compensation expenses.

Total revenues increased by $2,762,743 (19%). Revenues generated by program charges for services and payroll assessments were $3,023,402 (17% of total revenues) and State allotted appropriations were $14,539,215 (83% of total revenues) in 2006. The increase in revenues was primarily due to increases in workers' compensation and unemployment insurance interdepartmental payroll assessments from other State departments who have employees in federally funded positions. The payroll assessment rates are issued by the State Department of Budget and Finance, as part of the composite fringe benefit rate approved by the U.S. Department of Health and Human Services. The rates for workers' compensation and unemployment insurance increased in 2006 compared to 2005. The increase in General Fund appropriations was primarily due to collective bargaining augmentations.

Total expenses decreased by $1,167,527 (7%). Total expenses for the Department were $16,317,631 for the fiscal year. The expenses were for the following functions and divisions of the Department: general administration, employee claims, employee classification and compensation, employee relations, employee staffing, merit appeals board, unemployment insurance claim payment and workers' compensation claims and benefit payments. The largest expense totaling $7,221,978 (44%) was for workers' compensation claims and benefits for State general fund employees. The decreases in expenses were due to decreases in employee claims, $521,994 (24%) and workers' compensation claims and benefits, $754,361 (9%) based on actual payments during the year.

Financial Analysis of the Department's Governmental Funds

The focus of the Department's Governmental Funds is to provide information on near-term inflows, outflows and balances of spendable resources. Such information is useful in assessing the Department's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources for spending at the end of the fiscal year.

Exhibit 3.1

Comparison of Governmental Fund Balance Sheets
June 30, 2006 and 2005 (unaudited)

	ASSETS			LIABILITIES			FUND BALANCES		
	2006	2005 (unaudited)	Increase (Decrease)	2006	2005 (unaudited)	Increase (Decrease)	2006	2005 (unaudited)	Increase (Decrease)
General Fund	$1,005,898	$853,711	$152,187	$1,497,816	$1,445,786	$52,030	$(491,918)	$(592,075)	$100,157
Human Resources Development Special Fund	282,645	269,755	12,890	4,331	28,812	(24,481)	278,314	240,943	37,371
Workers' Compensation Interdepartmental Account	1,493,879	-	1,493,879	-	-	-	1,493,879	-	1,493,879
Unemployment Insurance Interdepartmental Account	860,846	-	860,846	-	-	-	860,846	-	860,846
Other Funds	3,683	3,683	-	-	-	-	3,683	3,683	-
Total	$3,646,951	$1,127,149	$2,519,802	$1,502,147	$1,474,598	$27,549	$2,144,804	$(347,449)	$2,492,253

As of the end for the current fiscal year, the Department's Governmental Funds reported combined ending fund balances of $2,144,804, an increase of $2,492,253 from the prior fiscal year. Of this total, $1,658,844 constitutes the unreserved fund balance. $2,354,725 of the total represents cash balances for the workers' compensation and unemployment insurance interdepartmental accounts.

Comparison of Revenues, Expenditures and Changes in Fund Balances
Years ended June 30, 2006 and 2005 (unaudited)

	REVENUES			EXPENDITURES			CHANGES IN FUND BALANCE		
	2006	2005 (unaudited)	Increase (Decrease)	2006	2005 (unaudited)	Increase (Decrease)	2006	2005 (unaudited)	Increase (Decrease)
General Fund	$14,539,215	$14,073,075	$466,140	$14,439,058	$15,166,748	$(727,690)	$100,157	$(1,093,673)	$1,193,830
Human Resources Development Special Fund	344,901	369,423	(24,522)	307,530	435,694	(128,164)	37,371	(66,271)	103,642
Workers' Compensation Interdepartmental Account	1,535,577	34,754	1,500,823	41,698	98,838	(57,140)	1,493,879	(64,084)	1,557,963
Unemployment Insurance Interdepartmental Account	1,142,924	322,623	820,301	282,078	322,796	(40,718)	860,846	(173)	861,019
Other Funds	-	-	-	-	-	-	-	-	-
Total	$17,562,617	$14,799,875	$2,762,742	$15,070,364	$16,024,076	$(953,712)	$2,492,253	$(1,224,201)	$3,716,454

The General Fund is the Department's primary operating fund. The Department's General Fund change in fund balance was $100,157 which represented a $1,193,830 increase from 2005. The increase was primarily due to an increase in state appropriations and a decrease in expenditures.

The Human Resources Development Special Fund accounts for the administrative costs to support and facilitate the entrepreneurial initiatives, training activities and programs for government employees. At the end of the current fiscal year, the fund balance of the Human Resources Development Special Fund was $278,314.

The Workers' Compensation and the Unemployment Insurance Interdepartmental Accounts are used to account for payroll assessments to other State departments with employees in federally funded positions. The assessment rates for workers' compensation and unemployment insurance increased in 2006 compared to 2005.

General Fund Budgetary Highlights

The difference between the General Fund original budget of $15,963,323 and the final budget of $16,124,858 was due to the $161,535 collective bargaining allocation received from the State Department of Budget and Finance. Actual expenditures were $14,582,665 for the fiscal year resulting in a variance between the final budget and actual expenditures on a budgetary basis of $1,542,193.

Capital Assets

The Department's investment in capital assets is summarized below. The investment in capital assets includes land, building and improvements, and equipment.

	2006	2005 (unaudited)	Increase (Decrease)
Buildings and improvements	$ 10,124,368	$ 10,124,368	$ -
Furniture and equipment	1,990,981	1,991,013	(32)
Total capital assets	12,115,349	12,115,381	(32)
Less accumulated depreciation	(6,626,906)	(6,061,945)	(564,961)
Capital assets, net	$ 5,488,443	$ 6,053,436	$ (564,993)

The change to the net capital asset balance was primarily due to the current year depreciation expense. Additional information of the Department's capital assets can be found in Note 5 of the notes to the basic financial statements.

Long-Term Obligations

A summary of the long-term obligations as of June 30, 2006 and 2005 is shown below:

	2006	2005 (unaudited)	Increase (Decrease)
Workers' compensation liability	$ 29,225,000	$ 28,553,000	$ 672,000
Accrued vacation	1,434,702	1,415,530	19,172
Capital leases obligations	49,312	58,210	(8,898)
Total long-term obligations	$ 30,709,014	$ 30,026,740	$ 682,274

The $29,225,000 of reserves for workers' compensation is the Department's best estimate of future payments for all open workers' compensation claims. The $1,434,702 of accrued vacation will be liquidated with future expendable resources. The $49,312 of capital leases represents the future minimum payments due for leases of office equipment expiring at various dates through December 2010. Additional information on the Department's long-term obligations can be found in Note 6 of the notes to the basic financial statements.

Economic Factors and Next Year's Budget

Hawaii's economy continues to perform well in all areas, and the significant gains of the past three years are expected to be sustained for 2007. The general fund tax revenues are projected by the Council on Revenues to increase in fiscal year 2007. Updates to revenue projections issued by the Council on Revenues will impact the Governor's policy on budget formulation, and accordingly, the Department's future budget.

Request for Information

Requests for additional information should be addressed to the Department of Human Resources Development, 235 South Beretania Street, Honolulu, Hawaii, 96813-2437.

Exhibit 3.2

Department of Human Resources Development
State of Hawaii
Statement of Net Assets
June 30, 2006

Assets	
Cash and short-term investments held in State Treasury	$ 3,646,951
Capital assets, net	5,488,443
Total assets	9,135,394
Liabilities	
Vouchers payable	501,776
Accrued payroll and employee benefits payable	316,891
Due to other agencies	677,480
Due to State General Fund	6,000
Long-term liabilities	
Due within one year	
Workers' compensation liability	6,500,000
Accrued vacation	582,000
Capital lease obligations	24,800
Due in more than one year	
Workers' compensation liability	22,725,000
Accrued vacation	852,702
Capital lease obligations	24,512
Total liabilities	32,211,161
Net assets	
Invested in capital assets, net of related debt	5,439,131
Unrestricted	(28,514,898)
Total net assets	$ (23,075,767)

The accompanying notes are an integral part of the financial statements.

Exhibit 3.3

Department of Human Resources Development
State of Hawaii
Statement of Activities
Year Ended June 30, 2006

Functions/Programs	Program Expenses	Program Revenue Charges for Services	Net Expense and Changes in Net Assets
General administration	$ 1,395,670	$ -	$ (1,395,670)
Employee claims	1,623,426	118,818	(1,504,608)
Employee classification and compensation	1,096,666	-	(1,096,666)
Employee relations	2,025,389	226,083	(1,799,306)
Employee staffing	1,648,299	-	(1,648,299)
Merit appeals board	7,026	-	(7,026)
Unemployment insurance claim payments	1,299,177	1,142,924	(156,253)
Workers' compensation claims and benefits	7,221,978	1,535,577	(5,686,401)
Total governmental activities	$ 16,317,631	$ 3,023,402	(13,294,229)
	General revenues		
	State allotted appropriations, net of lapsed appropriations		14,539,215
	Change in net assets		1,244,986
	Net assets at July 1, 2005		(24,320,753)
	Net assets at June 30, 2006		$ (23,075,767)

The accompanying notes are an integral part of the financial statements.

Exhibit 3.4

Department of Human Resources Development
State of Hawaii
Balance Sheet - Governmental Funds
June 30, 2006

	General Fund	Human Resources Development Special Fund	Workers' Compensation Inter-departmental Account	Unemployment Insurance Inter-departmental Account	Other	Total Governmental Funds
Assets						
Cash and short-term investments held in State Treasury	$ 1,005,898	$ 282,645	$ 1,493,879	$ 860,846	$ 3,683	$ 3,646,951
Total assets	$ 1,005,898	$ 282,645	$ 1,493,879	$ 860,846	$ 3,683	$ 3,646,951
Liabilities and Fund Balances						
Liabilities						
Vouchers payable	$ 497,445	$ 4,331	$ -	$ -	$ -	$ 501,776
Accrued payroll and employee benefits payable	316,891	-	-	-	-	316,891
Due to other agencies	677,480	-	-	-	-	677,480
Due to State General Fund	6,000	-	-	-	-	6,000
Total liabilities	1,497,816	4,331	-	-	-	1,502,147
Fund balances						
Reserved for encumbrances	485,960	-	-	-	-	485,960
Unreserved	(977,878)	278,314	1,493,879	860,846	3,683	1,658,844
Total fund balances	(491,918)	278,314	1,493,879	860,846	3,683	2,144,804
Total liabilities and fund balances	$ 1,005,898	$ 282,645	$ 1,493,879	$ 860,846	$ 3,683	$ 3,646,951

The accompanying notes are an integral part of the financial statements.

Exhibit 3.5

Department of Human Resources Development
State of Hawaii
Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds
Year Ended June 30, 2006

	General Fund	Human Resources Development Special Fund	Workers' Compensation Inter-departmental Account	Unemployment Insurance Inter-departmental Account	Other	Total Governmental Funds
Revenues						
State allotted appropriations	$ 16,124,858	$ -	$ -	$ -	$ -	$ 16,124,858
Intergovernmental revenues	-	-	1,535,577	1,142,924	-	2,678,501
Other	-	344,901	-	-	-	344,901
Total revenues	16,124,858	344,901	1,535,577	1,142,924	-	19,148,260
Expenditures						
General administration	1,376,362	-	-	-	-	1,376,362
Employee claims	1,435,250	40,245	-	-	-	1,475,495
Employee classification and compensation	1,008,917	-	-	-	-	1,008,917
Employee relations	1,608,637	267,285	-	-	-	1,875,922
Employee staffing	1,477,487	-	-	-	-	1,477,487
Merit appeals board	7,026	-	-	-	-	7,026
Unemployment insurance claim payments						
Workers' compensation claims and	1,017,099	-	-	282,078	-	1,299,177
benefits	6,508,280	-	41,698	-	-	6,549,978
Total expenditures	14,439,058	307,530	41,698	282,078	-	15,070,364
Excess of revenues over expenditures	1,685,800	37,371	1,493,879	860,846	-	4,077,896
Lapsed appropriations	(1,585,643)	-	-	-	-	(1,585,643)
Excess of revenues over expenditures and lapsed appropriations	100,157	37,371	1,493,879	860,846	-	2,492,253
Fund balances at July 1, 2005	(592,075)	240,943	-	-	3,683	(347,449)
Fund balances at June 30, 2006	$ (491,918)	$ 278,314	$ 1,493,879	$ 860,846	$ 3,683	$ 2,144,804

The accompanying notes are an integral part of the financial statements.

Exhibit 3.6

Department of Human Resources Development
State of Hawaii
Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets
June 30, 2006

Total fund balance — governmental funds	$ 2,144,804
Amounts reported in the statement of net assets are different because	
Capital assets used in governmental activities are not financial resources and therefore are not reported in the governmental funds	5,488,443
Long-term liabilities are not due and payable in the current period and therefore are not reported in the governmental funds	
Workers' compensation liability	(29,225,000)
Accrued vacation	(1,434,702)
Capital lease obligations	(49,312)
Net assets of governmental activities	$ (23,075,767)

The accompanying notes are an integral part of the financial statements.

Exhibit 3.7

Department of Human Resources Development
State of Hawaii
Reconciliation of the Governmental Funds Statement of Revenues, Expenditures and Changes in Fund Balances to the Statement of Activities
Year Ended June 30, 2006

Total net change in fund balances – governmental funds		$ 2,492,253
Amounts reported in the statement of net assets are different because		
Capital outlays are reported as expenditures in governmental funds. However, in the statement of activities, the cost of capital assets is allocated over their estimated useful lives and reported as depreciation expense. In the current period, these amounts are:		
Capital outlays	50,183	
Depreciation expense	(615,176)	(564,993)
Some expenses reported in the statement of activities do not require the use of current financial resources and therefore, are not reported as expenditures in governmental funds.		
Change in workers' compensation liability	(672,000)	
Change in accrued vacation	(19,172)	(691,172)
Capital lease principal payments of $21,198 are expenditures in the governmental funds, but the payments reduced the long-term liabilities in the statement of net assets. This was offset by a capital addition of $12,300.		8,898
Change in net assets of governmental activities		$ 1,244,986

The accompanying notes are an integral part of the financial statements.

Exhibit 3.8

Department of Human Resources Development
State of Hawaii
Statement of Revenues and Expenditures - Budget and Actual (Budgetary Basis)
General Fund
Year Ended June 30, 2006

	Original Budget	Final Budget	Actual Budgetary Basis	Variance Positive (Negative)
Revenue				
State allotted appropriations	$ 15,963,323	$ 16,124,858	$ 16,124,858	$ -
Expenditures				
General administration	1,339,742	1,464,742	1,461,655	3,087
Employee claims	1,443,273	1,449,691	1,440,214	9,477
Employee classification and compensation	1,032,382	1,042,383	1,019,775	22,608
Employee relations	1,629,070	1,643,912	1,631,473	12,439
Employee staffing	1,500,545	1,505,819	1,455,897	49,922
Merit appeals board	7,069	7,069	6,973	96
Unemployment insurance claim payments	1,021,620	1,021,620	1,017,099	4,521
Workers' compensation claims and benefits	7,989,622	7,989,622	6,549,579	1,440,043
Total expenditures	15,963,323	16,124,858	14,582,665	1,542,193
Excess of revenues over expenditures	$ -	$ -	$ 1,542,193	$ 1,542,193

The accompanying notes are an integral part of the financial statements.

Exhibit 3.9

Department of Human Resources Development
State of Hawaii
Statement of Revenues and Expenditures - Budget and Actual - Other Major Funds
Year Ended June 30, 2006

	Original Budget	Final Budget	Actual Budgetary Basis	Variance Positive (Negative)
Human Resources Development Special Fund				
Revenue	$ 700,000	$ 700,000	$ 344,901	$ (355,099)
Expenditures				
Employee claims	200,000	200,000	38,136	161,864
Employee relations	500,000	500,000	290,092	209,908
	700,000	700,000	328,228	371,772
Excess of revenues over expenditures	$ -	$ -	$ 16,673	$ 16,673
Workers' Compensation Interdepartmental Account				
Revenue	$ 1,886,281	$ 1,886,281	$ 1,535,577	$ (350,704)
Expenditures				
Workers' compensation claims and benefits	1,886,281	1,886,281	41,698	1,844,583
Excess of revenues over expenditures	$ -	$ -	$ 1,493,879	$ 1,493,879
Unemployment Insurance Interdepartmental Account				
Revenue	$ 3,000,000	$ 3,000,000	$ 1,142,924	$ (1,857,076)
Expenditures				
Unemployment insurance claim payments	3,000,000	3,000,000	282,078	2,717,922
Excess of revenues over expenditures	$ -	$ -	$ 860,846	$ 860,846

The accompanying notes are an integral part of the financial statements.

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Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Human Resources Development on November 14, 2007. 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 expressed its appreciation of the value of audits but did disagree with many of our findings and conclusions. The department provided detailed explanations supporting its disagreement with our findings. However, the department's responses either do not specifically address, or demonstrate a lack of understanding of, the actual findings.

The department disagrees with our audit finding concerning the level and source of financial information it submits to the Legislature. The department supports its claim by noting it generates numerous reports from the Human Resource Management System, which support the reports submitted annually to the Legislature and posted to the department's website. We are aware of, and reviewed, these reports during our audit. However, this system generates statistical information pertaining only to workers' compensation balances. Our audit notes the lack of department-wide financial reports showing the financial position and results of operations for the department as a whole. These reports should be prepared in accordance with applicable accounting standards to ensure comparability with other agencies. This type of information is not available in the mentioned system and is not currently being submitted to the Legislature.

The department disagrees with our conclusion that overstatements of fund balances occurred because accounting personnel and accurate financial reporting are not department priorities. Our conclusion is based on the accumulation of several identified accounting misstatements and errors resulting from a lack of qualified financial accounting personnel. We do acknowledge the department's proficiency with day-to-day accounting operations; however, the department has not dedicated appropriate resources to developing formal internal and external financial reporting systems that can mitigate such misstatements and errors.

The department disagrees with our conclusive statement that it does not take functional ownership over the Workers' Compensation Program. In disagreement with our assessment that workers' compensation liabilities are not systematically calculated, tracked, and reported, the department further notes that it does provide reserve data to all state departments for inclusion in their financial statements as well as in the statewide

Comprehensive Annual Financial Report (CAFR). However, the *June 30, 2006 State of Hawaii, Report on Internal Controls over Financial Reporting and on Compliance and Other Matters*, issued in conjunction with the CAFR audit, specifically stated that the State acknowledged that claims reserves reports are "inaccurate and unreliable for purposes of determining the State's estimated workers' compensation liability" and as a result, the State "continues to estimate its workers' compensation claims liability based on payroll information and insurance filings, as done in previous years." Our testing of claims' reserves validated this criticism, as we found significant and systematic errors in the calculation of individual workers' compensation claim liabilities.

We concluded the department has not taken ownership over the Workers' Compensation Program as it does not recognize the $29 million in related liabilities, calculate accurate reserves, or have formal claims processing procedures. A major point of our finding is that the department is unable to properly report the workers' compensation reserve liability in accordance with generally accepted accounting principles (GAAP) and that the department's personnel informed us on several occasions that this was not a department priority.

The department also disputes our statement that the department does not understand or calculate the Incurred But Not Reported (IBNR) portion of the workers' compensation claims liability, citing an IBNR report prepared by the department and submitted for inclusion in the statewide CAFR. During our audit we reviewed the report in question, noting that it simply lists claims filed within three months subsequent to the fiscal year end (June 30, 2006). However, IBNR calculations are much more complex than this and must take into account the fact that workers' compensation claims can be filed years after the date of injury. The IBNR calculation prepared by the department does not comply with financial accounting and reporting requirements specified by GAAP.

The department responds that our audit report incorrectly suggests that deficient departmental processes are responsible for alleged time lags between the posting and disbursement of workers' compensation payments. The department explains that time lags are inherent, as payments are posted daily by the department but actual payments are subsequently made by the Department of Accounting and General Services. We are aware of the nature of these time lags; however, our finding focuses on instances in which the reserve liability was misstated due to the recordation of *authorized* payments rather than *actual* payments, which occur at a later date.

STATE OF HAWAI'I
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawai'i 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

November 14, 2007

COPY

The Honorable Marie C. Laderta, Director
Department of Human Resources Development
Leiopapa a Kamehameha Building
235 South Beretania Street
Honolulu, Hawai'i 96813

Dear Ms. Laderta:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Financial Audit of the Department of Human Resources Development.* We ask that you telephone us by Friday, November 16, 2007, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Monday, November 26, 2007.

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 OF HAWAII

MARIE C. LADERTA
DIRECTOR

Cindy S. Inouye
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF HUMAN RESOURCES DEVELOPMENT
235 S. BERETANIA STREET
HONOLULU, HAWAII 96813-2437

December 11, 2007

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to provide comments on the draft report, *Financial Audit of the Department of Human Resources Development*. We believe that audits are a valuable tool to improve operations and we welcome constructive input. Below, we address some of the specific findings and conclusions contained in the report.

Page 9, "*Legislators receive some financial reports from the department in the form of budget requests. However, this information is taken straight from FAMIS* . . . ."

This is an inaccurate statement. The data that the department provides to the Legislature does not come from FAMIS. Our reports are generated by our Human Resource Management System. In addition to the information we provide for our yearly budget briefings, up until fiscal year 2008, the department was required to submit an annual report to the Legislature. This report, which is also posted on our department website, provided a wide variety of statistics, including: the number of payments processed per benefit type; average dollar per processed benefit type; total dollars spent per benefit type; number of claims processed during the fiscal year; number of claims closed out of the claims processed; number of claims that continued to be active into the following fiscal year out of the total active claims; the percentage of claims closed which were active for less than two years; the percentage of claims closed that had been open for more than five years; the average number of years that the closed claims had been active; duration of payments made to injured employees whose claims had been active for less than two years; average cost per claim by department; and total amount of benefits paid out of the workers' compensation appropriation by benefit type and department.

Although this report is no longer legislatively mandated, the department intends to continue preparing the report on a yearly basis and posting it on our website. It should also be noted that the department's expenditures are also reported and published in detail by the Department of Labor and Industrial Relations.

Page 10, "*We found that fund balances were overstated and did not lapse back into the general fund as prescribed . . . .*"

As noted in the department's financial statements, the cash balances in the workers' compensation interdepartmental account ($1,494,000) and the unemployment insurance interdepartmental account ($861,000) were transferred to the State General Fund in September 2006, after the fiscal year 2006 was closed. In addition, approximately $193,000 in contract encumbrances ($52,000 from Contract No. 4787101; $18,000 from Contract No. 4787102; $92,000 from Contract No. 4787103; $20,000 from Contract No. 4787104; $11,000 from Contract No. 5347001) were also lapsed to the State General Fund.

We appreciate the need to improve our financial reporting. However, we do not agree with the conclusion that the overstatement in fund balances occurred because accounting personnel and accurate financial reporting are not a priority of the department. Both the department and DAGS experienced turnover in key personnel during the audit period resulting in some delays and a period of adjustment. The department has implemented steps to monitor the expiration of encumbered contracts and lapsing of funds in the interdepartmental accounts. We will also give the recommendation to hire accounting personnel serious consideration.

Page 12, "*While the lack of accounting knowledge has led to the department's inability to produce accurate financial statements, a failure to take ownership of workers' compensation raises further questions of stewardship. The department is responsible for the processing of claims and administering of workers' compensation funds; however, it does not systematically calculate, track, and report approximately $29 million in related liabilities. Additionally, there are no formal, written policies and procedures governing the entire function.*"

The workers' compensation program has been audited many times since 1985, when the program was established. There has never been a conclusion that no functional ownership exists. We respectfully disagree with this assessment. Such a statement does disservice to the staff who have dedicated many years working to ensure that injured employees are properly compensated; that all expenditures are accounted for; that electronic data is maintained to ensure that the program is properly funded; and that accurate and sufficient data is available to provide to the departments and Legislature upon request.

In addition, we do not agree with the statement that liabilities are not systematically calculated, tracked and reported. Annually, we provide reserve data to all departments that are required to report their workers' compensation liability as part of their financial statements. Separate and apart from providing this information to individual departments, we provide reserve calculations for all departments to DAGS.

It is accurate to state that the department does not have formal, written policies governing the reserve function. A primary reason for this is that every claim is unique, and no one methodology for calculating reserves will apply to all claims. Reserves are calculated based upon a variety of factors, all of which are important in deriving an appropriate assessment of the total liability for a claim. Some of these factors are the nature of the injury; the specialty of the health care provider; the age of the injured employee; the type of work the injured employee was hired to do; whether there are underlying health problems that could delay recovery; and whether a department is able to accommodate an injured employee's return to duty during the recovery period. While this is not an exhaustive list of the factors considered, it illustrates the complexity of the reserve calculation process and also that not all back strains, head injuries, etc. present the same liability to the State. Another reason why the department does not have a formal manual setting forth procedures for reserve setting and claims processing is that we were orally advised by the Department of the Attorney General not to develop such a manual because it would be subject to subpoena and could be used in legal proceedings against the State.

Page 14, "*Ultimately, the department does not think it is important to track over $29 million related to workers' compensation claims that it, and the State, will be liable for paying. The department does not feel it is responsible for calculating or reporting the total reserves on claims it is responsible for, including IBNR, on an ongoing basis . . . .* * *Workers' compensation data is maintained in the Human Resource Management System but the department does not track or report the total related reserves. The department did generate a workers' compensation reserve report as of June 30, 2006, which was then recorded by the CPA firm it hired to complete its financial statements. However, the reserve report was generated only in anticipation of our audit . . . .*"

It is disappointing that such conclusory statements would be made. Department staff spent many hours with the accounting firm hired by the Legislative Auditor's office, and at no time did staff suggest that tracking the State's workers' compensation liability is unimportant, nor did staff ever disavow responsibility for calculating or reporting total reserves on claims that the department handles. This has been the department's responsibility for years, and is one that we take very seriously. We spend a great deal of time reviewing reserves on files and documenting bases for increasing or decreasing those reserves.

In addition, we dispute the statement that the department only generated a reserve report in anticipation of the audit. We have generated a reserve report as of the end of the fiscal year each and every year since DAGS opted to use this information for the Comprehensive Annual Financial Report (CAFR) instead of using a formula tied to the amount of the State's payroll.

Page 16, "*As noted in the most recent State of Hawai'i Report on Internal Control over Financial Reporting and on Other Matters as of June 30, 2005 (issued in conjunction with the CAFR audit), 'the claims reserves report accumulated [by the Department of Human Resources Development] in the current year continues to be inaccurate and unreliable for purposes of determining the State's estimated workers' compensation liability.'*"

The audit report fails to note our department's response to this comment. It is true that our reserves cannot be used to determine the State's entire workers' compensation liability since we do not have reserve data for the Department of Education, the University of Hawaii, the Hawaii Health Systems Corporation, or the Judiciary. Expenditures, and most likely reserves, are more than double of the reserves for which we are responsible.

Page 17, "*Based on a lack of understanding of the importance of recording IBNR, the staff's inability to calculate IBNR, and inaccurate or incomplete data to rely on, the department does not calculate or record an IBNR reserve.*"

Department staff certainly understand and acknowledge the importance of recording IBNR. Currently, we prepare an IBNR reserve report based upon the parameters set by DAGS. It is unclear why the audit report states that the department does not calculate or record an IBNR reserve since we do, in fact, prepare such a report.

Page 18, "*Moreover, the turnover or extended absences of key personnel could compromise the continuity of the entire program.*"

This statement assumes that the department is not taking, nor has it been taking, action to ensure that the workers' compensation program will run efficiently and effectively into the future. In fact, the department has been making and continues to make every effort to prevent deterioration in the service provided to injured employees and/or the departments by cross-training many of the department's professional staff in all facets of the program.

Page 19, "*A lack of written policies feeds into the department's current practice of reporting and recording workers' compensation data when convenient to its employees' schedules.*"

It is unclear what information the audit report is relying upon to opine that workers' compensation data is recorded only when convenient to the department employees. Data is input on a daily basis, by necessity. Two account clerks have responsibility for inputting data relating to the processing of approximately 15,000 invoices per year.

Page 19, "*We noted deficiencies in the department's process to ensure the State's workers' compensation liability was properly analyzed and reported for the year ended June 30, 2006. * * * Misstatements were caused by time lags between posting of payments and when payments were made.*"

It is incorrect to suggest that deficient processes on the part of our department are responsible for the alleged time lags between posting of workers' compensation payments and when payments are made. Department staff spoke at length with the CPA firm hired by the Office of the Auditor in an effort to explain the payment process. Checks are not issued by our office. All checks are issued by DAGS. Our department inputs payment data on a daily basis so that an electronic file can be created and transmitted to DAGS. DAGS then creates a summary voucher warrant, which is returned to our office via messenger mail. Although we do not doubt that DAGS issues the warrants as expeditiously as possible, our department has no control over how long it takes.

All summary warrant vouchers received from DAGS are checked against the invoices being processed for payment to ensure there are no errors. The vouchers are then signed by authorized individuals and hand-carried back to DAGS to expedite the process as much as possible. A positive byproduct of this process is that it gives us the ability to inform health care providers, injured employees, attorneys, and others waiting for payment when we have authorized payment and approximately when they can expect to receive the check. This is part of the good customer service that we work so hard to achieve.

Page 19 – 20, "*In addition, no process is in place for the calculation and recording of IBNR. * * * . . . that liability should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.* '"

Although a response to the IBNR issue has previously been made, we believe it bears repeating. We calculate and record IBNR reserves using the criteria given to us. We also wish to comment on the statement that liability should be based on the estimated ultimate cost of settling the claims. Workers' compensation claims have an extremely long tail, and most of the benefits provided for have no dollar limitation. Moreover, not all claims are settled. Both parties have to agree to any settlement, and many claims, including those of injured employees who are permanently and totally disabled, cannot be settled due to the employees' entitlement to on-going benefits.

In addition, inflation is not a factor that determines the rate of benefits a claimant receives because weekly benefits are derived from the year in which the injury occurred. For those claimants who receive benefits for permanent total disability, they might be eligible for a benefit adjustment. However, any increased payments we make due to a benefit adjustment are reimbursed to us by the DLIR/Special Compensation Fund. In other words, it is their liability not ours.

Page 20, "*Exhibit 2.4 Overstatement of Reserve Type*"

We are unable to comment on this exhibit, since the report does not contain information regarding which claims were reviewed to reach the conclusion that there was an overstatement of reserves between June 30, 2006 and October 23, 2006. Moreover, the report does not acknowledge that during this time period, we were completing our statewide reserve review which encompasses the quarterly review.

Page 22, "*Formal, written policies and procedures should be established related to workers' compensation claims.*"

We appreciate this input and will give this recommendation serious consideration, including possibly requesting a written opinion from the Department of the Attorney General on this issue, rather than relying on verbal advice. It is unlikely, however, that we will discontinue the practice of recording payments when authorized. We have found that this practice provides an excellent electronic trail that allows our support staff to expeditiously respond to telephone/other inquiries regarding pending payments.

Thank you again for providing us with the opportunity to review and respond to the draft audit report.

Sincerely,

Cathy S. Inouye

for MARIE LADERTA
Director