# Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2016

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

Conducted by
The Auditor, State of Hawai‘i
and N&K CPAs, Inc.

**Report No. 17-02**
March 2017


**OFFICE OF THE AUDITOR**
STATE OF HAWAI‘I

# OFFICE OF THE AUDITOR

STATE OF HAWAIʻI

## Constitutional Mandate

Pursuant to Article VII, Section 10 of the Hawaiʻi State Constitution, the Office of the Auditor shall conduct post-audits of the transactions, accounts, programs and performance of all departments, offices and agencies of the State and its political subdivisions.

The Auditor's position was established to help eliminate waste and inefficiency in government, provide the Legislature with a check against the powers of the executive branch, and ensure that public funds are expended according to legislative intent.

Hawaiʻi Revised Statutes, Chapter 23, gives the Auditor broad powers to examine all books, records, files, papers and documents, and financial affairs of every agency. The Auditor also has the authority to summon people to produce records and answer questions under oath.

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We conduct performance audits (also called management or operations audits), which examine the efficiency and effectiveness of government programs or agencies, as well as financial audits, which attest to the fairness of financial statements of the State and its agencies.

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We report our findings and recommendations to the Governor and the Legislature to help them make informed decisions.

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http://auditor.hawaii.gov

# Foreword

This is a report on the financial and program audit of the Department of Health's Deposit Beverage Container Program as of and for the fiscal year ended June 30, 2016. The audit was conducted pursuant to Section 342G-107, Hawai'i Revised Statutes, which requires the Office of the Auditor to conduct a management and financial audit of the Deposit Beverage Container Program and Deposit Beverage Container Deposit Special Fund in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005. The audit was conducted by the certified public accounting firm of N&K CPAs, Inc.

Leslie H. Kondo
State Auditor

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# Auditor's Summary

## Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2016

Report No. 17-02

PHOTO: THINKSTOCK.COM

## Deposit Beverage Container Program still relies on self-reported data, still at risk

**THIS IS THE SIXTH** biennial financial and program audit of the Deposit Beverage Container Program (the Program). We found, as we did in each of our previous audits, the Program relies on self-reported data from distributors and certified redemption centers and lacks adequate controls to monitor the accuracy and completeness of the information submitted by distributors and certified redemption centers. The lack of adequate controls exposes the Program to risks of underpayments by distributors and overpayments to certified redemption centers, either of which results in financial harm to the State.

The Department of Health, which administers the Program, has been aware of this flawed payment system since 2006 but has done little to address it; the department has neither made substantive changes to the program nor increased its enforcement and inspection activities. Because these deficiencies contribute to the inherent incentive for distributors, redemption centers, and exempt companies to misreport data, the Program continues to be exposed to fraud, which may result in higher costs and an unreliable reported redemption rate.

**Hawai'i Deposit Beverage Container Segregated Rates**

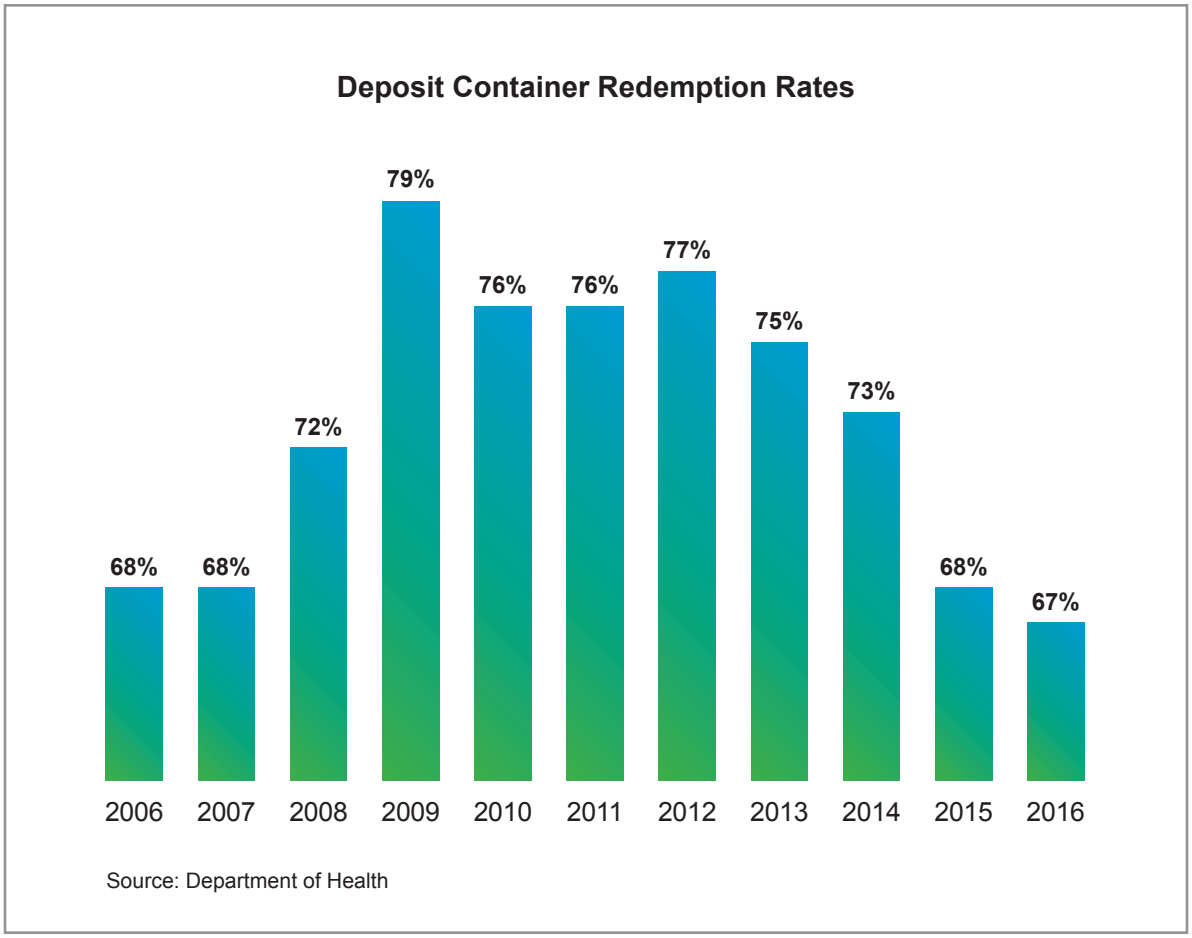
**Aluminum**
**$1.60/lb**

**Bi-Metal**
**$0.295/lb**

**Glass**
**$0.12/lb**

**Plastic**
**$0.94/lb**

**Plastic**
**(17 oz. or less)**
**$1.315/lb**




In our prior audits, we recommended that management strengthen controls to ensure that the Program is properly collecting deposits and container fees from distributors and that the costs of administering the Program (e.g., reimbursements and handling fees paid to certified redemption centers) are minimized. We repeat and reiterate those same recommendations.

The department concurred with the findings and the recommendations to establish an internal audit function to audit distributors and redemption centers timely using a risk based approach. However, until the recommendations are fully implemented, the Program will continue to be under significant risk of fraud and abuse.

# FINANCIAL AND PROGRAM AUDIT OF THE DEPARTMENT OF HEALTH STATE OF HAWAI'I DEPOSIT BEVERAGE CONTAINER DEPOSIT SPECIAL FUND

## Fiscal Year Ended June 30, 2016

**Submitted by**
**The Auditor**
**State of Hawai'i**

N&K CPAs, Inc.
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**DEPARTMENT OF HEALTH**
**STATE OF HAWAI'I**
**DEPOSIT BEVERAGE CONTAINER DEPOSIT SPECIAL FUND**

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# Chapter 1
# Introduction

In 2002, the Hawai‘i Legislature passed Act 176 (Bottle Bill) to establish the Deposit Beverage Container (DBC) Program (the Program). The Act, codified in Chapter 342G, Part VIII, Hawai‘i Revised Statutes (HRS), also established the Deposit Beverage Container Deposit Special Fund (DBC Fund) to account for program activities. The purpose of the Bottle Bill is to increase participation in deposit programs, increase recycling rates for specified deposit beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter.

Section 342G-107, HRS, requires the Office of the Auditor to conduct a management and financial audit of the Program in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005.

The Office of the Auditor hired the certified public accounting firm of N&K CPAs, Inc. (N&K) to conduct this financial and program audit.

## Background

Manufacturers and distributors of beverage containers are responsible for paying deposits and fees into the DBC Fund when they sell, donate, or otherwise distribute beverages in applicable containers in the State. Manufacturers and distributors may pass on the deposits and container fees they pay to their customers (e.g., retailers) who, in turn, may pass on the costs to consumers.

### *Deposit and Container Fee Collection Process*

The deposit is 5¢ per container and the fee is 1¢ per container on each eligible beverage container manufactured in or imported into Hawai‘i. The container fee was 1.5¢ as of September 1, 2012, but was lowered effective September 1, 2015 to 1¢ due to the statewide redemption rates falling below 70 percent since fiscal year 2015 as shown in Exhibit 1.1 below. The redemption rate is calculated as the ratio of containers redeemed to containers manufactured or distributed, as represented by deposits collected from distributors.

**Exhibit 1.1**
**Deposit Container Redemption Rates**

| Year Ended | Redemption Rate |
|---|---|
| June 30, 2006 | 68% |
| June 30, 2007 | 68% |
| June 30, 2008 | 72% |
| June 30, 2009 | 79% |
| June 30, 2010 | 76% |
| June 30, 2011 | 76% |
| June 30, 2012 | 77% |
| June 30, 2013 | 75% |
| June 30, 2014 | 73% |
| June 30, 2015 | 68% |
| June 30, 2016 | 67% |
| Average | 73% |

Source: Department of Health

Section 342G-101.5, HRS, exempts commercial passenger-vehicle companies from paying the deposit and container fees for beverages sold or delivered to such companies when the beverage container is intended for consumption on the commercial passenger-vehicle. Such vehicles include airplanes and cruise ships. To qualify for this exemption, eligible companies must have a beverage container recycling plan approved by the Department of Health (the Department).

***Redemption Process***

The Program uses redemption centers to collect empty beverage containers and return deposits to consumers, as well as to deliver redeemed beverage containers to recyclers. During FY 2016, the Program paid handling fees between 2¢ and 4¢ per container, depending on the location of redemption center and the end use of the recycled containers. Except for glass containers, redemption centers on Oahu were paid 2¢ per beverage container delivered to recyclers/recycling mills, while redemption centers on other islands were paid 3¢ per beverage container. To encourage remanufacturing of glass, handling fees for glass were 2¢ for agriculture/construction and 4¢ for remanufacturing uses on all islands.

An individual or business operating a redemption center must receive both a solid-waste permit and a redemption center certification from the Department. In addition to the conditions listed in the permit and certification, redemption centers must comply with the statutory requirements in Section 342G-114, HRS, which are: (1) accept all types of empty deposit beverage containers for which a deposit has been paid; (2) verify that all containers to be redeemed bear a valid Hawai‘i refund value; (3) pay the redeemer for the full refund value in either cash or a redeemable voucher for all deposit beverage containers, except as provided in Section 342G-116, HRS (conditions for refusal); (4) ensure each deposit beverage container is recycled

through a contractual agreement with an out-of-state recycler or an in-state recycling facility permitted by the Department (not applicable if redemption center is operated by a recycler permitted by the Department); and (5) forward the documentation necessary to support claims for payment as stated in Section 342G-119, HRS (redemption center reporting requirements).

As of June 2016, there was a total of 75 certified redemption centers statewide. Exhibit 1.2 provides a breakdown of sites on each island.

**Exhibit 1.2**
**Certified Redemption Centers**

| Island | Number of Centers |
|---|---|
| Oahu | 32 |
| Maui | 12 |
| Hawai‘i | 21 |
| Kaua‘i | 7 |
| Lanai | 1 |
| Molokai | 2 |
| Total | 75 |

Source: Department of Health

When determining the deposit refund to be paid to consumers, redemption centers may weigh redeemed beverage containers in excess of 200 rather than counting them, using Department-provided segregated rates to calculate the number of redeemed beverage containers. This practice may result in individual consumers receiving more or less than 5¢ per beverage container redeemed, but is intended to average 5¢ on a statewide basis. The number of beverage containers per pound by material type is required to be posted at all redemption centers.

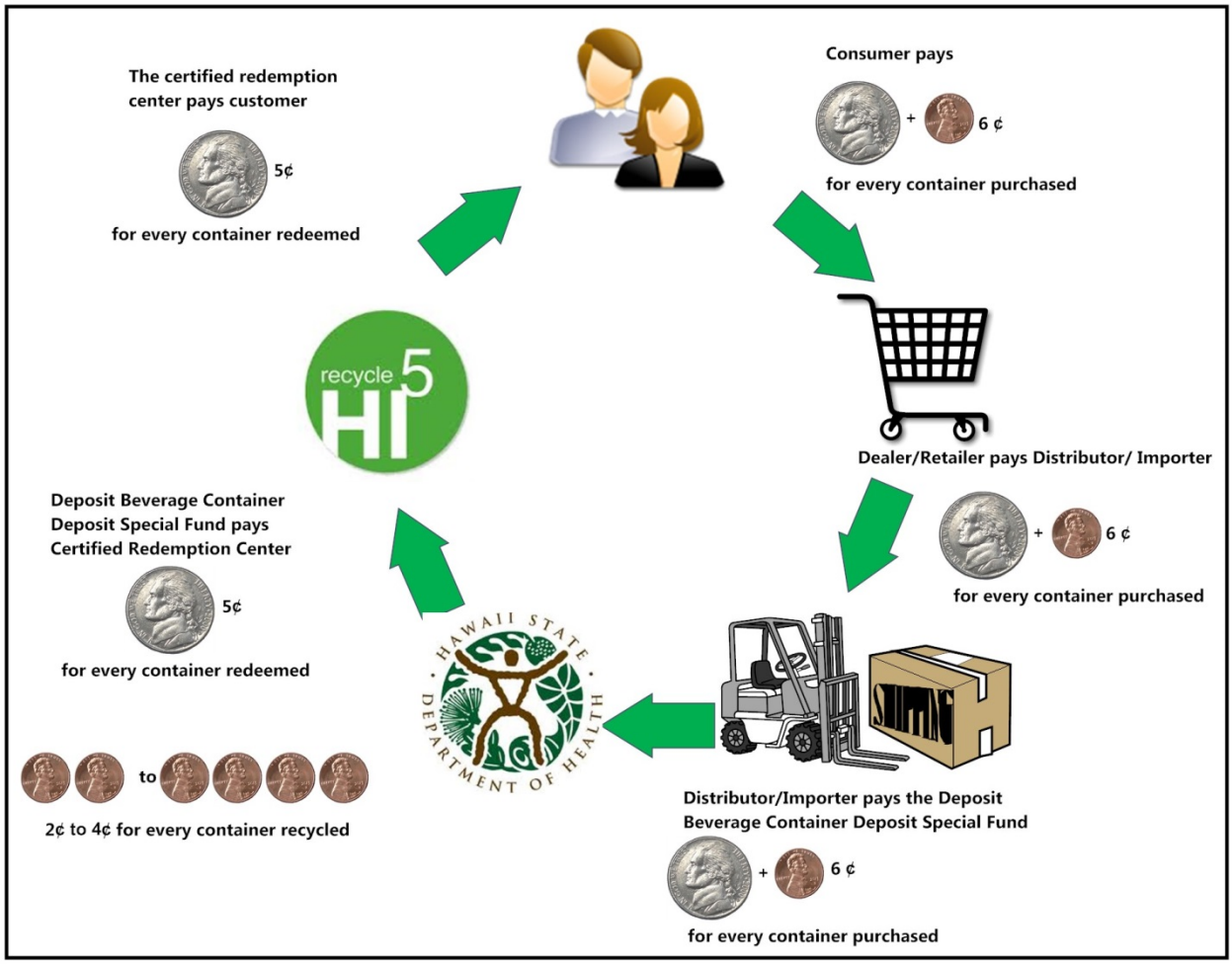
Exhibit 1.3 contains the current segregated rates in effect during the FY 2015-2016, which were effective beginning December 2010. Redemption centers may not issue refunds for beverage containers redeemed without *HI-5¢* marking. Exhibit 1.4 shows an overview of the deposit and redemption process.

**Exhibit 1.3**
**Hawai‘i Deposit Beverage Container Segregated Rates**

| Container Material Type | Number of Containers per Pound | Price per Pound |
|---|---|---|
| Aluminum | 32.0 | $1.60 |
| Bi-Metal | 5.9 | $0.295 |
| Glass | 2.4 | $0.12 |
| Plastic | 18.8 | $0.94 |
| Plastic (17 oz. or less) | 26.3 | $1.315 |

Source: Department of Health

**Exhibit 1.4**
**Overview of the Deposit and Redemption Process**




***Program Organization and Revenues***

The Department's Environmental Management Division, Solid Waste Branch, administers the Program and DBC Fund. The Program is managed by the solid waste management coordinator.

In FY 2016, the DBC Program had revenues of $23.6 million and expenditures of $19.5 million, resulting in a $4.1 million increase in fund balance to $27.0 million at June 30, 2016. The Program's container deposit liability decreased to $1.6 million at June 30, 2016. The DBC Fund had $29.7 million in equity in cash and cash equivalents and investment in State Treasury at June 30, 2016, to refund deposits and to pay for other liabilities and expenses. Additional information on the Program's financial information is included in the DBC Fund's financial statements in Chapter 3.

## Prior Audits

The Office of the Auditor has conducted five previous audits of the Program.

Report No. 05-09, *Audit of the Deposit Beverage Container Program* (2005), conducted by the Office of the Auditor, found numerous delays at the Department negatively impacted program planning and implementation. The Department failed to submit a timely budget request for program funding and was late in hiring staff. Redemption centers were poorly operated, with inconsistent operations, because the Department had not developed standard redemption procedures or levels of service. The Department failed to develop procedures to verify that data submitted by distributors were accurate or that resulting payments received from distributors were justified. Payments to redemption and recycling centers were based on unverified numbers. Inspections by environmental health specialists were limited, sporadic, and reactive. Lastly, the Department failed to establish a financial accounting system for the Program, was unable to complete reconciliations of accounting records or adjustments to prepare the financial statements, and lacked internal controls.

The *State of Hawai‘i Deposit Beverage Container Deposit Special Fund Financial and Program Audit June 30, 2008*, (unnumbered report) conducted by Accuity LLP, found that the Program lacked adequate procedures to prevent or detect whether distributors fraudulently or erroneously under-reported containers sold or distributed, or whether certified redemption centers fraudulently or erroneously over-reported containers redeemed. Deposit and fee collections from distributors as well as payments to certified redemption centers were based on unverified numbers with limited inspections performed by program personnel. The Program lacked controls to prevent or detect unauthorized beverage containers from entering the redemption stream. The Program’s management also misstated the Program’s fund balance by $5 million in FY 2007, which resulted in a $5 million restatement of the beginning fund balance in FY 2008.

The *State of Hawai‘i Deposit Beverage Container Deposit Special Fund Financial and Program Audit June 30, 2010*, (unnumbered report) also conducted by Accuity LLP, found that there were several deficiencies that exposed the Program to fraud, including over-reliance on self-reporting by Program personnel and lack of systematic compliance inspections. Deposits and fee collections from distributors as well as payments to redemption centers were unsupported. Exempt commercial passenger vessel companies had not been inspected since the Program’s inception. Consequently, the Program was potentially operating at a greater cost than necessary, and the reported redemption rate may not have been reliable.

Report No. 13-08, *Management and Financial Audit of the Deposit Beverage Container Program, June 30, 2012* (2013), conducted by the Office of the Auditor and Accuity LLP, found that the mismanagement of the Program puts its continued operation at risk. We found that unaddressed program flaws resulted in millions of dollars in overpayments and undermined the Program’s financial sustainability. Factors that contributed to this included continued reliance on self-reported data from distributors and certified redemption centers and an absence of a detailed audit function. We also found that inattention to basic management functions exacerbated the Program’s ability to prevent fraud and abuse.

Report No. 15-02, *Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014* (2015), conducted by the Office of the Auditor and N&K CPAs, Inc., resulted in findings related to operational risks. We found that remaining program flaws resulted in tens of thousands of dollars in underpayments, which directly affect the continued financial stability of the Program. We found that one distributor, Whole Foods Market, Inc. (Whole Foods), substantially underpaid the DBC Fund for more than six years. For the six years Whole Foods had been operating in Hawai‘i, they paid the DBC Fund 6¢ per case instead of 6¢ per container. Through consultation with the Department of the Attorney General, the DBC Program was advised that they would be able to collect on underpayments from July 1, 2012, not the full six-year period. Management of the DBC Program and Whole Foods were responsible for determining the amounts due as a result of this error. The total additional payment for the underreported deposit beverage fees for the period July 1, 2012 through December 31, 2014 was made in June 2016 and amounted to $46,198. Accordingly, the contributing factors identified in Report No. 13-08 have not been corrected and continue to affect the Program’s exposure to risk.

## Objectives of the Audit

1. Perform a financial and program audit of the DBC Fund.

    a. Assess the adequacy of the Program’s internal controls over financial reporting.
    b. Perform tests of compliance with applicable laws and regulations and the provisions of contracts and agreements.
    c. Perform testing of distributors’ and redemption centers’ compliance with Chapter 342G, Part VIII, HRS.

2. Follow-up on prior audit findings to determine the status of corrective actions taken by the Program.

3. Make recommendations for improvements as appropriate.

## Scope and Methodology

In addition to the financial statement audit procedures, we performed limited testing of distributors’ and redemption centers’ compliance with Chapter 342G, Part VIII, HRS.

For testing of beverage distributors, we obtained from the Department a list of cash receipts from 273 distributors for the fiscal year ended June 30, 2016, and judgmentally selected the largest 24 distributors for further testing. Invoices were selected from the respective distributor’s monthly detail of beverage container sales to verify that all containers reported as sold (or otherwise distributed) on the distributor’s invoice were properly substantiated by supporting documents and the proper deposit and container fees were paid to the Program. The distributors selected for testing are shown in Exhibit 1.5.

**Exhibit 1.5**
**Distributors Selected for Testing**

| Distributor | FYE 6/30/16 Total Receipts | Month Selected for Testing |
|---|---|---|
| Paradise Beverages, Inc. | $ 11,829,922 | July 2015 |
| BCI Coca-Cola Bottling of LA | 9,428,554 | August 2015 |
| Pepsi Beverage Company | 8,375,868 | September 2015 |
| Anheuser-Busch Sales of Hawai‘i, Inc. | 7,030,998 | October 2015 |
| Costco Wholesale Corporation | 4,484,488 | November 2015 |
| Hawaiian Isles Water Company | 3,781,333 | December 2015 |
| ITOEN (USA), Inc. | 2,750,809 | January 2016 |
| Maui Soda & Ice Works, Ltd. | 1,441,365 | February 2016 |
| Hawaiian Sun Products, Inc. | 1,221,706 | March 2016 |
| Safeway, Inc. | 962,262 | April 2016 |
| Sam’s Club East | 766,237 | May 2016 |
| Hawaiian Springs LLC | 632,581 | June 2016 |
| Johnson Brothers of Hawai‘i, Inc. | 562,668 | June 2016 |
| Menehune Water Co., Inc. | 548,150 | May 2016 |
| Young’s Market Company, LLC | 464,314 | April 2016 |
| Target Corporation | 391,438 | March 2016 |
| Wal Mart Stores East LP | 355,384 | February 2016 |
| C & S Wholesale Grocers, Inc. | 268,945 | March 2016 |
| Southern Wine and Spirits | 228,773 | December 2015 |
| The Home Depot USA, Inc. | 203,021 | November 2015 |
| Whole Foods Market, Inc. | 177,190 | September 2015 |
| Times Super Market | 174,678 | October 2015 |
| Southern Foods Group dba Meadow Gold Dairy | 103,484 | August 2015 |
| Kahuna Distribution | 99,270 | July 2015 |
| **Total** | **$56,283,438** | |

Source: N&K CPAs, Inc.

We visited ten of the State’s 75 certified redemption centers as of June 30, 2016, and observed whether the redemption centers were open during posted hours, informed customers of the procedures/policies of the redemption count, used properly calibrated scales to weigh redeemed beverage containers, paid appropriate refunds to consumers, provided consumers with a receipt for their redemptions, and properly recorded the redemption transactions. Our tests included determining that the deposit refunds followed segregated rate schedules. The ten redemption centers we visited are shown in Exhibit 1.6.

**Exhibit 1.6**
**Redemption Centers and Locations Tested**

| Redemption Center | Island | Address |
|---|---|---|
| Aiea Shell | Oahu | 99-170 Moanalua Rd., Aiea |
| Reynolds Recycling | Oahu | 254 N. Beretania St., Honolulu |
| Reynolds Recycling | Oahu | 850 Kamehameha Hwy., Pearl City |
| Reynolds Recycling | Oahu | 91-590 Farrington Hwy., Kapolei |
| RRR Recycling Kiosk | Oahu | 94-795 Lumiaina St., Waikele |
| RRR Recycling Kiosk | Oahu | 98-850 Moanalua Rd., Pearlridge |
| RRR Recycling Kiosk | Oahu | 1436 S. Beretania St., Makiki |
| Business Services Hawai‘i | Hawai’i | Hilo Solid Waste Recycling Transfer Station |
| Garden Isle Disposal | Kaua’i | 3460 Ahukini Rd., Lihue Airport |
| Reynolds Recycling | Maui | 380 Alamaha St., Kahului |

Source: N&K CPAs, Inc.

We redeemed beverage container deposits at each of the selected redemption centers and traced its redemption transaction through the redemption center’s reimbursement request/reporting process and subsequent payment by the Program.

Audit fieldwork was conducted from July 2016 through November 2016, in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

# Chapter 2
# Compliance Testing of Distributors and Redemption Centers

This is the sixth biennial financial and program audit of the Deposit Beverage Container (DBC) Program. As reported in our previous audits we found that, the DBC Program still relies on self-reported data from distributors and certified redemption centers and lacks adequate controls to monitor the accuracy and completeness of the information submitted by distributors and certified redemption centers, which exposes the Program to risks of underpayments by distributors and overpayments to certified redemption centers. Management should strengthen controls to ensure that the Program is properly collecting deposits and container fees from distributors and that the costs of administering the Program (e.g., reimbursements and handling fees paid to certified redemption centers) are minimized.

## Summary of Findings

1. The Deposit Beverage Container Program continues to rely on self-reported and unsupported deposit and fee collections data from distributors.

2. Program payments made to certified redemption centers for beverage containers redeemed are unsupported.

## The Program Relies on Self-Reported Data for Deposits and Fees Collected from Distributors

Distributors are required to report the number of deposit beverage containers sold/distributed and pay beverage container deposit and container fees to the Program on a monthly (semiannual for smaller companies) basis. While distributors are supposed to maintain adequate records and support for beverage sales, the Program continues to rely on the unsupported amounts reported by the distributors for collections, due to the lack of a systematic verification or inspection process. Distributors could fraudulently or erroneously underpay beverage container deposits and container fees, which is consistent with the exceptions found in the sample of distributor receipts tested.

### *Program reliance on self-reported amounts increases risk of under-reporting by distributors*

Section 342G-105, HRS, states that payment of the deposit beverage container fee and deposits shall be made monthly, based on inventory reports of the deposit beverage distributors. All deposit beverage distributors shall submit to the Department documentation in sufficient detail that identifies the net number of deposit beverage containers sold, donated, or transferred, by container size and type.

In addition, Section 342G-110, HRS, specifies that the deposit on each filled deposit beverage container shall be paid by the beverage distributor, who manufactures or imports beverages in deposit beverage containers. Beverage distributors shall also pay a deposit beverage container fee and register with the State.

Because distributors can pass on beverage container costs to retailers, distributors have an inherent incentive to under-report sales/distributions of deposit beverage containers. Distributors could collect deposits and container fees from retailers but not pay them to the Program.

Undetected underpayments by distributors would result in the Program having fewer funds available to pay for deposit redemptions and program administrative costs. This could also lead to an overstated redemption rate, because the number of deposit containers sold may be understated. An inaccurate redemption rate could then lead to an unjustified increase in container fee rates to sustain Program operations.

***The Program continues to lack a systematic process to detect under- and non-reporting by distributors***

Section 342G-103, HRS, requires all beverage distributors operating within the State to register with the Department and maintain records reflecting the manufacture of their beverages in deposit containers as well as the importation and exportation of deposit beverage containers. By law, the Department and the State Auditor may audit or inspect distributor records.

To encourage compliance, the DBC Program has broad enforcement powers, including assessing an administrative penalty, ordering corrective action, and commencing civil action in circuit court. Lack of effective distributor compliance inspections by the Program, however, hobbles the Program from deploying these enforcement tools and effectively limiting the risk of underpayment by distributors of beverage container deposits and container fees.

Robust enforcement would encourage distributors to accurately pay deposits and container fees. Penalties for non-compliance that include public announcements of violations could heighten distributor awareness of penalties and potentially hurt distributors' reputations, creating an incentive to comply with DBC laws.

***Distributors could not support amounts reported and payments made to the Program***

During our detailed testing of the 24 distributors selected, we found a number of exceptions. As illustrated in Exhibit 2.1, we noted two exceptions for underpayments by the same distributor.

**Exhibit 2.1**
**Exceptions noted in Distributor Testing - Sampled Invoices**

| | | | | Recalculated Deposit and Fee | | | | |
|---|---|---|---|---|---|---|---|---|
| Distributor | Date | Invoice Number | Number of Containers | Deposit Amount | Fee Amount | Total Deposit and Fee | Actual Amount Paid | Difference |
| *Underpaid* | | | | | | | | |
| Kahuna Distribution | 07/2015 | 145148 | 252 | $ 12.60 | $ 3.78 | $ 16.38 | $ 3.12 | $ 13.26 |
| Kahuna Distribution | 07/2015 | 145320 | 792 | $ 39.60 | $ 11.88 | $ 51.48 | $ 39.78 | $ 11.70 |

Source: N&K CPAs, Inc.

Kahuna Distribution (Kahuna) noted that the exceptions above were attributed to an error made in Kahuna's inventory system. Kahuna identifies product subject to the DBC Program's deposit and container fees in their inventory system. Kahuna then calculates the monthly DBC deposits and container fees owed to the Program based on the amount of sales of identified DBC

products. In both instances noted above, Kahuna failed to identify the same item as a DBC product, which resulted in underpayments of $13.26 and $11.70. Per further inquiry with Kahuna, it was noted that for this one product, a total of 2,339 containers were sold in the month of July which resulted in $152.04 that was underreported.

We also noted during our testing that three distributors failed to remit the proper deposit and container fees for the month selected for testing.

**Exhibit 2.2**
**Exceptions noted in Distributor Testing - Monthly Report to DBC**

| | | Actual Sales | | Originally Submitted by Distributor | | Difference | |
|---|---|---|---|---|---|---|---|
| Distributor | Month | Total Number of Containers | Deposit and Fee Amount | Total Number of Containers | Deposit and Fee Amount | Containers | Deposit and Fee Amount |
| Kahuna Distribution | Jul 15 | * | * | 146,663 | $ 9,533.10 | * | * |
| Wal Mart Stores East LP | Feb 16 | 763,495 | $ 45,809.70 | 763,495 | $ 45,816.93 | -- | $ (7.23) |
| Target Corporation | Mar 16 | 514,578 | $ 30,874.68 | 515,478 | $ 30,928.68 | (900) | $ (54.00) |

* Could not be determined based on information provided.

Source: N&K CPAs, Inc.

Several reasons were provided by distributors for the errors found. Kahuna noted that the errors for its payment was attributed to multiple factors including human error, credit memos, returned product, incorrect DBC product identification (as noted in Exhibit 2.1) and employee turnover. Based on the information provided by Kahuna, N&K could not determine the amount of misstatement for the month of July 2015 alone. Kahuna noted that these errors in reporting spanned from the months of January 2015 through September 2016 and has made corrective distributions totaling $5,496.22. As a result of our testing, Kahuna continues to work with the DBC program to further quantify and rectify its reporting discrepancies.

Wal Mart Stores East LP (Wal Mart) noted that its discrepancy was attributed to using an incorrect rate to calculate its DBC fee. Section 342G-102, HRS, states that the DBC fee shall be 1.5¢ per container if the redemption rate from the prior fiscal year is greater than or equal to 70 percent. If less than than 70 percent, the DBC fee shall be 1¢ per container. The fee shall be amended effective September 1st of the subsequent fiscal year. The redemption rate for the fiscal year ended June 30, 2015 was 68%, which resulted in the DBC fee being reduced to 1¢ effective September 2015. Wal Mart failed to adjust its rate for its website sales from September 1, 2015 through the present date. For the month of February 2016, this resulted in an overpayment of $7.23. As of November 2016, no amended returns have been filed to correct the overpayment.

Target Corporation (Target) noted that its error was attributed to incorrectly inputting the quantity (twelve instead of eight) of containers per case of a product into its inventory system. Target noted the issue for this product was not identified until July 2016. For the month of February 2016, total overpayment by Target amounted to $54.00. Based on the information provided, we were unable to quantify the total amount of overpayment to date. Furthermore, as of November 2016, no amended returns have been filed to correct the overpayment.

In addition to the exceptions above in our distributor testing, it was noted that one distributor, Safeway, Inc., failed to remit supporting documentation for April 2016 detail of container sales, despite several requests being sent. Whole Foods Market, Inc. provided the September 2015 detail of container sales that was requested. However, despite several requests, they were unable to provide supporting documentation for the sample of invoices selected from the monthly detail of beverage container sales. Anheuser-Busch was unable to provide a detailed listing of invoices which included the deposit and handling fee or the number of containers sold. Therefore, we could not determine whether the amount reported to the Program was accurate.

These errors highlight the need for the Program to more closely monitor amounts reported and paid by distributors. The Program’s reliance on self-reporting by distributors without a strong enforcement and substantiation function exposes it to fraud.

## The Program Pays Redemption Centers Based on Self-Reported Data

The Program reimburses and pays for beverage containers redeemed by certified redemption centers on a monthly basis based on reports prepared by the centers. We found, however, that the Program lacks adequate internal controls to prevent or detect whether certified redemption centers erroneously or fraudulently over-report beverage containers redeemed, thus overcharge the Program.

***Program’s continued reliance on self-reported amounts increases the risk of over-reporting by redemption centers***

Section 342G-119, HRS, specifies that the Department shall pay certified redemption centers handling and deposit refunds based on collection reports submitted by the redemption centers. Redemption reports include the number or weight of deposit beverage containers of each material type accepted at the redemption center for the reporting period; the amount of refunds paid out by material type; the number or weight of deposit beverage containers of each material type transported out of state or to a permitted recycling facility; and copies of out-of-state transport and weight receipts or acceptance receipts from permitted recycling facilities. Additionally, Section 11-282-47, Hawai‘i Administrative Rules (HAR), states that the Department shall pay certified redemption centers handling fees and refund values based on reports submitted by the redemption centers to the Department.

The Program pays certified redemption centers 50 percent of the handling fees claimed at the time of the initial request by submitting weight tickets for the amounts shipped to end-user recycling facilities. The remaining balance in paid upon receipt of corroborating weight reports prepared by the end-user recycling facilities. The Program also reimburses certified redemption centers for the amount of deposit refunds paid to consumers based on reports prepared by the certified redemption centers. The associated handling fees paid to the certified redemption centers are based on container equivalents from the weight of containers redeemed and sent to recycling facilities as reported by both the certified redemption centers and recycling facilities.

The Program relies on certified redemption center self-reporting and does not require such centers to submit any supporting documents with deposit refund reimbursement requests. Because the Program reimburses certified redemption centers for all deposits refunded, nothing prevents redemption centers from overpaying and over-reporting redemptions. Consistent

overpayment of deposit refunds by certain redemption centers may encourage more consumers to redeem deposit beverage containers at those specific locations, resulting in greater volume and handling fees to the redemption center.

The Program previously indicated plans to address this by paying the combined deposit reimbursement and handling fees only on the quantity of beverage containers shipped to and received by materials end-use recyclers. However, despite seeing indicators that overpayments have been occurring and planning changes since 2007, the Program has failed to adequately address these concerns by implementing planned changes.

The Program also attributes part of the difference between the weight of materials in collection reports and the weight of materials delivered to the end recycler to “shrinkage,” the result of inherent and expected inefficiencies in the recycling process. For instance, the accumulation and evaporation of liquid in DBC containers could account for some of these differences. The Program has established a standard shrinkage rate of up to 2.5 percent; thus, the Program pays the handling fee at the time it receives documentation for the actual weight of material recycled. However, shrinkage could also be an indicator of theft, fraudulent reporting, or other weaknesses and inefficiencies in redemption center operations.

Ultimately, redemption overpayments, irrespective of the cause, will result in the Program having fewer funds available to pay deposit refunds and may justify increasing the handling fees on beverage containers redeemed. During FY 2016, the handling fees were between 2¢ and 4¢ per container, depending on the location of the redemption center and the end-use of the recycled containers, which is two - to four-times the amount of the container fees paid into the DBC Fund by distributors. Program inefficiencies or inability to validate redemption center reports, however, should not justify increased container fees.

***Program still lacks a process to detect over-reporting by redemption centers***

Redemption centers have an inherent incentive to overstate the amount refunded for deposit beverage containers redeemed to increase demand for their services and the amount of handling fees generated. Knowing this, the Program should have a process in place to detect such over-reporting by redemption centers. However, we found that none of the inspections conducted during FY16 included procedures to detect over-reporting, such as inspecting deposit refund reimbursement request forms by obtaining and validating amounts reported to certified redemption centers’ supporting documents. In fact, the Program has neither scheduled nor systematically performed compliance inspections of redemption centers with any regularity. Instead, the Program’s compliance inspections either checked daily customer transactions at certified redemption centers to determine if refunds were properly calculated and whether proper segregated rates were used, or investigated complaints received from the public. The Program has failed to implement a systematic compliance inspection and enforcement process that would limit the risk of overpayment of redemptions.

The Program is in the process of implementing an audit function, through the services of an independent public accounting firm. As of January 2017, the request for proposal for these services has not yet been finalized.

***Redemption centers' errors are passed on to the DBC Program***

During the audit, we visited ten redemption centers to redeem beverage containers by count (two redemption centers) and by weight (eight redemption centers). In our testing of deposits refunded by certified redemption centers via count, we found one instance in which the redemption center did not accurately count the number of containers redeemed, which was counted as 28 compared to 38 containers actually redeemed. This resulted in an underpayment of $0.50.

No other exceptions were noted for redemption centers in which containers were redeemed by weight or by count. Although the redemption centers tested appear to be refunding deposit beverage containers at the Department's official segregated conversion rates (Exhibit 1.3), we noted that these rates were last updated based on a September 2010 survey. As provided in 11-282-61(b), HAR, the Program should consider re-evaluating the segregated rates.

For the redemption centers tested above, we also requested copies of redemption transactions and traced them through the redemption center's reimbursement request/reporting process and subsequent payment by the Program. We noted the following exception:

- One out of 10 redemption centers receipts totals provided did not agree to the summaries submitted by the redemption center for payment. In this instance, the amount reported on the summary sheets was less than the supporting receipts provided, indicating a request by the redemption center to the Program for a larger payment than substantiated by its receipts.

## Conclusions

The DBC Program's continued reliance on self-reporting by distributors and certified redemption centers and lack of systematic inspections expose the Program to a greater risk of fraud. Plans to address these program weaknesses are pending and remain unimplemented. Until the Program implements controls to verify reports submitted, underreported deposits and fees, and over-reported redemptions may not be detected. Consequently, the Program may be operating at a greater cost than necessary, and the reported redemption rate may not be reliable. Resolution of these deficiencies is necessary to alleviate public concerns over the cost of the State's beverage container recycling program, including questions regarding the container fee rate necessary to operate the Program.

## Recommendation

The Deposit Beverage Container Program management should:

1. Develop a risk-based process to select distributors and redemption centers to audit. The Program should consider a variety of risk factors, including the amount of money transacted, prior audit findings, and the frequency of distributor's or redemption center's prior audits.

2. Report results of distributor and redemption center audits annually and conduct follow-up audits, as necessary.

# Chapter 3
# Financial Audit

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# INDEPENDENT AUDITOR'S REPORT

To the Auditor
State of Hawai‘i

## Report on the Financial Statements

We have audited the accompanying financial statements of the State of Hawai‘i, Deposit Beverage Container Deposit Special Fund (the Fund), which comprise the balance sheet - governmental fund as of June 30, 2016, and the related statements of revenues, expenditures, and change in fund balance - governmental fund and budgetary comparison for the fiscal year then ended, and the related notes to the financial statements.

## Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

## Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments,

the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2016, and the change in its financial position and the budgetary comparison thereof for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America.

**Emphasis of Matter**

As discussed in Note A, the financial statements of the Fund, are intended to present the financial position and the changes in financial position of only that portion of the governmental fund type of the State of Hawaiʻi or the State of Hawaiʻi, Department of Health that are attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of Hawaiʻi or the State of Hawaiʻi, Department of Health as of June 30, 2016, and the changes in its financial position for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

**Other Matters**

*Required Supplementary Information*

Management has omitted the management’s discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated January 17, 2017 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control over financial reporting and compliance.

N&K CPAs, Inc.

Honolulu, Hawai'i
January 17, 2017

**Department of Health**
**State of Hawai‘i**
**Deposit Beverage Container Deposit Special Fund**
**BALANCE SHEET - GOVERNMENTAL FUND**
**June 30, 2016**

**ASSETS**

| | |
|---|---|
| Equity in cash and cash equivalents and investment in State Treasury | $ 29,675,959 |
| Accounts receivable | 1,638,079 |
| Interest receivable | 13,134 |
| Total assets | $ 31,327,172 |

**LIABILITIES AND FUND BALANCE**

| | |
|---|---|
| Liabilities | |
| Vouchers and contracts payable | $ 2,666,602 |
| Accrued wages and employee benefits | 41,176 |
| Beverage container deposits | 1,606,002 |
| Total liabilities | 4,313,780 |
| Fund balance | |
| Committed to deposit container program | 27,013,392 |
| Total liabilities and fund balance | $ 31,327,172 |

The accompanying notes are an integral part of this financial statement.

**Department of Health**
**State of Hawai‘i**
**Deposit Beverage Container Deposit Special Fund**
**STATEMENT OF REVENUES, EXPENDITURES, AND**
**CHANGE IN FUND BALANCE - GOVERNMENTAL FUND**
**Fiscal Year Ended June 30, 2016**

| | |
|---|---|
| **REVENUES** | |
| Deposit beverage container fees | $ 11,023,862 |
| Unredeemed deposits | 12,480,142 |
| Interest income | 84,309 |
| Non-imposed fringe benefits | 5,552 |
| Total revenues | 23,593,865 |
| **EXPENDITURES** | |
| Handling and redemption fees | 18,237,237 |
| Operating expenditures | 1,200,593 |
| Administrative expenditures | 59,382 |
| Total expenditures | 19,497,212 |
| Change in fund balance | 4,096,653 |
| Fund balance at July 1, 2015 | 22,916,739 |
| Fund balance at June 30, 2016 | $ 27,013,392 |

The accompanying notes are an integral part of this financial statement.

**Department of Health**
**State of Hawai‘i**
**Deposit Beverage Container Deposit Special Fund**
**BUDGETARY COMPARISON STATEMENT**
**Fiscal Year Ended June 30, 2016**

| | Budgeted Amounts | | Actual Amounts |
|---|---|---|---|
| | Original | Final | (Budgetary Basis) |
| **REVENUES** | | | |
| Current-year funds | $ 84,589,786 | $ 84,596,793 | $ 58,396,621 |
| Total revenues | 84,589,786 | 84,596,793 | 58,396,621 |
| **EXPENDITURES** | | | |
| Environmental health administration | 84,589,786 | 84,596,793 | 65,104,386 |
| Total expenditures | 84,589,786 | 84,596,793 | 65,104,386 |
| Excess of expenditures over revenues | $ -- | $ -- | $ (6,707,765) |

The accompanying notes are an integral part of this financial statement.

## NOTE A - FINANCIAL REPORTING ENTITY

### Establishment and Purpose of the Fund

In 2002, the State of Hawai'i Legislature passed Act 176 to establish the Deposit Beverage Container Deposit Program and the Deposit Beverage Container Deposit Special Fund (DBC Fund). The purpose of Act 176 was to increase participation in deposit programs, increase recycling rates for specified deposit beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter.

Pursuant to Section 342G, Part VIII of the Hawai'i Revised Statutes (HRS), the DBC Fund was initiated on July 1, 2005, to implement a Deposit Beverage Container Program, establish minimum standards for the collection of empty beverage containers, to foster systems of redemption which facilitate recycling of empty beverage containers, and to minimize costs without inconveniencing customers. Under the DBC Fund, the State of Hawai'i (the State) collects from manufacturers and distributors, a 5¢ per container refundable deposit on eligible beverage containers manufactured in or imported to the State that are expected to be sold in the State. The deposits are used to reimburse redemption centers. In addition, the Fund assessed a per container handling fee of 1.5¢ per container until August 31, 2015. Effective September 1, 2015, the handling fee was lowered to 1¢ per container.

The DBC Fund is administered by employees of the Solid Waste Branch, Environmental Management Division of the State of Hawai'i, Department of Health (the Department).

The accompanying financial statements are intended to present the financial position and the changes in financial position of only that portion of the governmental fund type of the State and the Department that are attributable to the transactions of the DBC Fund. They do not purport to, and do not, present fairly the financial position of the State or the Department as of June 30, 2016, and the changes in its financial position for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America.

## NOTE B - SIGNIFICANT ACCOUNTING POLICIES

(1) ***Basis of Presentation*** - The financial statements of the DBC Fund are reported using the current financial resources measurement focus and modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the DBC Fund considers revenues to be available if they are collected within 60 days after the end of the current fiscal year. Revenues susceptible to accrual include a handling fee of 1¢ per beverage container sold. In addition, the amounts for deposits of 5¢ are deferred when collected, and the amount estimated to be forfeited is recognized as revenue at the end of the fiscal year.

## NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

Expenditures are generally recorded when a liability is incurred; however, expenditures related to compensated absences are recorded only when payment is due.

Encumbrances are recorded for obligations in the form of purchase orders or contracts at the time purchase orders or contracts are awarded and executed. Encumbrances outstanding at fiscal year-end are reported as reservations of fund balance since they do not constitute expenditures or liabilities.

Had the financial statements been presented on the full accrual basis of accounting, additional adjustments would need to be recorded. These adjustments are recorded on a department-wide level for all governmental activities of the Department. The DBC Fund's portion of these department-wide accruals includes adjustments for capital assets and accrued vacation. At June 30, 2016, the DBC Fund's portion of these accruals was as follows:

| | |
|---|---|
| Total fund balance on the modified-accrual basis of accounting | $ 27,013,392 |
| Capital assets used in governmental activities are not financial resources and therefore are not reported as an asset in the governmental funds | 9,989 |
| Compensated absences reported in the statement of net position do not require the use of current financial resources and are not reported as liabilities in the governmental funds | (74,865) |
| Total net assets on the full accrual basis of accounting | $ 26,948,516 |

At June 30, 2016, the DBC Fund's portion of the department-wide activities is not materially different from the DBC Fund's activity.

(2) ***Use of Estimates*** - In preparing financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP), management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

(3) ***Governmental Funds - Fund Balance*** - The DBC Fund accounts for governmental fund balances in accordance with Governmental Accounting Standards Board (GASB)

## NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

Statement No. 54 (GASBS 54), *Fund Balance Reporting and Governmental Fund Type Definitions*. GASBS 54's hierarchical fund balance classification structure is based primarily on the extent to which a government is bound to follow constraints on how resources can be spent. Classifications include:

- *Nonspendable fund balance* - amounts that are not in spendable form (such as inventory) or are required to be maintained intact;

- *Restricted* - amounts constrained to specific purposes by their providers (such as creditors, grantors or other governments) through constitutional provisions, or by enabling legislation;

- *Committed* - amount constrained to specific purposes by a government itself, using its highest level of decision-making authority; to be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest level of action to remove or change the constraint;

- *Assigned* - amounts a government intends to use for a specific purpose; intent can be expressed by the governing body or by an official or body to which the government delegates the authority; and

- *Unassigned* - amounts that are available for any purpose; positive amounts are reported only in the general fund.

When both restricted and unrestricted balances are available for use, it is the DBC Fund's policy to use restricted fund balance first, then unrestricted fund balance. Furthermore, committed fund balances are reduced first, followed by assigned amounts, and then unassigned amounts when expenditures are incurred for purposes for which amounts in any of those unrestricted classifications can be used.

(4) ***Equity in Cash and Cash Equivalents and Investments in State Treasury*** - All monies of the DBC Fund are held in the State Treasury. The State Director of Finance is responsible for the safekeeping of cash in the State Treasury in accordance with State laws. The Director of Finance may invest any monies of the State, which in the Director's judgment, are in excess of the amounts necessary for meeting the immediate requirements of the State. Cash is pooled with funds from other State agencies and departments and deposited into approved financial institutions or in the State Treasury Investment Pool System. Funds in the investment pool accrue interest based on the average weighted cash balances of each account.

At June 30, 2016, information relating to the types, insurance, collateral, and related interest rate, credit and custodial risks of funds deposited with the State Treasury was not available for the DBC Fund since such information is determined on a statewide

## NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

basis. Cash deposits with the State Treasury are either federally insured or collateralized with obligations of the State or United States of America. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

(5) ***Accounts Receivable*** - Revenue is earned when it is considered measurable and available. The accounts receivable balance represents the expected receipts from distributors based on deliveries of the containers as of June 30, 2016.

(6) ***Beverage Container Deposits*** - Deposits of 5¢ are made by distributors to the DBC Fund for each qualifying container. The DBC Fund maintains all deposits until the recycling centers claim reimbursement for the deposits that they pay out to the consumers. The DBC Fund maintains the deposits that are expected to be redeemed.

Amounts paid out to the consumers are based on containers redeemed or a predetermined weight per type of container redeemed (i.e. aluminum, mixed plastics, etc.). These weights are determined based on the mix of containers redeemed and are reviewed when necessary. Management adjusts the deposit liability balance and unredeemed deposit revenue recognized based on the amount of deposits reimbursed to redemption centers in the first three months of the subsequent fiscal year related to deposits collected prior to year end.

(7) ***Deferred Outflows/Inflows of Resources*** - Deferred outflows of resources represent a consumption of net position that applies to a future period and will not be recognized as an outflow of resources (expense/expenditure) until that time. Deferred inflows of resources represent an acquisition of net position that applies to a future period and so will not be recognized as an inflow of resources (revenue) until that time. The DBC Fund does not have any items that qualify for reporting in these categories.

(8) ***Administrative Costs*** - The accompanying financial statements do not reflect certain administrative costs, which are paid for by other sources of funding from the Department. These costs include the Department's and State's overhead costs which the Department does not assess to the DBC Fund, since they are not practical to determine.

## NOTE C - BUDGETING AND BUDGETARY CONTROL

The DBC Fund follows these procedures in establishing the budgetary data reflected in the basic financial statements:

(1) ***The Budget*** - Not less than 20 days before the State Legislature convenes in every odd-numbered year, the governor submits to the State Legislature, and to each member thereof, a budget which contains the Program and budget recommendation of

## NOTE C - BUDGETING AND BUDGETARY CONTROL (Continued)

the governor for the succeeding biennium. The budget in general contains: the State program structure; statements of statewide objectives; financial requirements for the next biennium to carry out the recommended programs; a summary of State receipts and revenues in the last completed fiscal year; a revised estimate for the fiscal year in progress; and an estimate for the succeeding biennium.

(2) ***Legislative Review*** - The State Legislature considers the governor's proposed program and financial plan and budget, evaluates alternatives to the governor's recommendations, adopts programs, and determines the State budget. It may, from time to time, request the Department of Budget and Finance and any agency to conduct such analysis of programs and finances and will assist in determining the State's program and financial plan and budget.

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

Budgetary control is maintained at the appropriation line item level established in the appropriation acts.

A budget is adopted for the DBC Fund and is prepared on the cash basis of accounting, which is a basis of accounting other than U.S. GAAP.

The major differences between the budgetary and U.S. GAAP bases are that: (1) the budget is prepared on the cash basis of accounting; (2) encumbrances are recorded as the equivalent of expenditures under the budgetary basis; and (3) collections and payments of certain refundable deposits are not recognized as revenues and expenditures under U.S. GAAP.

Since budgetary basis differs from U.S. GAAP, budget and actual amounts in the budgetary comparison statements are presented on the budgetary basis. A reconciliation of excess of expenditures over revenues on a budgetary basis for 2016, to the change in fund balance presented in conformity with U.S. GAAP follows:

| | | |
|---|---|---|
| Excess of expenditures over revenues - actual on a budgetary basis | $ | (6,707,765) |
| Reserve for encumbrances at year end | | 13,262,593 |
| Expenditures for liquidation of prior year encumbrances | | (6,276,751) |
| Accruals and other adjustments | | 3,818,576 |
| Change in fund balance - U.S. GAAP basis | $ | 4,096,653 |

## NOTE D - BEVERAGE CONTAINER DEPOSITS

The changes to the beverage container deposit liability during fiscal year 2016 were as follows:

| | | |
|---|---|---|
| Balance as of July 1, 2015 | $ | 1,817,994 |
| Increase: Deposits received from distributors | | 47,460,689 |
| Decrease: Payments made to recycling centers, net of refunds | | (35,192,539) |
| Decrease: Unredeemed deposits recognized as revenue | | (12,480,142) |
| Balance as of June 30, 2016 | $ | 1,606,002 |

## NOTE E - EMPLOYEE BENEFIT PLANS

Substantially all eligible employees of the DBC Fund participate in the State's retirement and post-retirement benefit plans. The State's plans include the Employee's Retirement System (ERS) of the State, post-retirement health care and life insurance benefits, a deferred compensation plan, and sick leave benefits. For information on the State's benefit plans, refer to the State of Hawai'i and ERS's Comprehensive Annual Financial Reports (CAFR), or the audited financial statements of the Department. The State's CAFR can be found at the DAGS website: http://ags.hawaii.gov/reports/financial-reports/. The ERS CAFR can be found at the ERS website: http://ers.ehawaii.gov/resources/financials.

## NOTE F - COMMITMENTS AND CONTINGENCIES

The State maintains certain insurance coverage to satisfy bond indenture agreements as well as for other purposes, but is substantially self-insured for all other perils including workers' compensation. The State records a liability for risk financing and insurance related losses, including those incurred but not reported, if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. At June 30, 2016, the State recorded estimated losses for workers' compensation, automobile, and general liability claims as long-term liabilities as the losses will not be liquidated with currently expendable available financial resources. The estimated losses will be paid from legislative appropriations of the State's General Fund. The DBC Fund did not have a portion of the State's workers' compensation expense for the fiscal year ended June 30, 2016.

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# REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

## INDEPENDENT AUDITOR'S REPORT

To the Auditor
State of Hawai‘i

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the State of Hawai‘i, Deposit Beverage Container Deposit Special Fund (the Fund), which comprise the balance sheet - governmental fund as of June 30, 2016, and the related statements of revenues, expenditures, and change in fund balance - governmental fund, and budgetary comparison for the fiscal year then ended and have issued our report thereon dated January 17, 2017.

### Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in Chapter 2 of this report that we consider to be significant deficiencies.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

**Fund Management's Response to Findings**

The Fund management’s responses to the findings identified in our audit are described in the attached response. The Fund management's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

N&K CPAs, Inc.

Honolulu, Hawai‘i
January 17, 2017

# Appendix A
# Agency Response to Previous Recommendations

**Appendix A**
**Agency Response to Previous Recommendations**
**Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014**
**Report No. 15-02**

| RECOMMENDATION | AGENCY RESPONSE |
|---|---|
| 1. Combine the deposit redemption reimbursement request and handling fee request to streamline the payment process by moving beyond the multi-year assessment and adopting and implementing a back-end payment system. Review and adopt administrative rules to implement a back-end payment system. | The Program disagrees with the audit that a back-end payment system will shift risk away from the Department. In fact, implementation of a back-end payment system will result in the closure of all the Certified Redemption Centers (CRCs) Statewide and would require the Program to solicit and contract recycling companies to operate CRCs thereby further increasing risk, uncertainties, costs, and liabilities to the Program.<br><br>In response to the 2005 Program Audit, the Program prematurely suggested a back-end payment system without fully understanding the financial and operational constraints of such a system. The back-end payment system should no longer be considered as a viable solution to resolve some of the deficiencies associated with CRCs' claims. |
| 2. Develop a risk-based process to select distributors and redemption centers to audit. The Program should consider a variety of risk factors, including the amount of money transacted, prior audit findings, and the frequency of distributor's or redemption's prior audits. | The Program concurs with the recommendation that a risk-based process is required to select distributors and redemption centers to audit. A solicitation has been prepared by the Program to contract an auditing firm to develop a systematic audit program. The audit program will take into consideration and address risk factors, prior audit findings, and the frequency of distributor and certified redemption center audits.<br><br>The implementation of the audit program is contingent upon the successful completion of the contract, retention of staff and the establishment and recruitment of three new accounting positions that were authorized under Act 122/SLH 2014.<br><br>As of January 2017, the solicitation has yet to be approved by the Governor's office. In addition, while the new accounting positions have been authorized, the Program has had a hard time filling these positions. Currently, there are five vacancies at the Program, which include one environmental health specialist, one accountant, and three clerks. |

**Appendix A**
**Agency Response to Previous Recommendations (Continued)**
**Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014**
**Report No. 15-02**

| RECOMMENDATION | AGENCY RESPONSE |
|---|---|
| 3. Report results of distributor and redemption center audits annually and conduct follow-up audits, as necessary. | The Program concurs that the results of the distributor and redemption center audits should be published annually. In addition, the Program recognizes that follow-up audits, corrective and enforcement actions are necessary to resolve deficiencies, improve compliance, and alleviate public concerns. These actions are contingent on the Program's successful implementation of a systematic internal auditing program. |

## Response of the Affected Agency

N&K CPAs, Inc.
ACCOUNTANTS | CONSULTANTS

AMERICAN SAVINGS BANK TOWER
1001 BISHOP STREET, SUITE 1700
HONOLULU, HAWAII 96813-3696
T (808) 524-2255 F (808) 523-2090

To the Auditor
State of Hawai´i

We transmitted a draft of this report to the Department of Health, State of Hawai´i, Deposit Beverage Container Program (the Program) on January 4, 2016. The Program's written response dated January 17, 2017, is included on pages 41 - 44. We met with representatives of the Program and the Office of the Auditor, State of Hawaii, on January 26, 2017 to discuss the draft report and the Program's response. For the reasons explained in detail below, we disagree with several of the Program's responses to the draft report. Where we agree with points raised in the Program's response, we also indicate our agreement to those positions and report any revisions to the draft report that were made to address those points.

The Program concurred with many of our findings and recommendations. However, the Program believed there were certain statements within our report that "may have the unintended consequences of being misleading." The Program specifically noted that the statements "Deposit and Fee Collected from Distributors are Unsupported" and the "Program Regularly Pays for Unsupported Amounts of Beverage Containers Redeemed at Redemption Centers" were misleading and also felt that the results of our testing "shows quite the opposite".

These statements address the absence of internal controls implemented by the Program in relation to the payments received from distributors and the payments made to certified redemption centers. Because the Program relies on self-reported information from both distributors and certified redemption centers and does not require any supporting documentation to be provided, the Program is unable to determine whether amounts reported are accurate. In response to this comment, we have revised the statements to read "The Program Relies on Self-Reported Data for Deposits and Fees Collected from Distributors" and "The Program Pays Redemption Centers Based on Self-Reported Data".

In addition, the Program noted that in our testing of distributors, we "detected $5,496.22 in underpayments from only one (1) distributor out of 21 distributors that in total made $48,112,988.00 of payments to the Program." As noted in Chapter 2 of our report, we performed detailed testing of 24 distributors. In our testing approach, we selected the 24 distributors with the largest amount of deposits and fees paid to the Program during the fiscal year ended June 30, 2016. For each of the distributors selected, we reviewed supporting documentation for the payment received for one month during the fiscal year and tested a sample of individual transactions that were included in that payment. Three (3) out of the 24 distributors selected for testing, who made payments to the Program totaling $8,170,450, did not provide the documentation requested. Due to the missing information and because we did not select a statistical sample, we were unable to extrapolate potential understatements made to the Program as a whole.

Likewise, the Program noted "only one (1) out of ten (10) redemption centers tested by the Auditor did not reconcile the Program payments." While the misstatement found in our testing was not of a material amount, it sheds light on the fact that the Program pays redemption centers based self-reported data and does not require supporting documents for deposit refund reimbursement requests.

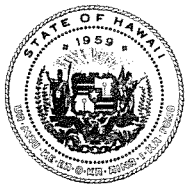
The Program also stated that “the report contains numerous assumptions and inaccuracies that have no other purposes but to mislead the reader and incite a negative reaction toward the Program” and continued “the audit report on page 14 makes the speculative statement, ‘distributors could collect deposits and container fees from retailer but not pay them to the Program,’ without the Auditor providing any supporting evidence that this is occurring.” Contrary to these statements, the distributor which was found to have made underpayments to the Program totaling $5,496.22 in fact did charge retailers for the deposits and redemption fees related to a certain brand of products and incorrectly excluded this brand of products from the report used when submitting payments to the Program.

The Program’s response also stated “the auditor clearly does not understand how the Program operates.” In our report, we listed examples of the Program’s “broad enforcement powers, including assessing an administrative penalty, ordering corrective action, commencing civil action in circuit court, and revoking a certification for payment.” The last measure of enforcement of revoking a certification for payment relates to redemption centers, not to distributors. Because we were focusing on “under- and non-reporting by distributors”, we have revised the enforcement powers mentioned and excluded revoking a certification for payment.

The Program mentioned that a contractor has been procured to evaluate and update the Department’s official segregated conversion rates. We commend the Program for taking this measure which, as noted by the Program, is aimed at “developing a methodology and schedule under which the segregated rates will be more regularly evaluated going forward”.

We appreciate the Program’s concurrence with our recommendations. We believe that the implementation of a risk-based audit process and reporting the results such audits over both distributors and certified redemption centers will provide the Program the ability to detect and deter under-reported deposits and fees and over-reported redemptions.

DAVID Y. IGE
GOVERNOR OF HAWAII



VIRGINIA PRESSLER, M.D.
DIRECTOR OF HEALTH

**STATE OF HAWAII**
**DEPARTMENT OF HEALTH**
P. O. BOX 3378
HONOLULU, HI 96801-3378

In reply, please refer to:
File:

January 17, 2017

The Honorable Leslie H. Kondo
State Auditor
Office of the Auditor
465 South King Street, Suite 500
Honolulu, HI 96813

Dear Mr. Kondo:

The Hawaii State Department of Health (DOH) in part concurs with the state auditor's finding and recommendations of the *Financial and Program Audit of the Department of Health State of Hawaii Deposit Beverage Container Deposit Special Fund Fiscal Year Ended June 30, 2016*. Please find attached our concerns and specific comments on the recommendations made in the report.

We appreciate the opportunity to comment on the audit report. Should you have any questions, please contact Dr. Darren Park, Solid Waste Management Coordinator, at (808) 586-4226 or via e-mail at darren.park@doh.hawaii.gov.

Sincerely,

Virginia Pressler

VIRGINIA PRESSLER, M.D.
Director of Health

Attachment

SUBJECT: FINANCIAL AND PROGRAM AUDIT OF THE DEPARTMENT OF HEALTH STATE OF HAWAII DEPOSIT BEVERAGE CONTAINER DEPOSIT SPECIAL FUND FISCAL YEAR ENDED JUNE 30, 2016

We appreciate the opportunity to comment on the subject report as we continue to work on strengthening Hawaii's recycling efforts. The Deposit Beverage Container Program (Program) essentially concurs with many of the findings of the report. However, we found several statements in this report that are incomplete or misleading findings. Our concern is that, without a full description, these statements portray an incomplete picture of the Program's adequacy of internal controls and compliance with applicable laws.

Prior to stating our specific comments to address the auditor's concerns, we would like to offer the following observation and examples of incomplete or misleading findings:

The Department of Health (Department) is concerned and wishes to go on record as noting that the practice of the Office of the Legislative Auditor (Auditor) in formatting the report in the manner of highlighting the criticisms in bold letters and not providing the underlying reasons for the existing problems, may have the unintended consequences of being misleading and creating confusion, particularly in light of the possibility that the media may choose to focus on the one particular highlighted point.

- The audit report on page 14 highlights in bold letters the title, "Deposit and Fee Collected from Distributors are Unsupported," that misleads the reader to believe that unsupported payments are prevalent for all distributors when the Auditor's own data shows quite the opposite. In fact, the majority, 21 of the 24 distributors tested by the Auditor were able to provide adequate supporting documentation. In addition, the Auditor detected $5,496.22 in underpayments from only one (1) distributor out of 21 distributors that in total made $48,112,988.00 of payments to the Program. An underpayment of $5,000.00 out of $48,000,000.00, equivalent to 0.01% of distributor payments, does not justify the misleading title used in the audit report.

- The audit report on page 17 also highlights in bold letters the title, "Program Regularly Pays for Unsupported Amounts of Beverage Containers Redeemed at Redemption Centers," that misleads the reader to believe the "Program Regularly Pays for Unsupported Amounts," to redemption centers when the Auditor's own data shows again quite the opposite. Only one (1) out of ten (10) redemption centers tested by the Auditor did not reconcile with Program payments. Furthermore, the Auditor also failed to include the amount of the discrepancy and possible reasons for the discrepancy at this single redemption center.

In addition, the report contains numerous assumptions and inaccuracies that have no other purpose but to mislead the reader and incite a negative reaction towards the Program.

- The audit report on page 14 makes the speculative statement, "Distributors could collect deposits and container fees from retailer but not pay them to the Program," without the Auditor providing any supporting evidence that this is occurring.

- The Auditor clearly does not understand how the Program operates. The audit report on page 15, in part highlights a number of "broad enforcement powers" the Program might use to limit the risks of underpayment from distributors. Included in this list is the suggestion that the Program could revoke a distributor's certification for payment. For the record, the Program does not issue certifications to distributors. Under the law, the Program is only empowered to issue certifications to redemption centers, so this particular enforcement power is not an option for the Program to employ regarding distributors.

- On page 19 the Auditor states, "Although the redemption centers tested appear to be refunding deposit beverage containers at the Department's official segregated conversion rates (Exhibit 1.3), we noted that these rates were last updated based on a September 2010 survey. As provided in 11-282-61(b), HAR, the program should consider re-evaluating the segregated rates." While the Program appreciates this recommendation, we wish to point out that the services of a contractor were in fact procured on May 2, 2016 to evaluate and update the segregated rates. The contractor completed the first round of sampling that included over 130,000 containers statewide. Work by the contractor is anticipated to be completed before the end of fiscal year 2018, and represents the Program's first step in developing a methodology and schedule under which the segregated rates will be more regularly evaluated going forward.

The Program recognizes it will continue to operate at greater risk to fraud until a comprehensive auditing program is implemented. The Department has taken steps towards the implementation of an auditing program by requesting and obtaining authorization to add three (3) additional accounting positions from the 2014 legislature (Act 122) to support this function. The Program is also in the process of developing a request for proposal to procure the services of an independent public accounting firm. However, due to turnover, inability to retain staff and recruit, the Program has been hampered in its desire to establish a systematic audit program.

Having stated the above, we now offer the following specific comments on the recommendations made in the report:

**Recommendation No. 1**

**Develop a risk-based process to select distributors and redemption centers to audit. The program should consider a variety of risk factors, including the amount of money transacted, prior audit findings, and the frequency of distributor's or redemption's prior audits.**

The Program concurs with the recommendation that a risk-based process is required to select distributors and redemption centers to audit. The procurement of a public

accounting firm was delayed due to the loss of a planner who served as the sole contract officer, and the revision of the solicitation to also include the establishment of an internal accounting control program in addition to developing a systematic audit program for distributors and redemption centers. The auditing programs will take into consideration and address risk factors, prior audit findings, and the frequency of distributor and certified redemption center audits. The implementation of the auditing programs is contingent upon the successful completion of the solicitation, procurement of an independent public accounting firm, retention of staff, hiring and training of a new planner to serve as contract administrator, and the recruitment of three (3) new accounting positions that were authorized under Act 122/SLH 2014.

**Recommendation No. 2**
**Report results of distributor and redemption center audits annually and conduct follow-up audits, as necessary.**

The Program concurs that the results of distributor and redemption center audits should be published annually. In addition, the Program recognizes that follow-up audits, corrective and enforcement actions are necessary to resolve deficiencies, improve compliance, and alleviate public concerns. These actions are contingent on the Program's successful solicitation, procurement of services from an independent public accounting firm, implementation of a systematic internal and external auditing program, retention of staff, and successful recruitment of positions critical to achieve this recommendation.