

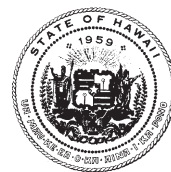
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# Financial Examination of the Department of Budget and Finance

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

Report No. 10-03  
March 2010



**THE AUDITOR**  
STATE OF HAWAI'I

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## 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.



### THE AUDITOR

STATE OF HAWAII

Kekuanao'a Building

465 S. King Street, Room 500

Honolulu, Hawai'i 96813

# OVERVIEW

## *Financial Examination of the Department of Budget and Finance*

Report No. 10-03, March 2010

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### Summary

The Office of the Auditor and the certified public accounting firm of Accuity LLP conducted a financial examination of the Department of Budget and Finance for the fiscal year July 1, 2008 to June 30, 2009. Our examination evaluated the financial processes and related systems of internal controls of the department and involved inquiry and review of relevant policies, procedures, systems, transactions, and records. The firm also assessed the design and operating effectiveness of internal controls over the department's financial accounting and reporting process for the fiscal year ended June 30, 2009.

Our examination revealed a lack of proper leadership and accountability in the Department of Budget and Finance and resulting deficiencies in its execution of statutorily mandated fiscal responsibilities. We found that the department is not efficiently and effectively managing the State's \$3.8 billion treasury. Its investment policy, which is meant to delineate investment procedures and requirements, has neither been formally updated since 1999, nor reviewed in detail since 2002. Management of state cash and investments is governed by the 1999 policy and general statutory guidance and is carried out via informal, manual procedures that increase risk and hamper efficiency. Neither the director of finance nor the Financial Administration Division (FAD) administrator has exercised proper oversight of investment decisions and activities.

As a result, the state treasury now holds approximately \$1 billion of illiquid auction-rate securities (ARS). We found that the department significantly increased ARS holdings to more than \$1 billion in FY2008, shortly before the ARS market froze. Although the investment policy states that yield is of secondary importance to safety and liquidity, we found the department continued investing in ARS primarily based on their high yields, which generally indicate greater risk. However, the department did not perform a risk assessment or cost-benefit analysis prior to purchase, nor did it obtain and review the securities' offering documents that disclose related risks.

We also found the FY2008 purchases of ARS violated state law and policy. Although student loan-backed ARS are an allowable type of investment, state law requires that investments have maturity dates of five years or less from the date purchased. The department believed the securities met that limit because auctions were held every seven to 49 days, providing investors the option to sell. However, maturities are determined by the maturity dates of the underlying loans, which range from 2016 to 2045. We found that neither the director of finance nor the FAD administrator was consulted prior to purchasing the ARS. Additionally, because auctions for the securities have failed since early 2008, they cannot be liquidated at par until auctions become functional, securities are called, or underlying loans mature. Consequently, the State wrote down the value of these securities by \$114 million as of June 30, 2008; an additional write-down of over \$140 million is expected for FY2009.

The department also failed to perform other required financial administration functions essential to proper oversight and safeguarding of funds. For example, FAD did not timely prepare and review monthly bank reconciliations, a fundamental control used to

ensure cash balances are properly stated and to reduce the risk of misappropriation. For the budget process, we found that while the Budget, Program Planning and Management Division provides detailed written instructions and forms to other agencies to assist in budget preparation, the division's internal procedures and practices are largely informal and undocumented. We also observed deficiencies in the department's information technology (IT) management and controls. Given the vital role of the department and its fiscal responsibilities, it should improve IT controls to ensure its systems and data are reasonably protected. Enhancing IT functions could also address shortcomings identified in the financial administration processes.

With respect to Accuity's LLP's assessment of internal controls, in the opinion of the firm, because of the material weaknesses identified in the department's financial administration processes, the department has not maintained effective financial accounting and reporting processes and related internal controls for the fiscal year ended June 30, 2009.

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## Recommendations and Response

We made several recommendations regarding the department's management and accountability of state funds. Among them, we recommended the department formalize the policies, procedures, and practices used in its financial administration and budget processes. We recommended improvements to the cash and investment management process, including formally reviewing the investment policy at least annually, updating procedures to improve efficiency and decrease risk, and ensuring proper oversight of investment activities. We also made specific recommendations for the department to improve its IT management and controls.

In its response to our draft report, the department charged our report with being improperly classified as an *examination* and replete with false and misleading statements. However, our work was performed in accordance with *Government Auditing Standards* (GAS), and our findings and conclusions are based on specific, well-documented evidence. Unlike the department's response, we counter the department's claims with supportable and reasoned explanations.

The department first claims our report is misleading in being entitled a *financial examination*. However, GAS classifies an *examination* as a type of attestation engagement that "can cover a broad range of financial or nonfinancial objectives" and "consists of obtaining sufficient, appropriate evidence to express an opinion . . ." The primary objectives of the examination were to examine the effectiveness of the department's financial accounting and financial reporting processes and internal controls, and assess the adequacy, efficiency, and effectiveness of its financial administration organizational structure, systems, procedures, and practices. GAS also requires auditors conducting attestation engagements to report any material weaknesses and significant deficiencies in internal controls. Consequently, it would be misleading not to label the report a *financial examination*.

The director of finance further claims our findings are inconsistent with those of annual independent audits, which are the *financial statement audits* of the State's Comprehensive Annual Financial Report (CAFR). Consistent with GAS, our *examination* involved examining the department's internal controls for the purpose of providing an opinion on their effectiveness, as well as evaluating the efficiency of the department's financial systems and processes. In contrast, the CAFR audit focuses on fair presentation of the State's financial statements and provides no assurances related to the State's internal controls or compliance with laws. Far from "inconsistent" with our *examination*, the most recent *Report on Internal Control Over Financial Reporting and On Compliance and Other*



*Matters*, issued in conjunction with the annual CAFR audit, actually includes a *material weakness* relating to the State's valuation of auction-rate securities.

The department also contends our report should have relied on a February 3, 2010 Standard & Poor's "credit rating report" that notes the State's management practices are "good." Aside from demonstrating its lack of understanding of GAS, basic audit principles, and the purpose and scope of ratings reports, the department conveniently overlooked reports by two other ratings agencies dated February 2 and 3, 2010—Fitch Ratings and Moody's Investor Services, respectively—that assigned a "negative" outlook to Hawai'i's general obligation bond ratings. Those reports indicated that the negative outlook reflected the State's narrowed financial operations and limited flexibility underscored by reduced reserve levels, funding gaps, and liquidity challenges.

The department's contentions against our finding that ARS do not comply with state law are flawed for a number of reasons. First, it is indisputable that ARS holdings currently do not comply with state law. Because many of their ratings have dropped below AAA, they do not meet the statutory requirement that investments maintain a AAA rating. Second, the department primarily relies on a March 1, 2010 memorandum from the attorney general (AG memorandum) as support. However, the AG memorandum is merely an *interpretation* of the statute with which we respectfully disagree based on its unsound analysis. The foremost rule of statutory construction is that statutory meaning and intent must be "obtained primarily from the language contained in the statute itself[.]" Section 36-21, HRS, is clear and unambiguous as to intent. It is entitled *Short-term investment of state moneys* and explicitly states that investments are allowable "provided that the investments are due to mature not more than five years from the date of investment." Instead of applying the statute's plain language, however, the AG memorandum makes a number of vulnerable presumptions in concluding the maturity limit is inapplicable to ARS, including comparing ARS to investments that have *no* stated maturity dates and going so far as to liken ARS to bank savings accounts. It also delves into an extensive and unnecessary review of the statute's legislative history, which should only be used to interpret intent when the statutory language is ambiguous. The maturity provision in Section 36-21, HRS, is unambiguous as it applies to ARS. In fact, a plain reading indicates it applies to all investments made under the statute. Third, the AG memorandum would have more significance had the department obtained it in FY2008 when it escalated ARS investments, or at least during our examination. We requested any documentation the department had related to ARS, including on the issue of compliance. The AG memorandum, dated the same day as the department's response, was the first document provided on the issue. The fact that the department did not previously obtain a written opinion on this issue underscores our overall finding that the director is not exercising sufficient oversight to ensure proper management of the state treasury.

In downplaying the severity of the State's predicament, the department attempts to compare the State's situation with numerous other public and private entities who were "all impacted by the freeze and collapse of the ARS market." However, few have been impacted to the same extent as Hawai'i. The State currently holds approximately \$1 billion of the *total* \$330 billion ARS market. As an objective basis of comparison, a survey by a national valuation services firm of public companies with ARS holdings as of September 30, 2009 found that of 430 public companies identified with a total par value of \$21 billion in ARS, the highest par value held by a single company was \$1.1 billion. The remaining top four ARS holders held par values at or below \$500 million. It is thus unsurprising that the State's ARS situation has garnered attention on a national level.

The primary significance of the State's ARS holdings is that the department continued increasing them due to their higher yields despite increasing risk, in direct conflict with its



own policy providing that yield is of secondary importance to safety and liquidity. Moreover, the department escalated those investments without exercising basic, prudent investment principles—it did not gain a full understanding of the securities, did not perform a risk assessment or cost-benefit analysis prior to purchase, and invested almost 30 percent of the State’s portfolio in that single investment type. Although the department now denies its statements that it did not perform a risk assessment prior to escalating ARS investments in FY2008, it has been unable to produce any evidence of its “ongoing” risk assessment. Further, the FAD administrator confirmed in an email (included in our comments) that the only form of “risk assessment” done was to check for inclusion of ARS in the statute as allowable, which does not qualify as a risk assessment.

The department also claims that it could not have known or understood the risks in FY2008. However, as laid out in our report, the cover page of an offering document for ARS held by the department stated: **“You should carefully consider the risk factors beginning on page 12 of this offering memorandum.”** As the first risk listed warns that **“you may have difficulty selling your notes,”** it is remiss that the department did not obtain and review copies of offering documents prior to purchase. Further, had the department heeded the investment guidelines and limitations in the statute and its own investment policy, it might not have invested such significant amounts in this one type of investment. The department rebukes our finding on its violation of the policy’s diversification requirements by simply stating that the policy allows for exceptions. Our report describes that exception provision—that exceptions “shall be approved by the [FAD] Administrator prior to being executed” and that “significant exceptions shall also be approved in advance by the Director of Finance.” However, the director, FAD administrator, and department staff repeatedly stated that the director and administrator were not consulted prior to increasing ARS in FY2008 and did not approve in advance the deviation from the 20 percent limit. The FAD administrator confirmed in an email (included in our comments) that “the Director was not consulted prior to increasing our position in ARS. I was informed of our increased holding due to the favorable yields.” At an August 27, 2009 meeting, the director admitted she had never been consulted prior to any ARS investment decision. That meeting was attended by nine individuals.

The director contends that holding \$1 billion of illiquid ARS poses no harm to the State, rejecting the merit of any write-down and touting actual “gains.” However, the bottom line is the State’s ARS lost approximately \$255 million in value as of June 30, 2009. Contrary to the director’s belief, the department’s valuation (conducted through its own broker) was prepared using a “discounted cash flow” method, which estimates *actual* losses to be incurred by holding the ARS to maturity. Further, having a large portion of the treasury tied up in ARS for seven to 35 years may hinder the State’s ability to cover anticipated cash disbursements.

While the director’s response accuses our report of being “an undeserved attack on the hard working men and women of this department,” we reiterate our overall conclusion that *The Department’s Lack of Leadership and Accountability Puts the State’s Funds at Risk*. The director’s deflection of findings to her staff highlights this same concern. Additionally, the department urges that failure to substantially amend the report would “be a gross disservice to the public and could mar our hard-earned reputation as a prudent fiscal manager of the public’s resources.” We fail to see how ignoring risks and chasing yields on the way to tying up \$1 billion of state funds has not already accomplished this.

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# Financial Examination of the Department of Budget and Finance

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A Report to the  
Governor  
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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. 10-03  
March 2010

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## Foreword

This is a report on the financial examination of the Department of Budget and Finance, State of Hawai'i, for the fiscal year July 1, 2008 to June 30, 2009. The examination was conducted pursuant to Section 23-4, Hawai'i Revised Statutes, which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. The examination 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 director and staff of the Department of Budget and Finance during the course of the examination.

Marion M. Higa  
State Auditor



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# Chapter 1

## Introduction

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This is a report of our financial examination of the State of Hawai‘i’s Department of Budget and Finance for the period July 1, 2008 to June 30, 2009. The examination was conducted by the Office of the Auditor and the independent certified public accounting firm Accuity LLP.

The examination 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.

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### Background

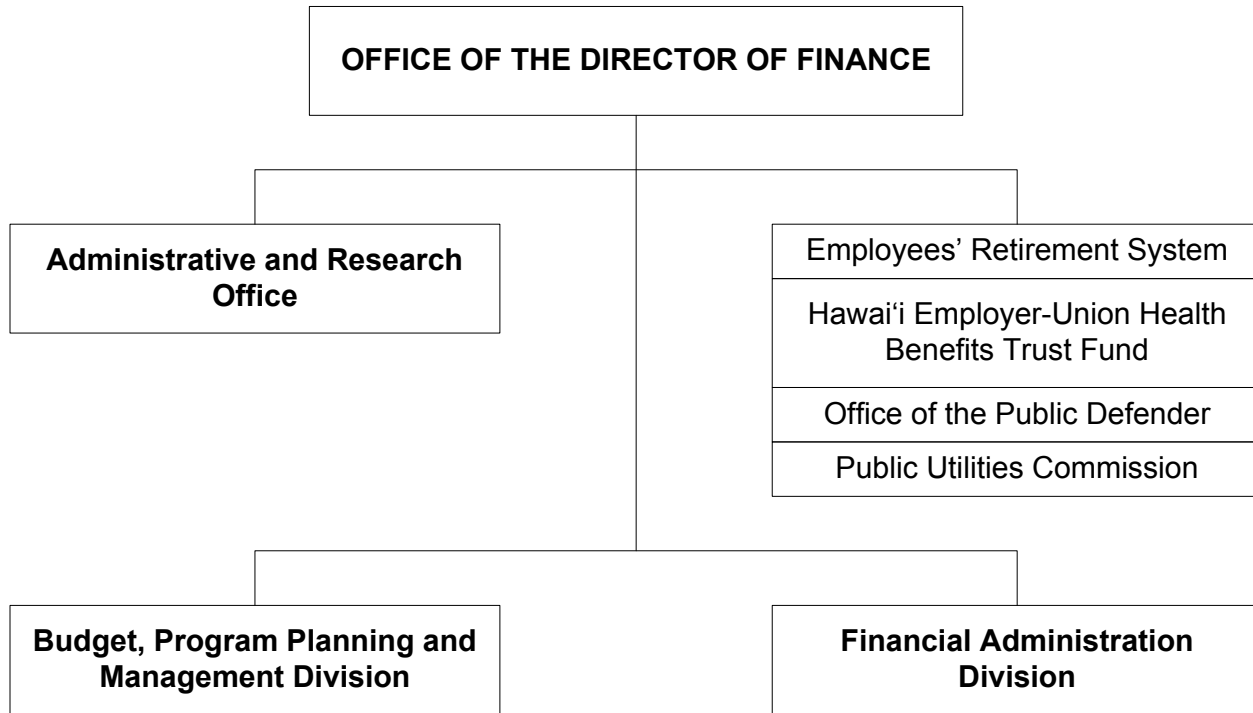
The Department of Budget and Finance is part of the executive branch of the State of Hawai‘i. The Legislature established the department through the Hawai‘i State Government Reorganization Act of 1959 (Act 1, Second Special Session Laws of Hawai‘i 1959). Section 26-8, HRS, sets forth the department’s responsibilities, which include preparing and executing the executive budget of the state government. The department is also responsible for conducting systematic and continuous reviews of the finances, organization, and methods of state departments to assist each department in achieving the most effective expenditure of public funds and to ensure that such expenditures are in accordance with budget laws and established internal controls. Additionally, the department is the custodian of state funds, responsible for their safekeeping, management, investment, and disbursement; and is responsible for administering the State’s debt.

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### Organization

The Department of Budget and Finance is headed by the director of finance. The Office of the Director of Finance plans, organizes, directs, and coordinates the various activities of the department 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 Budget and Finance Organization Chart**



Source: Adapted from the Department of Budget and Finance June 30, 2008 organization chart

The scope of our examination covered the following office and divisions within the Department of Budget and Finance.

***Administrative and Research Office***

The Administrative and Research Office provides administrative and research services for the other divisions within the department. Services include budget, organizational management, procurement, financial accounting management, and systems analyses. The office also assists the department's administration, programs, and employees with personnel management issues.

***Divisions***

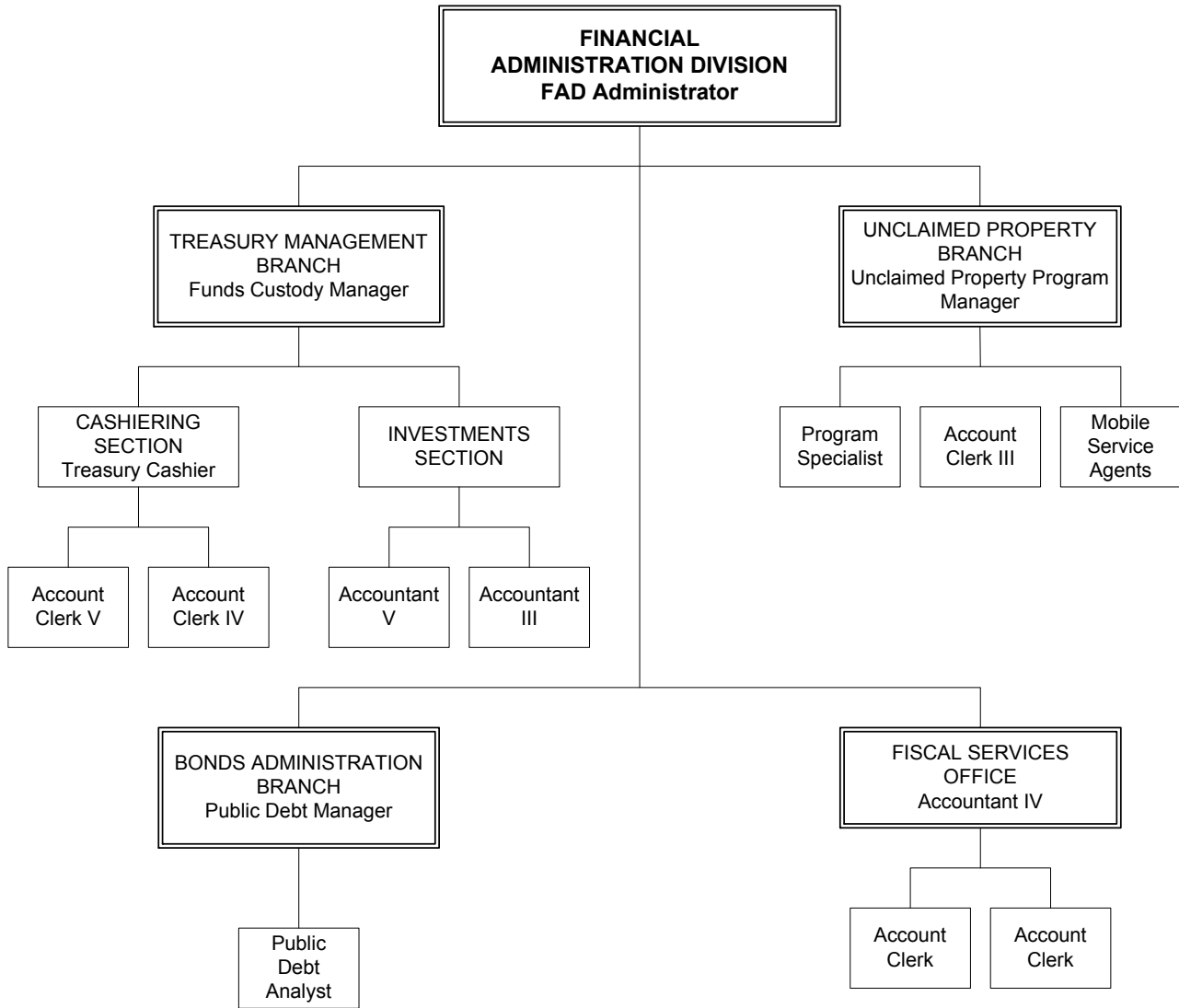
Two divisions are responsible for administering financial and budgetary services to the State's departments and agencies.

### **Financial Administration Division**

The Financial Administration Division administers the State's financial affairs by managing the State's treasury, financial planning and research, and debt issues. The division plans, directs, and coordinates development of the State's plans and strategies regarding cash management, investments, and bond financing. The division is responsible for determining the State's investment policies and strategies; investing state funds within established policies and guidelines; accounting for all state treasury deposits and disbursements; planning, monitoring, and managing the issuance of state bonds; and administering the State's debt activities such as maintaining accounting records, paying bond and coupon holders, and assisting bond holders with lost, stolen, defaced, and destroyed bonds or coupons. The division also administers the State's Unclaimed Property Program.

The organization of the department's Financial Administration Division is illustrated in Exhibit 1.2.

**Exhibit 1.2**  
**Department of Budget and Finance Financial Administration Division Organization Chart**

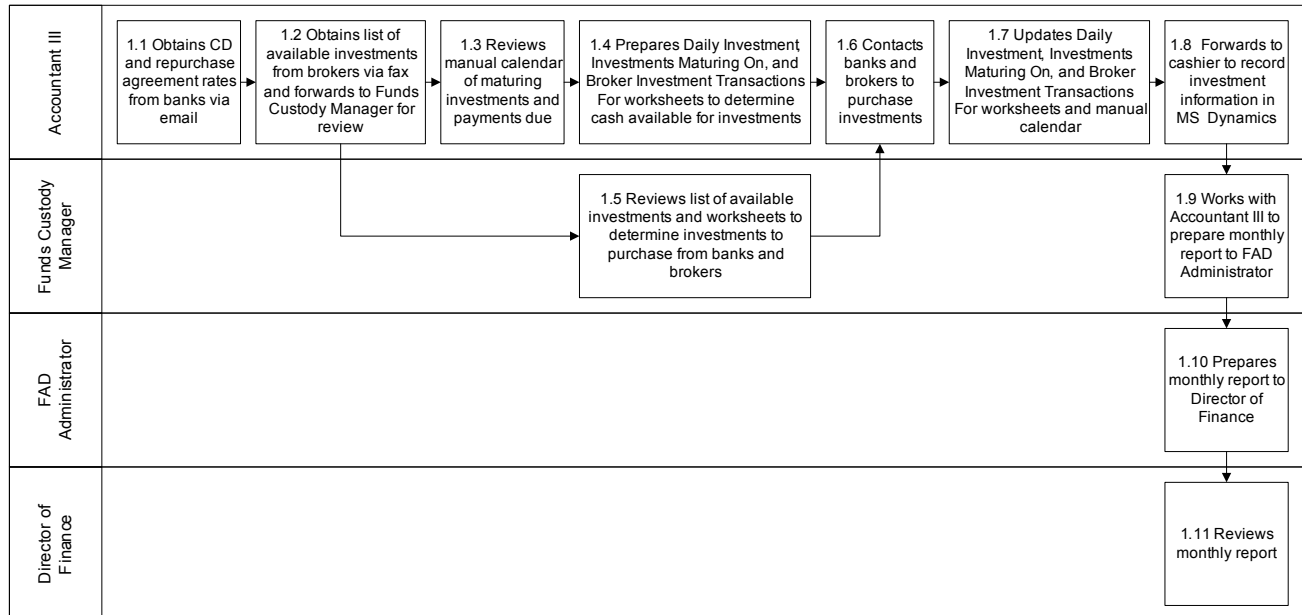


Source: Adapted from the Department of Budget and Finance June 30, 2008 Position Organization Chart

***Cash and Investment Management***

The division works daily with local banks and brokers to invest available funds in the State’s \$3.8 billion treasury (as of June 30, 2009) in liquid investments such as certificates of deposit (CDs), repurchase agreements, government agency securities, and student loan-backed auction-rate securities. The department’s cash investment process is illustrated in Exhibit 1.3.

**Exhibit 1.3  
Overview of the Department of Budget and Finance Cash Investment Process**



Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

***Bond Issuance and Management***

The Financial Administration Division also issues and manages the State’s general obligation (GO) bond program and assists other state agencies with the issuance of revenue bonds. The division works with the Legislature in estimating the amount of bonds to issue in the upcoming fiscal year in conjunction with preparing the state budget. Based on the approved budget, the division monitors the bond market and the remaining balance in the State’s bond funds while working with the underwriter and other members of the issuance team to determine the proper time to issue new and refunding bonds. Subsequent to the sale of bonds, the division is also responsible for the management of outstanding bonds, including payments to bondholders.

**Budget, Program Planning and Management Division**

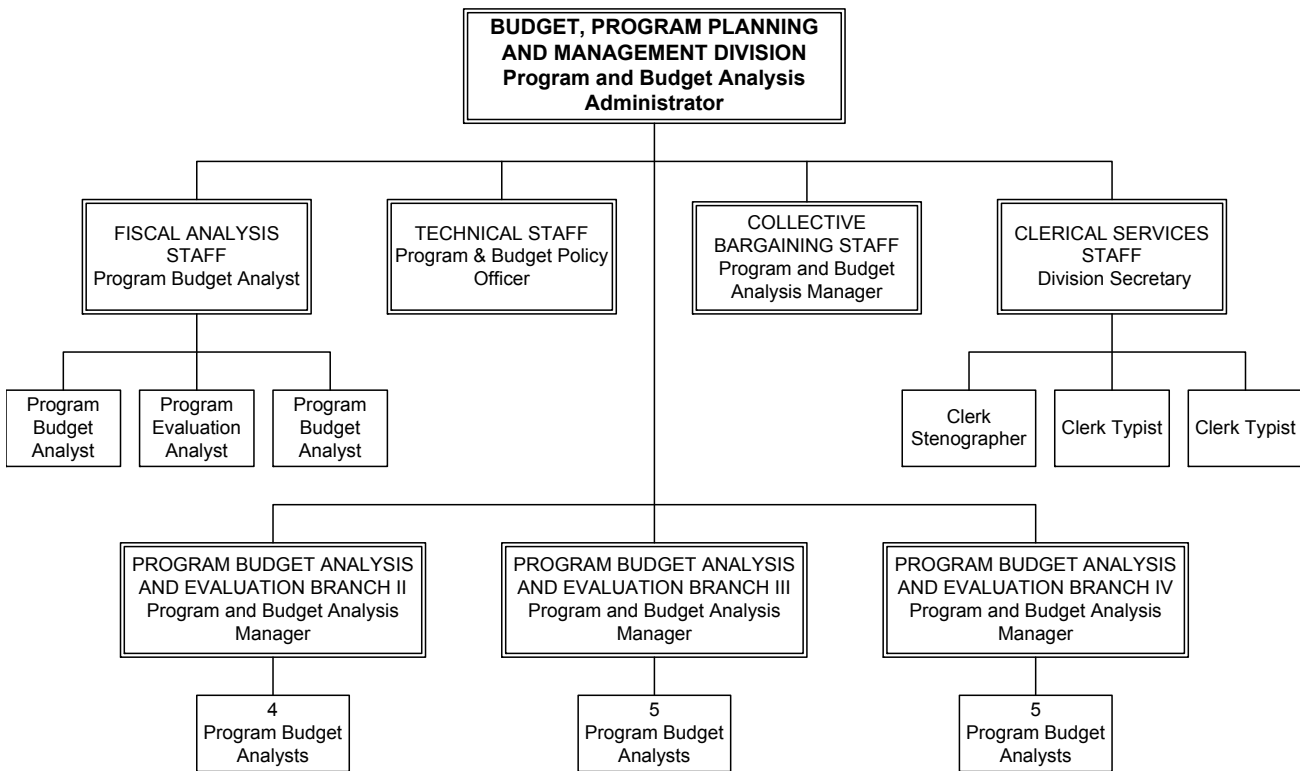
The Budget, Program Planning and Management Division (Budget Division) prepares and monitors the State’s multi-year program and financial plan, which describes the financial and program implications of an executive budget request over the corresponding planning period, in accordance with Chapter 37, HRS. The Budget Division also prepares and monitors the executive budget, coordinates the State’s capital



improvement program, carries out the budgetary and fiscal policies of the state government, and supervises and controls budget appropriations authorized by the Legislature. In addition, the division reviews departments' requests for reorganization and provides budgetary support in statewide collective bargaining negotiations.

The organization of the department's Budget Division is illustrated in Exhibit 1.4 below.

**Exhibit 1.4**  
**Department of Budget and Finance Budget Division Organization Chart**

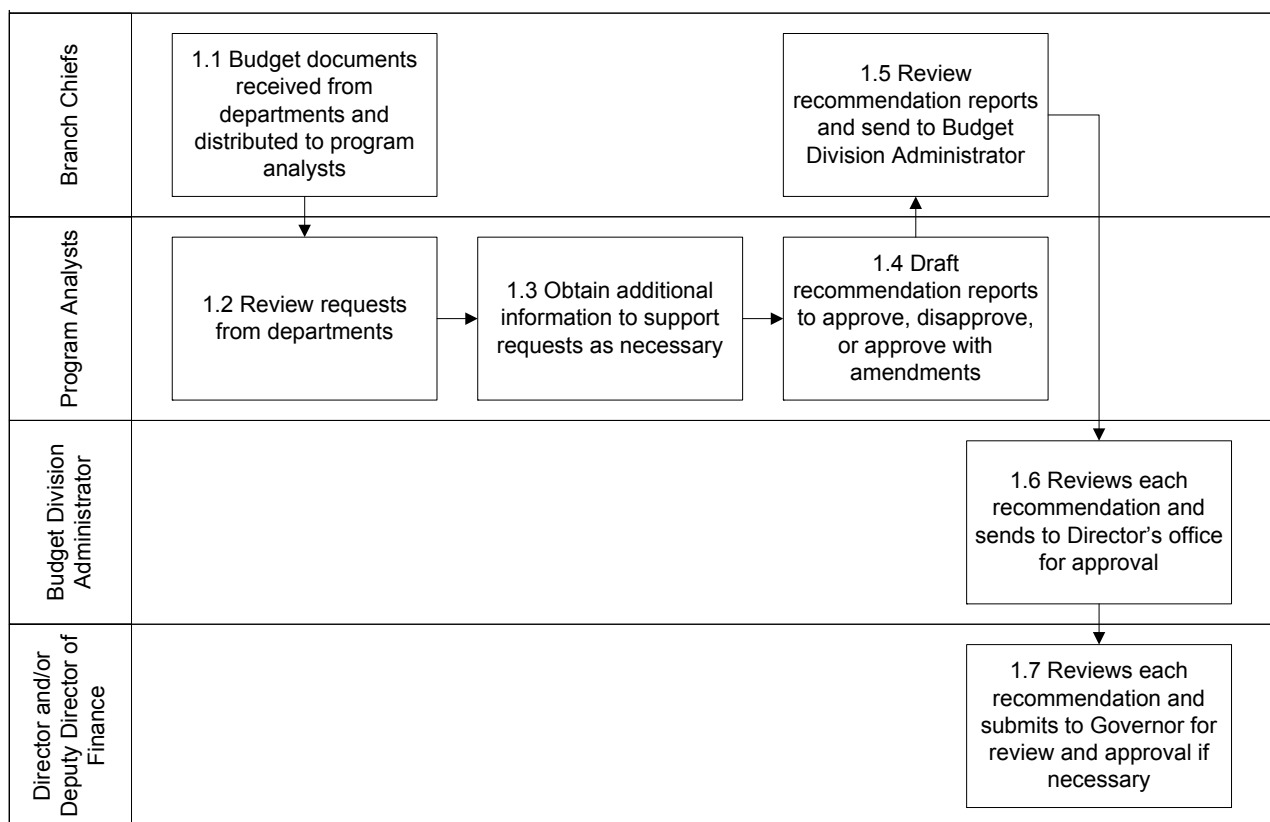


**Note:** According to the department, Program Budget Analysis and Evaluation Branch I has not been operational since 2000. Also, contrary to the organizational chart, Program Budget Analysis and Evaluation Branch IV is no longer operational; following retirement of that branch chief in July 2008, employees from that branch were reassigned to Program Budget Analysis and Evaluation Branches II and III.

Source: Adapted from the Department of Budget and Finance June 30, 2008 Position Organization Chart and an informal FY2009 organizational chart provided by the department

Prior to each legislative session, the division collects and compiles information from executive branch departments and agencies to prepare the proposed executive budget and works with the Legislature in formulating the final budget. Upon approval of the final budget by the Legislature, the division works with executive branch departments and agencies to execute the approved budget through the allotment process. Exhibit 1.5 depicts the budget preparation and execution process.

**Exhibit 1.5  
Overview of the Department of Budget and Finance Budget Preparation and Execution Process**



Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

A summary of the State’s cash and investments held by the department as of June 30, 2008 and 2009 is presented in Exhibit 1.6 below.

**Exhibit 1.6**  
**State Cash and Investments Held by the Department of**  
**Budget and Finance as of June 30, 2008 and 2009 (unaudited**  
**and rounded to the nearest thousand)**

	<b>2008</b>	<b>2009</b>
Demand deposits	\$162,225,000	\$229,770,000
Cash with fiscal agents	507,000	5,980,000
Cash with Secretary of Treasury, USA – Unemployment Trust Fund	527,352,000	265,499,000
Investments		
Time certificates of deposit	522,342,000	618,192,000
U.S. Treasury bonds and notes	121,000	--
U.S. government securities	1,111,641,000	528,130,000
Student loan auction-rate securities	1,065,575,000	1,006,975,000
Repurchase agreements	1,141,995,000	1,151,620,000
Total investments	<u>3,841,674,000</u>	<u>3,304,917,000</u>
Total cash and investments	<u>\$4,531,758,000</u>	<u>\$3,806,166,000</u>

Source: Compiled by Accuity LLP from information provided by the Department of Budget and Finance in the Money and Securities in the State Treasury Audit as of June 30, 2008 and the June 2009 Monthly Investment Summary

Exhibit 1.7 below shows summarized financial information for the department for the fiscal years ended June 30, 2008 and 2009.

**Exhibit 1.7  
Department of Budget and Finance Summarized Financial  
Results for Years Ended June 30, 2008 and 2009 (unaudited  
and rounded to the nearest thousand)**

	2008	2009
<b>Revenues</b>		
General fund allotments	\$155,930,000	\$278,120,000
Debt service allotments	310,481,000	324,572,000
Total revenue	466,411,000	602,692,000
<b>Expenditures and Transfers</b>		
Departmental administration	9,059,000	8,887,000
Budget, planning and management	1,903,000	1,881,000
Financial administration	2,106,000	1,328,000
Debt service	565,017,000	492,139,000
Transfers out (net)	--	60,982,000
Total expenditures	578,085,000	565,217,000
Revenues over (under) expenditures	\$(111,674,000)	\$37,475,000

Source: Department of Budget and Finance, Administrative and Research Office

### ***Other agencies***

Our examination did not include the following four agencies that are administratively attached to the Department of Budget and Finance:

#### **Employees' Retirement System**

The Employees' Retirement System administers retirement, disability, and survivor benefits for the State's general employees, teachers, professors, judges, county general employees, police officers, firefighters, and elected officials.

#### **Hawai'i Employer-Union Health Benefits Trust Fund**

The Hawai'i Employer-Union Health Benefits Trust Fund administers health and life insurance benefits to eligible state and county employees. The fund replaced the Hawaii Public Employees Health Fund effective July 1, 2003.

### **Office of the Public Defender**

The Office of the Public Defender provides statutorily entitled legal services for criminal and related cases to individuals financially unable to obtain such services.

### **Public Utilities Commission**

The Public Utilities Commission regulates all chartered, franchised, certified, and registered public utility companies that provide electricity, gas, telecommunications, private water and sewage, and motor and water carrier transportation services in the state.

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## **Prior Audit**

The Office of the Auditor and the certified public accounting firm of Deloitte & Touche LLP last conducted a financial audit of the combined financial statements of the Department of Budget and Finance for the fiscal year July 1, 1992 to June 30, 1993, pursuant to Section 23-4, HRS. The report was published as Report No. 93-17 in December 1993. In the opinion of the firm, except for keeping balances of revenues received for computer and telecommunication services provided by the Information and Communication Services Division (ICSD) in special revenue funds instead of transferring the balances to the general fund, the department's financial statements fairly presented its financial position as of June 30, 1993. The audit did not reveal any instances of non-compliance with applicable laws and regulations, nor any weaknesses in the department's control measures that would affect an opinion on the financial statements. As of July 1997, ICSD was transferred from the Department of Budget and Finance to the Department of Accounting and General Services.

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## **Objectives of the Examination**

1. Examine the effectiveness of the financial accounting and financial reporting processes and related internal controls of the Department of Budget and Finance.
2. Assess the adequacy, efficiency, and effectiveness of the department's organizational structure, systems, procedures, and practices over its financial administration functions.
3. Make recommendations for improvements as appropriate.

## Scope and Methodology

The scope of the examination was to examine the financial records, transactions, and related systems of internal controls of the Department of Budget and Finance for the fiscal year July 1, 2008 to June 30, 2009. The examination considered information from prior and subsequent fiscal years as available and relevant to our overall objectives. Included in our examination were the department's Administrative and Research Office, Financial Administration Division, and its Budget, Program Planning and Management Division.

We examined the accounting, reporting, and internal control structures to identify deficiencies and weaknesses and to make appropriate recommendations for improvements. We interviewed departmental personnel involved in the financial administration and budget processes, including those responsible for management and oversight, and examined related forms, records, accounting and operating procedures, and information technology (IT) systems, processes, and controls. We also reviewed transactions, systems, and procedures for compliance with applicable laws and regulations.

The examination was conducted from August 2009 through January 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform examinations to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our examination objectives.

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# Chapter 2

## The Department's Lack of Leadership and Accountability Puts the State's Funds at Risk

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The Department of Budget and Finance is the central fiscal agency for the State of Hawai'i. It is statutorily mandated to oversee and carry out vital financial responsibilities on behalf of the State, including managing its \$3.8 billion treasury, developing financial plans and strategies for the State, and administering the state budget.

We found a number of deficiencies in the department's execution of its statutory responsibilities. Inadequate oversight over management of the state treasury and investment pool, coupled with informal and manual procedures, increase risk to state funds and inhibit effectiveness of the department's cash and investment management process. The department also failed to perform other required financial administration functions essential for proper fiscal oversight and safeguarding of the State's moneys. The department's budgetary procedures and practices are also largely informal and may diminish the value and stability of the budget process. In addition, while the department uses various electronic applications in its key processes, its overall information technology (IT) controls and IT management are lacking. Given the critical role of the department to the effective functioning of our state government, the department must improve its core procedures and practices and ensure that the director of finance and all department personnel are held accountable for carrying out their responsibilities.

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### Summary of Findings

We found two material weaknesses involving the department's internal control over financial reporting and operations. As defined in *Government Auditing Standards*, a material weakness is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the subject matter will not be prevented or detected.

Significant deficiencies, which are less severe than material weaknesses, are deficiencies in internal controls or a combination of deficiencies that adversely affect an entity's ability to initiate, authorize, record, process, or report data reliably in accordance with applicable criteria or frameworks such that there is more than a remote likelihood that a more than inconsequential misstatement of the subject matter will not be prevented or detected.



**Material weaknesses:**

1. Lax management of the State's \$3.8 billion treasury has increased risk and reduced available funds.
2. The Financial Administration Division has failed to perform essential functions.

**Significant deficiencies:**

1. The Budget Division's informal and undocumented budget process lacks transparency and leaves the department vulnerable.
2. Inattention to information technology management exposes the department to unnecessary risk.

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## **Lax Management of the State's \$3.8 Billion Treasury Has Increased Risk and Reduced Available Funds**

The Department of Budget and Finance is responsible for managing the State's \$3.8 billion treasury. Chapter 36, Hawai'i Revised Statutes (HRS), entitled *Management of State Funds*, sets forth the general responsibilities of the department and the director of finance in this regard. Section 36-1, HRS, makes the director of finance responsible for safekeeping all moneys paid into the treasury and for properly disbursing and appropriating them. Statute also permits the director to invest excess funds within specified guidelines and restrictions. The State has a fiduciary duty to maximize returns on those investments while maintaining requisite liquidity and preserving invested funds.

However, we found that the department is not efficiently and effectively managing the State's treasury. Although the department has implemented the State's Treasury Investment Policy to delineate more specific investment requirements and limitations, the policy has not been updated since 1999 nor reviewed in detail since at least 2002. The department's management of the State's \$3.3 billion investment pool is primarily based on the 1999 policy and general statutory guidance, and is carried out via informal, manual procedures that increase risk to state funds and hamper the department's efficiency. Investment decisions and activities of the department are ultimately overseen by the director of finance and the Financial Administration Division administrator; neither has exercised proper oversight.

We found that the department significantly increased its holdings of auction-rate securities to more than \$1 billion in FY2008. Because the market for auction-rate securities has been largely frozen since then, those securities are no longer liquid and their value was written down by \$114 million in FY2008. More importantly, investment in these securities violate state laws regarding maturity limits.

***Investment policy has not been updated since 1999***

The department's responsibilities for managing the state treasury include investing excess funds to achieve a return commensurate with the general market while preserving and maintaining a requisite degree of liquidity. Section 36-21, HRS, permits the director to:

[I]nvest any moneys of the State which in the director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State and where in the director's judgment the action will not impede or hamper the necessary financial operations of the State....

The statute provides guidelines and limitations on allowable investments. The department has also implemented the State's Treasury Investment Policy, the purpose of which is "to outline objectives, provide guidelines, and set forth reporting procedures for the investment of cash assets of the State...." The policy establishes more detailed investment parameters and restrictions, including descriptions of allowable investments and diversification requirements. According to the department's Financial Administration Division (FAD) administrator and the funds custody manager, who together are primarily responsible for managing the treasury and investments, the investment policy is the primary document governing investment strategy and decision-making related to moneys in the state treasury.

The investment policy mandates an annual review and updates as necessary. Part VI of the investment policy states: "This investment policy will be reviewed annually to ensure that it remains consistent with the overall objectives of the State and within current financial trends. The policy may be reviewed and updated more frequently if conditions dictate...."

However, the department does not formally review the investment policy on an annual or regular basis. According to the FAD administrator, the investment policy is periodically reviewed; the most recent in-depth review was performed in 2002. As part of that review, the FAD administrator consulted with various lenders and banks on the adequacy of the policy; however, there was no formal or documented evidence of the review. Based on the informal input received from various lenders and banks, the FAD administrator and funds custody manager determined in 2002 that the State's policy was standard for state and local governments and revisions to the policy were not necessary. The investment policy has not been formally reviewed since then, although the administrator and funds custody manager indicated they informally review the policy on an ongoing basis.

We also found that the investment policy was last updated in January 1999. Thus, it has not been updated to consider market changes since then or the appropriateness of the previously established limits for the State's various types of investments.

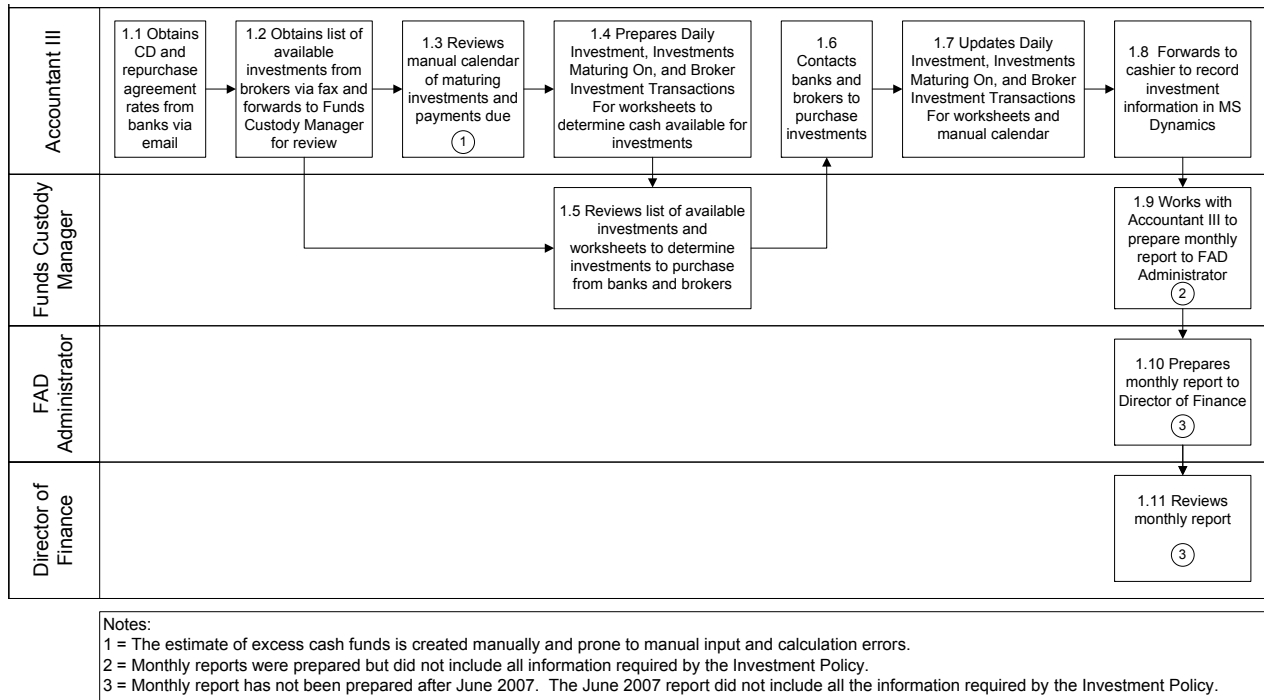
***The department's informal and manual cash management process is at odds with stated objectives of safety and prudence***

The State has a fiduciary duty to maximize returns on investments within guidelines set forth in Section 36-21, HRS, and the State's investment policy while maintaining requisite liquidity and preserving invested funds. The investment policy expressly states that "the objective of the cash management investment program shall be the safe and prudent investment of short-term cash...."

Although state law and the investment policy are both conservative, they allow the department to make several different types of investments. These generally provide a greater return than the interest paid by banks, even on interest bearing accounts. However, approximately 10 percent of the State's checking account balances do not earn interest.

The department does not have formalized procedures for performing daily and longer term cash projections. The informal, often manual, procedures established within FAD result in informal daily projections prone to errors and which provide less assurance than formal projections. Consequently, in fiscal year 2009 there were large uninvested cash balances of, for instance, \$126 million on June 30, 2009. Exhibit 2.1 shows the department's cash investment process.

**Exhibit 2.1  
Overview of the Department of Budget and Finance Cash Investment Process**



Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

**FAD does not perform formal cash projections and has retained significant checking account balances that could have been invested**

The Treasury Management Branch of FAD is responsible for investing excess daily cash. According to the FAD administrator and funds custody manager, the treasury's normal daily cash inflows and outflows are roughly equal and therefore formal cash projections are not performed. Branch personnel prepare informal cash projections daily, based on the expected maturities of securities and large recurring payments, which are recorded in a handwritten monthly investment calendar. As discussed in detail below, an informal estimate of excess funds available for investment is also performed daily. As a result of this informal and manual process, we found there were large amounts of uninvested cash during fiscal year 2009. These amounts remained in demand deposit checking accounts that earn minimal interest (e.g., rates ranged from 0.03 percent to 0.16 percent for June 2009). It is the department's responsibility to invest those funds to achieve a higher rate of return, while maintaining liquidity and heeding risks.

To ensure there are no cash shortages, the Treasury Management Branch typically keeps a cushion of \$20 to \$30 million in demand deposits in the state treasury each day. However, since approximately May 2009, the department retained approximately \$50 to \$80 million per day. The FAD administrator and funds custody manager told us they decided it was appropriate to maintain greater liquidity due to the falling revenues of the State from the economic recession and low yields on available investments in the second half of fiscal year 2009. However, by keeping large uninvested cash balances in checking accounts, the State may be foregoing potential investment earnings, particularly when interest rates are higher.

Based on a judgmental sample of 20 days selected during fiscal year 2009, we calculated an average checking account balance of \$63 million and an actual balance of \$126 million on June 30, 2009. We also noted that the estimated cash requirement in the Daily Investment Worksheet considers known cash disbursements for that day. Therefore, it appears the department could have invested, on average, \$63 million in cash on each of the 20 days we sampled, even if only in short-term investments.

The percentage yield rates for U.S. Treasury investments during fiscal year 2009 are shown in Exhibit 2.2 below.

**Exhibit 2.2**  
**Fiscal Year 2009 U.S. Treasury Percentage Yield Rates by Maturity**

Date	1 mo	3 mo	6mo	1 yr	2 yr	3 yr	5 yr
07/01/2008	1.92	1.87	2.13	2.38	2.63	2.90	3.33
07/31/2008	1.55	1.68	1.89	2.27	2.52	2.81	3.25
08/29/2008	1.63	1.72	1.97	2.17	2.36	2.60	3.10
09/30/2008	1.02	0.92	1.60	1.78	2.00	2.28	2.98
10/31/2008	0.12	0.46	0.94	1.34	1.56	1.80	2.80
11/28/2008	0.02	0.01	0.44	0.90	1.00	1.27	1.93
12/31/2008	0.11	0.11	0.27	0.37	0.76	1.00	1.55
01/30/2009	0.15	0.24	0.36	0.51	0.94	1.32	1.85
02/27/2009	0.16	0.26	0.45	0.72	1.00	1.40	1.99
03/31/2009	0.17	0.21	0.43	0.57	0.81	1.15	1.67
04/30/2009	0.04	0.14	0.29	0.49	0.91	1.38	2.02
05/29/2009	0.14	0.14	0.30	0.47	0.92	1.42	2.34
06/30/2009	0.17	0.19	0.35	0.56	1.11	1.64	2.54

Source: U.S. Treasury website: [http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield\\_historical\\_main.shtml](http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_main.shtml)

If the department had invested approximately \$30 million of the \$63 million average balance in its checking accounts, the State's investment earnings could have been approximately \$300,000 higher using an average yield of 1 percent. Moreover, a formal cash projection would have provided greater confidence to the estimate of cash necessary for current requirements and available for investment.

**Estimates and assessments of cash needs and investment amounts are manually prepared and prone to error**

The Treasury Management Branch's process for assessing the State's cash requirements and determining allowable amounts to be invested is manual, laborious, and prone to input and calculation errors. The process, reflected in Exhibit 2.1 as steps 1.3 and 1.4 and in note 1, involves a handwritten investment calendar and three worksheets: (1) "Daily Investment Worksheet"; (2) "Investments Maturing On \_\_\_\_\_" worksheet; and (3) "Broker Investment Transactions For \_\_\_\_\_" worksheet. The data from these worksheets are manually prepared and entered into the Microsoft Dynamics accounting system.

***Manual, handwritten investment calendar***

The accountant III in the Treasury Management Branch uses a handwritten monthly investment calendar to prepare daily informal cash projections. The investment calendar is color-coded to note expected maturities of securities (e.g., CDs, repurchase agreements, U.S. Treasury bonds, and other government agency bonds) and large recurring payments (e.g., payroll, Hawai'i Employer-Union Health Benefits Trust Fund, other medical, and taxes allocated to counties such as fuel, transient accommodations tax, and general excise tax surcharges). The investment calendar prepared for June 2009 is shown in Exhibit 2.3.

**Exhibit 2.3**  
**Manual Investment Calendar for June 2009**

MONTH June YEAR 2009

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
	1 14.5 <i>DS 1957</i>	2 5.530 2.25	3 13, 5.4, 14.4 10, 20, 19.5 <i>Acc 1.757</i> 31.5M - BOT 20-PFB 20-PFB-DN BOT	4 10, 25 16.50	5 8, 27, 7.5, 5.0 20-PFB 10, 10 5 BOT 10-PFB 10-LPB 10-Ten ML 500	6 10, 10, 19, 9.1
7 <i>ML 500</i> 5.500, 3.00	8 10 BOT 10-Ten 34.5 BOT 5-hub 13-cpb	9 5.25 2.25 31-PFB 46-ML 7018 BOT	10 15, 10, 3.9, 5.10, 20 19.25, 13, 5.4, 14.4 42.5 BOT <i>ML 500</i> 15-cpb <i>Acc 2.112</i>	11 5.15, 2.65, 100 1.850, 2.1, 5, 6.5 <i>Holiday</i> SB 100 6-COPEL CPE	12 9.5, 12.1, 10, 10, 10 33.75, 9.050, 10, 10 10.8, 27.75, 1.550 10, 10 SB 450 <i>ML 500</i>	13
14 <i>OUTF 15.545</i>	15 1 BOT 20-PFB 4-6 hub 10-Ten 10-hub 15-cpb <i>ML 500</i>	16 10.65, 1.2, 20 49, 18.5, 8.95 2.25 <i>SEARCHED</i>	17 5, 10, 3.9, 19.6 <i>ML 500</i> 34 BOT 15-CPE 15-cpb <i>Acc 2.20</i>	18 10, 3.2, 16, 6.9 10, 10, 26.7 <i>ML 500</i> SBPC <i>ML 500</i> 250 150 700-CPE	19 11.55, 20, 11.55 30-PFB 2.25 11-BOT 30-PFB 15-cpb SBPC 350	20 11, 9.4, 0, 12 29 8, 27.75, 1.55, 10 10, 1
21 <i>Rates FASB Bank proceeds</i>	22 5 <i>ML 500</i> 15-PFB 15-PFB <i>ML 2000</i> <i>2000 - PFB 1111</i>	23 5.73, 20, 5.4 5, 2.25 <i>ML 500</i>	24 16, 25, 19.25, 13 5.4, 14.4, 10, 20 <i>Acc 2.470</i> 18-cpb	25 4.8, 19.45, 6.5 <i>1000 CAD-COMES</i> <i>1000 CAD-COMES</i> <i>Changto rep</i> @ 25 9144	26 9.45, 6.5, 10 5.35, 10, 10 6.25, 27.75, 550, 10 10	27
28	29 14.40 <i>20 BOT OFF</i>	30 5.550 10-PFB 10-BOT 10-PFB 10-Ten 10-cpb	31 2.25 <i>96 hyl 20 since 116</i>	<i>SuTF</i>	8.938	

Source: Department of Budget and Finance

Each day, information from the calendar is recorded in the “Daily Investment Worksheet,” the “Investments Maturing On” worksheet, and the “Broker Investment Transactions For” worksheet. We understand that there are investments maturing almost every day; so if there is a shortfall in the daily cash receipts, some of the maturing investments can offset the shortfall.

**Daily Investment Worksheet**

The accountant III checks the State’s account balances at its three main banks (First Hawaiian Bank, Bank of Hawai’i, and American Savings Bank) and enters the information into the Daily Investment Worksheet, which is used to determine the amount of excess cash available for investment. The Daily Investment Worksheet prepared for June 30, 2009 is shown in Exhibit 2.4.

**Exhibit 2.4**  
**Daily Investment Worksheet for June 30, 2009**

Daily Investment Worksheet		June 30, 2009			Small Banks		Total
	Bank of Hawaii	First Hawaiian	American Svg Bk	Bank	Amount		
<b>Resources:</b>							
Collected Balance (+ FHB Sweep)	1,767,755.12 ✓	126,356,237.96 ✓	437,547.87	cpb ✓	10,000,000.00		138,561,540.95
One day float	-	17,105,951.88 ✓	440.00	terr ✓	10,000,000.00		17,106,391.88
TCD's Maturing	-	-	-	-	-	-	-
Repos Maturing	46,000,000.00 ✓	50,000,000.00 ✓	-	-	-	-	96,000,000.00
U.S. Agencies Maturing	-	-	-	-	-	-	-
ML-call	-	-	-	-	-	-	-
hta	-	-	-	-	-	-	-
Money in from City for EUTF	-	40,110,047.25 ✓	-	-	-	-	40,110,047.25
<b>Total Resources</b>	<b>47,767,755.12</b>	<b>233,572,237.09</b>	<b>437,987.87</b>		<b>20,000,000.00</b>		<b>291,777,980.08</b>
<b>Requirements:</b>							
Med Quest Payments-Weekly	-	-	-	-	-	-	-
Debt Service	-	-	-	-	-	-	-
Special Redemption (bonds)	-	-	-	-	-	-	-
Fuel Tax to Counties-Monthly	-	-	-	-	-	-	-
TAT to Counties-Semi-annual	-	-	-	-	-	-	-
TAT to HTA-Monthly	-	-	-	-	-	-	-
Wire to ML - purch settle	-	-	-	-	-	-	-
Wire to SB- purch SL	-	-	-	-	-	-	-
Wire to SB- purch fhfb	-	-	-	-	-	-	-
Misc. Wire Payments-returned to SB	-	-	-	-	-	-	-
<b>Total Requirements</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Available Cash</b>	<b>47,767,755.12</b>	<b>233,572,237.09</b>	<b>437,987.87</b>		<b>20,000,000.00</b>		<b>301,777,980.08</b>
<b>Less: Investments Purchased that will Settle Today</b>							
ICB (SoH) <i>Repos</i>	-	40,110,047.25	-	cpb <i>Repos</i>	10,000,000.00		50,110,047.25
FED (SoH) <i>Repos</i>	-	7,450,000.00	-	terr <i>Repos</i>	10,000,000.00		10,000,000.00
" " (by State Agencies)	-	-	-	-	-	-	-
Repos (SoH)	-	-	-	-	-	-	-
" " (by State Agencies)	-	-	-	-	-	-	-
U.S. Treasury & Agencies (SoH)	-	-	-	-	-	-	-
" " (by State Agencies)	-	-	-	-	-	-	-
Student Loans for Cash (SSB)	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-
<b>Total Investments</b>	<b>-</b>	<b>47,560,047.25</b>	<b>-</b>		<b>20,000,000.00</b>		<b>60,110,047.25</b>
<b>Transfers Between Banks</b>	<b>(47,300,000.00)</b>	<b>47,300,000.00</b>	<b>-</b>		<b>-</b>		<b>-</b>
<b>Compensating Balance</b>	<b>467,755.12</b>	<b>233,312,189.84</b>	<b>437,987.87</b>		<b>-</b>		<b>241,667,932.83</b>
<b>Note: Balance remains to cover estimated checks clearing tonight, etc.</b>							
Payroll (UH, State)	\$	15,000,000.00					
eutf-hmas	\$	27,646,129.32					
eutf-drugs	\$	5,271,002.87					
hta	\$	7,382,808.64					
fuel	\$	6,668,304.91					
uh cancer	\$	1,542,240.00					
tat	\$	44,743,108.37					
	\$	<b>108,253,594.11</b>					

Source: Department of Budget and Finance



As shown above, the Daily Investment Worksheet lists the following:

- balances at the State's three primary banks as well as a combined balance for all its other bank accounts;
- maturing repurchase agreements and CDs in all banks;
- investment calls and actual maturities (information on maturities is taken from the department's Microsoft Dynamics accounting system);
- large disbursements for the day, including MedQuest payments, debt service, fuel tax and transient accommodations tax (TAT) to counties, TAT to the Hawai'i Tourism Authority, and wires to brokers for investment purchases (this section is not always completed);
- investments purchased (settling) that day; and
- checks over \$1 million expected to clear that night or the following day, including payroll and items noted above, if not already calculated (these checks are included for informational purposes to ensure the department does not overinvest funds based on its needs the following day).

***Investments Maturing On worksheet***

The 'Investments Maturing On...' worksheet is partially handwritten and partially typed. It includes handwritten information on CDs and repurchase agreements maturing by bank and fund (general, special, trust and bond). The totals by type of investment (e.g., repurchase agreements, CDs, government agency securities purchased through brokers) are typed and automatically summed to a grand total of maturing investments. There is also a section for investment purchases, but this section is not typically used, as purchases are documented in the 'Daily Investment Worksheet' or the 'Broker Investment Transactions For...' worksheet.

***Broker Investment Transactions For worksheet***

The 'Broker Investment Transactions For...' worksheet is another manual spreadsheet that summarizes investment transactions (maturities, including calls/partial calls, sales, rollovers, new purchases and investment terms such as number of days to maturity, maturity date, and rate for new purchases or rollovers of investments). The worksheet is organized by broker.

### **Process of obtaining quotes from banks and brokers is informal**

The Treasury Management Branch accountant III obtains daily quotes from banks for CDs and repurchase agreements and from brokers for government agency securities to determine what short-term vehicles to invest in. This is an informal process; the accountant requests the information from the banks and brokers via email. According to the funds custody manager, she and the accountant select short-term investments based on amount, product type (CD or repurchase agreement), and maturity; they invest with the bank that offers the highest interest rate for the specified maturity, assuming the bank meets the State's collateral requirements. It is not uncommon for the daily invested cash to exceed \$100 million.

Brokers send the department a daily list of new issues that meet the State's investment requirements. In addition to the requirements stated above, the department may only invest in new issues at par; that is, without premiums or discounts, as the State's policy is to hold investments until maturity. Clauses in the department's contracts with its brokers state that prices and yields offered are "inclusive of any fees, commissions, wiring fees or mark-ups for any securities sold, purchased, or exchanged." After purchases are made, checks are processed for purchases settling that day. Checks require dual signatures: an authorized signature from the department and an authorized signature from the Department of Accounting and General Services (DAGS).

The manual nature of the department's current cash and investment management process is contrary to its stated objectives of safety and prudence. The process is highly susceptible to errors such as misread handwritten amounts, transposition errors between spreadsheets, and incorrect calculations where automated formulas are not used. It could also result in a material error in the projected amount of cash available for investment on any given day.

In addition to the risks inherent in the manual process, internal policies and procedures are not formalized. Reliance is placed on the experience of Treasury Management Branch staff involved in the investment process. The department is dependent on these employees' accumulated knowledge and insights about operations when making investment decisions. However, as noted earlier, the accountant V left the department in April 2009 and the accountant III was one of 12 people in the department eligible for retirement by December 31, 2009. Also, the FAD administrator and funds custody manager believe the department's current investment process is sufficient and have not felt the need to update or formally document the process. This lack of formalized procedures, particularly in conjunction with the retirement and pending

retirement of Treasury Management Branch personnel, makes it difficult to minimize the loss of critical, valuable experience and information when employees leave the department.

**Director and management oversight of investment decisions and activities are lacking**

The director of finance and the FAD administrator are ultimately responsible for monitoring and overseeing the State's investment pool and investment activities. Part III.K of the investment policy regarding *Structure, Responsibility and Authority* provides that the director shall:

- a. Review and approve the State's investment policy.
- b. Approve all relationships with banks and other financial institutions for the purpose of conducting investment business.
- c. Review periodic investment reports for general compliance and confirmation with this investment policy.

Part III.K also mandates that the FAD administrator shall:

- a. Draft for the approval of the Director of finance the State's investment policy and amendments thereto.
- b. Recommend to the Director of finance relationships with banks and other financial institutions for the purpose of conducting investment business.
- c. Prepar[e] periodic investment reports which indicate general compliance and confirmation with this investment policy.
- d. Approve, in advance, all investment transactions that are not consistent with the guidelines prescribed in this policy and notify the Director of finance of such transactions.
- e. Ensure that control systems and procedures provide an appropriate level of segregation of duties related to the conduct and accounting of investment activity for the State.

Paragraph three of Part III.K, *Responsibility for Review of Investment Decisions*, also mandates that at least two people be involved in each investment decision, one in a direct capacity and another in a review capacity.

We found that many of these fundamental oversight procedures are not being performed by the department, and further, are not being enforced by the director of finance or the FAD administrator.

**Monthly investment reports are infrequently submitted and contain insufficient and inaccurate information**

The investment policy sets forth specific internal reporting requirements for the director and administrator to carry out their oversight responsibilities. According to the Investment Policy, Part IV.A, *Internal Reports*:

The Administrator is primarily responsible for the preparation of and review of a monthly investment report that contains the following information:

1. Inventory of portfolio investments as of the date of the report with a percentage mix of the portfolio by type of investment.
2. Average portfolio maturity.
3. Notations, which shall include the amounts and reasons, of the exceptions to the investment policy.
4. Status of any investments that might require management attention (such as investments affected by a credit rating change, or similar circumstances that could have an effect on the value and collectability of the investment).

The investment report will contain information for all transactions occurring during the month, whether or not they have been fully settled as of the end of the month.

The investment report will contain a management summary that will describe the status of the portfolio. The management summary should be presented in a manner that will allow the Director of finance to determine whether investment activity during the month being reported on has adhered to this investment policy.

To comply with these reporting requirements, the department typically prepares two monthly investment reports: 1) a report from the Treasury Branch to the FAD administrator (*Report to the Administrator*), which is reflected at Exhibit 2.1 as step 1.9 and in note 2; and 2) a report from the FAD administrator to the director of finance (*Report to the Director*), which is reflected at Exhibit 2.1 as steps 1.10 and 1.11 and in note 3. Based on our review of fiscal year 2009 reports, the department did not comply with the investment policy: it failed to submit reports on time or at all; failed to include all required information in submitted reports; and inaccurately presented investment information in the reports it did submit.

#### ***Failure to prepare reports***

During fiscal year 2009, neither the monthly *Report to the Administrator* nor *Report to the Director* were prepared in a timely manner. The last *Report to the Administrator* was for the month of January 2009, which was prepared in April 2009; as of October 2009, no reports had been prepared for the remaining five months of the fiscal year (February to June 2009). The last *Report to the Director* prepared was for June 30, 2007. As of October 2009, there were no *Reports to the Director* for fiscal years 2008 or 2009. Based on our interviews and discussions with the director, FAD administrator, and other key personnel involved with investments, the information required to be reported is not otherwise communicated to the director via informal means.

***Lack of required information***

Based on the sample we reviewed, reports to the administrator and to the director that were submitted did not contain all of the information required by the investment policy.

***Report to the Administrator***

The July 2008, December 2008, and January 2009 *Reports to the Administrator* prepared by the FAD Treasury Management Branch all lacked required information. Exhibit 2.5 shows the information required versus what was included in the reports for July 2008, December 2008, and January 2009.

**Exhibit 2.5  
Information Included in the *Report to the Administrator* Compared to Requirements**

Information Required by the Investment Policy	Included/Not Included
Inventory of portfolio of investments as of the date of the report with a percentage mix of the portfolio by type of investment	(a)
Average portfolio maturity	Not included (b)
Notations, which shall include the amounts and reasons, of the exceptions to the investment policy	Not included (c)
Status of any investments that might require management attention (such as investments affected by a credit rating change, or similar circumstances that could have an effect on the value and collectability of the investment)	Not included
Information for all transactions occurring during the month, whether or not they have been fully settled as of the end of the month	Not included (d)
Management summary that describes the status of the portfolio. The summary should be presented in a manner that allows the director of finance to determine whether investment activity during the month being reported has adhered to the investment policy.	Included
<p><i>Notes:</i></p> <ul style="list-style-type: none"> <li>(a) The information by type of investment was included with the percentage mix. However, the information was at a high level, aggregated by bank-issued and government-issued securities. While it appears that the information by type of investment was included, it may be useful to include more disaggregated information such as investments in U.S. Treasuries, U.S. government agency securities, State of Hawai'i securities, repurchase agreements, CDs, auction-rate securities, etc.</li> <li>(b) Totals by range of maturity were included. However, the average portfolio maturity was not included.</li> <li>(c) Notations of exceptions to the investment policy or that require management attention were not included. For example, the department owned investments that did not comply with Section 36-21, HRS during FY2009, such as student loan-backed auction-rate securities. Additionally, some of the auction-rate securities were rated below AAA and had maturities exceeding 5 years. The department also held some investments that exceeded the maximum percentages allowed in the portfolio, which was not noted on the report.</li> <li>(d) There was no information for investment transactions occurring during the month other than total calls on outstanding investments.</li> </ul>	

Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

Based on our review, the *Report to the Administrator* typically included the following investment information:

- By type of securities:
  - Bank-issued securities xx.xx%
  - Government agency-issued securities xx.xx%
  - 100.00%
  
- By maturities:
  - Within next 6 months xx.xx%
  - 7 months to 1 year xx.xx%
  - 2 years xx.xx%
  - 3 years xx.xx%
  - 4 years xx.xx%
  - 5 years xx.xx%
  - Over 5 years xx.xx%
  - 100.00%
  
- Total calls for the month;
  
- Student loan-backed auction-rate securities average yields are for 28 days as compared to an average of what the banks could offer over the period; and
  
- Table of investment pool portfolio allocation (in dollars and percentage) between banks and government agencies by maturity dates as of the month-end.

*Report to the Director*

As there were no *Reports to the Director* prepared for fiscal year 2009, we reviewed the last report submitted, which was for June 2007, and found that required information was not included in the report. Exhibit 2.6 illustrates the information required versus the information in the June 2007 *Report to the Director*.

**Exhibit 2.6**  
**Information Included in the *Report to the Director* Compared to Requirements**

Information Required by the Investment Policy	Included/Not Included
Inventory of portfolio of investments as of the date of report, with a percentage mix of the portfolio by type of investment	Not included
Average portfolio maturity	Not included
Notations, which include amounts and reasons, of exceptions to the investment policy	Not included
Status of any investments that might require management attention (such as investments affected by a credit rating change, or similar circumstances that could have an effect on the value and collectability of the investment)	Not included
Information for all transactions occurring during the month, whether or not they have been fully settled as of the end of the month	Not included
Management summary that describes the status of the portfolio. The summary should be presented in a manner that allows the director of finance to determine whether investment activity during the month being reported on has adhered to the investment policy	(a)
<p><i>Notes:</i></p> <p>(a) While the <i>Report to the Director</i> was a management summary as required by the investment policy, it did not contain all of the information necessary for the director of finance to determine whether the investment activity during the month and investment positions at the end of the month adhered to the State's investment policy.</p>	

Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

The June 2007 *Report to the Director* included the following information on investment pool earnings:

- The amount of interest realized and distributed to the participating agencies' accounts and the accrued interest for the month;
- Comparison of the average interest yield for the current month and previous month;

- Total calls for the month;
- Brief description of interest yield changes;
- Amount of the treasury investment pool in student loan-backed auction-rate securities and percentage of investments comprising the treasury investment pool portfolio;
- Brief description of the yield of student loan-backed auction-rate securities;
- Table of investment pool interest earnings (realized interest and accrued interest) by departments for the current and previous months and a cumulative fiscal year total; and
- Annualized rate of return and average daily investment amount for the total current and previous month and cumulative fiscal year amounts.

According to the FAD administrator, the funds custody manager, and the completed reports examined, the funds custody manager is responsible for preparing the *Report to the Administrator*, and the FAD administrator is responsible for preparing the *Report to the Director*. However, due to the departure of the Treasury Management Branch's accountant V in April 2009, the Fiscal Services Office's accountant IV in July 2007, and the temporary assignment of an account clerk III to the Unclaimed Property Branch since fiscal year 2008, the remaining three accountants and one account clerk in the Treasury Management Branch and Fiscal Services Office have assumed the work previously performed by those individuals, and their responsibilities were reprioritized. The FAD administrator and funds custody manager determined that the *Reports to the Administrator* and *Reports to the Director* were a lower priority than the other tasks previously performed by the accountant V and accountant IV.

We noted that prior to his departure in April 2009, the accountant V in the Treasury Management Branch prepared a Monthly Investment Summary – a schedule containing detailed monthly information such as:

- Investment pool composition historical information;
  - Percentages by local banks and government agencies
  - By maturities
- Diversification by depository;
- Diversification by type of investment instrument; and
- Diversification by issuer of investment instrument.



According to the funds custody manager, the investment summary is submitted to her and is used to prepare reports to the FAD administrator and the director of finance. However, when those reports are not prepared, the summary and detailed information contained within are not conveyed to the administrator or director.

***Inaccurate information***

We also noted inaccuracies in the presentation of the reports' investment information. The student loan-backed auction-rate securities were classified as short-term securities (because auctions were occurring every seven to 49 days to allow investors to sell their investments and reset the applicable interest rates). However, the State's auction-rate securities are collateralized by student loans that have final maturities of up to 36 years. As the auctions have generally failed since early 2008, it appears that the maturity information reported is inaccurate; the report should state the final maturity dates in determining compliance with maximum maturity constraints.

The FAD administrator and funds custody manager indicated that not all the information required by the investment policy, which was last updated in 1999 by previous management, is necessary. They believe the information currently included in the *Report to the Administrator* and *Report to the Director* is sufficient to effectively manage the State's investments and ensure compliance with state laws and investment policy objectives. They do not believe any additional information is needed to meet the requirements of Part IV of the investment policy.

Although FAD management indicated they believe the requirements of the investment policy may be outdated or unnecessary, they have not updated the policy despite having the authority to do so. As discussed above, the FAD administrator and funds custody manager told us they informally review the policy on an ongoing basis and have determined that revisions to the 1999 version are not necessary.

**Certain investments that exceeded maximum allowable percentages were not properly approved**

The State's investment policy allows for exceptions to the policy upon approval by the FAD administrator prior to the purchase of the investment, when it is determined that an investment transaction is in the best interest of the State and is consistent with the investment policy's objectives. The policy further states that the director of finance should also approve significant exceptions, and inadvertent breaches of the policy should be immediately reported to the director.

According to the funds custody manager, however, the department performs procedures to monitor compliance only at the end of each

month, after purchases have been made. Consequently, the department may not become aware of violations to the investment policy until after the end of the month in which they occur. This also means that if non-complying purchases are made during the month they are not approved in advance, as is required.

The department also violated the investment policy since the FAD administrator and director of finance did not approve the purchases of investments that resulted in balances exceeding the maximum amounts stated in the investment policy. We found the department held certain investments during fiscal year 2009 that exceeded maximum diversification percentage requirements. These exceptions are shown in Exhibit 2.7 below. For example, student loan-backed auction-rate security holdings exceeded the 20 percent limit for every month of 2009; repurchase agreements with First Hawaiian Bank exceeded the 70 percent limit for four months; and CDs invested with two banks exceeded the 50 percent limit for five months. The FAD administrator and director of finance did not approve any of the purchases of investments that resulted in balances exceeding maximum amounts.

**Exhibit 2.7**  
**Exceptions to Maximum Investments Allowed**  
 (Figures shown in bold exceed allowable percentages)

Month	Investments in Auction-Rate Securities Must Not Exceed 20% of the Total Portfolio	Repurchase Agreements by Issuer Must Not Exceed 70% of the Total Portfolio	CDs by Issuer Must Not Exceed 50% of the Total Portfolio	
			FHB	CPB
July 2008	<b>29.00%</b>	<b>81.00%</b>	21.90%	48.83%
August 2008	<b>29.49%</b>	65.15%	22.34%	47.79%
September 2008	<b>30.19%</b>	64.60%	22.25%	47.60%
October 2008	<b>30.47%</b>	<b>71.91%</b>	33.76%	41.10%
November 2008	<b>32.13%</b>	60.00%	37.45%	38.24%
December 2008	<b>31.12%</b>	42.19%	<b>60.65%</b>	23.02%
January 2009	<b>32.63%</b>	69.48%	<b>50.13%</b>	28.81%
February 2009	<b>33.86%</b>	<b>78.97%</b>	29.23%	39.60%
March 2009	<b>35.87%</b>	<b>85.12%</b>	19.91%	49.54%
April 2009	<b>37.88%</b>	65.08%	13.84%	<b>53.50%</b>
May 2009	<b>37.48%</b>	65.84%	7.12%	<b>57.73%</b>
June 2009	<b>30.47%</b>	33.69%	<b>61.21%</b>	10.96%

FHB = First Hawaiian Bank  
 CPB = Central Pacific Bank

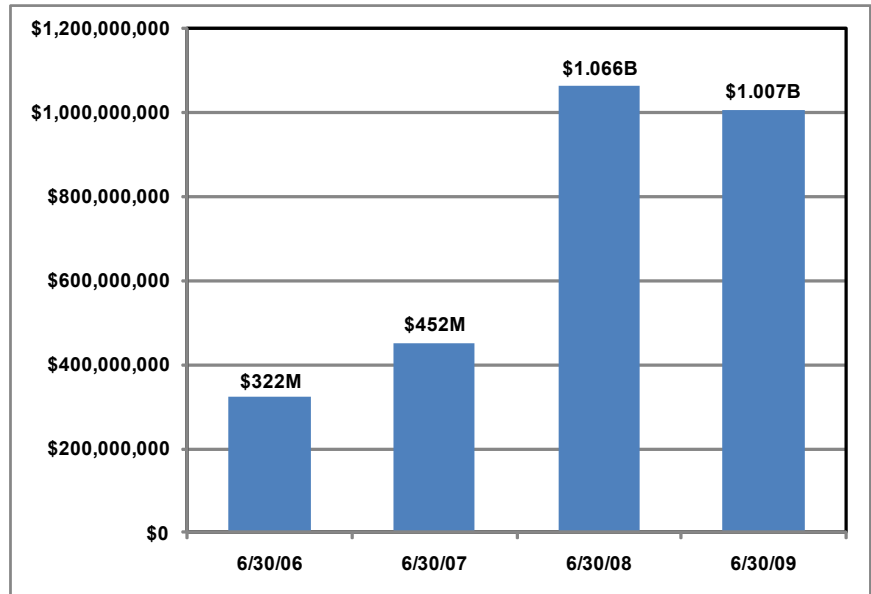
Source: Investment Pool Composition Historical schedule prepared by the Department of Budget and Finance

The director of finance is ultimately responsible for ensuring investment holdings and transactions comply with state law and the investment policy, as well as for managing investment risk while attempting to achieve the State's investment objectives. If monthly investment reports are not prepared, are untimely, or do not contain appropriate or accurate information, it is questionable whether the director can fulfill those responsibilities. The director's failure to monitor investment activities puts the treasury at serious risk, as the State's increased holdings in auction-rate securities exemplifies.

***The department holds approximately \$1 billion in impaired auction-rate securities that do not comply with state law***

As of June 30, 2009, the state treasury investment pool of approximately \$3.3 billion held student loan-backed auction-rate securities with a total cost basis of \$1,006,675,000. Auction-rate securities are debt instruments with long-term maturities from underlying loans (in this case, student loans). Auction-rate securities were previously marketed as highly liquid and safe short-term investments, which could be purchased and sold at Dutch auctions held every seven to 49 days. At such auctions, interest rates were reset, creating a regular market for the securities. Act 47, Session Laws of Hawai'i 1997 (codified as Section 36-21, HRS) authorized the department to invest in student loan-backed auction-rate securities.

According to the department, it began investing in auction-rate securities in September 1998 with a total purchase of \$171.8 million. The department has continued to invest in these securities since, with a substantial increase in FY2008 when the concentration of these investments increased from approximately \$452 million (11 percent of the State's portfolio at the end of June 2007), to more than \$1 billion (29 percent in July 2008). Exhibit 2.8 illustrates the State's investments in auction-rate securities as of June 30, 2006 through June 30, 2009.

**Exhibit 2.8****State Investments in Auction-Rate Securities – June 30, 2006 through June 30, 2009**

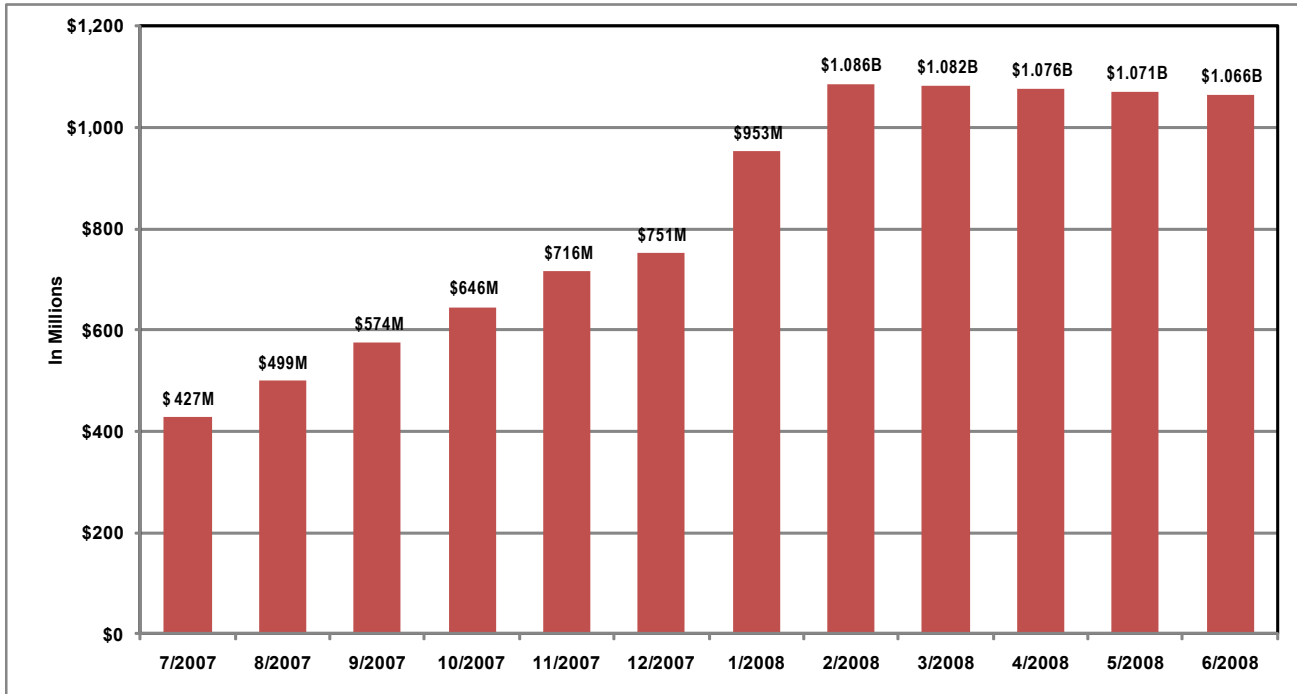
Source: Compiled by Accuity LLP from information provided by the Department of Budget and Finance

**The department did not evaluate risks before more than doubling its investment in auction-rate securities**

The decision to increase holdings of auction-rate securities during fiscal year 2008 was made by Treasury Management Branch personnel. According to the FAD administrator, the decision was primarily based on the higher yields of these securities compared to other allowable investments; the department believed auction-rate securities were good investments because they provided a return yield approximately twice that of 30-day U.S. treasury investments or bank CDs at the time. However, the department did not perform any risk assessment or cost-benefit analysis prior to purchasing these securities because they did not believe it was necessary. The department relied on information provided by a third-party investment broker, who was paid commissions related to the department's purchase of auction-rate securities.

Further, the department significantly increased investments in auction-rate securities during January and February 2008, when auctions for the securities began failing. As shown in Exhibit 2.9, state investments in auction-rate securities rose by more than \$335 million from December 2007 to February 2008.

**Exhibit 2.9**  
**State Investments in Auction-Rate Securities - Fiscal Year 2008 by Month**



Source: Compiled from information provided by the Department of Budget and Finance

In early 2008 most auction-rate security auctions began failing, and the auction market has been largely frozen since then. According to the FAD administrator, FAD personnel were not fully aware of the risks of investing in auction-rate securities, including the potential effects of failed auctions. He also stated that no one could have predicted such risks. However, risk factors associated with the securities, including the risk of failed auctions, were set forth in the offering documents—the formal documents detailing the terms, objectives, risks, and other relevant information for a security being offered for sale. As depicted in Exhibit 2.10, one offering document for student loan-backed auction-rate securities owned by the department at June 30, 2008 clearly states on page one, “You should carefully consider the risk factors beginning on page 12 of this offering memorandum.”

Exhibit 2.10


Front Page of an Offering Document for Auction-Rate Securities Owned by the State of Hawai'i at June 30, 2008

**\$571,000,000**  
**AUCTION RATE STUDENT LOAN-BACKED NOTES**  
 Series 2006-1

**NEXTSTUDENT MASTER TRUST I**  
 Issuer

**NEXTSTUDENT EDUCATION LOAN FUNDING, LLC**  
 Depositor

**NEXTSTUDENT INC.**  
 Seller



We are offering our notes in the following nine series:

Series	Original Principal Amount	Interest Rate	Final Maturity Date	Price to Public	Initial Purchasers' Discount	Proceeds to the Issuer <sup>(1)</sup>
Series 2006A-1	\$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 72,545,200
Series 2006A-2	\$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 72,545,200
Series 2006A-3	\$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 72,545,300
Series 2006A-4	\$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 72,545,200
Series 2006A-5	\$ 68,500,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 68,260,250
Series 2006A-6	\$ 68,500,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 68,260,250
Series 2006A-7	\$ 57,100,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 56,900,150
Series 2006A-8	\$ 57,100,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 56,900,150
Series 2006B-1	\$ 28,600,000	Auction Rate	June 1, 2041	100%	0.35%	\$ 28,499,900
<b>Total</b>	<b>\$571,000,000</b>					<b>\$ 569,001,500</b>

(1) Before deducting expenses, estimated to be \$856,500.

The notes will be secured by student loans made under the Federal Family Education Loan Program. The notes are issued by a trust and constitute obligations of the trust payable solely from the student loans and other assets of the trust. The notes are not obligations of NextStudent Education Loan Funding, LLC or NextStudent Inc. or any of their affiliates.

The notes have not been registered under the Securities Act of 1933, as amended (the "Securities Act"), or any state securities laws, and, unless so registered, may not be offered or sold except pursuant to an exemption from or in a transaction not subject to the registration requirements of the Securities Act and applicable state securities laws. Accordingly, the notes are being offered and sold only to "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) in compliance with Rule 144A and to "institutional accredited investors" as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act.

All of the Class A notes offered pursuant to this offering memorandum will be rated AAA by Fitch Ratings and Aaa by Moody's Investors Service, Inc. The Class B notes offered pursuant to this offering memorandum will be rated A by Fitch Ratings and A2 by Moody's Investors Service, Inc.

**Neither the SEC nor any state securities commission has approved or disapproved of these notes or determined that this offering memorandum is accurate or complete. Any representation to the contrary is a criminal offense.**

**You should carefully consider the risk factors beginning on page 12 of this offering memorandum.**

The initial purchasers named below are offering the notes subject to approval of certain legal matters by their counsel. Delivery of the notes will be made on or about April 20, 2006, against payment in immediately available funds.

**Citigroup**  
**JPMorgan**  
**Deutsche Bank Securities**  
**RBC Capital Markets**

The date of this offering memorandum is April 14, 2006

Source: Investment broker, via auditor of the State of Hawai'i FY2008 financial statements and Comprehensive Annual Financial Report

Page 12 of that offering document begins with the paragraph shown in Exhibit 2.11 below.

**Exhibit 2.11**

**Excerpt from an Offering Document for Auction-Rate Securities Owned by the State of Hawai'i at June 30, 2008**

**RISK FACTORS**

**You should consider the following risk factors in deciding whether to purchase the notes.**

***You may have difficulty selling your notes*** We do not intend to list the notes on any securities exchange. **As a result, we cannot assure you that a secondary market for the notes will develop.** If a secondary market for the notes does develop, the spread between the bid price and the asked price for your notes may widen, thereby reducing the net proceeds to you from the sale of your notes. The initial purchasers intend to make a secondary market for the notes and may do so by offering to buy the notes from investors that wish to sell. However, the initial purchasers will not be obligated to make offers to buy the notes and may stop making offers at any time. In addition, the prices offered, if any, may not reflect prices that other potential purchasers would be willing to pay, were they to be given the opportunity. **There have been times in the past where there have been very few buyers of asset-backed securities, and there may again be such a time in the future. As a result, you may not be able to sell your notes when you want to or you may not be able to obtain the price that you wish to receive.**

Source: Investment broker, via auditor of the State of Hawai'i FY2008 financial statements and Comprehensive Annual Financial Report

Numerous other risk factors are discussed on pages 12 to 32 of the offering document, including:

**You may not be able to sell some or all of your notes at an auction and you may not be able to retain some or all of your notes during an auction.** You may not be able to sell some or all of your notes at an auction if the auction fails; that is, if there are more notes offered for sale than there are buyers for those notes. . . .

**You may incur losses or delays in payment on your notes if borrowers default on their student loans. . . .**

**Borrowers of student loans are subject to a variety of factors that may adversely affect their repayment ability and our ability**

**to pay the noteholders.** For a variety of economic, social and other reasons, we may not receive all the payments that are actually due on the student loans held in the trust estate. Deterioration in economic conditions could be expected to adversely affect the ability or willingness of borrowers to repay student loans. Furthermore, student loans are not secured by any assets of the borrowers. . . .

**The notes are not suitable investments for all investors.** The notes are not a suitable investment if you require a regular or predictable schedule of payments or payment on any specific date. The notes are complex investments that should be considered only by investors who, either alone or with their financial, tax and legal advisors, have the expertise to analyze the prepayment, reinvestment, default and market risk, the tax consequences of an investment, and the interaction of those factors. . . .

According to the FAD administrator, the department did not request, obtain, or review copies of the offering documents prior to purchasing the auction-rate securities, nor did it inquire about possible risks associated with the securities, focusing instead on the higher yields anticipated. The approach taken by the department was therefore contrary to Part III.C of the State's investment policy, which expressly provides:

C. YIELD

1. Yield on the State's investment portfolio is of secondary importance compared to the safety and liquidity objectives described above.

Investments are limited to relatively low-risk securities in anticipation of earning a market rate of return commensurate with the risk being assumed. . . .

This provision reflects the familiar investment principle that higher yields are generally commensurate with higher investment risk. Thus, a potential investment with comparatively higher yields should have triggered some type of independent risk analysis to determine whether and how much to invest in that particular instrument, rather than relying on the advice of a third party investment broker who received commissions on the sale of that investment.

**Auction-rate securities purchased by the department in FY2008 violated state law**

Section 36-21, HRS, and the State's investment policy list student loan-backed auction-rate securities as an allowable type of short-term investment. However, the statute and policy also contain other requirements that must be met for an investment to be allowable.



Section 36-21, HRS, provides that the State can only invest in securities with maturity dates not exceeding five years from the date of purchase. Part III.D of the investment policy also states that individual security maturities shall not exceed five years in accordance with Section 36-21, HRS, which applies to individual investment transactions and to the portfolio as a whole. Part III.D.1.b of the investment policy further provides that “each investment will be made with the intention of holding the investment to maturity.”

The department erroneously believed the auction-rate securities met the State's five-year maturity limit as the securities could be auctioned and thus sold every seven to 49 days. However, although investors had the option to sell auction-rate securities at the regular auctions, the actual maturity dates for the securities are the maturity dates of the underlying student loans and not the frequency of the auctions. The applicable maturity dates of the securities are often clearly stated on the front of the offering document and, in some instances, are more than 35 years from the date of purchase. The excerpt at Exhibit 2.10 above provides an example of the first page of an offering document for auction-rate securities owned by the State at June 30, 2008. The “Final Maturity Date” for that series of securities is clearly stated as “June 1, 2041.” Accordingly, auction-rate securities due to mature more than five years from the time purchased in FY2008 violated the maturity restriction established in the statute as well as the department's own investment policy.

In addition, the department's purchase of auction-rate securities in FY2008 violated its own investment diversification requirements. Part III.G of the policy provides percentage limits for the types of allowable investments and states that auction-rate securities may comprise up to 20 percent of the investment portfolio. The increased investment of auction-rate securities to 29 percent of the State's portfolio in FY2008 violated the policy limit. As of June 30, 2009, the percentage of auction-rate securities is slightly higher, comprising approximately 30 percent of the portfolio. Holding a significant portion of the State's treasury investment pool in one type of security is also contrary to sound investment principles. The department's own policy acknowledges the prudence of investment diversification: Part III.A, entitled *SAFETY*, includes a provision requiring the State to mitigate risk by diversifying assets when practical as described in Part III.G of the policy.

The investment policy contains explicit guidelines for exceptions to the policy. Part III.K.2 makes the FAD administrator responsible to “approve, in advance, all investment transactions that are not consistent with the guidelines prescribed in this policy and notify the Director of Finance of such transactions.” Part V allows for exceptions to the policy if the administrator determines that an investment transaction is in the

best interest of the State and is consistent with the objectives of the investment policy, subject to the following requirements:

- A. Exceptions shall be approved by the Administrator prior to being executed.
- B. Significant exceptions shall also be approved by the Director of Finance.
- C. Inadvertent breach of policy shall be immediately reported to the Director of Finance.

However, with respect to the FY2008 investments in auction-rate securities, the FAD administrator said he was informed of the increase in holdings through the monthly *Report to the Administrator* after they had been purchased. Thus, he did not approve the transactions in advance. The director of finance was not consulted or involved in any decisions to purchase or increase holdings in auction-rate securities. Both the director of finance and administrator acknowledged that the director has never been consulted prior to any investment transactions.

### **The State's auction-rate securities are illiquid and have been impaired by at least \$114 million**

Because the auctions, and thus the market, for auction-rate securities have failed since early 2008, the department is unable to sell these securities until auctions become functional, securities are called, or the underlying loans mature. Although the State's auction-rate securities were rated AAA by major ratings agencies at the time they were purchased, the ratings on many of these securities have since dropped below the AAA rating. A cost basis of over \$630 million of the more than \$1 billion total cost basis of state-owned auction-rate securities are now rated below AAA by at least one rating agency. Those securities therefore now violate the requirement in Section 36-21, HRS, and Part III.F of the investment policy that auction-rate securities "maintain a triple-A rating by Standard & Poor's, Moody's, Duff & Phelps, Fitch, or any other major national securities rating agency." Both the FAD administrator and funds custody manager stated their understanding of the requirement is that auction-rate securities should maintain AAA ratings from the major rating agencies throughout the period the investments are owned by the State.

Accordingly, the value of the State's auction-rate securities has been significantly impaired. The department was required to write down the value of these investments by \$114 million as of June 30, 2008. As of the end of December 2009, the department was still in the process of determining the fair value of its auction-rate securities at June 30, 2009. However, based on a preliminary, unaudited valuation provided by an investment broker, it appears the value of the State's auction-rate securities has further decreased by more than \$100 million. Thus, as

the director has stated, if the department were to currently sell these securities, it would realize an actual loss of over \$200 million.

The department has determined that the State is able to hold the auction-rate securities until maturity without impacting liquidity, and thus the State will not have to realize any actual loss in selling the securities. Consequently, both the director of finance and the FAD administrator have stated that the department's holdings of auction-rate securities is not an issue and has no negative effect on the state treasury or the State's current financial condition. As discussed above, however, the maturity dates for these securities are the maturities of the underlying loans, which range from 2016 to 2045 according to the department's June 30, 2009 investment statement. It is highly improbable that the state treasury would not be affected by having a significant percentage of its moneys tied up for seven to 35 years, or alternatively, sold at a significant loss. It is further unreasonable to believe there is no impact to liquidity when the State is currently facing substantial budget shortfalls and does not have available funds to cover its anticipated disbursements. Moreover, the department's determination that there is no risk of loss by holding these securities until maturity does not consider the other risks associated with the securities, such as the potential for loss if borrowers default on the underlying student loans.

The director and administrator also point out that the State is not alone in this predicament since many other investors, including other governments, did not understand the risks and are now stuck holding auction-rate securities. According to the department, the auction-rate securities market grew over time to approximately \$330 billion, with many other states and private institutions investing in the securities. However, based on the department's estimate of the total market, the State of Hawai'i held \$1 billion of the \$330 billion total auction-rate securities held by thousands of institutional and other investors across the nation.

We believe that deficiencies in the department's investment process discussed above played a significant role in the current condition of the state treasury and its investments. This situation highlights the need for the department to update its investment policy, conduct risk assessments, and formally monitor monthly transactions and holdings. More importantly, the director of finance and the FAD administrator were not involved in the decision to significantly increase the State's holdings in auction-rate securities. It was irresponsible of the key individuals charged with oversight of the state treasury to allow more than \$1 billion to be invested in an instrument not fully understood and without their knowledge and approval.

## **Recommendations**

We recommend that the Department of Budget and Finance:

1. Formally review and update the State of Hawai'i Treasury Investment Policy on an annual basis, as currently required, or consider whether it is necessary for the department to update the policy related to the frequency of review.
2. Consider best practices identified by the Government Finance Officers Association (GFOA) related to managing market risk, benchmarking, and measuring total performance in a portfolio while reviewing the investment policy, including the article "Innovation in Managing Public Funds: Benchmarking and Total Return" from the August 2007 *Government Finance Review* and the GFOA Recommended Practice white paper "Managing Market Risk in a Portfolio (2007) (CASH)." In particular, the following points should be considered:
  - a. The maturity structure of a security should be fully understood. Prior to purchase, the government should confirm compliance with its investment constraints and overall investment strategy. If a security has options associated with it such as call options, the structure of the option should be analyzed to determine its potential impact on market risk through an analysis. The stated maturity date should always be used to determine compliance with maximum maturity constraints, not any potential call dates unless an official announcement of a call has been released.
  - b. Although the department's investment policy currently sets a maximum maturity restriction for individual securities to not exceed five years, consistent with the statutory limitation, the GFOA does not consider this the most effective way to manage market risk and to obtain an understanding of the potential price volatility of either an individual security or an entire portfolio. The GFOA recommends adopting weighted average maturity limitations and/or weighted average duration targets, which often range from 90 days to three years, consistent with the government's investment objectives, constraints, cash flow needs, and risk tolerances. The weighted average maturity limitations can be used to limit market risk in a portfolio consistent with the five-year maturity limit in the statute. The weighted average duration targets can be used to manage market risk in a portfolio.
  - c. Although the investment policy states that the yield on the State's investment portfolio is of secondary importance compared to the safety and liquidity objectives, the department also has a fiduciary duty to taxpayers to ensure that it is obtaining a

competitive rate of return on those funds as long as safety and liquidity are satisfied. While the investment policy states that investments are limited to relatively low-risk securities in anticipation of earning a market rate of return commensurate with the risk assumed, no formal benchmarks are specified in the investment policy. Benchmarks are points of reference, or targets, that an agency can use to evaluate its investment performance. For budgeting performance measurement goals, an agency will generally start with the one-year U.S. Treasury note as a base, consider trends in the market and the direction of interest rates, and determine an estimated return rate as its performance measurement goal. As part of the investment policy review, the department should determine an appropriate total return index as a benchmark that reflects the State’s investment objectives and tolerances for risk. Sample benchmarking indices identified by the GFOA are presented below in Exhibit 2.12.

**Exhibit 2.12  
Sample Benchmarking Indices**

Index	Duration (Years)	10-year Annualized Return
Merrill Lynch 0-1 Year Treasury	0.43	3.99%
Merrill Lynch 1-3 Year Government	1.63	4.84%
Lehman 1-3 Year Government	1.66	4.87%
Merrill Lynch 1-5 Year Government	2.22	5.18%
Lehman 1-5 Year Government	2.24	5.21%
Merrill Lynch 1-5 Year Corporate and Government “A” and above	2.32	5.38%

Source: Innovations in Managing Public Funds Benchmarking and Total Returns; Joya C. De Foor and Kay Chandler; GFOA website: [www.gfoa.org/downloads/Benchmarking\\_aug07.pdf](http://www.gfoa.org/downloads/Benchmarking_aug07.pdf)

3. Consider reviewing investment practices of other states (e.g., through review of websites, telephone discussions, networking at conferences, etc.) for best practices and innovations that can lead to improvements in the State’s investment policy and practices.
4. Update and document operational procedures for performing daily cash projections to determine excess cash in the state treasury available for investment. The Treasury Management Branch

may consider investigating the use of an automated system to perform the projection, including investigating if such functionality exists in the Microsoft Dynamics accounting system it already uses. Alternatively, if manual spreadsheets are determined to be most cost effective, the Treasury Management Branch should use automated formulas and streamline the calculation on a single worksheet, or link cells within a workbook, to ensure that accurate amounts are translated throughout the spreadsheets in calculating projected amounts available for investment. An automated process or formulas will assist in providing a more reliable projection of excess cash, enable the consistent performance of procedures, and aid in the transition of tasks to new or other employees (including management) during an employee's absence or position vacancy.

5. Perform and document an appropriate level of review of investment decisions as required.
6. Review the investment policy to determine whether any revisions are necessary to the current internal reporting requirements. In addition, investment reports should be prepared in a timely manner and with adequate information to allow the director of finance and FAD administrator to determine whether the State's investments comply with state law and the investment policy. The department should properly report the maturities of auction-rate securities based on the stated maturities of the underlying loans, rather than the next scheduled auction date, which significantly shortens the average maturity of the investment portfolio.
7. Ensure that investments comply with all provisions of Section 36-21, HRS, and the investment policy. The department should also perform adequate risk assessments of all current and potential investments to ensure it understands all risks related to an investment and that an investment complies with state law and the investment policy. Furthermore, the department should ensure that the State can exit any investment, without penalty, that no longer complies with state law.
8. Follow the guidance stated in Section V of the investment policy and obtain proper approvals from the FAD administrator and, when exceptions are significant, the director of finance prior to the purchase of investments if they exceed quantitative guidelines but are deemed to be in the best interest of the State. Also, as required under the investment policy, inadvertent breaches of the policy should be immediately reported to the director of finance.

## **The Financial Administration Division Has Failed To Perform Essential Functions**

***Failure to perform timely bank reconciliations increases the risk of undetected errors and has resulted in misstatements***

In addition to maximizing returns, the department is responsible for safeguarding the State's moneys. This encompasses establishing protective measures over state assets, including formal policies, timely reconciliations, and managerial reviews. The Financial Administration Division (FAD) is also responsible for distributing investment returns to respective state agencies. However, FAD has not performed these essential functions and responsibilities. It has failed to perform timely bank reconciliation or record reconciling adjustments; failed to timely allocate investment pool earning to participants; and violated award notification requirements for the procurement of bond issuance underwriters.

Pursuant to Section 36-2, HRS, the director of finance "shall keep, or cause to be kept, in appropriate books, a clear, distinct, and full record of all the transactions and business" of the department. This includes maintaining proper and accurate records of the significant cash and deposits managed by the department. The timely preparation and review of monthly bank reconciliations is a basic but essential internal control used to ensure that an entity's financial records are properly stated and mitigates the risk of misappropriation of an entity's cash. However, the department is delinquent both in reconciling bank balances to its cash sub-ledger and in reconciling its cash sub-ledger to the State's general ledger system. As of September 2009, neither reconciliation had been completed since March 2009. The department also lacks a formal review process over bank reconciliations. The department's records were not properly adjusted, resulting in misstated cash balances in the cash sub-ledger (Microsoft Dynamics). Also, without reconciliations to identify differences between the department's Microsoft Dynamics balance and bank balances, misappropriations of cash are neither deterred nor timely detected.

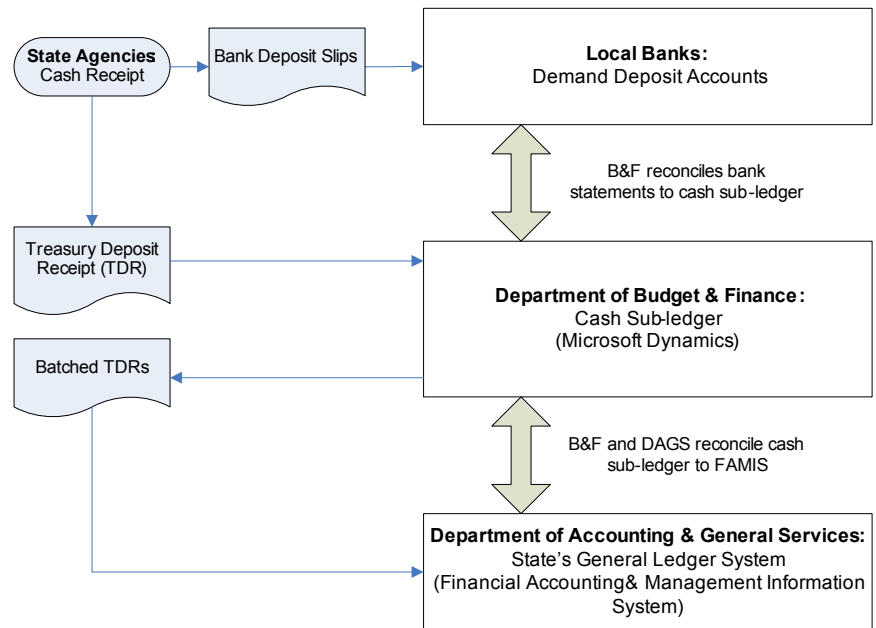
### **Lack of timely preparation and formal review of bank reconciliations**

The State has checking accounts with local financial institutions. The First Hawaiian Bank (FHB) demand deposit account is the state treasury's primary bank account, and the Bank of Hawaii (BOH) demand deposit account is the second-largest account. The department also maintains its own cash sub-ledger (Microsoft Dynamics), which should reflect the actual amount of cash belonging to the State, or the "book" balance.

State agencies are required to deposit cash receipts into one of the treasury bank accounts. A treasury deposit receipt (TDR) is also

prepared and submitted to the department within 30 to 60 days to ensure proper recordation of cash receipts into Microsoft Dynamics. The division is responsible for reconciling the sub-ledger cash balance to monthly bank statements, identifying and resolving any discrepancies. The cash receipts and reconciliation process is depicted in Exhibit 2.13.

**Exhibit 2.13  
Overview of Cash Receipts and Reconciliation Process**



Source: Compiled by Accuity LLP based on information provided by the Department of Budget and Finance

We found that as of September 30, 2009, the FHB and BOH demand deposit account reconciliations were only performed through March 2009. Additionally, there is no formal management review process for any of the bank reconciliations. Bank and book balances are reflected in Exhibit 2.14.



**Exhibit 2.14**  
**FHB and BOH Bank and Book Balances as of March 31, 2009**

<b>Bank</b>	<b>Type of Account</b>	<b>Bank Balance March 31, 2009</b>	<b>Book Balance March 31, 2009</b>
First Hawaiian Bank	Primary bank account	\$109,023,978	\$59,945,510
Bank of Hawaii	Demand deposit account	\$662,973	\$344,129

Source: Compiled by Accuity LLP

According to the FAD administrator and funds custody manager, the department is behind on its reconciliations due to short staffing and a general hiring freeze on vacant positions within the State's executive branch during FY2009. They also do not believe it is necessary to have formally documented procedures over bank reconciliations. However, formal and timely cash reconciliations are fundamental to a well-controlled cash management process, ensuring balances are properly stated and reducing the likelihood of errors and misappropriation. This is especially critical for the State's cash accounts considering the time lag between the actual receipt of cash and its recording in Microsoft Dynamics.

**Lack of proper adjustment of the department's records**

Transactions, including cash receipts, should be recorded during the period in which they occur. However, FAD generally records cash receipts as of the date supporting documents are received from state agencies, regardless of when the underlying transactions occurred. Consequently, the department does not properly record deposits, debits, or debit memos that should be identified during the bank reconciliation process. As of March 31, 2009 (the most recently completed bank reconciliation as of October 2009), the following items in the primary bank account with First Hawaiian Bank were not reflected in the department's cash sub-ledger, as supporting documents had not been received from the state agencies involved in these transactions:

➤ Unrecorded deposits	\$164,988,496
➤ Unrecorded debits	(\$120,085,546)
➤ Unrecorded debit memos (i.e., return of bad checks and deposit errors) over 60 days old	<u>(\$239,000)</u>
➤ Total understatement	<u>\$44,663,950</u>

***Unrecorded Deposits***

The division does not record cash receipts until it receives a treasury deposit receipt (TDR), which can be up to 60 days or more after an agency has made a deposit. As a result, between the date of deposit and the date of recordation, the State's book balance is understated compared to the cash in its bank account. This situation is not problematic if timely reconciliations are performed to identify these amounts and properly adjust the book balance of cash. However, as previously noted, the department is over six months behind in its bank reconciliations.

We were informed that the department has made efforts to remind other departments and agencies to submit all TDRs in a timely manner, including sending quarterly notices to department heads. However, the department has limited control over other agencies' submission of TDRs.

During testing of the U.S. Treasury Trust Fund reconciliations, we also noted unrecorded deposits as of June 30, 2009, as the department had not received the TDRs in a timely manner. Consequently, these items were not recorded until July 2009.

***Unrecorded Debits***

Unrecorded debits are related to check settlements in subsidiary accounts that are reflected in the bank before midnight on the last day of a month. As check settlements are recorded by the bank between the department's close of business and midnight, the department is unaware of those transactions until the following day and records settlements in the cash sub-ledger the next day, which is in the subsequent month.

***Unrecorded Debit Memos***

Unrecorded debit memos consist of returns of bad checks, deposit errors, etc. The FAD administrator and funds custody manager informed us that the informal policy is for the department to properly identify and record bank debit memos within 60 days. The majority of the \$239,000 of unrecorded debit memos over 60 days old relates to legal action from 1999 approximating \$170,000. These debit memos require the state attorney general's action to resolve. The department is currently monitoring the status of the legal action and requested that the attorney general assist in resolving the matter.

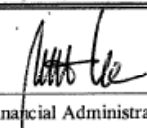
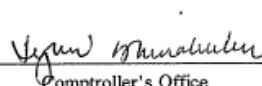
Due to unrecorded deposits, debits, and debit memos, the department's cash balance was understated by approximately \$44.7 million as of March 31, 2009. Monthly bank reconciliations, necessary to identify unrecorded reconciling items and proper financial statement adjustments, are not being performed on a timely basis.

**Reconciliations between FAD and DAGS's records are not completed timely nor reviewed by the department**

On a monthly basis, the FAD and the Department of Accounting and General Services (DAGS) work together to reconcile the department's cash sub-ledger (Microsoft Dynamics) to the state general ledger system (FAMIS) for cash and investments by fund type (i.e., bond fund, general fund, trust fund and special fund). The Treasury Management Branch cashier initiates the process by completing the FAD records column of the "Monthly Reconciliation of Funds" based on the Microsoft Dynamics statement of cash system report. The reconciliation is reviewed and signed off by the FAD administrator, funds custody manager, or public debt manager, then forwarded to DAGS for reconciliation of the FAD amounts to the comptroller's (i.e., FAMIS) balances.

The reconciliation is sent back to the department, where the Treasury Management Branch cashier reviews the reconciliation and works with DAGS to determine whether any adjustments to the department's or DAGS's records are necessary. The cashier signs the reconciliation, and the funds custody manager signs to approve any adjustments that require posting as well as to evidence review of the final reconciliation. The reconciliation for March 2009 is shown in Exhibit 2.15.

**Exhibit 2.15**  
**Reconciliation of FAD and DAGS Cash Balances as of March 31, 2009**

MONTHLY RECONCILIATION OF FUNDS BETWEEN FINANCIAL ADMINISTRATION DIVISION AND COMPTROLLER'S RECORDS As of <u>March 31, 2009</u>			
FUND: <u>GENERAL</u>	Financial Administration Division Records	Comptroller's Records	Financial Administration Division Over or (Under)
Cash on hand and in Banks (Commercial Accounts)	<u>(950,466,599.40)</u>	<u>(455,208,249.18)</u>	<u>(495,258,350.22)</u>
Bank Certificates of Deposit	<u>870,327.24</u>	<u>870,327.24</u>	<u>- 0 -</u>
U. S. Treasury - UI	_____	_____	_____
Other (Specify)	_____	_____	_____
Repurchase Agreement	<u>6,742,276.29</u>	<u>6,742,276.29</u>	<u>- 0 -</u>
U.S. Treasury Security	_____	_____	_____
U.S. Treasury Security-SLUGS	_____	_____	_____
Other Investment-Gov. Agencies	<u>124,700,000.00</u>	<u>124,700,000.00</u>	<u>- 0 -</u>
<b>TOTAL FUNDS</b>	<b><u>(818,153,995.87)</u></b>	<b><u>(322,895,645.65)</u></b>	<b><u>(495,258,350.22)</u></b>
Commercial Bank Accounts and Fin. Admin. Div. Records Reconciled by:	<u></u> Financial Administration Division		<u>4.6.09</u> Date
FAD Records and Comptroller's Records Reconciled by:	<u></u> Comptroller's Office		<u>6/10/09</u> Date
Financial Administration Use: _____			
ADJUSTMENTS, if any, per attached DAGS detailed Reconciliation of Funds.			
Adjustments Posted by:	_____	_____	_____
	Treasury Cashier		Date
Reconciliation Reviewed by:	_____	_____	_____
	Funds Custody Manager		Date
Monthly reconciliation to be made on or before the end of the following month.			
After completion, filed as part of the record with the Financial Administration Division, Treasury Br.			

Source: Department of Budget and Finance

We noted that the monthly reconciliations for 2009 were initiated by the department and sent to DAGS. As of the end of October 2009, the department had only received from DAGS reconciliations through March 2009. However, according to the funds custody manager, the department has not completed the final step to verify if any reconciling items require adjustment to the department's or DAGS's accounting records since the reconciliation for June 2008, which was the last fully completed reconciliation. According to the FAD administrator and funds custody manager, the Treasury Management Branch is behind in completing some of its other work. Consequently, cash and investment reconciliations to balances recorded by DAGS were not reviewed during the entire fiscal year 2009.

We tested three monthly reconciliations from July 2008 through March 2009 that were returned to the department. For all three, there was no evidence of a subsequent review or posting of any adjustments by the department after the reconciliations were received from DAGS.

However, if reconciliations are not completed and reviewed on a timely basis, the department may be unaware of and unable to correct errors in its cash and investment balances in a timely manner, resulting in delays in the preparation of the State's Comprehensive Annual Financial Report (CAFR) and the financial statements of other state departments and agencies. Delays in completing the departmental financial statements may lead to departments failing to submit their financial reporting package to federal agencies in a timely manner, in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, which may jeopardize future federal funding or lead to costly additional requirements on the use of future federal funds.

The following represent examples of problems that can occur as a result of untimely or incomplete reconciliations of the department's cash sub-ledger to both bank accounts and the state general ledger system.

***\$1,196,000 overstatement of fiscal agent account cash balances as of June 30, 2009***

During prior fiscal years, the department's fiscal (bond paying) agents disbursed funds in their custody but did not provide the department sufficient information to properly record these payments. Although the department does not dispute these transactions, it has not recorded them, and the balances from unrecorded transactions appear as reconciling items on the department's reconciliations to the fiscal agents' balance. Consequently, the department's cash balance for fiscal agent accounts is overstated by \$1,196,062 as of June 30, 2009.

For long-outstanding unreconciled items, the department deemed that it would not receive any additional information from fiscal agents, fiscal agents' balances are correct, and a process was established to remove old unreconciled items via journal voucher adjustments after consulting with DAGS. While the department is still in the process of adjusting the balances, time constraints have not allowed FAD to record many adjustments during fiscal year 2009, resulting in an increase in the balance of the unreconciled items from \$859,740 at June 30, 2008 to \$1,196,062 at June 30, 2009.

***Information sent to DAGS for adjustments to the financial statements is incomplete***

The department did not send a complete list of financial statement adjustments to DAGS in accordance with generally accepted accounting principles (GAAP). We noted a \$300,000 call on a security on June 30, 2009, which was not paid or recorded until July 1, 2009, should have been reported to DAGS for recording on a trade date basis as of June 30, 2009.

Since FAD personnel are not familiar with GAAP and transactions are recorded on a cash basis, investment transactions are recorded on the settlement date, rather than the trade date. We understand that DAGS requests the department provide information on transactions with trade dates prior to year end, which the department failed to do in this instance.

***The department is delinquent in allocating investment pool earnings to participants***

The treasury investment pool combines the State's cash resources to maximize investment returns on general, special, trust, and general obligation bond funds. The bond investment pool is similar to the treasury investment pool except it is specifically used to invest the proceeds of revenue bonds. While a significant portion of interest is credited to the general fund, many agencies' special and trust funds are entitled to, and dependent upon, their respective share of investment returns.

Section 36-21(a), HRS, requires the department to pay investment pool income to respective agencies' funds based on each fund's contribution of moneys into the pool. However, the department has fallen significantly behind in allocating interest to respective agency funds. Further, the lack of documented interest allocation procedures makes it difficult to assess the department's compliance with policies and for the department to minimize the loss of critical, valuable experience and information when employees leave.

### **Unallocated treasury and bond pool interest earnings**

Director of Finance Memorandum No. 99-15, dated July 14, 1999, states that the department will distribute interest to participating agencies' designated interest accounts on the tenth workday of the following month the interest was earned. However, as of June 30, 2009, the department had not performed the interest allocation for the treasury investment pool beyond January 2009, and had not performed the allocation for the bond investment pool for the entire fiscal year. In fact:

- The department has unallocated treasury investment interest earnings of \$13,662,778 as of June 30, 2009, which represents the amounts unallocated from February 2009 to June 2009.
- The department has unallocated bond investment pool interest earnings of \$2,669,522 as of June 30, 2009, which represents the investment earnings in the bond investment pool for all of fiscal year 2009 (i.e., since July 2008).

We noted that unallocated interest in the investment pools is held in trust funds in the department's name, until the department is able to allocate those earnings to the relevant departments and agencies.

The bond investment pool includes bond proceeds from special revenue bonds. A special revenue bond issuance may be planned for a capital improvement project, a project approved by the Legislature, and expenditures incurred for the approved project, but the bond issuance may be delayed or there may be changes in the planned issuance and the sale is not completed as initially planned. To pay for the expenditures incurred, the agency can advance money from its special revenue funds and transfer it to the bond fund so expenditures can be paid from the bond fund. When the special revenue bond issue is completed, a portion of the proceeds from the bond sale are returned to the special revenue fund as reimbursement for the advance.

During fiscal year 2009, the Treasury Management Branch noticed the bond pool interest allocation system failed to include moneys advanced to the bond fund from the special revenue fund in allocating the bond investment pool's earnings. Due to the large amounts advanced during the year, the bond funds received smaller allocations of investment earnings than they should have. We were informed that this system was corrected in April 2009.

According to the FAD administrator, interest allocations were not performed timely because work was reprioritized due to short staffing within FAD. Although the accountant V was responsible for interest earnings allocations and maintenance of investment schedules, some

of those responsibilities were reprioritized to cover other functions, including some of the accountant IV's responsibilities, whose position was vacant for two years. Based on discussions with the FAD administrator and the funds custody manager, the department considers completing the monthly interest allocation by the tenth workday of the following month a guideline rather than a requirement. We also noted that interest earnings allocation procedures were not formally documented and other FAD staff were not properly trained on the procedures before the accountant V left the department in April 2009.

Due to the lack of a documented policy, the department was unable to perform the interest allocations after the accountant V left or to explain the process to us until after it consulted with DAGS' Information and Communications and Services Division (ICSD), which maintains the interest allocation system, in September 2009.

Delays in allocating interest earnings create a financial burden on departments and agencies that rely on those earnings for spending. In addition, if amounts are significant to certain departments, delays in allocating interest earnings can delay completion of financial statements and federal compliance audits for those departments, as interest amounts need to be properly accrued and reported. Consequently, completion of the statewide financial statements and Comprehensive Annual Financial Report (CAFR) could also be delayed.

### **Revised allocation policy and methodology was not issued or communicated to investment pool participants**

Finance Memorandum No. 99-15 also states that interest earned on pool investments is to be computed monthly by the Investment Pool System maintained by FAD on an accrual and cash (realized/paid) basis. Each appropriation account is to be credited with its pro-rata share of accrued monthly interest earnings, but is to be paid interest based on its pro-rata share of cash received as interest during a month.

Upon implementing an accounts payable aging system for accrued interest in 2006, the allocation methodology was revised. The FAD administrator and funds custody manager told us an email was sent to participants in the treasury investment pool explaining the change in allocation methodology. However, the department was unable to locate that email or any other correspondence, memorandum, or documentation explaining the change in the interest earnings allocation methodology.

Furthermore, as we could not verify whether the department informed participants of the change in the interest earnings allocation, participating agencies may not know of the change or have a clear understanding of how interest earnings are allocated under the revised methodology.



***The department failed to post awards for underwriting contracts***

Section 103D-304(i), HRS, states that contracts of \$5,000 or more are to be posted electronically within seven days of the award by the chief procurement officer and posted for at least one year. The department violated this provision for one out of two general obligation bond issuance underwriting contracts and all four special revenue bond issuance underwriting contracts in FY2009.

According to the Notice of Award posting for the underwriting contract for the general obligation (GO) bond issuance which closed on December 16, 2008, the contract was awarded on July 18, 2008. However, the notice of award was not posted until August 22, 2008, over one month (36 days) after the date of the award.

There was no Notice of Award posted for any of the four underwriting contracts awarded for special revenue bond issuances in fiscal year 2009.

The FAD administrator informed us that the delay in posting and the non-postings of Notices of Award were oversights. In the case of the special revenue bond contracts, there was a misunderstanding as to who was responsible (the department or the agency issuing the bonds) for posting the award. According to the FAD administrator, if the contract is with the department, as was the case with these contracts, the department is responsible for posting the Notice of Award. The FAD secretary, who is responsible for posting notices of awards, posts the award notifications when the contracts are sent for filing. However, the secretary was not aware that the department was required to also post award notifications for special revenue bonds.

Non-compliance with Section 103D-304(i), HRS, is a violation of state law. Failure of the department to comply with this section exposes it to potential protests of awards by nonselected professional service providers, which could result in delays of the issuance of bonds or additional costs.

***Recommendations***

We recommend that the Department of Budget and Finance perform the following to ensure timely preparation and review of bank reconciliations:

1. Establish formal policies and procedures for preparing and reviewing bank reconciliations. The policy should include the timeframe and individuals responsible for the preparation and review of reconciliations.

2. Report unrecorded items to DAGS for proper adjustment as of month/year-end and record adjustments in the department's sub-ledger in a timely manner for the preparation of its own financial statements of cash and investments in the state treasury.
3. Record adjustments in a timely manner and provide the necessary information to DAGS for proper recording in the State's CAFR and dissemination to state departments and agencies for preparation of their financial statements.
4. Write off the difference with the fiscal agents of \$1,196,062.
5. Follow established procedures and timely complete reconciliations of FAD records to the comptroller's records received from DAGS. If necessary information is not received from DAGS on a timely basis, FAD should liaise with DAGS to obtain the information, review reconciliations, and ensure any necessary adjustments are recorded in the department's and/or DAGS's books in a timely manner.

We recommend that the department perform the following related to the treasury and bond investment pools:

1. Immediately complete interest allocations for the remaining months in fiscal year 2009. We also recommend the department ensure allocations for fiscal year 2010 are performed within the timeframe stated in Finance Memorandum No. 99-15.
2. Formally document the methodology in allocating interest earned (received and accrued). In the event of employee turnover or absence, written procedures will allow individuals who assume the process to properly perform the allocation in a timely manner.
3. Formally inform investment pool participants of the revised interest earnings allocation methodology and any subsequent changes to the investment pool that may affect participating agencies.

To ensure compliance with Section 103D-304(i), HRS, we recommend that the department immediately post Notices of Award for the four underwriting contracts for special revenue bond issuances awarded in FY2009. We also recommend that the department comply with the provisions of Section 103D-304(i), HRS, for all current and future bond issuances.

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## **The Budget Division's Informal and Undocumented Budget Process Lacks Transparency and Leaves the Department Vulnerable**

The Budget, Program Planning and Management Division (Budget Division) of the Department of Budget and Finance is responsible for preparing, monitoring, and executing the State's executive budget and six-year program and financial plan. The purpose of the State's budget and budgetary process, as stated in Section 37-63, HRS, is "to establish a comprehensive system for state program and financial management which furthers the capacity of the governor and legislature to plan, program, and finance the programs of the State."

Statutes set forth the duties of the Department of Budget and Finance regarding the state budget. Section 37-67, HRS, *Responsibilities of the department of budget and finance*, mandates that the director assist the governor in preparing and administering the state budget and financial plan. It also identifies more specific responsibilities, including but not limited to:

1. Developing procedures, rules, and regulations to guide state agencies in preparing program and financial plans, program budget requests, and program performance reports, and to assure the availability of information needed for effective policy decision-making;
2. Assisting state agencies in the formulation of program objectives, preparation of program plans and budget requests, and reporting of program performance;
3. Coordinating, analyzing, and revising as necessary program objectives, plans, budget requests, and performance reports prepared by state agencies and developing the state comprehensive program and financial plan, budget, and program performance report; and
4. Administering its responsibilities so that policy and budget decisions made are implemented to the fullest extent possible within the concepts of proper management.

We reviewed the efficiency and effectiveness of the Budget Division's methodologies and procedures for preparing and monitoring the State's budget. We noted that the Budget Division provides detailed written instructions to other state agencies as well as standardized forms outlining various stages of the budget process. However, we identified procedures and practices in the Budget Division's own internal operations that should be improved.

First, the division lacks standardized review criteria, documentation requirements, and documentation retention procedures, which has led to a budget preparation and execution process that lacks transparency and

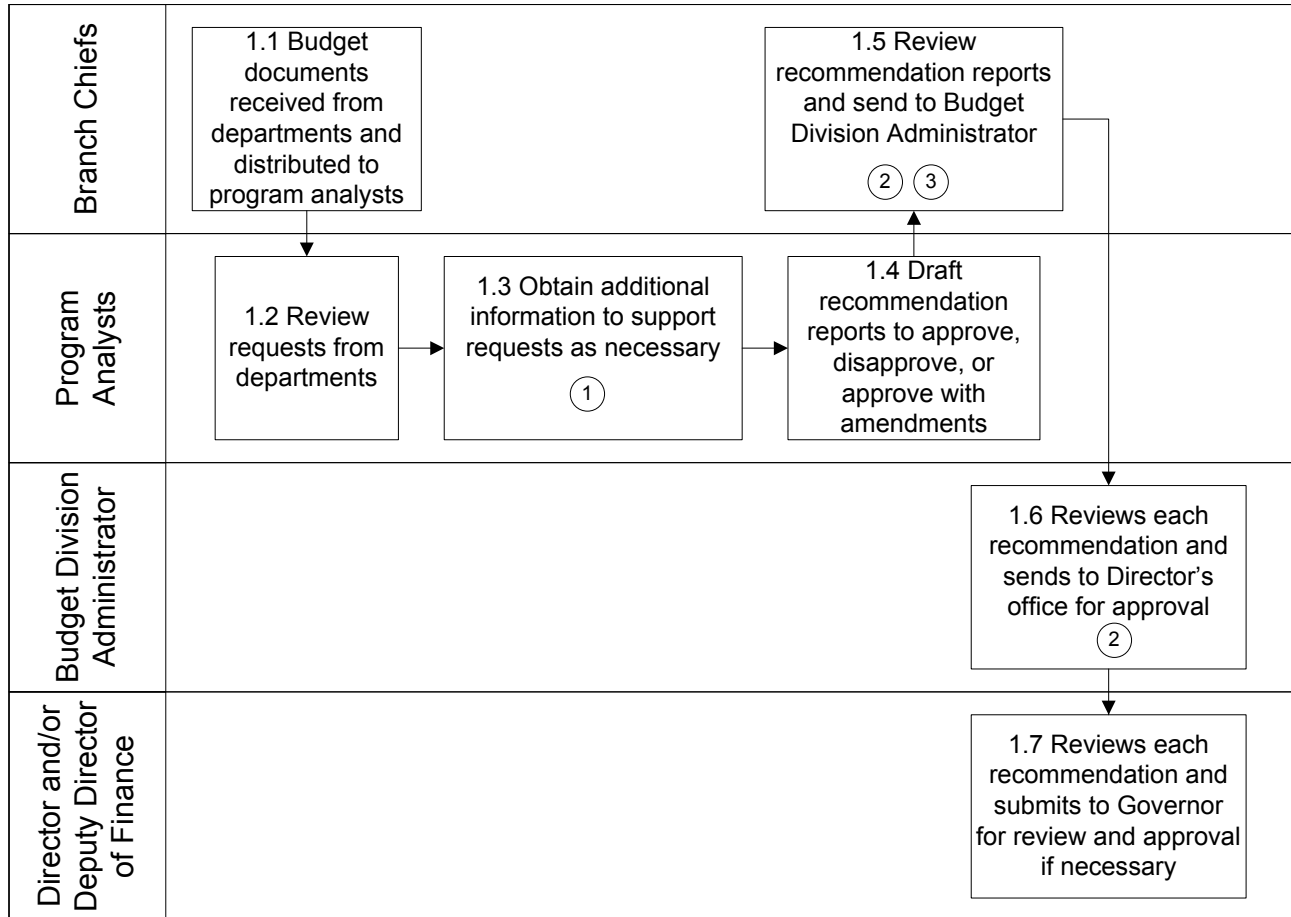
uniformity. Second, the department's lack of a formal succession plan leaves it vulnerable in light of a large percentage of employees reaching retirement age. Third, the Budget Division inaccurately reported its performance data, which diminishes the value of the State's performance-based budgeting process, particularly since the division has considerable responsibilities related to performance reporting for the State.

***Budget preparation and execution process is not standardized or documented***

Well-documented, formalized procedures provide both management and their employees with a common understanding of the policies and procedures that govern their jobs and decisions; they also ensure consistency and minimize transition issues when staff change or leave. Based on our review of the budget preparation and execution process and interviews with key personnel, including the Budget Division program analysts and branch chiefs, we noted that there are no documented, formal internal procedures nor standardized review criteria, documentation requirements, or document retention or disposition guidelines for budget preparation or execution reviews.

Exhibit 2.16 describes the budget preparation and execution process.

**Exhibit 2.16**  
**Overview of the Department of Budget and Finance Budget Preparation and Execution Process**



Notes:  
 1 = There is a lack of standardized review criteria, documentation requirements, and document retention for budget preparation and execution.  
 2 = Internal reviews by supervisors are not evidenced.  
 3 = According to the variance reports, the Budget Division achieved its target measure of reviewing requests within 5 business days 90 percent of the time; however, a sample tested showed it only achieved its target 4 percent of the time.

Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

To support the recommendation of a budget adjustment request, program analysts take steps to ensure the necessity and validity of each request based on its type. This process is reflected in Exhibit 2.16 as steps 1.2, 1.3, and 1.4 and in note 1, and includes understanding the purpose of the request, the impact it will have on the requesting department's customers, whether it is a health and safety issue, whether the program/activity is mandated, whether there are existing resources that could be reallocated to perform the same function, etc. However, these steps are not formalized and vary among analysts.

Program analysts' recommendations are reviewed by a branch chief, the Budget Division administrator, and the director of finance before being presented to the governor. These procedures are reflected in Exhibit 2.16 as steps 1.5, 1.6, and 1.7 and in note 2. However, internal signatures and dates of review are not indicated on supporting documentation to record the proper levels of review.

According to our discussion with branch chiefs, many internal guidelines and decisions are orally communicated to Budget Division staff. For example, if they receive clarification on a budget preparation guideline, it is common practice for the Budget Division administrator and branch chiefs to orally notify their staff. Consequently, historical knowledge on key decisions for handling specific matters, such as the Felix Consent Decree, is not documented. This could result in inconsistent practices within the State, as subsequent budget requests may be handled differently.

Furthermore, there is no formalized training for new employees to ensure consistency of operations. The Budget Division administrator and branch chiefs have relied on current budget analysts' accumulation of knowledge and critical insight about operations, their role, and their customers (departments/agencies) in using their judgment and making budget recommendation decisions.

However, the lack of formalized procedures makes it difficult to assess the department's compliance with budget protocols and policies. Moreover, in conjunction with pending retirements and the reduction-in-force that occurred in November to December 2009, discussed further below, the lack of formalized policies and procedures makes it difficult to minimize the loss of critical, valuable experience and institutional knowledge when employees leave the department.

***Lack of a formalized succession plan and a high percentage of retirement-eligible employees could lead to loss of critical and valuable information***

In addition to lacking formal, documented procedures and standardized criteria for its budget processes, the Budget Division also lacks a formalized succession plan. With a large percentage of Budget Division employees, including key personnel, close to retirement age, the department is vulnerable to the loss of critical and valuable institutional knowledge that is currently undocumented.

In comparing a list of the department's total employees against a list prepared by the department of its employees eligible for retirement over the next five years, we discovered that of 66 total employees in the Department of Budget and Finance, 21 employees (32 percent) are eligible for retirement by December 31, 2013, as summarized in Exhibit 2.17 below.

**Exhibit 2.17  
2009 to 2013 Eligible Retirees**

<b>Eligible Retirement Year</b>	<b>Projected Eligible Retirees</b>
2009	12
2010	2
2011	2
2012	1
2013	4
<b>Total</b>	<b>21</b>

Source: Summarized based on a list of employees eligible for retirement provided by the Department of Budget and Finance

Within the Budget Division, nine of 22 employees (41 percent), including individuals in five key management positions, are eligible for retirement over the next two years. The five key management positions include the Budget Division administrator, the program and budget policy officer, the program and budget analysis managers of branch II and branch III, and the program budget analyst (fiscal analysis). Furthermore, three of the five key management/supervisory positions were included in the State's reduction-in-force in November and December 2009.

The governor also established a general hiring freeze within the State's executive branch, making it difficult to adequately replace retiring employees and ensure institutional knowledge is not lost. Furthermore, according to the Budget Division administrator, the department does not have any formalized workforce or succession planning strategies

to ensure the effective and efficient continuance of operations and documentation of institutional knowledge. Without qualified and knowledgeable budget personnel, the Budget Division will be unable to ensure the delivery of effective and timely services in compliance with Chapter 37, HRS.

***Budget Division substantially overstated its performance results to match target measures, diminishing the value of the performance reporting process***

Pursuant to Section 37-75, HRS, the governor is required to submit an annual variance report to the Legislature 30 days before the start of each regular legislative session. The Budget Division is responsible for issuing instructions to and collecting data from state agencies to prepare the report. In accordance with Section 37-75, HRS, *Variance report*:

Not fewer than thirty days prior to the convening of each regular session of the legislature, the governor shall submit to the legislature and to each member thereof a report on program performance for the last completed fiscal year and the fiscal year in progress. In format, the report generally shall follow the fiscal requirements portion of the executive budget or budgets. The report shall include:

- (1) At the lowest level of the program structure, for each program contained in the budget finally approved by the legislature for the last completed fiscal year and the fiscal year in progress: . . .
  - (D) The effectiveness measures and a comparison of the level of effectiveness anticipated and the level actually attained in the last completed fiscal year and the level of effectiveness anticipated and the level estimated for the fiscal year in progress; and
  - (E) A narrative explanation of the significant differences for the last completed fiscal year in each of the comparisons made in subparagraphs (A), (B), (C), and (D), including an explanation of the basis upon which the original estimates were made and the reasons why the estimates proved accurate or inaccurate, and a statement of what the actual experience portends for the future of the program in terms of costs, size, and effectiveness; provided that expenditure amounts in the comparisons shall be shown to the nearest thousand dollars. . . .

We reviewed the Variance Report to see how well the division was performing against its own reported target measures of effectiveness. One of the measures by which the Budget Division measures its performance is the percentage of recommendations on department requests completed within five business days. This is reflected at Exhibit 2.16 in step 1.5 and note 3. According to the variance reports for fiscal years 2007, 2008, and 2009, the Budget Division achieved its target measure of reviewing requests within five business days 90 percent of the time for all three fiscal years. However, when we judgmentally selected a sample of 25 budget adjustment requests in FY2009, only one (4 percent) was completed within the target due date; two (8 percent)



were not applicable, as review by the Budget Division was not necessary; and 22 (88 percent) were not completed by the target due date. Of the 22 requests where reviews were completed after the target due date, the number of delinquent business days ranged from three to 92 days.

We asked the Budget Division administrator about the cause of the inaccurate reporting. We were informed that the number was a “best-guess estimate” rather than the actual achievement rate. Although the Budget Division tracks the information necessary to report its actual achievement rate, it appears the administrator does not feel that accurate performance reporting is a priority, resulting in the highly inaccurate success rate reported. It appears that to avoid the requirement in Section 37-75, HRS, to investigate variances from the target, an estimate equal to the target rate was reported.

As the group within the State responsible for preparing and analyzing the State's comprehensive program and financial plan, budget, and program performance report, the Budget Division should take performance reporting seriously and report its results as accurately as possible. Moreover, since the department is statutorily responsible for guiding and assisting other state agencies in formulating target measures and developing performance reports, the Budget Division should set an example for other departments and agencies to follow in performing the variance analysis as part of the State's performance-based budgeting process. Unless decision makers demand more meaningful and accurate performance data and use the information in making critical decisions about allocation of resources, other departments have little incentive to develop meaningful measures or report accurate performance results. This defeats the goals of performance-based budgeting, which is the base for the State's budgeting process. The Variance Reports can only be as useful as the data contained within them.

### ***Recommendations***

1. We recommend that the Budget Division document operational and administrative policies and procedures to reflect current activities and procedures, including the documentation of common and unusual cases so that procedures are consistently performed within the division. This documentation will also aid in training new employees and guide management in performing tasks during an employee's absence or position vacancy.
2. Given current fiscal constraints and the State's general hiring freeze, we recommend that the department use cost-effective strategies to retain qualified staff, cultivate employees' skills to develop future leaders, promote knowledge transfer through job-shadowing and mentoring programs, and document internal procedures and practices with examples of how to perform critical tasks.

3. In regards to accurate reporting and use of measures of effectiveness, we recommend the department be held accountable for developing meaningful measures of effectiveness and that the department, governor, and Legislature utilize the performance data for actual decision-making regarding budget and resource allocation. We also recommend that both agencies and decision-makers receive adequate training on how to effectively utilize performance-based budgeting and apply performance measures to the allocation or management of resources in the public sector. The Budget Division should set an example for other departments by accurately performing the variance analysis required under Section 37-75, HRS, to maximize effectiveness of the State's performance-based budgeting process. The Budget Division, as the agency responsible for optimizing the expenditure of all public funds by developing meaningful budgets and plans, should review its own performance targets on an annual basis to ensure they are realistic and relevant to divisional goals; the division should also report accurate performance results and information.

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## **Inattention to Information Technology Management Exposes the Department to Unnecessary Risk**

We performed a high-level assessment over the Department of Budget and Finance's information technology (IT) controls and management practices, primarily as they relate to the department's financial administration and budget processes. Based on our review, the department has inadequate security controls to ensure its data is protected from unauthorized access and environmental factors, thereby exposing the department to unnecessary risk. Furthermore, the department is not effectively using its Microsoft Dynamics accounting application, inhibiting the efficiency of its cash and investment process and increasing the risk of manual errors.

The department uses numerous applications for both state budgeting purposes and the department's own financial management. Most of the department's applications were developed and are hosted by the DAGS Information and Communication Services Division (ICSD).

The Information and Communication Services Division is the central information processing and communications service organization for all state executive departments and agencies. Although ICSD is responsible for maintaining and operating the budgeting applications it hosts for the department, the department is responsible for user security administration of the applications.

The department's budgeting applications include the Budget Request System (eBUDDI), Capital Improvement Project System (eCIP), Revenue System (eREV), eVARIANCE System, eANALYTICAL

System, eTITLES System, and eXwalk System. These applications are web-based and most are accessible by state departments and agencies so they may submit budget plans for the coming fiscal period. The applications are all administered and maintained by ICSD at its data center.

Some budgeting applications are not web-enabled and are primarily used internally by the department for financial management and state budgeting purposes. These include the Interest Allocation System, State Cash Management Improvement System, Bond Allocation Tracking System, Bank Reconciliation System, Collateral & Securities Inventory System, Budget Request System, and Capital Improvement Project System. These applications are all hosted on a mainframe managed by ICSD at its data center.

Internally, the department hosts three applications, which are administered by the department's IT staff. Two Microsoft Access applications are stored on a fileshare on an internal file server at the department – the Bond and Coupon Redemption System and the Bank Return Item & Miscellaneous Adjustment System. The applications were developed by ICSD and any maintenance is handled by ICSD. The department's financial accounting is performed via a third, Microsoft Dynamics, application hosted on the department's internal network. The department's IT staff is responsible for maintenance and operation of the Microsoft Dynamics application.

***The department's IT security and controls must be improved***

The department is responsible for certain IT controls, including:

- Regularly reviewing end user access to sensitive applications to ensure access is commensurate with job responsibilities;
- Establishing controls to secure and monitor direct access to data for applications it maintains such as Microsoft Dynamics (the application used for the department's cash/investments accounting system);
- Implementing adequate password controls to prevent sharing or easy guessing of end user passwords;
- Having adequate physical security and environmental controls to safeguard sensitive financial systems from hacking or theft; and
- Implementing off-site rotation or replication of financial data to prevent the total loss of financial information for applications it maintains, such as Microsoft Dynamics.

We observed a number of deficiencies in the department's IT management and controls, which expose its sensitive information to unnecessary risk.

***No regular review of access to sensitive applications***

The department does not conduct a regular review of user access to its sensitive applications, including Microsoft Dynamics, the Budget Division's seven electronic applications (e-applications), and the mainframe applications maintained by ICSD. Based on our review and discussions with key staff, we noted that there is no established procedure for the department to regularly review end user access to sensitive applications. The department relies on ICSD to perform all IT-related work for the e-applications. However, although ICSD maintains the e-applications, it is the department's responsibility, as the application owner, to perform user access reviews. As a result of the lack of review, the Budget Division is unable to determine whether or not end users are only allowed enough access within the system to perform their job duties and that no segregation of duties issues exist. Unauthorized access to e-applications and mainframe applications may exist within the systems, which could potentially lead to erroneous or fraudulent activity on the systems.

***Inadequate password controls and access monitoring for Microsoft Dynamics***

Password controls for the Microsoft Dynamics application are inadequate compared to industry standards. While there is a required minimum password length of seven characters, there are no controls for password age, history, or complexity. There is no monitoring of direct data access for the Microsoft Dynamics application or any established procedure for monitoring such access. Consequently, the funds custody manager is unable to determine whether any unauthorized access or changes were made to the Microsoft Dynamics application data—the department's primary accounting system for cash and investments. Because of limited activity with the application, it is not considered a high risk by the funds custody manager or department's IT group. However, lack of adequate password controls increases the risk of password sharing or easy-to-guess passwords. It also increases the risk of unauthorized access to the Microsoft Dynamics application, particularly in conjunction with the lack of access monitoring. Such unauthorized access could lead to errors or fraudulent activity which may cause material errors in the financial reporting process.

***Inadequate server room controls***

We found there were inadequate physical security and environmental controls in the department's server room. The server room is behind a locked door but access to the room can be obtained by taking the key, which is hung in an open area in one of the department's offices.

According to the department's IT personnel, the department uses a converted office as its server room and did not consider installing or implementing physical controls based on its assessment that there was low risk of unauthorized access to the server room as well as budget constraints. However, a simple control such as assigning the server room key to a designated IT or other responsible employee could be implemented at little to no cost, and would help protect the department's systems from unauthorized access, theft, or fraud.

In addition, while the server room does have air conditioning from the building, it does not have any other type of control to prevent environmental damage from occurring. There are no heat sensors, moisture sensors, or fire suppression systems. While there may be structural or other challenges to implementing such controls, given the critical nature of the department's systems and data and the potential consequences if environmental factors were to cause systems failure or damage, the department should identify and evaluate possible control options and implement reasonable controls to help protect its vital information.

***No off-site rotation of backup media***

There is no off-site rotation of backup media. Backup media are merely stored in the department's server room. The Microsoft Dynamics application is maintained by FAD, and FAD personnel were not aware of the best practice in IT to rotate backup media off-site. If a fire or other disaster takes place, the department could potentially lose all financial data for the Microsoft Dynamics application, especially in light of the department's inadequate physical and environmental controls for the server room.

***Ineffective use of the Microsoft Dynamics accounting application inhibits the department's cash and investment process***

It is generally best practice to use technological resources to increase productivity and efficiency, particularly for existing resources.

The department utilizes Microsoft Dynamics as its accounting system for cash and investments. However, current Treasury Management Branch personnel responsible for performing the accounting and utilizing the system have not received in-depth training on the application. Consequently, the department does not believe it is maximizing the capabilities of Microsoft Dynamics and is unsure whether there are other ways it could use the program to gain efficiencies in maintaining and reporting investment information.

The department currently enters investment information into both Microsoft Dynamics and a separate Excel spreadsheet, also used as a sub-ledger. The information entered into Microsoft Dynamics includes

a unique reference number assigned by the department and description of the investment, purchase date, maturity date, principal, and interest. However, the yield maintained in the Microsoft Dynamics program is not the actual yield for the investment, but a system-calculated yield. According to the FAD administrator and funds custody manager, they believe the yield calculated in Microsoft Dynamics is incorrect but are unsure how it is calculated or how to correct it.

The information the department enters into the Excel spreadsheet includes the bank, type of investment, investor group, investment number, investment date, due date, amount purchased, matured amount, balance, realized interest, realized cumulative interest, and projected interest allocation.

There is some difficulty in tracing the information from the Microsoft Dynamics system to the Excel spreadsheet and the investment statement since investments are recorded in Microsoft Dynamics using a unique reference number assigned by the department. To determine the link between the Microsoft Dynamics information, the Excel spreadsheet, and the investment statement, the Treasury Management Branch prepares a separate monthly schedule showing the department's unique reference number and the corresponding CUSIP (Committee on Uniform Security Identification Procedures) identifier. The CUSIP identifier is a unique alphanumeric identifier given to securities and issuers. However, we noted that the monthly schedules are not always retained. Consequently, if a subsequent review is necessary but the monthly cross-referencing schedule was not retained, it could be difficult to agree or reconcile the investment information from Microsoft Dynamics to the Excel spreadsheet and the investment statements. Since the Excel spreadsheet is used as the basis for the information entered into the interest earnings allocation system (a separate system used to calculate monthly interest to be allocated to departments and agencies participating in investment pools) the department should ensure the information is accurate.

According to the funds custody manager, FAD staff received basic training on the application when Microsoft Dynamics was installed in August 1999. However, the primary FAD users at the time of implementation have all retired and the current personnel primarily responsible for utilizing the application have not received training.

The lack of training may create inefficiencies with regards to the maintenance of accurate investment information. As department personnel cannot adequately use the Microsoft Dynamics application, they also maintain the Excel spreadsheet, which requires additional time that could be spent on other tasks, such as those that were identified as neglected or delayed in our previous findings. Also, due to the lack of corresponding identification numbers between the data in Microsoft

Dynamics and the Excel spreadsheet, FAD is required to spend additional time preparing the monthly cross-referencing schedule. These additional manual procedures not only decrease efficiency of the process but also increase the risk of errors occurring.

### **Recommendations**

We recommend that the Department of Budget and Finance improve management and controls over its IT system by:

- Establishing a periodic review of user access to electronic applications and mainframe applications. For e-applications, a list of user accounts with access levels should be requested from ICSD and distributed to all departments' representatives for review. For the mainframe applications, the department should request the list of users for each application and have division managers review the lists for proper access levels.
- Implementing controls to secure and monitor direct access to the Microsoft Dynamics database.
- Enabling additional password settings for the Microsoft Dynamics application, including password age, history, and complexity. The department should utilize these settings to provide reasonable assurance that passwords are not easy-to-guess and force users to periodically change their passwords.
- Identifying physical security and environmental control alternatives and performing a risk assessment and cost-benefit analysis to determine what controls are reasonably necessary to protect the department's systems and information. The department may consider moving the server room to a more secure location or implementing additional physical security controls, such as closed circuit televisions monitored by building security or motion sensors within the server room. Possible environmental controls include installation of smoke detectors, fire extinguishers, heat sensors to detect systems overheating, or moisture sensors to detect flooding or high humidity. Implementation of unfeasible or cost-prohibitive measures is not required; however, the department should identify and implement economically viable controls to ensure its financial systems and data are reasonably protected.
- Establishing an off-site rotation of backup media (or off-site replication of data) for the Microsoft Dynamics application to prevent potential loss of financial data.

We also recommend that the Treasury Management Branch undergo Microsoft Dynamics training to take full advantage of the investment tools and capabilities of the Microsoft Dynamics system. We further recommend that the department keep abreast of technological efficiencies that other states are using to maintain investment information.

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## Conclusion

As the agency primarily responsible for fiscal planning and management for the State, the Department of Budget and Finance is integral to the operation of our state government. However, the department's procedures and practices raise questions as to how effectively the department is managing the State's funds. Furthermore, these deficiencies leave the department vulnerable to both unexpected as well as foreseeable challenges. The recent downturn in the national and global economies has highlighted the deficiencies in the department and made the potential consequences of those deficiencies a reality. Although other governments and entities across the nation have been affected by the economic slump, the impacts on the department—including the significantly reduced value and availability of funds in the state treasury and the department's inability to perform essential duties following employee turnover and position freezes—have been alarming, exacerbated by the department's failure to fulfill basic responsibilities.

While the current financial crisis facing our State is attributable in part to external economic factors, the department must be held accountable for its role. Financial and economic conditions are variable and unpredictable by nature, and it is the responsibility of those charged with fiscal management to be prepared for such changes, particularly the declines. The director of finance must initiate improvements in the department to ensure she is satisfying her statutory responsibilities and to better prepare the State to weather future economic challenges.



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# Chapter 3

## Independent Accountant's Report on Internal Controls

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This chapter presents the independent accountant's report issued by Accuity LLP on the design and operating effectiveness of internal controls over the Department of Budget and Finance's financial accounting and reporting processes for the fiscal year ended June 30, 2009.

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### Independent Accountant's Report

To the Auditor, State of Hawai'i:

We have examined the effectiveness of the State of Hawai'i, Department of Budget and Finance's (the department) financial accounting and financial reporting processes and related internal controls for the fiscal year ended June 30, 2009. The department's management is responsible for maintaining effective financial accounting and financial reporting processes and related internal controls. However, we did not request, and the department's management did not provide us, a written assertion about the department's financial accounting and financial reporting processes or related internal controls for the fiscal year ended June 30, 2009. Our responsibility is to express an opinion on those processes and related internal controls based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to attestation engagements contained in *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included examining, on a test basis, evidence supporting the department's financial accounting and financial reporting processes and related internal controls and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

A material weakness is a significant deficiency, or combination of significant deficiencies that results in more than a remote likelihood that material noncompliance with the specified requirements will not be prevented or detected. A significant

deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the department's ability to comply with the specified requirements such that there is more than a remote likelihood that noncompliance with the specified requirements that is more than inconsequential will not be prevented or detected by the department's internal control. We identified several significant deficiencies and material weaknesses which are described in Chapter 2 of this report.

In our opinion, because of the effects of the material weaknesses described in Chapter 2 of this report on the achievement of the objectives of the control criteria, the department has not maintained effective financial accounting and financial reporting processes and related internal controls for the fiscal year ended June 30, 2009.

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

/s/ Accuity LLP  
Honolulu, Hawai'i  
January 19, 2010

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## Response of the Affected Agency

### Comments on Agency Response

We transmitted drafts of this report to the Department of Budget and Finance on February 19, 2010. A copy of the transmittal letter to the department is included as Attachment 1. The response from the department, including its attachment, is included as Attachment 2.

In its response, the department expressed its dismay with our report, stating that our report is improperly labeled a *financial examination* and is “replete with false and misleading statements.” These claims are both offensive and baseless. Aside from an accompanying memorandum from the attorney general, which we address later in this commentary, the department offers little meaningful explanation as to how our report is false or misleading, often offering no explanation at all. Moreover, through its responses, the department frequently displays its lack of understanding of relevant issues.

In contrast, our work is subject to strict standards and scrutiny. The examination, conducted with the certified public accounting firm of Accuity LLP, was performed in accordance with generally accepted government auditing standards (*Government Auditing Standards*) issued by the Comptroller General of the United States. Those standards require that we plan and perform the examination to obtain sufficient and appropriate evidence to provide a reasonable basis for the findings and conclusions expressed in our report. For this engagement, such evidence included not only statements and representations by the director of finance, department administrators, and relevant personnel, but also extensive review of departmental systems, documents, and records and walk-throughs and observations of actual procedures and practices. In addition, *Government Auditing Standards* require us to conduct our engagement in accordance with strict ethical principles.

Unlike the department’s response to our report, we counter the department’s claims with specific arguments backed by identifiable and well-documented evidence.

### ***Department’s response displays its lack of understanding of auditing standards and principles***

#### **Classification of our report as a *financial examination* is proper**

The department began its response by claiming that our report is misleading in being entitled a *financial examination*. However, the term is based on *Government Auditing Standards*—the same standards we

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adhered to in conducting the engagement. Those standards classify an *examination* as a type of attestation engagement that “can cover a broad range of financial or nonfinancial objectives” and “consists of obtaining sufficient, appropriate evidence to express an opinion. . . .” As clearly set forth in our report, the primary objectives of the examination were:

1. To examine the effectiveness of the financial accounting and financial reporting processes and related internal controls of the department; and
2. To assess the adequacy, efficiency, and effectiveness of the department’s organizational structure, systems, procedures, and practices over its financial administration functions.

(emphasis added).

Chapter 3 of the report contains the independent opinion issued by Accuity LLP on the department’s internal controls over its financial accounting and reporting processes. *Government Auditing Standards* also expressly require auditors conducting attestation engagements to report any material weaknesses and significant deficiencies in internal controls. Consequently, it would in fact be inaccurate and misleading *not* to refer to the report as a *financial examination*. As for the department’s classification of our engagement as an “operational review,” the department provided no definition or explanation of the term and we are unaware of the existence of such classification in the *Government Auditing Standards*.

### **Department’s comparison of financial examination to CAFR audit is misguided**

The department appears to have confused the term *financial examination* with *financial statement audit*, which demonstrates its lack of understanding of audits in general and the differing scopes involved. This confusion is further exemplified by the department’s claim that our opinions are inconsistent with findings of annual independent audits. The annual audit referred to by the department is the *financial statement audit* of the State’s Comprehensive Annual Financial Report (CAFR). That audit and our examination are both conducted in accordance with *Government Auditing Standards*, which provide clear but distinct descriptions of each type of engagement.

Consistent with our objectives stated above, our examination involved obtaining sufficient, appropriate evidence relating to the effectiveness of the department’s financial administration internal controls, systems, procedures, and practices with the specific purpose to express an opinion on whether these controls, systems, procedures, and practices are functioning effectively and in compliance with applicable laws

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and policies. In contrast, the audit of the CAFR is focused on the fair presentation of the State's financial statements, which are ultimately the responsibility of the State. *Government Auditing Standards* specifically provide that the "primary purpose of a *financial statement audit* is to provide reasonable assurance through an opinion about whether an entity's financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles." Unlike our examination, the CAFR audit provides no assurances related to the State's internal controls or its compliance with laws and regulations. The actual independent auditors' opinion further states:

An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the State of Hawaii's internal control over financial reporting. Accordingly, we express no such opinion. (emphasis added).

The *Report on Internal Control Over Financial Reporting and On Compliance and Other Matters*, issued in conjunction with the annual CAFR audit, specifically states that "providing an opinion on compliance with [certain provisions of laws, regulations, contracts, and grant agreements] was not an objective of our audit, and accordingly, we do not express such an opinion." Furthermore, the most recent internal control report issued for FY2008 actually includes a *material weakness* relating to the State's holdings of auction-rate securities (ARS). Although the internal control report did not evaluate ARS holdings with as much scrutiny as our present *examination* due to its different scope and purpose, the report did include elements *consistent* with our *examination* findings, even recommending that "B&F should also perform a regular review of the investment pool to ensure that the investments are in alignment with the objectives and requirements of the State's Treasury Investment Policy." Contrary to the department's unsupported claims, previous audits of the CAFR do not conflict with our findings.

### **Reliance by department on Standard & Poor's credit rating report displays lack of understanding of auditing standards**

Similarly, the department contends our report should have relied on a February 3, 2010 Standard & Poor's "credit rating report" which notes that the State's management practices are "good." Such an assertion once again demonstrates the department's utter lack of understanding of *Government Auditing Standards*, basic audit principles, and the purpose and scope of ratings reports. What we did rely on were various objective criteria, as well as our own systematic examination of department-provided information as required by applicable standards and principles. Moreover, while claiming we should have relied on

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that single ratings report as an objective source of information, the department overlooked reports by two other ratings agencies dated February 2 and 3, 2010—Fitch Ratings and Moody’s Investor Services, respectively—that assigned a “negative” outlook to Hawai‘i’s general obligation bond ratings. Those reports indicated that the negative outlook reflected the State’s narrowed financial operations and limited flexibility underscored by reduced reserve levels, funding gaps, and liquidity challenges.

***Auction-rate securities and investment oversight by department is deficient***

The present condition of the state treasury and surrounding circumstances are key indicators of the validity of our specific findings. As detailed in our report, the circumstances related to ARS highlight the numerous deficiencies in the department’s oversight and accountability in managing the treasury. The department attempts to compare the State’s situation with “numerous other states, municipal entities, and fortune 500 companies” who were “all impacted by the freeze and collapse of the ARS market.” Our report acknowledges that many other investors across the nation have been impacted by holding ARS; however, few have been impacted to the same extent as Hawai‘i. As mentioned in our report, the State currently holds approximately \$1 billion of the *total* \$330 billion ARS market. As an objective basis of comparison, a national valuation services firm has published a survey of public companies with ARS holdings compiled from searches of public record filings as of September 30, 2009. Of 430 public companies identified as holding ARS with a total par value of \$21 billion, the highest par value of ARS held by a single company was \$1.1 billion; the remaining top four ARS holders held par values at or below \$500 million. Thus, it should not come as any surprise that the State’s ARS situation has garnered attention on a national level.

The primary significance of the State’s ARS holdings is that the department continued increasing those investments due to their higher yields despite increasing risk, in direct conflict with its own investment policy providing that yield is of secondary importance to safety and liquidity. These facts are indisputable, and the department has not disputed them. Moreover, the department escalated those investments without exercising basic, prudent investment principles—they did not gain a full understanding of the securities, did not perform a risk assessment or cost-benefit analysis prior to purchase, and invested almost 30 percent of the State’s investment portfolio in that single investment type.

The department responded to our finding that it did not evaluate risks prior to more than doubling its ARS investments in FY2008 by stating

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that it evaluates investment risk on an ongoing basis. During our examination, however, the FAD administrator and relevant personnel repeatedly told us that they did not perform any risk assessment or cost-benefit analysis prior to purchasing ARS. Instead, the department relied on the fact that ARS was listed in the statute as an acceptable type of investment and decided to increase investments based on the higher yields. For instance, the email below is the FAD administrator's response to an email inquiry as to what type of assessment of risk/cost/benefit was done in deciding to increase ARS investments in FY2008.

**From:** Scott.A.Kami@hawaii.gov [mailto:Scott.A.Kami@hawaii.gov]  
**Sent:** Monday, October 26, 2009 3:14 PM  
**To:** Accuity LLP  
**Cc:** Judy.A.Dang@hawaii.gov  
**Subject:** Re: Auction-Rate Security Question

Accuity LLP

Act 47, SLH 1997, enacted statutory language that authorized the department to invest in Auction Rate Securities (ARS). The State began investing in ARS in approximately September, 1998. As the original decision to invest in ARS was made over 10 years ago, we do not have any records that reflect who made the original decision to invest in ARS.

As far as a "risk assessment", Act 47, SLH 1997 determined that investing in Student Loan ARS was acceptable and authorized investing in such instruments. The Department, along with many other institutional investors and professional money managers, were not aware of the impending disruption in the Student Loan ARS market. As far as a cost benefit analysis, in February 2008, prior to the disruption in the Student Loan ARS market, the Student Loan ARS yields were approximately two times the yield on similar 30-day treasury investments or 30-day bank certificates of deposit. Due to the substantial yield benefit, investments were made in the Student Loan ARS.

With respect to the investment portfolio's percentage of Student Loan ARS, I'll provide you with our comments no later than tomorrow, Tuesday, 10/27.

Thanks,  
Scott

The department also claims that it could not have known or understood the risks when it escalated ARS investments in FY2008. However, as laid out in Exhibits 2.10 and 2.11 of our report and the corresponding discussion, had the department simply obtained and reviewed copies of the offering documents prior to purchase, it should have been aware of the considerable risks. Further, had the department heeded the investment guidelines and limitations in the statute and its own investment policy, it may not have invested such significant amounts in this one type of investment. In response to our finding that the department's FY2008 purchases of ARS violated the investment policy's diversification requirements, the department simply stated that the policy allows for exceptions. Our report specifically describes that exception provision, which provides that exceptions "shall be approved by the [FAD] Administrator prior to being executed" and that "significant exceptions shall also be approved in advance by the Director



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of Finance.” However, despite the department’s current implications to the contrary, key department personnel—including the director and FAD administrator—have repeatedly stated that the director and administrator were not consulted prior to increasing ARS investments in FY2008 and did not approve in advance the deviation from the 20 percent limit. For example, in response to one such inquiry via email, the FAD administrator stated that he was “informed” of the increased holdings and that the director was not consulted prior to the increase.

**From:** Scott.A.Kami@hawaii.gov [mailto:Scott.A.Kami@hawaii.gov]  
**Sent:** Tuesday, October 27, 2009 2:12 PM  
**To:** Accuity LLP  
**Cc:** Judy.A.Dang@hawaii.gov  
**Subject:** RE: Auction-Rate Security Question

Accuity LLP

While there was an increase in our position with ARS due to the very favorable interest rates, please keep in mind that while the amount of ARS may have been relatively stable after the market froze, the decline in the overall amount of funds available for investment caused the percentage to increase (i.e. numerator stayed constant, denominator decreased). As staff did not believe that the deviation from the 20% figure was significant, the Director was not consulted prior to increasing our position in ARS. I was informed of our increased holding due to the favorable yields.

Scott

Such breaches of policy limitations were not particular to ARS—Exhibit 2.7 of our report illustrates other breaches that occurred in FY2009 without prior approval from the director or FAD administrator. This is not surprising, however, since as detailed in our report, the department’s procedures do not monitor for compliance prior to investment purchases; any compliance monitoring is performed at month-end after purchases have already been made.

The department’s statement on page 12 of its response that “[t]he FAD administrator and Director are apprised and exercise the appropriate control over the investment activities of the Department” is therefore puzzling. It seems either the department is making false statements or its director and management are unfamiliar with the requirements of its investment policy and of basic oversight and monitoring procedures.

**Attorney General memorandum confirms that ARS presently do not comply with statute**

In its response, the department takes issue with our finding that the State’s ARS holdings do not comply with state law, relying primarily on a March 1, 2010 memorandum from the attorney general (AG memorandum) as support. However, the department’s contentions are flawed for a number of reasons. First, although the department

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characterizes our report as “misleading as it purports and insinuates that non-compliance has occurred,” it seems the department’s assertion is misleading since it is indisputable that the State’s ARS currently do not comply with state law. As set forth in our report, because many of their ratings have dropped below AAA, they clearly do not comply with the statutory requirement that investments maintain a AAA rating. The AG memorandum itself appears to confirm that ARS presently do not comply with statute. In answering the question of whether the State is required to dispose of its ARS in the negative, the AG memorandum cites case law recognizing that an agency cannot be ordered or made to comply with a mandatory statutory deadline where it proves it is impossible to do so. As an aside, we have not made any recommendations or even suggested that the State dispose of any ARS.

Second, the AG memorandum is merely an *interpretation* of the statute, and we respectfully disagree with this interpretation for the following reasons. As the AG memorandum states, the rules of statutory construction are well-established. The Hawai‘i Supreme Court language cited in the AG memorandum sets forth the foremost rule—that the meaning and intent of a statute must be “obtained primarily from the language contained in the statute itself,” read “in the context of the entire statute . . .” Here, the relevant language of Section 36-21, Hawai‘i Revised Statutes (HRS), is clear and unambiguous. The statute, entitled *Short-term investment of state moneys*, provides a list of allowable investment types immediately followed by a general provision that they are allowable “provided that the investments are due to mature not more than five years from the date of investment.” Because the State’s student loan-backed ARS have clearly stated maturity dates that exceed five years, there is no ambiguity in the statutory language as it applies to ARS.

However, instead of applying the plain language of the statute, the AG memorandum makes a number of vulnerable presumptions to reach its conclusion that the maturity limit is inapplicable to ARS. In doing so, the memorandum compares ARS to various investments that have *no* stated maturity dates, and even goes so far as to liken ARS to bank savings accounts. Attempting to analogize ARS to such investments is absurd as they are clearly distinguishable based on a number of factors, including the fact that ARS do have stated maturity dates. The AG memorandum also delves into an extensive review and interpretation of the statute’s legislative history, going back to its enactment in 1945. Not only does the cited history *support* an interpretation that the five-year maturity limit should apply to ARS, but such an analysis is inappropriate here. As the AG memorandum recognizes, extrinsic aids such as legislative history should only be used to interpret legislative intent when the statutory language is ambiguous. The relevant language of Section 36-21, HRS, is clear. The statute contains no language

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suggesting the maturity provision does not apply to certain investments or in certain circumstances; rather, a plain reading indicates the provision applies to all investments made by the department under this statute.

Third, the AG memorandum, whether correct or not, would have more significance had it been obtained at the time the department escalated its ARS investments in FY2008, or at least during the course of our examination when the issue of legality was repeatedly raised to the department. We requested from the department any documentation it had related to ARS, including anything related to the issue of compliance. However, the AG memorandum, dated the same day as the department's March 1, 2010 response to our draft report, was the first document the department provided to us on the issue. The fact that the department did not obtain a written opinion from the attorney general on this issue prior to the date of its response underscores the main point of our report—that the director is not exercising sufficient oversight to ensure proper management of the state treasury.

**Auction-rate securities are long-term debt investments, not short-term investments**

Regardless of the attorney general's interpretation as to the applicability of the maturity provision to ARS, the actual maturities of ARS are now abundantly clear. The AG memorandum acknowledged that:

- 1) "Auction rate securities 'are long-term debt investments'" [page 7];
- 2) The State is "dealing here with a circumstance in which market forces have changed significantly from what they were when the assets were purchased" [note 10];
- 3) "Auctions need to be held for ARS investment products to function fully" and "to the best of our understanding, auctions have not been held since" February 2008 [note 3]; and
- 4) The State "presently holds" ARS that "for the most part, it has not been able to sell since February 2008, and as a consequence some of the SLARS have had to be held for more than five years . . ." [pages 1-2]

The department stated on page 8 of its response that it "fully understands the maturity structure of its investments" and that our recommendation that it gain such an understanding was unnecessary. However, through at least June 30, 2009, the department continued to show the next *auction* date as the maturity date for ARS on its internal investment schedules,

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even though auctions had failed since February 2008—more than 15 months prior. Further, despite resounding information to the contrary, the department persists in maintaining the fallacy that ARS are comparable to short-term investments. On page 4 of its response, the department states that ARS earn a higher rate of interest “as compared to one-year or shorter investments,” suggesting that this is somehow positive for the State. These statements by the department highlight its distorted perspective on the State’s ARS circumstances.

**Department’s arguments addressing ARS liquidity and write-down are hypocritical and uninformed**

The department’s remaining arguments to our ARS findings are likewise unsound. In contesting our findings that the department’s nearly \$1 billion investment in ARS is illiquid and impaired by \$114 million as of June 30, 2008, the department is both hypocritical and uninformed. First, the department disputes our finding that the ARS are illiquid and impaired by citing a February 2010 sale of \$10 million of ARS at par value. The sale of 1 percent of the almost \$1 billion holdings in ARS since February 2008 hardly proves liquidity. The director’s claim of liquidity contradicts its own response as the attached AG memorandum notes that it “was asked to address the SLARS [student loan auction-rate securities] the State has not been able to sell . . .” The AG memorandum actually closes by noting that “. . . billions of dollars of investments in SLARS would be illiquid after February 2008 because the auctions fundamental to their proper functioning were no longer occurring.”

Second, the director asserts that when the State receives principal payments or sale proceeds on ARS, the State realizes an actual gain. However, the only way to recognize gains on these transactions at par is to accept that they were impaired to begin with. Ironically, the director of finance renounces the initial impairment on auction-rate securities, yet readily touts the subsequent recapture of these losses as “gains.”

Third, and most importantly, regardless of any principal repayments or sales, the State’s \$1 billion investment in ARS as of June 30, 2009, has been written down by approximately \$255 million, or 25 percent. The department conveniently fails to mention or address this fact despite being provided with the valuation back in December 2009. Further, while the director continues to dispute any write-down, we point out that the valuation was paid for by the department itself, conducted by the department’s own broker, and accepted and approved by the department and the State for inclusion in its FY2009 CAFR.

The director of finance would like the public to believe that this most current valuation is a meaningless “paper” loss and is only an estimate of potential loss *if* the State were to sell its entire ARS holdings. However,

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this point of view is misleading and displays a lack of understanding of the purpose of financial reporting. The State reports all of its investments at “fair value” as prescribed by Governmental Accounting Standards Board (GASB) Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. In discussing the relevance of “fair value,” GASB Statement No. 31 states:

Fair value provides users with information to help them assess a government’s accountability. . . . The Board also believes fair value is the more relevant and faithful representation of the asset and more accurately reports the resources available to provide services because it portrays the market’s estimate of the net future cash flows of investments, discounted to reflect both time value and risk.

It is also probable that the state treasury will be affected by having a significant percentage of its moneys tied up for seven to 35 years and may not have available funds to cover its anticipated cash disbursements.

***Funds in demand deposit checking accounts are not investments***

Our report notes that the department “does not perform formal cash projections and has retained significant cash balances that could have been invested.” It continues that approximately 10 percent of the State’s reserve balances are held in non-interest bearing accounts and that these significant amounts result in lost potential interest income. The department responded that these statements are not supported by fact and that this demonstrates we do not have a clear and accurate understanding of the department’s investment practices. The department further emphasized that all of the funds in the State Treasury are invested at all times.

However, this response highlights the department’s misunderstanding of its own accounts and a misinterpretation of our finding. First, in stating that all funds are invested at all times, the director is claiming that the significant balances sitting in minimal-yield demand deposit checking accounts constitute “investments.” While most of this balance does earn interest (at rates ranging from 0.03 percent to 0.16 percent for June 2009), it is the responsibility of the department to formally project cash needs, which would enable it to invest more of those funds in short-term and generally higher-yield investments. Moreover, the director is either unaware, or unwilling to admit, that not all of the funds in its “interest earning demand deposit checking account” actually earn interest. Each of the State’s bank accounts specifically set aside a 10 percent “reserve” that earns *no* interest. Those reserve balances are identified on the monthly bank statements.

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### ***Department's claims of false, misleading, and inaccurate statements are unfounded***

In its response, the department commented extensively on our report and stated that it “repeatedly states false, misleading, and inaccurate statements to promote faulty conclusions.” However, when disputing specific points, in most instances the department simply stated they were false or inaccurate without much explanation, or misconstrued and misrepresented relevant facts. The following are only a few of the more glaring attempts by the director to dispute our findings and undermine our credibility by presenting unsupported claims or select pieces of incomplete information.

- 1) The department includes the following excerpt of our broader finding on the ineffective use of its cash and investment accounting system (Microsoft Dynamics) and claims it is inaccurate:

*However, the yield maintained in the Microsoft Dynamics program is not the actual yield for the investment, but a system-calculated yield. According to the FAD administrator and funds custody manager, they believe the yield calculated in Microsoft Dynamics is incorrect but are unsure how it is calculated or how to correct it.*

The department first notes that the FAD administrator never made the statement. However, during a meeting in August 2009, the funds custody manager did make the statement noted in our finding to us in the presence of the FAD administrator, who made no objections or corrections to the fund custody manager's statement during the meeting. We accordingly attribute this *belief* to both the funds custody manager and the FAD administrator and stand by the statement in our report. Ironically, the department's response then confirms that the yield is, in fact, *incorrect* but that it is only limited to one report. Of course, the department ignores the overall focus of the finding, which are the inefficiencies resulting from the fact that the department has to also input the investment information into an Excel spreadsheet then reconcile both Microsoft Dynamics and the spreadsheet to the investment statements.

- 2) The department refers to a statement in our report attributed to the FAD administrator and funds custody manager that cites falling state revenues and low yields on available investments as the reason they decided to maintain greater liquidity. The department claims that these individuals never referred to low yields as a reason for liquidity; however, our documented interview notes prove otherwise. Both of these individuals made these statements several times throughout the examination and the statements were confirmed at meetings held on August 5, 2009 and August 17, 2009.

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The department's response confirms that a high percentage of the State's excess cash is on deposit in the interest earning demand deposit checking account because the amount of taxes, fees, etc., that the State collects and deposits daily to cover cash needs has been substantially reduced. However, during our interviews, the individuals above also explained that their projections of cash needs are only rough estimates and that the yields on potential investments were so low that it was not worth transferring funds from these bank accounts.

- 3) Further, the department inexplicably disputes our finding that its process of obtaining bank and broker quotes is informal by stating that "while this procedure may not be written in a document, it is a formal process that is followed." The fact that the director equates undocumented procedures with a formalized process emphasizes her casual approach to managing the State's funds.
- 4) The department contends our finding that it does not formally review the investment policy on an ongoing basis is false. The department states it reviews the policy on an ongoing basis; however, the simple fact that the policy is dated 1999 seems to belie this claim. We stand by our finding as the FAD administrator repeatedly stated the last formal review and update of the policy took place in 1999, with only an informal review taking place in 2002 since that date.

The department's response does concede that it needs to improve in numerous areas. For a number of findings, the department acknowledged their validity and stated that procedures or actions were not done due to staffing and resource challenges. Similarly for many of the recommendations, the department indicated it would try to implement them as "staffing," "resources," and "time" permit. The department's apparent perspective that performance of essential functions and procedures is optional underscores the primary message of our report—that the director is not doing enough to ensure the department is meeting its fiscal responsibilities.

While the director's response accuses our report of being "an undeserved attack on the hard working men and women of this department," we reiterate our overall conclusion that *The Department's Lack of Leadership and Accountability Puts the State's Funds at Risk*. The director's deflection of our findings to her staff and away from herself only serves to highlight our concern. Additionally, the department urges that our failure to substantially amend the report would "be a gross disservice to the public and could mar our hard-earned reputation as a prudent fiscal manager of the public's resources." We fail to see how ignoring risks and chasing yields on the way to tying up over \$1 billion of state funds has not already accomplished this.

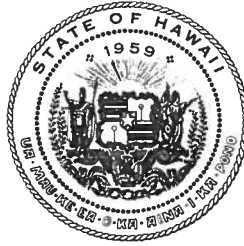
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As the department was apprised, our audit/examination process includes providing agencies with an opportunity to review a confidential draft report prior to official release. The two primary interrelated purposes for this step are to: 1) afford agencies an opportunity to respond to our findings, conclusions, and recommendations; and 2) modify the report as necessary to address agency comments that are valid and supported with sufficient, appropriate evidence, consistent with *Government Auditing Standards*. Based on our evaluation of the department's response, our final report contains a few minor changes to address any valid and supported comments from the department. However, as the bulk of the department's comments were unsupported and at odds with the evidence obtained during our examination, we stand by the substantive findings and conclusions in our draft report.



ATTACHMENT 1

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

February 19, 2010

*COPY*

The Honorable Georgina K. Kawamura  
Director of Finance  
Department of Budget and Finance  
No. 1 Capitol District Building  
250 S. Hotel Street  
Honolulu, Hawai'i 96813

Dear Ms. Kawamura:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Financial Examination of the Department of Budget and Finance*. We ask that you telephone us by Tuesday, February 23, 2010, 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 Friday, February 26, 2010.

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,

A handwritten signature in cursive script, appearing to read "Marion M. Higa".

Marion M. Higa  
State Auditor

Enclosures

LINDA LINGLE  
GOVERNOR



GEORGINA K. KAWAMURA  
DIRECTOR

BARBARA A. ANNIS  
DEPUTY DIRECTOR

EMPLOYEES' RETIREMENT SYSTEM  
HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND  
OFFICE OF THE PUBLIC DEFENDER  
PUBLIC UTILITIES COMMISSION

**STATE OF HAWAII**  
**DEPARTMENT OF BUDGET AND FINANCE**  
P.O. BOX 150  
HONOLULU, HAWAII 96810-0150

ADMINISTRATIVE AND RESEARCH OFFICE  
BUDGET, PROGRAM PLANNING AND  
MANAGEMENT DIVISION  
FINANCIAL ADMINISTRATION DIVISION

March 1, 2010

RECEIVED

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OFC. OF THE AUDITOR  
STATE OF HAWAII

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

Dear Ms. Higa:

We offer the following comments on the draft report, *Financial Examination of the Department of Budget and Finance (report)*.

We were initially informed that the scope of your review would be a Financial Examination of the Department of Budget and Finance (Department). Your report is actually an operational review of this Department and should not be described by any other title since it is misleading to call it a financial examination.

**THE LEGISLATIVE AUDITOR'S REPORT IS NOT A FINANCIAL EXAMINATION AND IS REPLETE WITH FALSE AND MISLEADING STATEMENTS**

The report makes an inflammatory and headline-seeking statement that "the department's lack of leadership and accountability puts the State's funds at risk." This statement is unwarranted and unfounded as the report does not cite any specific instance to substantiate this conclusion.

We are concerned that this baseless conclusion may damage Hawaii's hard-earned reputation as a prudent manager of public resources and adversely affect our ability to sell bonds.

A recent credit rating report dated February 3, 2010 by Standard & Poor's considered the State's management practices as "good." This assessment states that "the finance staff and treasury adhere to an official investment policy, and investment performance is disclosed monthly." Standard & Poor's report should have been used as an objective source of information by those who prepared this report.

Your report contains a number of inaccurate, misleading, and false statements. In many instances, statements were attributed to the FAD (Financial Administration Division) Administrator and/or Funds Custody Manager that either were never made, or were reported incompletely or inaccurately.

While we may agree with some of your findings and recommendations, and have either implemented actions or are exploring appropriate and economically feasible measures to address them, we strongly disagree with other comments, characterizations, findings, and conclusions that are contained in your report. Detailed responses and comments for the specific items that we strongly disagree with are provided in the following sections.

I. Lax management of the State's \$3.8 billion treasury has increased risk and reduced available funds (Page 14).

1. *Statement (Page 17): "FAD does not perform formal cash projections and has retained significant cash balances that could have been invested."*

Response: The report makes untrue and totally inaccurate statements to allege that State funds are either not being invested or are being held in non-interest bearing accounts.

Page 16, third paragraph: "However, approximately 10 percent of the State's reserve balances are held in non-interest bearing accounts."

Page 16, fourth paragraph: "Consequently, in fiscal year 2009, there were large uninvested cash balances of, for instance, \$126 million on June 30, 2009."

Page 18, second paragraph: "Based on a judgmental sample of 20 days selected during fiscal year 2009, we calculated an average uninvested cash balance of \$63 million and an actual uninvested balance of \$126 million on June 30, 2009."

Page 18, second paragraph: "Therefore, it appears that the department could have invested, on average, \$63 million in cash on each of the 20 days we sampled, even if only in short-term investments."

Page 19, first paragraph: "If the department had invested approximately \$30 million of the average uninvested cash of \$63 million, the State's investment earnings could have been approximately \$300,000 higher at a 1 percent yield."

These statements are not supported by fact, demonstrating that the Legislative Auditor does not have a clear and accurate understanding of the Department's investment practices. **All of the funds in the State Treasury are invested at all times.** The Legislative Auditor makes the false claim that funds held in the demand deposit checking account did not generate interest. This assertion is not true and ignored clarification provided by the

Department. The Department staff informed the auditors that funds needed for daily liquidity needs are placed in a demand deposit checking account which generates interest income. To further demonstrate the Legislative Auditor's lack of understanding of cash management practices, the comment on page 19, in the first paragraph states that "If the department had invested approximately \$30 million of the average uninvested cash of \$63 million, the State's investment earnings could have been approximately \$300,000 higher at a 1 percent yield...." to suggest that of the alleged \$63 million of uninvested funds, it would be acceptable to invest \$30 million and leave \$33 million uninvested.

The report states that "FAD does not perform formal cash projections and has retained significant cash balances that could have been invested." First, as aforementioned, **all of the State Treasury funds are invested at all times**. The Department performs cash projections to determine days on which larger than normal amount of liquid cash will be needed to cover large expenditures, such as payroll dates, debt service payments due on general obligation and revenue bonds, social security payments, and other large denomination transactions. Based upon the cash projections performed, the Department invests available funds to ensure that a sufficient amount of investments will mature on the days identified as requiring higher balances in our accounts to cover these expenditures. This process was described in detail with the auditors. The report does not cite any specific example to support the statement that we do not perform formal cash projections and is an irresponsible comment by the Legislative Auditor.

**THE LEGISLATIVE AUDITOR'S REPORT MISCHARACTERIZES THE ACTUAL CONDITIONS AND CIRCUMSTANCES SURROUNDING INVESTMENTS IN AUCTION RATE SECURITIES**

2. *Statement (Page 14, last paragraph): "Because the market for auction-rate securities has been largely frozen since then (FY 2008), those securities are no longer liquid and their value was written down by \$114 million in FY 2008."*

Response: The Legislative Auditor's comment that "*those securities are no longer liquid and their value was written down by \$114 million in FY 2008*" is misleading and inaccurate.

Student Loan ARS are investment securities financially backed by individual student loans. To provide further protection to the investor, the individual student loans are guaranteed by the federal government or the ARS were guaranteed for payment by "AAA" insurance policies at the time they were purchased. Every 7 or 28 days, depending upon the individual ARS, auctions would be conducted which allowed investors to sell or liquidate their ARS at par (full face value). The yields or interest rates on the ARS were generally higher than comparable alternative investments.

While the level of activity in the ARS market is currently limited, there have been recent transactions. **On February 24, 2010, the Department sold \$10,000,000 of ARS at par value.** The report fails to mention that as the State receives periodic principal payments or sales proceeds on the ARS, the State will realize a gain.

Regarding the ARS value being “written down” by \$114 million, the Legislative Auditor, citing the Governmental Accounting Standards Board (GASB) Statement 31, required the State to provide a fair market value of the ARS at the end of each fiscal year. A model prepared by the financial brokerage firm of Morgan Stanley Smith Barney was used to generate an estimate of the fair value of the ARS. This estimate was subsequently accepted by the auditing firm of Deloitte & Touche for inclusion in the Comprehensive Annual Financial Report. Thus, it is important to note that the estimated fair value used for accounting and financial statement purposes is just an estimate, based on this model. The \$114 million impairment was an estimate of potential loss to the State if the Department sold its entire ARS holdings on June 30, 2008, which we did not do.

The Department has stated on numerous occasions that in the absence of a market that would allow the State to sell the ARS at par, we intend to hold these securities until maturity as the investments themselves remain sound and the State has been receiving all of the principal and interest payments on a timely basis. As the State has not liquidated its ARS holdings at amounts below par, we have not lost any of the principal invested and the State has been earning a higher rate of interest on the ARS as compared to one-year or shorter investments where these funds could also have been invested.

**THE LEGISLATIVE AUDITOR OFFERS STATEMENTS REGARDING AUCTION RATE SECURITIES THAT ARE NOT SUPPORTED BY LAW OR LEGAL OPINIONS**

3. *Statement (Page 14): “More importantly, initial investment in these securities violated state laws regarding maturity limits.”*

Response: This statement is misleading, inaccurate and completely false. The Director of Finance has the statutory authority pursuant to Section 36-21(15)(A), HRS, to invest excess cash in Student Loan ARS. Section 36-21(15)(A), HRS, specifically authorizes the Director to invest in “Student loan resource securities including: (A) Student loan auction rate securities;”

Attached is a written opinion from the Attorney General confirming that the ARS purchased were legal and in compliance with State statutes.

**THE LEGISLATIVE AUDITOR OFFERS OPINIONS THAT ARE INCONSISTENT WITH FINDINGS OF ANNUAL INDEPENDENT AUDITS**

Furthermore, in every annual independent audit conducted on the State dating back to fiscal year 1999, there were no issues or concerns raised with respect to the Department's investment in ARS prior to the collapse of the ARS market. For fiscal years 1999 through 2008 (FY 2008 being the most recent independent audit available), Ernst & Young LLP, KPMG LLP, and Deloitte & Touche LLP examined the Department's records and none raised concern or had issue with respect to the legality of the Department's investment in Student Loan ARS. In fiscal year 2006, the last completed audit prior to the experience and knowledge of the ARS market failure, KPMG LLP specifically referenced the State's investment in Student Loan ARS (again with no issues or concerns raised with respect to their legality) and recognized the ARS as short-term investments having a maturity of five years or less (i.e., in compliance with statutory requirements). The FY 2006 independent financial audit stated "As of June 30, 2006, the State held short-term investments in student loan resource securities maintaining a Triple-A rating."

**LEGAL REVIEW SUBSTANTIATES THE LEGAL VALIDITY OF THE DEPARTMENT'S ACTIONS THAT WERE CONSISTENT WITH MEASURES OBSERVED BY OTHER STATES, MUNICIPALITIES AND FORTUNE 500 COMPANIES**

4. *Statement (Page 32): "The department holds approximately \$1 billion in impaired auction-rate securities that do not comply with state law."*

Response: This statement is patently false. At the time the ARS were purchased, they were legal investments and in compliance with State laws as evidenced by the opinion letter of the Attorney General. Due to the unforeseen failure of the ARS market, auctions are not being held on the regular 7 or 28 day auction cycle. We intend to hold the ARS until such time that the auction market returns or until maturity.

5. *Statement (Page 33): "The department did not evaluate risks before more than doubling its investment in auction-rate securities."*

Response: The Department evaluates the risk of its investments on an ongoing basis. Prior to the collapse of the ARS market, the Department did not have any information or indication that the ARS market would fail. The Department, along with numerous other States, municipal entities and fortune 500 companies, who employed professional investment advisors, were all impacted by the freeze and collapse of the ARS market.

Recommendation 7 (Page 43): *"Ensure that investments comply with all provisions of Section 36-21, HRS, and the investment policy. The*

*department should also perform adequate risk assessments of all current and potential investments to ensure it understands all risks related to an investment and that an investment complies with state law and the investment policy. Furthermore, the department should ensure that the State can exit any investment, without penalty, that no longer complies with state law."*

Response: The Department has and continues to perform these functions. The reference in the recommendation that the department ensure compliance with State law is deliberately misleading as it purports and insinuates that non-compliance has occurred.

**THE LEGISLATIVE AUDITOR'S REPORT REPEATEDLY STATES FALSE, MISLEADING AND INACCURATE STATEMENTS TO PROMOTE FAULTY CONCLUSIONS**

6. *Statement (Page 33): "Further, the department significantly increased investments in auction-rate securities during January and February 2008, when auctions for the securities began failing."*

Response: This statement is totally misleading, false and irresponsible. The Department did not purchase any ARS after the Student Loan ARS market froze beginning on February 12, 2008.

7. *Statement (Page 38): "The department erroneously believed the auction-rate securities met the State's five-year maturity limit as the securities could be auctioned and thus sold every seven to 49 days."*

Response: The Attorney General's opinion affirms that the Department's investment in ARS was in compliance with all applicable statutory requirements.

8. *Statement (Page 38): "In addition, the department's purchase of auction-rate securities in FY 2008 violated its own diversification requirements. Part III.G of the policy provides percentage limits for the types of allowable investments and states that auction-rate securities may comprise up to 20 percent of the investment portfolio."*

Response: Section V of the Investment Policy provides Policy Exceptions which specifically allow exceptions to the Investment Policy.

*Recommendation 8 (Page 43): "Follow the guidance stated in Section V of the investment policy and obtain proper approvals from the FAD administrator and, when exceptions are significant, the director of finance prior to the purchase of investments if they exceed quantitative guidelines but are deemed to be in the best interest of the State. Also, as required*

*under the investment policy, inadvertent breaches of the policy should be immediately reported to the director of finance."*

Response: The Department has followed the Investment Policy guidelines. The Department will explore additional procedures to enhance and document compliance with the Investment Policy as resources permits.

9. *Statement (Page 39): "The state's auction-rate securities are illiquid and have been impaired by at least \$114 million."*

*Statement (Page 39): "Because the auctions, and the market, for auction-rate securities have failed since early 2008, the department is unable to sell these securities until auctions become functional, securities are called, or the underlying loans mature."*

Response: This statement is obviously false as evidenced by the February 24, 2010 sale of \$10,000,000 of ARS at par value as earlier noted on Page 4. The Department also is able to sell, if it desired, ARS at a discount in the secondary market. The Department has received inquiries from various entities to determine if we would be willing to sell our ARS at a discount. It is our intention to hold these securities to maturity, if necessary; or wait until the market returns to allow us to sell some or all of the ARS at par value.

Since the ARS market froze in February 2008, we have received \$139,850,000 in principal payments, a portion of which is recognized for accounting purposes, as an actual gain which offsets the \$114 million accounting loss.

As of February 25, 2010, the Department's ARS investment balance was \$946,375,000.

10. *Statement (Page 39): "Accordingly, the value of the State's auction-rate securities has been significantly impaired. The department was required to write down the value of these investments by \$114 million as of June 30, 2008."*

Response: Due to the lack of a fully functioning primary ARS market involving a willing seller and a willing buyer, an estimate of the fair value of the ARS was required for accounting purposes as of June 30, 2008. A model prepared by the financial brokerage firm of Morgan Stanley Smith Barney was used to generate an estimate of the fair value of the ARS. This estimate was subsequently accepted by the auditing firm of Deloitte & Touche for inclusion in the Comprehensive Annual Financial Report. Thus, it is important to note that the estimated fair value used for accounting and financial statement purposes is just an estimate, based on this model. The \$114 million impairment was an estimate of potential loss to the State if the



Department sold its entire ARS holdings on June 30, 2008, which we did not sell.

11. *Statement (Page 15): "However, the department does not formally review the investment policy on an annual or regular basis."*

Response: This statement is false. The Investment Policy is reviewed on an ongoing basis.

*Recommendation 1 (Page 41): "Formally review and update the State of Hawai'i Treasury Investment Policy on an annual basis, as currently required, or consider whether it is necessary for the department to update the policy related to the frequency of review."*

Response: The Department will document the current review process and formally acknowledge annual review of the Investment Policy.

*Recommendation 2 (Page 41): "Consider best practices identified by the Government Finance Officers Association (GFOA) related to managing market risk, benchmarking, and measuring total performance in a portfolio while reviewing the investment policy, including the article "Innovation in Managing Public Funds: Benchmarking and Total Return" from the August 2007 Government Finance Review and the GFOA Recommended Practice white paper "Managing Market Risk in a Portfolio (2007) (CASH)." In particular, the following points should be considered:"*

*"a. The maturity structure of a security should be fully understood. Prior to purchase, the government should confirm compliance with its investment constraints and overall investment strategy. If a security has options associated with it such as call options, the structure of the option should be analyzed to determine its potential impact on market risk through an analysis. The stated maturity date should always be used to determine compliance with maximum maturity constraints, not any potential call dates unless an official announcement of a call has been released."*

Response: The Department fully understands the maturity structure of its investments and has not used potential call dates in place of maturity dates. The recommendation is unnecessary.

*Recommendation 2 Continued (Page 41): "b. Although the department's investment policy currently sets a maximum maturity restriction for individual securities to not exceed five years, the GFOA does not consider this the most effective way to manage market risk and to obtain an understanding of the potential price volatility of either an individual security or an entire portfolio. The GFOA recommends adopting weighted average maturity limitations and/or weighted average duration targets, which often range from 90 days to three years, consistent with the government's investment*

*objectives, constraints, cash flow needs and risk tolerances. The weighted average maturity limitations can be used to limit the market risk in a portfolio consistent with constraints in the state statutes and investment policy. The weighted average duration targets can be used to manage market risk in a portfolio."*

Response: The maximum maturity restriction for individual securities is established pursuant to Section 36-21, HRS, as opposed to the investment policy as cited above.

The Department's investments and maturity dates are primarily driven by liquidity needs as determined by the cash forecasting process. We will consider this recommendation when reviewing investment strategies.

Recommendation 2 Continued (Page 41): *"c. Although the investment policy states that the yield on the State's investment portfolio is of secondary importance compared to the safety and liquidity objectives, the department also has a fiduciary duty to taxpayers to ensure that it is obtaining a competitive rate of return on those funds as long as safety and liquidity are satisfied. While the investment policy states that investments are limited to relatively low-risk securities in anticipation of earning a market rate of return commensurate with the risk assumed, no formal benchmarks are specified in the investment policy. Benchmarks are points of reference, or targets, that an agency can use to evaluate its investment performance. For budgeting performance measurement goals, an agency will generally start with the one-year U.S. Treasury note as a base, consider trends in the market and the direction of interest rates, and determine an estimated return rate as its performance measurement goal. As part of the investment policy review, the department should determine an appropriate total return index as a benchmark that reflects the State's investment objectives and tolerances for risk."*

Response: The Department evaluates its investment performance through the annual Variance Report submitted to the Legislature. We concur that formal benchmarking is a good practice and will implement and administer benchmarking as resources permits.

Recommendation 3 (Page 42): *"Consider reviewing investment practices of other states (e.g., through review of websites, telephone discussions, networking at conferences, etc.) for best practices and innovations that can lead to improvements in the State's investment policy and practices."*

Response: The Department has and will continue to follow these practices as resources permits.

Recommendation 6 (Page 43): *"Review the investment policy to determine whether any revisions are necessary to the current internal reporting*

*requirements. In addition, investment reports should be prepared in a timely manner and with adequate information to allow the director of finance and FAD administrator to determine whether the State's investments comply with state law and the investment policy. The department should properly report the maturities of auction-rate securities based on the stated maturities of the underlying loans, rather than the next scheduled auction date, which significantly shortens the average maturity of the investment portfolio."*

Response: The Department will conduct a review of the Investment Policy as recommended.

12. *Statement (Page 16): "The department's informal and manual cash management process is at odds with stated objectives of safety and prudence."*

*Recommendation 4 (page 42): "Update and document operational procedures for performing daily cash projections to determine excess cash in the state treasury available for investment. The Treasury Management Branch may consider investigating the use of an automated system to perform the projection, including investigating if such functionality exists in the Microsoft Dynamics accounting system it already uses. Alternatively, if manual spreadsheets are determined to be most cost effective, the Treasury Management Branch should use automated formulas and streamline the calculation on a single worksheet, or link cells within a workbook, to ensure that accurate amounts are translated throughout the spreadsheets in calculating projected amounts available for investment. An automated process or formulas will assist in providing a more reliable projection of excess cash, enable the consistent performance of procedures, and aid in the transition of tasks to new or other employees (including management) during an employee's absence or position vacancy."*

Response: The Department utilizes spreadsheets and incorporates formula based calculations in these spreadsheets to provide reliable cash projections. The Department will look to increase automation in the cash management process as resources permits.

**THE REPORT CONTAINS STATEMENTS THAT WERE NEVER MADE BY DEPARTMENT PERSONNEL**

13. *Statement (Page 17): "According to the FAD administrator and funds custody manager, the treasury's normal daily cash inflows and outflows are roughly equal and therefore formal cash projections are not performed."*

Response: The FAD administrator and funds custody manager did not make this statement.

14. *Statement (Page 18): "The FAD administrator and funds custody manager told us they decided it was appropriate to maintain greater liquidity due to the falling revenues of the State from the economic recession and low yields on available investments in the second half of fiscal year 2009."*

Response: Neither the FAD administrator nor the funds custody manager made reference to low yields on available investments as a reason to keep a greater amount of funds liquid. A higher percentage of the State's excess cash is on deposit in the State's interest earning demand deposit checking account because the amount of taxes, fees, etc., that the State collects and deposits daily to cover cash needs has been substantially reduced.

15. *Statement (Page 19): "Estimates and assessments of cash needs and investment amount are manually prepared and prone to error."*

Response: The Department's process is not fully automated; however, it is functional, accurate and efficient. While the report states that the process is "prone to error", no actual instances of errors were noted by the auditors.

16. *Statement (Page 23): "Process of obtaining quotes from banks and brokers is informal."*

Response: The Department has a formal process to solicit quotes and place investment on a daily basis. The process is as follows:

- a. A determination is made on the amount of excess funds available for investment on a daily basis.
- b. Through the cash projection process, staff determines the appropriate amount and duration of investments to be purchased.
- c. Based on the duration and maturity dates, staff solicits via email interest rate quotes from various financial institutions for the specified maturities.
- d. Investments are placed with the financial institutions that offer the highest yield for the specified maturities provided that the financial institutions meet other investment criteria, such as meeting the collateral requirement for the amount of funds to be deposited into their institution.

While this procedure may not be written in a document, it is a formal process that is followed. Furthermore, there are procedures in place to correct errors if there are any.

The Department will document the process to acknowledge the current procedures.

17. *Statement (Page 23): "The amount of cash invested daily generally exceeds \$100 million."*

Response: This is not an accurate figure of the normal amount of funds invested on a daily basis; we are not aware of how this figure was derived or otherwise determined. Furthermore, since all of the State's funds are invested, we question the purpose of this comment.

18. *Statement (Page 23): "Also, the FAD administrator and the funds custody manager believe the department's current investment process is sufficient and have not felt the need to update or formally document the process."*

Response: This is an inaccurate statement. The FAD administrator and funds custody manager did not state that formal documentation of the process was not needed. Documentation of processes and procedures are beneficial and preferred. However, due to current limitation on staffing resources, the documentation of such processes and procedures are subservient to performing the daily and ongoing functions of the Treasury Branch. As noted in various sections of the report, the Treasury Branch is not current in performing investment allocations and reconciliations and the limited staff is concentrating their efforts to become current in these responsibilities.

19. *Statement (Page 24): "Director and management oversight of investment decisions and activities are lacking."*

Response: This statement is false. The FAD administrator and Director are apprised and exercise the appropriate control over the investment activities of the Department.

The report cites a lack of two (2) formal memorandums or reports to the FAD administrator and Director as indications that there is a lack of oversight. The Department acknowledges that these formal memorandums or reports were not submitted to the FAD administrator or Director on a regular basis for the period covered by this report. However, the FAD administrator and Director were kept apprised of the investment activities of the Department and exercised the appropriate level of supervision and direction through direct discussions, emails with the appropriate staff and access to a number of other reports. The Director has direct communication with staff to oversee the affairs of the Department.

There are 12 other reports prepared by the Treasury Management Branch related to the Branch's activities of the Department. These reports are prepared on a regular basis and were used to oversee and monitor the investment activities of the Department.

Recommendation 5 (Page 43): *"Perform and document an appropriate level of review of investment decisions as required."*

The Director has performed and exercised the appropriate level of review of investment decisions as cited above. The Department will take action to ensure that formal memorandums and reports are prepared and submitted to the FAD administrator and Director to replace or supplement, as appropriate, the current verbal and email communication process.

20. *Statement (Page 25): "Based on our interviews and discussions with the director, FAD administrator, and other key personnel involved with investments, the information to be reported is not otherwise communicated to the director via informal means."*

Response: This statement is inaccurate and misleading. Pertinent and essential information is being communicated to the director through discussions or emails. Pertinent and essential data was being conveyed to the director with respect to investment activities.

21. *Statement (Page 30): "The FAD administrator and funds custody manager indicated that not all of the information required by the investment policy, which was last updated in 1999 by previous management, is necessary. They believe the information currently included in the Report to the Administrator and Report to the Director is sufficient to effectively manage the State's investments and ensure compliance with state laws and investment policy objectives. They do not believe any additional information is needed to meet the requirements of Part IV of the investment policy."*

Response: The last sentence of this paragraph is inaccurate and false. The FAD administrator and funds custody manager did not make this statement.

The FAD administrator and funds custody manager stated that not all of the information required by the investment policy is necessary and acknowledge that additional information was needed to meet the requirements of Part IV of the Investment Policy.

22. *Statement (Page 41): "Although the department's investment policy currently sets a maximum maturity restriction for individual securities to not exceed five years, the GFOA does not consider this the most effective way to manage market risk and to obtain an understanding of the potential price volatility of either an individual security or an entire portfolio."*

Response: The five year maturity limitation is not set by the investment policy. It is established in the State statutes in Section 36-21, HRS.

II. *"The Financial Administration Division Has Failed to Perform Essential Functions"*

1. *Statement (Page 44): "Failure to perform timely bank reconciliations increases the risk of undetected errors and resulted in misstatements."*

*Statement (Page 44): "However, the department is delinquent both in reconciling bank balances to its cash sub ledger and in reconciling its cash sub-ledger to the State's general ledger system. Neither reconciliation has been completed since March 2009."*

Response: This statement is false. Due to resource limitations, the Department was delayed in completing the reconciliation process. On October 31, 2009, bank reconciliations were completed to May 2009 and the DAGS reconciliations completed to June 2009.

*Recommendation 1 (Page 54): "Establish formal policies and procedures for preparing and reviewing bank reconciliations. The policy should include the timeframe and individuals responsible for the preparation and review of reconciliations."*

Response: The Department will document the current policies and procedures for the bank reconciliation process as staffing permits.

2. *Statement (Page 46): "They (FAD administrator and funds custody manager) do not believe it is necessary to have formally documented procedures over bank reconciliations."*

Response: This statement is false. The FAD administrator and funds custody manager did not make this statement. As previously stated, generally, we would agree that documentation of processes and procedures are beneficial and preferred. However, due to limited resources, the documentation of such processes and procedures are subservient to performing the daily and ongoing functions of the Treasury Branch.

3. *Statement (Page 45): "We found that as of October 31, 2009, the FHB and BOH demand deposit account reconciliations were only performed through March 2009."*

Response: This statement is false. As of October 31, 2009, bank reconciliations were completed to May 2009.

*Statement (Page 47): "This situation is not problematic if timely reconciliations are performed to identify these amounts and properly adjust the book balance of cash."*

Response: The Department is not able to record, and subsequently reconcile, deposits made by the various departments and agencies without a Treasury Deposit Receipts (TDR) being submitted by the specific department or agency. As the report acknowledges, the Department has limited control over the other departments and agencies submission of TDR and we have a formal process to follow-up with departments on a regular basis.

4. *Statement (Page 50): "We tested three monthly reconciliations form July 2008 through March 2009 that were returned to the department. For all three, there was no evidence of a subsequent review or posting of any adjustment by the department after the reconciliations were received from DAGS."*

Response: The report does not reflect a date when this test was performed; the subsequent reviews and reconciliations for fiscal year 2009 were completed in December 2009.

*Recommendation 5 (Page 55): "Follow established procedures and timely complete reconciliations of FAD records to the comptroller's records received from DAGS. If necessary information is not received from DAGS on a timely basis, FAD should liaise with DAGS to obtain the information, review reconciliations, and ensure any necessary adjustments are recorded in the department's and/or DAGS's books in a timely manner."*

Response: The Department has strived to provide timely reconciliations; however, staffing challenges has limited our ability to be current at all times.

5. *Statement (Page 51): "Since FAD personnel are not familiar with GAAP and transactions are recorded on a cash basis, investment transactions are recorded on the settlement date, rather than the trade date. We understand that DAGS requests the department provide information on transactions with trade dates prior to year end, which the department failed to do in this instance."*

Response: This statement is misleading and false. First, as the Department's records primarily reflect banking transactions, we are required to record transactions on a cash basis. The DAGS is responsible to maintain the accounting records and as such, it is in their purview to be familiar with GAAP and maintain records in accordance with GAAP.

The Department staff is aware of the GAAP requirements and as such, the reconciliation between the Department's records and the broker account statements clearly reflect this issue as a reconciling item to the Department's records. Furthermore, the DAGS auditors are provided with our reconciliation report and as such, we did not "fail" to provide this information.



Recommendation 2 (Page 55): *"Report unrecorded items to DAGS for proper adjustment as of month/year-end and record adjustments in the department's sub-ledger in a timely manner for the preparation of its own financial statements of cash and investments in the state treasury."*

Recommendation 3 (Page 55): *"Record adjustments in a timely manner and provide the necessary information to DAGS for proper recording in the State's CAFR and dissemination to state departments and agencies for preparation of their financial statements."*

Response: The Department has and will continue to provide the necessary information to DAGS. The DAGS has not requested from the Department a list of unrecorded items.

6. *Statement (Page 53): "Due to the lack of a documented policy, the department was unable to perform the interest allocations after the Accountant V left or to explain the process to us until after it consulted with DAGS' Information and Communications and Services Division (ICSD), which maintains the interest allocation system, in September 2009."*

Response: Since the Department does not have a documented formal "policy" for the interest allocation system, documentation was prepared by the Accountant V prior to his departure to allow subsequent staff to gain an understanding of the process and procedures of the interest allocation system. The statement "...the department was ...unable to explain the process to us until after it consulted with DAGS..." is inaccurate and misleading. Department staff was able to explain the interest allocation process to the legislative auditors. However, when questioned on the specifics of the computer programming component used to compute the interest allocations, our staff wished to verify information with DAGS ICSD as it is their responsibility to maintain the programming component of the interest allocation system.

#### Other Recommendations:

Recommendation 1 (Page 55): *"Immediately complete interest allocations for the remaining months in fiscal year 2009. We also recommend the department ensure allocations for fiscal year 2010 are performed within the timeframe stated in Finance Memorandum No. 99-15."*

Response: The interest allocations for FY 2009 to departments were completed in February 2010. The Department strives to provide timely allocations consistent with available staffing.

Recommendation 2 (Page 55): *"Formally document the methodology in allocating interest earned (received and accrued). In the event of employee turnover or absence, written procedures will allow individuals who assume the process to properly perform the allocation in a timely manner."*

Response: The Department will document the current procedures as staffing permits.

Recommendation 3 (Page 55): *"Formally inform investment pool participants of the revised interest earnings allocation methodology and any subsequent changes to the investment pool that may affect participating agencies."*

Response: The Department notified investment pool participants of the change in methodology which increased the accuracy of the investment income calculation through email. The Department will follow-up with a memorandum to document this event.

Recommendation 4 (Page 55): *"Write off the difference with the fiscal agents of \$1,196,062."*

Response: The Department was aware of this issue and had initiated steps to write-off the difference prior to this report. We will continue with this project as resources permits.

Recommendation (No Number) (Page 55): *"To ensure compliance with Section 103D-304(i), HRS, we recommend that the department immediately post Notices of Award for the four underwriting contracts for special revenue bond issuances awarded in FY2009. We also recommend that the department comply with the provisions of Section 103D-304(i), HRS, for all current and future bond issuances."*

Response: The Bonds Branch is comprised of two (2) positions and both were vacant for approximately four months in 2007. The vacancies were a result of one retirement and the other employee relocating out of state. The posting function was then assigned to the Division secretary. There was a misunderstanding with respect to the posting requirement and as such, contracts were not posted timely. It is important to note that the auditors acknowledged that this deficiency was limited to the posting of the award, and not the entire procurement process.

The Department has since assigned oversight responsibilities to the Bonds Branch staff and implemented a formal checklist and procedure to ensure that contract awards are posted on a timely basis. The Department will post notices of past awards.

III. The Budget Division's informal and undocumented budget process lacks transparency and leaves the department vulnerable:

Statement (Page 56, fourth paragraph): *"First, the division lacks standardized review criteria, documentation requirements, and documentation retention*

*procedures, which has led to a budget preparation and execution process that lacks transparency and uniformity.”*

Response: The Department issues detailed budget preparation policies that set forth standardized criteria that are used for both the submission and the review of budget requests. In addition, standardized forms are included in the preparation policies to document and justify budget requests. The Department believes that using the same set of policies for both budget submission and review, rather than having separate internal review policies, is a better approach to promoting transparency because both the requestor and the reviewer are working from the same set of guidelines. Similarly, the Department issues detailed budget execution policies that set forth criteria and guidelines to be used in budget execution.

It should be noted that the State budget is a complex, multifaceted policy document that reflects a myriad of policy decisions by both the Administration and the Legislature. Imbedded in it are policy choices on statewide and Department priorities, specific program requirements and means of funding. The policy decisions made on funding vary considerably between programs and are based on historical as well as current policy choices. Given this context, the Department believes that it is overly simplistic to assume that uniformity can be achieved, or is even desirable.

Statement (Page 57, first paragraph): *“Second, the department’s lack of a formal succession plan leaves it vulnerable in light of a large percentage of employees reaching retirement age.”*

Response: The Department recognizes that it does have a long service workforce and within the constraints of civil service rules, trains and prepares employees for key managerial and technical positions through job shadowing, temporary assignments, rotation of assignments and mentoring. This effort will continue and may be augmented as resources permits.

Statement (Page 57, first paragraph): *“Third, the Budget Division inaccurately reported its performance data, which diminishes the value of the State’s performance-based budgeting process, particularly since the division has considerable responsibilities related to performance reporting for the State.”*

Response: The Department does not have an automated system to compile and produce performance statistics on the timeliness of processing of requests. Production of those statistics is a time consuming and labor intensive process based on reviewing manual and database logs. Consequently, due to staffing constraints, “best guess estimates” were utilized in lieu of actual data. In the future, the Department will review its measures of effectiveness and program activity indicators and attempt to get and report more accurate and meaningful measures and indicators.

Recommendation 1 (Page 62): *“We recommend that the Budget Division document operational and administrative policies and procedures to reflect current activities and procedures, including the documentation of common and unusual cases so that procedures are consistently performed within the division. This documentation will also aid in training new employees and guide management in performing tasks during an employee’s absence or position vacancy.”*

Response: The Department will attempt to document operational procedures as resources and time permits. Given the severe resource constraints, the Department, as well as all other State agencies face, first priority must be placed on delivering public services and direct support of such services.

Recommendation 2 (Page 62): *“Given current fiscal constraints and the State’s general hiring freeze, we recommend that the department use cost-effective strategies to retain qualified staff, cultivate employees’ skills to develop future leaders, promote knowledge transfer through job-shadowing and mentoring programs, and document internal procedures and practices with examples of how to perform critical tasks.”*

Response: As indicated in our response to the Auditor’s finding on a formal succession plan, the Department has been actively pursuing, albeit on an informal basis, a host of strategies to develop future leaders and promote knowledge transfer. For the most part, staff retention within the division has been good because the journey-level rating for a Department of Budget and Finance budget analyst is higher than the journey-level rating for a budget analyst in the operating departments. As for documentation, the Department will attempt to document operational procedures as resources and time permits.

Recommendation 3 (Page 63): *“In regards to accurate reporting and use of measures of effectiveness, we recommend that the department be held accountable for developing meaningful measures of effectiveness and the department, governor, and Legislature utilize the performance data for actual decision-making regarding budget and resource allocation. We also recommend that both agencies and decision-makers receive adequate training on how to effectively utilize performance-based budgeting and apply performance measures to the allocation or management of resources in the public sector. The Budget Division should set an example for other departments by accurately performing the variance analysis required under Section 37-75, HRS, to maximize effectiveness of the State’s performance-based budgeting process. The Budget Division, as the agency responsible for optimizing the expenditure of all public funds by developing meaningful budgets and plans, should review its own performance targets on an annual basis to ensure they are realistic and relevant to divisional goals; the division should also report accurate performance results and information.”*

Response: When the State's program planning and budgeting (PPB) system was implemented in the early 1970s, extensive training and support was available to focus efforts on all levels in developing and measuring program performance outputs and activities measures. This was necessary because, in addition to changing to a new budgeting system, a major implementation hurdle of the PPB system was the inherent difficulty in accurately and effectively measuring performance outputs of public services.

Over the years, interest and use of the performance based aspects of the PPB system has varied depending on the interest of legislators during the budget review process. Today, focus on achieving results still exists under the current administration and is an important component of budget preparation.

During the past seven years, the Department, utilizing existing resources, has been working with the departments and the Legislature to improve both the presentation and understandability of the budget, as well as trying to focus attention on the performance-based aspects of the PPB system. Preparation of a Budget-in-Brief was successful in providing a meaningful and user-friendly document for the Legislature and the public. These efforts have been consistent with accountability and transparency standards requested by the Legislature in how the budget is presented, reviewed and discussed.

With regards to the Budget Division improving its performance measures and reporting, the Department will review its measures of effectiveness and program activity indicators and attempt to get and report more accurate and meaningful measures and indicators.

IV. The department's inattention to information technology management exposes the department to unnecessary risk:

*Statement (Page 66): "There is no off-site rotation of back-up media. Backup media are merely stored in the department's server room. The Microsoft Dynamics application is maintained by FAD, and FAD personnel were not aware of the best practice in IT to rotate backup media off-site."*

Response: The State does not have a centralized designated off-site secure location to store data. The FAD backup media are rotated and stored in FAD's fire resistant vault located with the Treasury Branch.

*Statement (Page 66): "Consequently, the department does not believe it is maximizing the capabilities of Microsoft Dynamics and is unsure whether there are other ways it could use the program to gain efficiencies in maintaining and reporting information."*

Response: The Microsoft Dynamics system was acquired to assist the Department in preparing a number of specific reports for the Treasury Branch and the system is providing all of the reports as intended.

*Statement (Page 67): "However, the yield maintained in the Microsoft Dynamics program is not the actual yield for the investment, but a system-calculated yield. According to the FAD administrator and funds custody manager, they believe that the yield calculated in Microsoft Dynamics is incorrect but are unsure how it is calculated or how to correct it."*

Response: This statement is inaccurate. First, the FAD administrator did not make this statement. Second, the incorrect yield being calculated is limited to one report and the funds custody manager started discussions with a programming consultant to correct this item prior to this review being performed.

*Statement (Page 65, fourth paragraph and continued on Page 66): "Inadequate server room controls – The server room is behind a locked door but access to the room can be obtained by either taking the key, which is hung in an open area in one of the department's office, or scaling the wall from the adjacent room."*

Response: These statements: 1) that the key to the locked room where the departmental servers are located can be accessed by either taking the key that is hung in an open area or 2) by scaling the wall from the adjacent room are both incorrect. The key to the locked room has been well hidden in a discrete location in the office and that location has been known by only the IT and management staff who are authorized to enter the locked room. The ability of someone to scale a wall from an adjacent room and enter the locked room is also false. Based on our physical inspection of the four walls and ceiling areas of the locked room it is noted that all four walls run continuous from the floor up to the concrete slab that is situated above the false ceiling to the locked room. We further note that the eighteen inches of space located between the false ceiling and the concrete slab is filled with air conditioning ducting, plumbing, electrical wiring, and conduits that would impede any realistic forced entry into the locked room from an adjacent room.

Specific management and IT staff that are authorized to enter the locked room have been assigned a key and are the only ones responsible and accountable for physical entry into the locked room. Other measures will be evaluated to determine both the feasibility and cost effectiveness to further increase the security and to further limit access.

*Statement (page 66, second paragraph): "the server room does have air conditioning from the building, it does not have any other type of control to prevent environmental damage from occurring. There are no heat sensors, moisture sensors, or fire suppression systems. While there may be structural or other challenges implementing such controls, given the critical nature of the department systems and data and the potential consequences if environmental*

*factors were to cause systems failure or damage, the department should identify and evaluate possible control options and implement reasonable controls to help protect its vital information."*

Response: The Department will look into feasible and cost effective measures to possibly improve the environmental conditions for the locked room. The Department is located in a designated and registered historic building and that limits our ability to make interior and exterior building modifications.

Finally we have also made it clear that our departmental LAN servers and IT equipment are located in a locked room and are not in an actual "file server room". To comply with best practices for IT would require elaborate environmental controls, state of the art fire suppression, and high end sensor equipment that for our limited IT applications would be difficult to justify as being either practical or cost effective.

Statement (Page 66, third paragraph): *"No off-site rotation of backup media. Backup media is merely stored in the department's server room."*

Response: While the Department will look into the costs and feasibility of an off-site rotation storage solution for the backup media, the departmental IT staff is aware of the importance of ensuring against the possibilities of fire or other types of disasters and does rotate two weeks of backup media for storage in the State Treasury bank vault which is located on a separate floor of this building and is also security enabled with an alarm system.

In closing, we are dismayed and disappointed that this report is so often misleading, inaccurate and false. This report is not a financial examination as characterized by its title. It has inferred findings based on legal conclusions that are not supported by facts, substantiating evidence or formal legal opinion. The result of the review is an undeserved attack on the hard working men and women of this Department.

Ms. Marion M. Higa  
March 1, 2010  
Page 23

I urge you to substantially amend this report to reflect accurate, truthful and valid comments and findings. To do less would be a gross disservice to the public and could mar our hard-earned reputation as a prudent fiscal manager of the public's resources.

Sincerely,



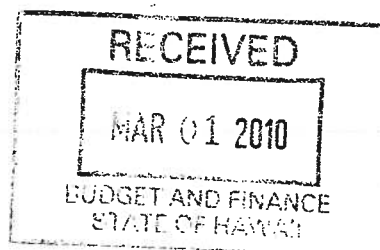
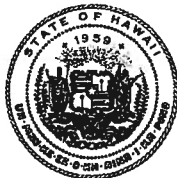
GEORGINA K. KAWAMURA  
Director of Finance

Attachment

- c: Honorable Linda Lingle, Governor of Hawaii
- Honorable Colleen Hanabusa, Senate President
- Honorable Calvin Say, House Speaker
- Honorable Donna Mercado Kim, Chair, Senate WAM
- Honorable Marcus Oshiro, Chair, House FIN



LINDA LINGLE  
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March 1, 2010

The Honorable Georgina K. Kawamura  
Director of Finance, State of Hawaii  
250 South Hotel Street  
Honolulu, Hawaii 96813

Dear Ms. Kawamura:

Re: Student Loan Auction Rate Securities

By memorandum dated January 6, 2010, you asked

1. Was the State's investment in ARS<sup>1</sup> consistent with the statutory provisions governing the investment of State funds?
2. Is the State required to undertake any action with respect to the disposition of the ARS currently held by the State?

We understand that these questions have been raised because the State presently holds student loan auction rate securities ("SLARS") that, for the most part,<sup>2</sup> it has not been able to sell since February 2008,<sup>3</sup> and as a consequence some of the SLARS have

<sup>1</sup>We understand that "ARS" refers to the student loan auction rate securities that the State has invested in and held since section 36-21(a)(15)(A), Hawaii Revised Statutes, was amended to authorize the Director of Finance to invest in them in 1997.

<sup>2</sup>We understand these investments in SLARS were made between August 28, 2004 and February 11, 2008, and there actually has been a very recent sale, at "par," of certain of the SLARS.

<sup>3</sup>Auction rate securities ("ARS") were developed and marketed as short-term investment products as early as 1984. Irrespective of whether the form of their underlying debt is mortgage loans, corporate or municipal bonds, or insured or government guaranteed student loans, the basic components of this form of investment are short-term interest rates, set at auctions held periodically at intervals as short as 7, or as long as 28 days. Auctions

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had to be held for more than five years, or are being held even though the AAA ratings of the insurers of the SLARS's underlying loans have been down-graded.<sup>4</sup> Concern has also been expressed about the fact that most, if not all of the SLARS the State has held or holds were "due to mature" more than five years after they were purchased.

#### BRIEF ANSWERS

1. We answer Question 1 affirmatively.

Based on the rules of statutory construction the Hawaii Supreme Court has established, the language and history of the State's short-term investment statute, we believe it is more reasonable and correct to construe that portion of section 36-21, Hawaii Revised Statutes, which limits short-term investments to those "due to mature not more than five years from the date of the investment" as inapplicable to the nominal maturity dates of the SLARS the State has invested in since the law was amended to include them as permissible short-term investments. Thus, their purchase was consistent with and did not violate section 36-21.

2. We infer that Question 2 was asked to address the SLARS the State has not been able to sell and, consequently, has held for more than five years, or after prerequisites for investments such as insurer ratings change subsequent to making the investments. With respect to those investments, and in response to your second question, we answer as follows.

The State's short-term investment law does not address what, if anything, must be done when circumstances in the marketplace beyond its control prevent the State from liquidating an investment altogether, or limit it to having to

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need to be held for ARS investment products to function fully, and as designed and intended. About the same time that the credit market began to collapse in the summer of 2007, ARS auctions began to fail, initially for mortgage-backed ARS in August 2007, and later for all forms of ARS investment products, including SLARS, in February 2008. To the best of our understanding, auctions have not been held since then, and if ARS have been traded at all, they have been traded by direct sales, and not by the auctions they were designed to use.

<sup>4</sup>We understand also that it has always been the State's practice to sell SLARS when the insurers of their underlying debt lost the AAA rating they had when the investment was purchased, and that this practice has not continued only because of the market conditions described in fn. 3 above.

sell an asset at a substantial loss when one or more of the statute's investment prerequisites cannot be, or is no longer being met. Given the underlying revenue generating objective of the short-term investment statute, and the deference the section extends to the Director of Finance to determine when an investment should be made, and when it should be sold, we would construe section 36-21 as allowing the Director to hold an investment for as long as it was financially prudent to do so in the extreme and unique circumstances presented here. In our view, this comports with the plain language of the statute that the Director judge whether an investment "will impede or hamper the necessary financial operations of the State," and its underlying objective that the State's short-term investments generate as much additional revenue as possible, safely and securely.

1. Was The State's Investment In ARS Consistent With State Law?

Section 36-21, Hawaii Revised Statutes, "identifies the types of securities that are allowable for investments by the State Treasury." H. Stand. Comm. Rept. No. 243, Haw. H.J. 1209 (1997). It provides in pertinent part:

**§36-21 Short-term investment of state moneys.** (a)

The director of finance may invest any moneys of the State which in the director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State and where in the director's judgment the action will not impede or hamper the necessary financial operations of the State in:

- (1) Any bonds or interest-bearing notes or obligations:
  - (A) Of the State (including state director of finance's warrant notes issued pursuant to chapter 40);
  - (B) Of the United States;
  - (C) For which the faith and credit of the United States are pledged for the payment of principal and interest;
- (2) Federal Farm Credit System notes and bonds;
- (3) Federal Agricultural Mortgage Corporation notes and bonds;
- (4) Federal Home Loan Bank notes and bonds;
- (5) Federal Home Loan Mortgage Corporation bonds;

- (6) Federal National Mortgage Association notes and bonds;
- (7) Student Loan Marketing Association notes and bonds;
- (8) Tennessee Valley Authority notes and bonds;
- (9) Securities of a mutual fund whose portfolio is limited to bonds or securities issued or guaranteed by the United States or an agency thereof or repurchase agreements fully collateralized by any such bonds or securities;
- (10) Securities of a money market mutual fund that is rated AAA, or its equivalent, by a nationally recognized rating agency or whose portfolio consists of securities that are rated as first tier securities by a nationally recognized statistical rating organization as provided in 17 Code of Federal Regulations section 270.2a-7;
- (11) Federally insured savings accounts;
- (12) Time certificates of deposit;
- (13) Certificates of deposit open account;
- (14) Repurchase agreements with federally insured banks, savings and loan associations, and financial services loan companies;
- (15) **Student loan resource securities including:**
  - (A) **Student loan auction rate securities;**
  - (B) **Student loan asset-backed notes;**
  - (C) **Student loan program revenue notes and bonds; and**
  - (D) **Securities issued pursuant to Rule 144A of the Securities Act of 1933, including any private placement issues;**  
**issued with either bond insurance or overcollateralization guaranteed by the United States Department of Education; provided all insurers maintain a triple-A rating by Standard & Poor's, Moody's, Duff & Phelps, Fitch, or any other major national securities rating agency;**
- (16) Commercial paper with an A1/P1 or equivalent rating by any national securities rating service; and
- (17) Bankers' acceptances with an A1/P1 or equivalent rating by any national securities rating service; provided that the investments are due to mature not more than five years from the date of investment. Income derived from those investments shall be a realization of the general fund; provided that income earned from moneys

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invested by the general funds, special funds, bond funds, and trust and agency funds on an investment pool basis shall be paid into and credited to the respective funds based on the contribution of moneys into the investment pool by each fund. As used in this section, "investment pool" means the aggregate of state treasury moneys that are maintained in the custody of the director of finance for investment and reinvestment without regard to fund designation. (Emphasis added).

The section was first enacted in 1945. In its initial form, it permitted the Territory's Treasurer to invest excess funds in what are described in item (1) of the present statute, and in federal land bank bonds or joint stock farm loan bonds. It included the following "maturity proviso": "provided the said security is due to mature not more than three years from the date of investment." See Act 59, Session Laws of Hawaii 1945 at 207. The accompanying committee report noted: "This bill authorizes the investment of excess moneys . . . in short term obligations of the Territory, County or the United States . . . Your Committee believes that the bill conforms with intelligent investment practice . . . ." Stand. Com. Rep. No. 82, Haw. S.J. 252 (1945). All three forms of investment had stated maturity dates.

In 1947, the law was amended to extend the three year duration of the "maturity proviso" to five years, and to direct that any income earned be deposited into the general fund. See Act 244, Session Laws of Hawaii 1947 at 229-30. Without referring to maturity dates, the Senate committee wrote:

The purpose of this bill is to authorize the investment of general, special, loan or revolving fund money of the Territory, which is in excess of immediate requirements in certain short term (5 year) securities . . . .

Stand. Com. Rep. No. 251, Haw. S.J. 707 (1947). The committee report made no reference to "maturity dates."

In 1959, the section was amended by Act 119, Session Laws of Hawaii 1959 at 75, to add "to the list of authorized investments: bank savings accounts, time certificates of deposit, and certificates of deposits, open accounts." Stand. Comm. Rept. No. 480, Haw. H.J. 764 (1959). The "maturity proviso" was changed to refer to "such investments" rather than

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"such securities," but no change was made to accommodate the generally understood fact that given their nature and function, savings accounts, and certificates of deposit open accounts do not have stated maturity dates because by design they are readily liquidatable, i.e., they can be converted into cash, at will, as long as the bank in which they have been placed is open.

In 1982, the section was amended to specify that investments in "savings accounts" have to be "federally insured" but again, no change was made to the "maturity proviso" to acknowledge that savings accounts do not have stated maturity dates.

In 1995, the section was amended to allow investments in mutual funds whose portfolio is limited to bonds or securities issued or guaranteed by the United States or one of its agencies, or by repurchase agreements fully collateralized by those bonds or securities, i.e., the present item (9) of section 36-21. See Act 109, Session Laws of Hawaii 1995 at 179. Again, no amendment was made to the "maturity proviso," even though these securities are generally understood, if not by the general public necessarily, certainly by those who practice in the industry,<sup>5</sup> as not having stated maturity dates. The Senate Committee on Ways and Means nonetheless found that

this bill is necessary to enhance the ability of the director of finance to manage state moneys by providing the director with additional investment opportunities to increase investment earnings of the State without compromising the State's primary objectives of safety and liquidity.

Stand. Comm. Rept. No. 1335, Haw. S.J. 1340 (1995).

Similarly, when item (10) was added to section 36-21 in 2001, see Act 39, Session Laws of Hawaii 2001 at 69, no

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<sup>5</sup>"Statutes dealing with trade and commerce are intended for practical use and application by men engaged in trade and commerce. Many trade and commercial terms have either a common or technical meaning or both. The general rule is that in the absence of a manifested legislative intent to the contrary, or other overriding evidence of a different meaning, commercial terms used in a statute relating to trade or commerce are presumed to have been used in their trade or commercial context." §47:31, Common, technical, legal, and trade or commercial terms - Commercial meaning; Singer, Sutherland Statutory Construction (7<sup>th</sup> ed. 2007).

amendment was made to the "maturity proviso," even though like item (9), this form of money market mutual fund securities does not have stated maturity dates. Instead, the Senate Ways and Means Committee said:

The purpose of this measure is to authorize the Director of Finance to invest state moneys over the short-term in the securities of an AAA-rated money market mutual fund.

. . . .  
Your Committee finds that this measure will allow the Director of Finance to invest in mutual funds that satisfy the cash management criteria of safety and liquidity.

Stand. Comm. Rept. No. 647, Haw. S.J. 1190-1 (2001).

Thus, by the time the Legislature amended section 36-21 in 1997 to expressly authorize the Director of Finance to make short-term investments in "student loan auction rate securities" or SLARS, see Act 47, Session Laws of Hawaii 1997 at 92, section 36-21 authorized and, it is reasonable to presume, the Director of Finance had invested in at least three forms of investments that did not have stated maturity dates.

In the case of the two mutual fund investments, the Legislature clearly believed that the liquidity provided by the marketplace and the nature of the investments themselves were what allowed them to be held as short-term investments, notwithstanding the lack of stated maturity dates (theoretically, mutual funds can be held forever, or for at least the life of a fund, which can certainly exceed five years).

Auction rate securities "are long-term debt investments that are traded at periodic, usually monthly,<sup>6</sup> Dutch auctions. The securities are frequently marketed as an alternative short-term investment." ExpressJet Airlines Inc., v. RBC Capital Markets Corp., 2009 WL 2244468 (S.D. Tx.) at p. 1. They are generally regarded by economists and practitioners of the

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<sup>6</sup>Again, it is our understanding that the auctions occurred on a seven or twenty-eight day cycle, depending on the particular security, until they ceased to be held altogether in February 2008.

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financial industry as "debt instruments, such as corporate or municipal bonds, that have long-term nominal maturity dates." Openwave Systems Inc., v. Fuld, 2009 WL 1622164 (N.D. Cal.) at p. 1. Their maturity dates are characterized as "nominal"<sup>7</sup> or listed on a prospectus as "final" because by design they "are traded [i.e., bought and sold] at periodic, usually monthly, Dutch auctions." Like bank savings accounts, they are structured so that they may be liquidated without reference to a maturity date, as long as auctions to "trade" or buy and sell them are held. Our understanding is that notwithstanding their stated "nominal" or "final" maturity dates, they were regarded by all who marketed and invested in them to be "short-term" investments.

The three committee reports recommending the addition of SLARS to section 36-21's list of permitted short-term investments noted that "[t]he purpose of [the] bill is to extend the investment options of the State" to include "student loan auction rate securities," that "student loan auction rate securities" "meet all of the strict criteria that the State already has in place for short-term investments, including high credit quality and safety, high liquidity, competitive return rates, and low administration and transaction cost," that they are an "important" "additional security investment option" in "period[s] of declining revenue," and "enhance the State's investment earnings, . . . in light of declining state revenues." See Stand. Comm. Rept. No. 243, Haw. H.J. 1209 (1997); Stand. Comm. Rept. Nos. 1047 and 1487, Haw. S.J. 1290 and 1456 (1997).<sup>8</sup> The Legislature, like the industry, understood

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<sup>7</sup>Black's Law Dictionary (9<sup>th</sup> ed. 2009) defines "nominal" as "existing in name only." See also, Cummings v. Connell, 402 F.3d 936 (9<sup>th</sup> Cir. 2005), where it is used to describe "damages" as existing in name only; Astor v. Merritt, 111 U.S. 202 (1884), where "nominal" is distinguished from the terms "actual" or "real."

<sup>8</sup>Two of the three reports also indicate that the committee received testimony from Smith Barney, Inc., which explained how student loan auction rate securities could be bought and sold on specified auction date which follow either a 7 or 28 day cycle, what the auction procedures were, and how and when auctions would be held, and how, even if a SLARS was not offered for sale at one of these auctions, the auction's interest re-setting feature effectively acted as a rollover by compounding the value of interest paid over time, and increased yield.

In conjunction with the passage of Act 297, Session Laws of Hawaii 1998 at 972, which amended section 46-50, Hawaii Revised Statutes, to allow the counties to make short-term investments in SLARS, the Senate Committee on Transportation and Intergovernmental Affairs also noted that investments in



the investments to be "short-term" in nature, and clearly intended to extend the authority to purchase, notwithstanding the stated but nominal maturity dates of the securities. Like the mutual funds that the Director of Finance is also authorized to invest in short-term, it was the "liquidity provided by the marketplace" feature subsumed in the ARS investment product itself that made SLARS suitable, in the Legislature's view, for short-term investment.

The Hawaii Supreme Court has frequently said:

Our statutory construction is guided by the following well established principles:

our foremost obligation is to ascertain and give effect to the intention of the legislature, which is to be obtained primarily from the language contained in the statute itself. And we must read statutory language in the context of the entire statute and construe it in a manner consistent with its purpose.

When there is doubt, doubleness of meaning, or indistinctiveness or uncertainty of an expression used in a statute, an ambiguity exists....

In construing an ambiguous statute, "[t]he meaning of the ambiguous words may be sought by examining the context, with which the ambiguous words, phrases, and sentences may be compared, in order to ascertain their true meaning." Moreover, the courts may resort to extrinsic aids in determining legislative intent. One avenue is the use of legislative history as an interpretive tool.

This court may also consider "[t]he reason and spirit of the law, and the cause which induced the legislature to enact it ... to discover its true meaning."

United Public Workers, AFSCME, Local 646, AFL-CIO v. Hanneman, 106 Hawai'i 359, 363 (2005) quoting Guth v. Freeland, 96 Hawai'i 147, 149-50 (2001) (citations omitted) (ellipsis points in original).

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SLARS provided "the opportunity to earn larger returns than are available through current investments, while providing safety and security of county funds." Stand. Comm. Rept. No. 2849, Haw. S.J. 1161 (1998).

Further, a statute should be interpreted to accord its operative terms their plain meaning. The terms "should be read in the context of the entire statute . . . and construed consistent with [the statute's] purpose." Kinkaid v. Board of Review of City and County of Honolulu, 106 Hawai'i 318, 323 quoting State v. Vigliemo, 105 Hawai'i 197, 203 (2004).

And, finally, "[a] rational, sensible, and practicable interpretation of a statute is preferred to one which is unreasonable or impracticable." Metcalf v. Voluntary Employees' Benefit Ass'n of Hawaii, 99 Hawai'i 53, 59 quoting S.Foods Group, L.P. v. Dep't of Educ., 89 Hawai'i 443, 453-453 (1999).

We note that were the "due to mature" provision read to refer to the stated but nominal maturity dates of SLARS, the Legislature would have been essentially both authorizing and forbidding the purchase of the SLARS at the same time. In fact, however, like the mutual funds it has authorized the Director of Finance to purchase short-term, it was explicitly authorizing, not forbidding the purchase of SLARS.

In our view, section 36-21(a)(15)(A) allowed the Director of Finance to invest in SLARS without regard to their stated but nominal maturity date, when the market that they were designed to be traded in was functioning, i.e., with the auction cycles.<sup>9</sup>

The section expressly allows investments in "student loan auction rate securities," and it should be interpreted literally to allow the Director to do what it says the Director may do. We believe the "due to mature" provision is simply inapplicable to the stated but nominal maturity dates of SLARS, and the Legislature did not intend that provision to be applicable to SLARS (and in the Legislature's view, the seven or twenty-eight day auction cycles essentially functioned as the maturity dates of the SLARS).

Construing the statute's "maturity proviso" as qualifying the authority to invest in SLARS would not only have rendered the authorization essentially meaningless, it would have undercut the Legislature's stated intent to provide an additional option for "enhanc[ing] the State's investment earnings" by allowing the Director of Finance to make short

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<sup>9</sup>It is our understanding that the current Director of Finance and all of her predecessors understood this, and authorized purchases of SLARS based upon this premise, from the time section 36-21 was amended to expressly include them as permissible short-term investments.

investments in a security that by design met "all of the strict criteria that the State already has in place for short-term investments, including high credit quality and safety, high liquidity, competitive return rates, and low administration and transaction cost." Because SLARS were not marketed until the late 1980's, confining the authority to invest in them to the last five years before they matured would also have meant that in 1997, the Director would have had to wait until 2000 as the soonest, to invest in a 20-year SLARS issued in 1985, and until 2013 to invest in a 30-year SLAR issued in 1988. The committee reports accompanying the passage of Act 47 clearly indicate that this was not what the Legislature intended and that instead, the Legislature expected the Director to take advantage of the authority to invest in SLARS immediately. Thus, again, the Legislature did not view the "due to mature" provision as applicable to the stated but nominal maturity dates of SLARS, just as it did not view the "due to mature" provision as applicable to mutual funds it authorized the Director to invest in short-term.

Moreover, as a practical matter, construing the statute's "due to mature" provision as dictating when the Director could invest, would have stripped the SLARS of many of the qualities that prompted the Legislature to include them as permitted short-term investments in the first place. Liquidity has value when it can be used, and the rollover effect of the SLARS's cyclical resetting of interest feature was worth more the longer a SLARS could be rolled-over. The State would have derived little value from holding SLARS if it was only allowed to invest in them in the last five years before their stated nominal maturity date, and this was clearly not the Legislature's intent. While the collapse of the market, with the benefit of hindsight, may now make it seemingly obvious that SLARS were not the functional equivalent of the other short-term investments allowed, the question here is simply whether the Legislature intended the "due to mature" provision to apply to the stated but nominal maturity dates of the SLARS the State invested in, not whether in hindsight its decision was a wise one.

Finally, if section 36-21's "due to mature" provision were construed as qualifying what otherwise are expressly authorized investments, then investments likely could not be made in the other investment forms that have no stated maturity dates, e.g., the mutual fund securities described in items (9) and (10), investments in certificates of deposit open account described in item (14), or in item (12)'s federally insured savings accounts.

This would mean that the legislation the Legislature enacted in 1959, 1982, 1995, and 2001 to make these permitted short-term investments, served no purpose, which clearly could not have been what the Legislature intended.

Accordingly, we believe it is more reasonable and correct to construe section 36-21's "due to mature" provision as inapplicable to the stated but nominal maturity dates of any SLARS the State has held or holds, and thus we conclude that the investments in SLARS the current Director of Finance and her predecessors made complied fully with state law.

2. Is The State Required To Take Any Action To Dispose Of The ARS It Currently Holds?

The State's short-term investment statute does not anticipate or make any provision for dealing with the situation where circumstances beyond its control preclude the State from liquidating a short term investment, or force it to sell an asset at a substantial loss because one or more of section 36-21's underlying investment assumptions or requirements, including that insurers of the student loans underlying SLARS maintain their triple-A rating, cannot be, or is no longer being met. The statute does not, moreover, compel the Director of Finance to act in a manner financially disadvantageous to the State. We believe the Director of Finance may, in the unique circumstances presented here, hold or sell (if possible) the SLARS the State holds, in whatever manner the Director believes is in accord with the best financial interests of the State.

We believe it is reasonable to construe section 36-21 as conferring discretion on the Director of Finance in circumstances like those presented here, to hold an investment if, on balance, selling the asset would be more financially disadvantageous to the State than holding it until it can be sold more advantageously.<sup>10</sup> As already noted, section 36-21 was enacted to provide the State with an additional means of generating revenue, and it defers to the Director of Finance to judge when an investment "will not impede or hamper the necessary financial operations of the State."

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<sup>10</sup> We note that we are dealing here with a circumstance in which market forces have changed significantly from what they were when the assets were purchased, and do not address a hypothetical circumstance in which that has not occurred.

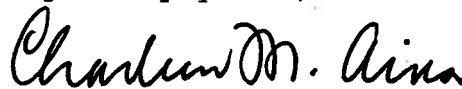
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The common law recognizes that when an agency proves that it is impossible for it to comply with a mandatory statutorily imposed deadline, the agency cannot be ordered or made to comply.<sup>11</sup> Conservation Law Foundation of New England, Inc. v. Reilly, 755 F.Supp. 475 (D.Mass. 1991). Moreover, courts have excused performance under a contract when it is "objectively impossible" for a term to be performed, that is, when "no similarly-situated contractor could have performed it," Seaboard Lumber Company v. United States, 308 F.3d 1283, 1294 (Fed. Cir. 2002), or "where the agreed upon performance has been rendered 'commercially impracticable' by an unforeseen supervening event not within the contemplation of the parties at the time the contract was formed," Hercules Inc. v. United States, 24 F.3d 188, 204 (Fed. Cir. 1994).

Our survey of media reports of litigation filed and settled in connection with the failure of ARS auctions after February 2008, strongly suggests that with the exception of the issuers and underwriters of SLARS themselves, few of those who invested in SLARS knew or could have foreseen that billions of dollars of investments in SLARS would be illiquid after February 2008 because the auctions fundamental to their proper functioning were no longer occurring.

Under these circumstances, and for these reasons, we believe the only action the State is required to take with regard to the SLARS it presently holds, is to act in a financially prudent manner under the circumstances.

Very truly yours,



*for* Mark J. Bennett  
Attorney General

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<sup>11</sup>We note again, however, that while the statute anticipated short holding periods, there is no specific statutory mandate to sell after any particular period.