Financial and Program Audit of the Department of Health's Deposit Beverage Container Program, June 30, 2018

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

Conducted by
The Auditor, State of Hawai'i
and KMH LLP

Report No. 19-08
March 2019

OFFICE OF THE AUDITOR
STATE OF HAWAI'I

OFFICE OF THE AUDITOR
STATE OF HAWAI‘I

Constitutional Mandate

Pursuant to Article VII, Section 10 of the Hawai‘i 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.

Hawai‘i 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.

Our Mission

To improve government through independent and objective analyses.

We provide independent, objective, and meaningful answers to questions about government performance. Our aim is to hold agencies accountable for their policy implementation, program management and expenditure of public funds.

Our Work

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.

Additionally, we perform procurement audits, sunrise analyses and sunset evaluations of proposed regulatory programs, analyses of proposals to mandate health insurance benefits, analyses of proposed special and revolving funds, analyses of existing special, revolving and trust funds, and special studies requested by the Legislature.

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

For more information on the Office of the Auditor, visit our website:
http://auditor.hawaii.gov

COVER PHOTO: ISTOCK.COM

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, 2018. 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 KMH LLP.

Leslie H. Kondo
State Auditor

FINANCIAL AND PROGRAM AUDIT OF THE
DEPARTMENT OF HEALTH
STATE OF HAWAIʻI
DEPOSIT BEVERAGE CONTAINER DEPOSIT SPECIAL FUND

Fiscal Year Ended June 30, 2018

Submitted by
The Auditor
State of Hawaiʻi

DEPARTMENT OF HEALTH STATE OF HAWAI'I
DEPOSIT BEVERAGE CONTAINER DEPOSIT SPECIAL FUND

TABLE OF CONTENTS

TABLE OF CONTENTS

Chapter 1
Introduction

Background

In 2002, the Hawai‘i Legislature passed Act 176 to establish the Deposit Beverage Container Program (the Program). The Act, codified as Chapter 342G, Part VIII, Hawai‘i Revised Statutes (HRS), also established the Deposit Beverage Container Deposit Special Fund to account for the Program's activities. The purpose of the Program 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 even-numbered fiscal years after the initial audit for the fiscal year ended June 30, 2005. The Office of the Auditor contracted KMH LLP, a certified public accounting firm, to conduct this financial and program audit for the fiscal year ended June 30, 2018.

Program Organization and Revenues

The Department of Health's (the Department) Environmental Management Division, Solid and Hazardous Waste Branch administers the Program. The Program is managed by the solid waste management coordinator.

In FY 2018, the Program had revenues of $24.6 million and expenditures of $17.5 million, resulting in a $7.1 million increase in fund balance to $37.7 million at June 30, 2018. The Program's container deposit liability increased to $1.9 million at June 30, 2018. To refund deposits and to pay for other liabilities and expenses, the Program had $41.9 million in equity in cash and cash equivalents and investments in State Treasury at June 30, 2018. Additional information on the Program's financial information is included in the Program's financial statements in Chapter 3.

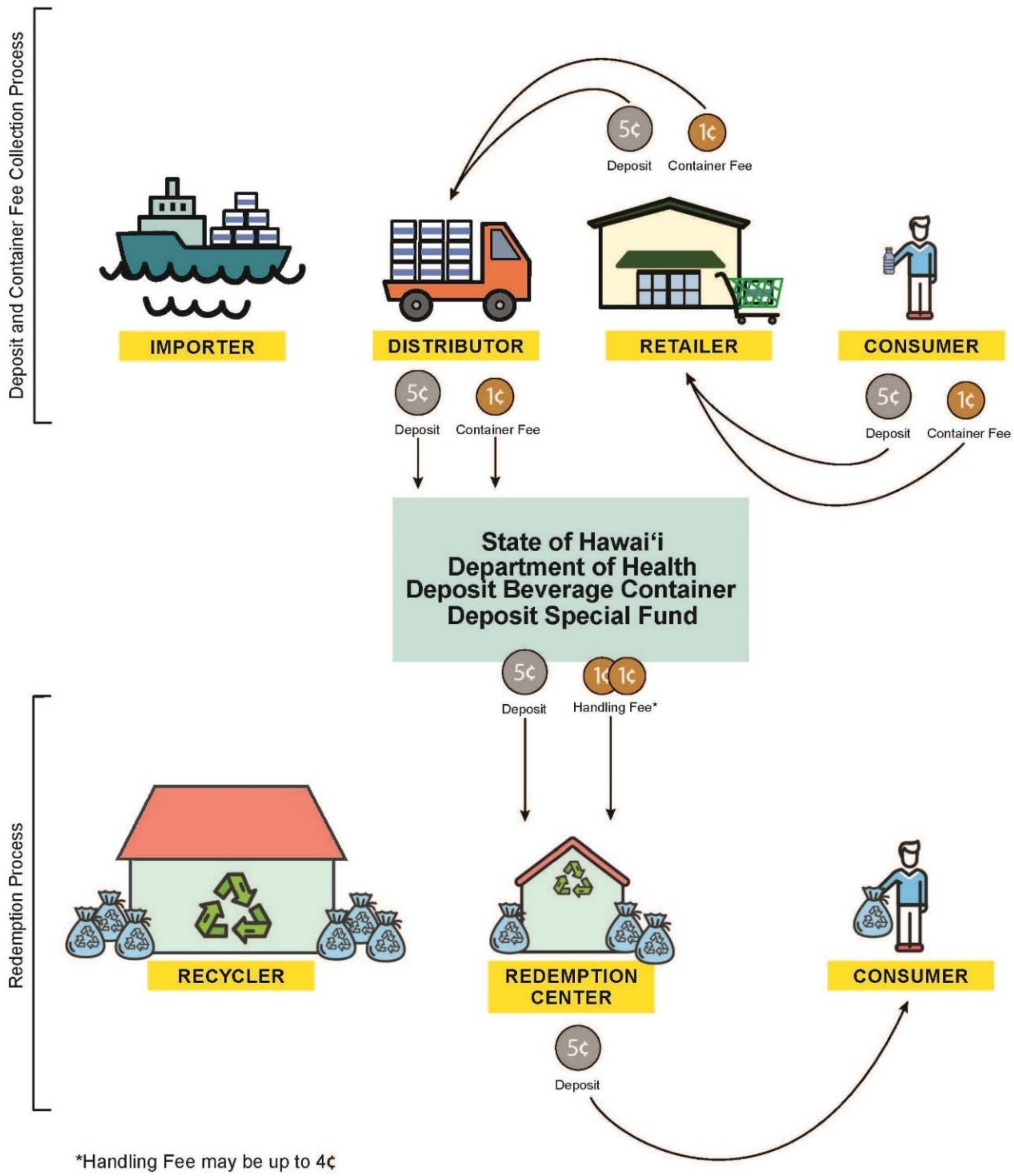
Overview of the Deposit and Redemption Process

The Program requires deposit beverage distributors (distributors), defined in the HRS as "a person who is a manufacturer of beverages in the sale of filled deposit beverage containers or who imports and engages in the sale of filled deposit beverage containers," to pay a deposit and container fee to the Program. In turn, distributors shall pass on the costs to dealers or consumers. Dealers are defined in the HRS as "a person who engages in the sale of beverages in deposit beverage containers to a consumer for off-premises consumption in the State."

Consumers or redeemers, as defined by the HRS, turn in empty containers to redemption centers and claim the deposit amount. Redemption centers then deliver containers to recycling facilities and submit required forms and documentation to the Program to obtain reimbursement for deposits and handling fees.

Exhibit 1.1 below illustrates the overall deposit and redemption process for a typical scenario.

Exhibit 1.1
Overview of Deposit and Redemption Process



Source: KMH LLP

Deposit and Container Fee Collection Process

Distributors of beverage containers are responsible for paying deposits and container fees to the Program when they sell, donate, or otherwise distribute beverages in applicable containers in the State. The deposit is $0.05 and the container fee is $0.01 on each eligible beverage container manufactured in or imported into Hawai‘i. The container fee was $0.015 as of September 1, 2012, but was lowered effective September 1, 2015, to $0.01 due to the statewide redemption rates falling below 70 percent since FY 2015, as shown in Exhibit 1.2 below.

Exhibit 1.2
Deposit Container Redemption Rates

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 use and 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 Program.

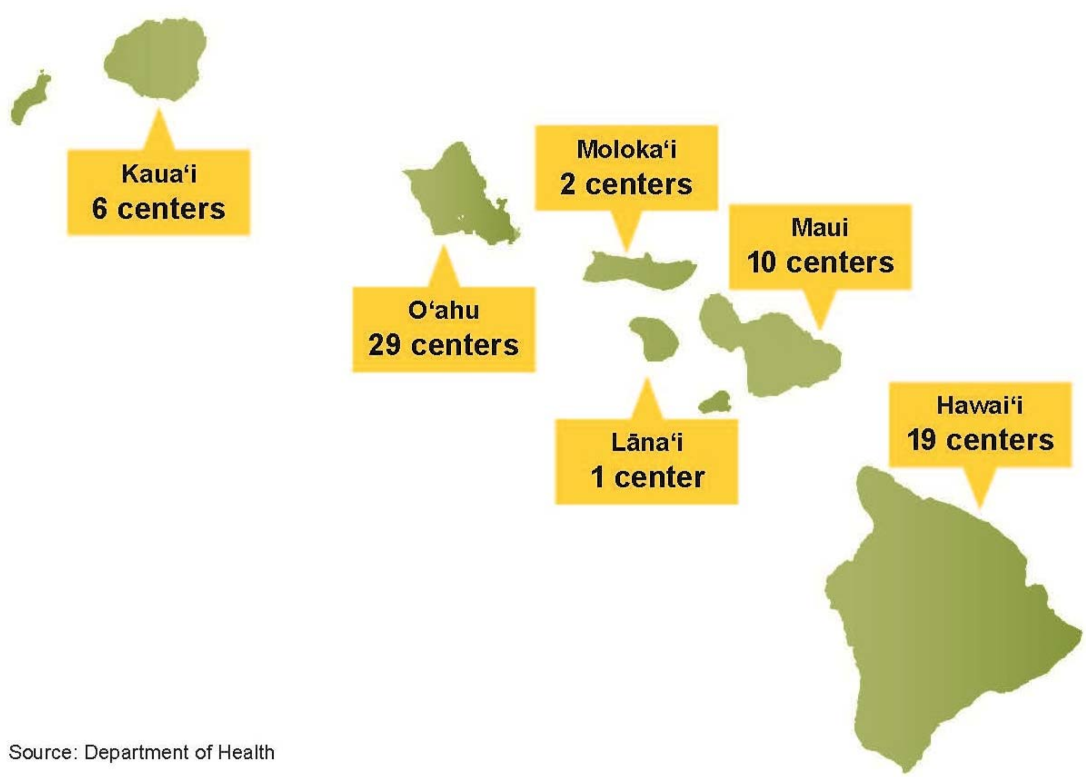
Redemption Process

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 2018, the Program paid handling fees between $0.02 and $0.04 per container, depending on the location of the redemption center and the end use of the recycled containers. Except for glass containers, redemption centers on Oahu were paid $0.02 per beverage container delivered to recyclers/recycling mills, while redemption centers on other islands were paid $0.03 per beverage container. To encourage remanufacturing of glass, handling fees for glass were $0.02 for agriculture/construction and $0.04 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 Hawaiʻi 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 the redemption center is operated by a recycler permitted by the Department); (5) remain open at least thirty hours per week in high density population areas, of which at least five hours shall be on Saturday or Sunday; and (6) forward the documentation necessary to support claims for payment as stated in Section 342G-119, HRS (redemption center reporting requirements).

As of June 2018, there was a total of 67 certified redemption centers statewide. Exhibit 1.3 provides a breakdown of sites on each island. This represents an 11% decrease in redemption centers from June 30, 2016.

Exhibit 1.3
Redemption Centers in Hawaiʻi



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 Program-provided segregated rates to calculate the number of redeemed beverage containers. These segregated rates are established by the Program based on statewide statistical studies of containers being redeemed at redemption centers. Since the conversion rate is an average, this practice may result in individual consumers receiving more or less than $0.05 per beverage container redeemed. The number of beverage containers per pound by material type is required to be posted at all redemption centers.

Exhibit 1.4 contains the current segregated rates in effect during FY 2018, which were effective beginning December 2010. Redemption centers may not issue refunds for beverage containers redeemed without the *HI-5¢* marking.

Exhibit 1.4
Hawai‘i Deposit Beverage Container Rates for Weighing

Source: Department of Health

Redemption Rate

The redemption rate is a key performance measure of the Program’s effectiveness in meeting its objectives, and it determines the container fee charged to consumers. The redemption rate is calculated as the ratio of containers redeemed to containers manufactured or distributed, as represented by deposits collected from distributors. The usefulness of this performance measure is diminished if either the containers redeemed data provided by redemption centers or the deposits collected data provided by distributors is inaccurate. An inflated redemption rate may also result in consumers paying higher container fees.

Prior Audits

The Office of the Auditor has conducted six 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 that 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 processes because the Program had not developed standard redemption procedures or levels of service. The Program failed to develop procedures to verify that data submitted by distributors was accurate or whether resulting payments received from distributors were substantiated. 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 on behalf of the Office of the Auditor, found that the Program lacked adequate procedures to prevent or detect if distributors fraudulently or erroneously under reported containers sold or distributed, or if redemption centers fraudulently or erroneously over reported containers redeemed. Deposit and fee collections from distributors as well as payments to 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 on behalf of the Office of the Auditor, found that there were several deficiencies that exposed the Program to fraud, including overreliance on self-reporting by the Program personnel and lack of systematic compliance inspections. Deposits and fee collections from distributors and 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 put its continued operation at risk. It 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 redemption centers and an absence of a detailed audit function. It also found that inattention to basic management functions exacerbated the Program's inability 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. It found that remaining Program flaws resulted in tens of thousands of dollars in underpayments to the Program, which directly affect the continued financial stability of the Program. It found that one distributor, Whole Foods Market, Inc. (Whole Foods), substantially underpaid the Program for more than six years. For the first six years that Whole Foods operated in Hawai‘i, they paid the Program $0.06 per case instead of $0.06 per container. Through consultation with the Department of the Attorney General, the Program was advised that it would be able to collect only on underpayments from July 1, 2012 and not for the full six-year period. The total additional payment for the under reported deposit beverage fees for the period July 1, 2012 through December 31, 2014 was made in June 2016 and amounted to $46,198. The contributing factors identified in Report No. 13-08 have not been corrected and continue to expose the Program to the risk of inaccurate or fraudulent reporting from distributors and redemption centers.

Report No. 17-02, *Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2016* (2017), conducted by the Office of the Auditor and N&K CPAs, Inc., resulted in findings related to operational risks. It found that factors identified in prior reports have not been corrected and continue to expose the Program to the risk of inaccurate or fraudulent reporting from distributors and redemption centers.

Objectives of the Audit

1. Perform a financial and program audit of the Program.
   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, we performed limited testing of distributors' and redemption centers' compliance with Chapter 342G, Part VIII, HRS.

For testing of distributors, we obtained from the Program a list of cash receipts from 264 distributors for the fiscal year ended June 30, 2018, and judgmentally selected the largest 24 distributors for testing. We tested one random month from the fiscal year ended June 30, 2018, for each of these 24 distributors. With the assistance of the Program, we requested a detailed schedule of invoice numbers and distribution values (container count, container fee amount, and deposit amount) that supported the monthly distributor report submitted by the distributor for that respective month. We subsequently selected invoices from the detailed schedule of invoice numbers and distribution values to verify that all containers reported on the distributor’s invoice were properly substantiated by supporting documents and the proper deposit and container fees were reported and paid to the Program. For distributors that also act as retailers, this procedure could not be performed because they report individual retail sales to customers and reviewing invoices would be ineffective. We performed alternative procedures by recalculating individual line items on the schedule provided by these distributors. The 24 distributors selected for testing are shown in Exhibit 1.5.

Exhibit 1.5
Distributors Selected for Testing

Distributor	FYE 6/30/18 Total Receipts	Month Selected for Testing
Paradise Beverages, Inc.	$ 11,592,477	July 2017
Pepsi Beverage Company	9.590,699	August 2017
Coca-Cola Bottling of Hawai‘i LLC	7,075,450	September 2017
Anheuser-Busch Sales of Hawai‘i, Inc.	6,653,042	October 2017
Costco Wholesale Corporation	5,328,545	November 2017
Ito En (Hawai‘i) LLC	2,774,568	December 2017
Hawaiian Isles Water Company	2,440,586	January 2018
Maui Soda & Ice Works, Ltd.	1,215,744	February 2018
Hawaiian Sun Products, Inc.	1,139,081	March 2018
Menehune Water Co., Inc.	900,912	April 2018
Sam’s Club West Inc. (Sam’s Club East)	879,282	May 2018
The Home Depot USA Inc.	625,853	June 2018
Safeway, Inc.	856,756	June 2018
Target Corporation	575,382	May 2018
Southern Glazer’s Wine & Spirits, LLC	563,578	April 2018
Johnson Brothers of Hawai‘i, Inc.	488,109	March 2018
Wal Mart Stores, Inc.	418,024	February 2018
Hawaii Volcanic Beverages	281,398	January 2018
C & S Wholesale Grocers, Inc.	265,207	December 2017
Young’s Market Company, LLC	232,283	November 2017
Whole Foods Market, Inc.	154,570	September 2017
Kahuna Distribution LLC	117,618	October 2017
Southern Foods Group dba Meadow Gold Dairy	114,713	August 2017
James D. Swoish, Inc.	97,624	July 2017
Total Distributors receipts selected for testing	**$54,381,501**	
Other Distributors receipts	**$1,990,212**	
Total receipts from Distributor Population (264)	**$56,371,713**	

Source: KMH LLP

We visited ten of the State's 67 redemption centers as of June 30, 2018, and observed whether the redemption centers had a certified redemption center sign, were open during posted hours, informed customers of the procedures/policies of the redemption count and refund values, used properly calibrated scales to weigh redeemed beverage containers, paid appropriate refunds to consumers, provided consumers with a receipt for their redemptions, segregated weighted items, and properly recorded the redemption transactions. Our tests included determining that the deposit refunds complied with 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
Atlas Recycling Center	Hawai‘i	30 Makaala St., Hilo
Reynolds Recycling	Kaua‘i	3343 Wilcox Rd., Lihue
Aloha Glass Recycling	Maui	74 Amala Pl., Kahului
C.M. Recycling LLC	Oahu	204 Sand Island Access Rd., Honolulu
ICR (Island Recycling)	Oahu	61-140 Kaomi Lp., Kapolei
Reynolds Recycling	Oahu	99-1160 Iwaena St., Aiea
Reynolds Recycling	Oahu	1106 University Ave., Honolulu
K & C Metal LLC	Oahu	94-037 Waipahu Depot Rd., Waipahu
RRR Recycling Services	Oahu	46-640 Alaloa St., Kaneohe
RRR Recycling Services	Oahu	47-705 Kamehameha Hwy., Kaneohe

Source: KMH LLP

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

Audit fieldwork was conducted from August 2018 to November 2018, 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 this reasonable basis.

Chapter 2
Compliance Testing of Distributors and Redemption Centers

Summary of Findings

This is the seventh biennial financial and program audit of the Program since its inception. As in the prior years' audits, we have found that the Program has failed to develop and execute procedures to verify the accuracy and completeness of data used to prepare the required forms that determine:

1. Deposits and container fees paid to the Program by the distributors
2. Deposits and handling fees paid to the redemption centers

Because procedures were not developed and executed to verify the accuracy of critical self-reported data, the Program has essentially relied upon and accepted that cash receipts from the distributors and payments made to redemption centers were accurate and complete.

Due to this failure of the Program to validate the accuracy and completeness of critical data, our testing has found inaccuracies and possible fraudulent reporting in the data used in the aforementioned calculations. Our testing revealed the following:

1. There were differences noted between the amounts reported on the Monthly Distribution Report Form and the distributor's supporting records
2. There potentially exists fraudulent overpayments of deposit refund reimbursements to redemption centers

Given the discrepancies noted in the prior years' audits and the discrepancies noted above and considering the limited sample testing performed, there are concerns as to whether the amounts being remitted by the distributors or amounts paid to the redemption centers are appropriate.

A detail description of our findings is included below.

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

The Program does not have procedures in place to verify or inspect data that is reported on the Monthly Distribution Report Form submitted by the distributors. Distributors are required to maintain records reflecting the manufacture of their beverages in deposit beverage containers as well as the importation and exportation of deposit beverage containers under Section 342G-103, HRS.

Because distributors can pass on beverage container costs to retailers or consumers, distributors have an inherent incentive to under report sales/distributions of deposit beverage containers. Distributors have the opportunity to fraudulently or erroneously collect deposits and container fees from retailers and not remit the amounts to the Program. Based on the results of the current and previous audits, differences exist between the report totals on Monthly Distribution Report Form and the supporting records for those amounts. The majority of these differences indicate potential underpayments by distributors.

Undetected underpayments by distributors would result in the Program having fewer funds available to pay for deposit redemptions and Program administrative costs. This potential understatement of deposit containers sold by distributors could also lead to an inflated redemption rate. A skewed redemption rate hampers the Program’s ability to make decisions including budgeting and adjustments to container fee rates to sustain the Program’s operations.

The lack of verification procedures severely restricts the effectiveness of the Program’s enforcement powers

Should the Program determine that that any person has violated or is violating any provision of Chapter 342G, HRS, the Program has broad enforcement powers, including assessing an administrative penalty, ordering corrective actions, and commencing civil action in civil court. However, the lack of a systematic verification or inspection process to identify potential fraudulent occurrences or errors in the amounts being reported severely limits the determination of any violations, thereby precluding any enforcement actions.

Active monitoring procedures or an audit function would identify potential “red flags” that may be indicative of material errors and/or fraudulent reporting. This would allow the Program to conduct an investigation and take corrective action, including but not limited to assessing penalties for non-compliance.

Enforcement powers, when applied, serve as an effective deterrent to any fraudulent activities or behaviors. Alternately, the lack of any enforcement or consequences may encourage or promote lackadaisical attitudes towards record keeping and compliance with the Program’s requirements. Under Section 342G-103, HRS, distributors are required to make their records available, upon request, for inspection by the Program. However, during the audit, there were difficulties encountered in obtaining supporting records from the various distributors. In fact, one distributor did not respond to the request for supporting records. Without consequences, distributors may believe it’s acceptable to breach their responsibility to provide supporting records.

Differences Identified Between Amounts Reported to the Program and the Distributor’s Supporting Records

During our detailed testing of the 24 distributors selected, we found exceptions in six distributors. We noted that one distributor did not respond to our request for supporting records or schedules to support the Monthly Distribution Report Form for the selected months. We also noted two distributors that could not provide detailed schedules of invoice numbers and distribution values (container count, container fee, and deposit amounts). As a result, we could not fully complete our testing. These two distributors only provided summary data that was used to prepare the Monthly Distribution Report Form.

Exhibit 2.1 illustrates the testing results for distributors which had differences between the Monthly Distribution Report Form submitted to the Program and the supporting records comprised of a detailed schedule of invoice numbers and distribution values provided by the distributor.

Exhibit 2.1
Exceptions Noted in Distributor Testing - Monthly Distribution Report (MDR) Form

Distributor	Month	# of Units Per Schedule	Fee ($) Per Schedule	# of Units Per MDR	Fee ($) Per MDR	Diff (Units) Over/ (Under)	Diff ($) Over/ (Under)
Pepsi Co.	Aug 17	13,832,940	$829,976.38	13,832,903	$829,974.18	(37)	($2.20)
Young's Market	Nov 17	*	*	335,148	$20,108.88	*	*
HI Volcanic	Jan 18	341,016	$20,460.96	295,176	$17,710.56	(45,840)	($2,750.40)
Maui Soda	Feb 18	1,409,335	$84,560.08	1,409,254	$84,555.24	(81)	($4.84)
Hawaiian Sun	Mar 18	1,252,524	$75,151.44	1,252,523	$75,151.38	(1)	($0.06)
Safeway, Inc.	Jun 18	1,259,573	$75,574.38	1,260,199	$75,611.94	626	$37.56
Target Corp.	May 18	760,481	$45,628,86	760,493	$45,629.58	12	$0.72

*valid data not determinable

Source: KMH LLP

Several reasons were provided by distributors for the errors found. Pepsi Beverages Company, Target Corporation, and Hawaiian Sun indicated that the differences between the detailed schedule of invoice numbers and distribution values and the Monthly Distribution Report Form were due to input errors.

Young's Market Company, LLC (Young's Market) provided two different summary reports that were used to populate the Monthly Distribution Report Form. Although Young's Market selected the higher of the two unit counts for beverage containers, it could not provide a reason for differences or identify which one was correct. As the differences in the reports could not be explained, we could not determine which counts should be reported on the Monthly Distribution Report Form.

While responding to our audit request, Hawaii Volcanic Beverages (HI Volcanic) self-reported that it had underpaid its deposit and container fees for January 2018. After further research by HI Volcanic, they found similar underpayments for February, April and June 2018 and communicated these differences to the Program. HI Volcanic noted that some new products that were subject to the deposit and container fees were excluded from the submitted Monthly Distribution Report Form. HI Volcanic worked with the Program to make corrective payments and rectify its reporting discrepancies.

Maui Soda & Ice Works, Ltd. (Maui Soda) provided a summary schedule that agreed with the Monthly Distribution Report Form and the requested detailed schedule of invoice numbers and distribution values. There were unexplained differences between the system generated summary schedule and detailed schedule. Maui Soda notified us that its software provider would be contacted.

Upon our audit request, Safeway, Inc. (Safeway) self-reported that it had overpaid its deposit and container fees for June 2018. Safeway noted that a certain container type was being double-counted in its system, causing the difference. Safeway noted that it would be corrected moving forward.

In our sampling of specific invoices, we also found differences between the invoices and the summary schedule that was provided as support for the Monthly Distribution Report Form. As only a sample of these invoices was tested, it raises concerns over the distributors' controls over accounting and reporting of deposits and container fees.

Exhibit 2.2 illustrates the differences between the sampled invoices and the schedule provided to support the Monthly Distribution Report Form submitted to the Program.

Exhibit 2.2
Exceptions Noted in Distributor Testing - Sampled Invoices

			Recalculated Deposit and Container Fee				
Distributor	**Invoice**	**Units Per Invoice**	**Deposit**	**Container Fee**	**Total**	**Fees Reported on MDR**	**Difference**
Menehune	6189891	4,620	$231.00	$46.20	$277.20	$264.60	$12.60
Menehune	1629905	156	$7.80	$1.56	$9.36	$0.43	8.93
Menehune	1771173	59	$2.95	$0.59	$3.54	$3.45	0.09
							$21.62

Source: KMH LLP

Menehune Water Co., Inc. (Menehune) noted that the exceptions above were attributed to input errors in their detailed schedule of invoice numbers and distribution values, which is prepared manually. The total from the detailed schedule is used to prepare the Monthly Distribution Report Form. As a result of the errors noted above, Menehune under reported the containers sold for the month of April 2018, which resulted in underpayments of $21.62.

We noted five distributors that remitted detailed schedules that either did not reflect invoice transactions or did not contain invoice data in which invoices could be sampled. We performed alternative procedures by randomly selecting line items in the schedule provided and checking the propriety of certain calculations. Because we were unable to perform our detailed test and because our alternative procedures were inconclusive, we were unable to determine if the underlying transaction that supports the schedule was accurate.

Differences identified indicate a lack of adequate internal controls over supporting records at the distributor

These errors and differences between the Monthly Distribution Report Form and supporting records raise concerns over the distributors' process and procedures in maintaining adequate supporting records. Internal controls over the financial reporting process provide reasonable assurance that the financial information is complete and accurate and that the Monthly

Distribution Report Forms are reliable. The presence of these errors and differences suggest underlying issues with the quality of the distributors' internal control systems and reporting process. The consequences of a breakdown or ineffective internal controls increases the risk for erroneous or fraudulent reporting resulting in underpayments by the distributors to the Program.

The Program Pays Redemption Centers Based on Unsupported Redemption Activity

The Program reimburses and pays for beverage containers redeemed by redemption centers on a monthly basis based on forms prepared by the redemption centers. We found that the Program does not require the redemption centers to provide any supporting records for the amounts reported and paid to the redemption centers. Consequently, the Program does not know if amounts reported and paid are appropriate.

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

Section 342G-119, HRS, specifies that the Program shall pay redemption centers a handling fee and deposit refunds based on collection reports submitted by the redemption centers. The Program reimburses redemption centers for the amount of deposit refunds paid to consumers based on the 5¢ Deposit Refund Request Form (DR-1) that is prepared by the redemption centers. The DR-1 form includes 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.

For handling fees, the redemption centers prepare a Handling Fee Request Form (HR-1), which details the type of materials, the weight of the materials, the shipping or delivery dates and the total handling fee amount requested. The Program pays redemption centers 50 percent of the handling fees claimed at the time of the initial request for the amounts shipped to end-user recycling facilities. The handling fees paid to the redemption centers are based on container equivalents from the weight of containers redeemed and sent to recycling facilities as reported by both the redemption centers and recycling facilities. The remaining balance is paid upon receipt of corroborating weight reports prepared by the end-user recycling facilities.

The Program does not require redemption centers to submit any supporting records with the deposit refund reimbursement and handling fee requests. Because the Program reimburses redemption centers for all deposits refunded, there are opportunities for redemption centers to overstate redemptions and consequently receive overpayments for both the deposit refunds and handling fees.

The Program previously indicated plans to address these issues 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 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 recycled containers account for some of these differences. The Program has established a standard shrinkage rate of up to 2.5 percent. The Program pays the handling fee when it receives documentation reporting 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.

During FY 2018, the handling fees were between $0.02 and $0.04 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 Program by distributors. Ultimately, redemption overpayments, irrespective of the cause, will result in the Program having fewer funds available to pay deposit refunds and handling fees.

Program still lacks a process to detect overstating by redemptions centers

Redemption centers have an inherent incentive to overstate the amount refunded for deposit beverage containers redeemed to increase the amount of handling fees generated. Knowing this, the Program should have an audit process in place to detect such overstating by redemption centers. The Program performs a redemption center site inspection to determine compliance with proper posting of signage and with specific operational redemption process requirements. However, we found that none of the Program inspections conducted during FY18 included procedures to detect overstatements, such as inspecting deposit refund reimbursement request forms by obtaining and validating amounts reported on 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 redemption centers to determine if refunds were properly calculated and whether properly segregated rates were used, or investigated complaints received from the public. The Program has failed to implement an effective systematic compliance inspection and enforcement process that would limit the risk of overpayment of redemptions.

The Program has considered implementing an audit function through the services of an independent public accounting firm. However, to date, the request for proposal for these services has not yet been finalized.

Potentially Fraudulent Overpayments of Deposit Refund Reimbursements to a Redemption Center Discovered

In early October 2018, we performed 15 unannounced visits at 10 different redemption centers located throughout the State to verify that the redemption centers were in compliance with the law. In four of the visits, we requested redemption center staff to redeem beverage containers by counting each container. In the remaining eleven visits, we requested redemption center staff to redeem beverage containers by weight.

As part of our testing of redemptions by weight, in four of our visits we standardized our redemptions by bringing twelve glass bottles of the same brand to ensure that weight results were similar. Our visits also included visual inspections of the location to check for compliance with Title 11, Chapter 282, Hawai'i Administrative Rules (HAR), which established minimum standards for the collection of empty beverage containers, including but not limited to proper posting of signage and with specific operational redemption process requirements. In these visits, we did not note any exceptions. Some of the redemption centers used a "mechanical device" similar to a reverse vending machine or a type of register, whereby amounts were input or registered by the "mechanical device" and a receipt was generated detailing amounts redeemed and paid by the redemption centers. Other redemption centers recorded the transactions manually on hand written logs, and a "10-key" tape or a manually prepared form served as the receipt.

Although the redemption centers tested appear to be refunding deposit beverage containers at the Program'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 Section 11-282-61(b), HAR, the Program should consider re-evaluating the segregated rates.

We waited about a month for the redemption centers to submit their DR-1 forms to the Program for reimbursement. We then had the Program request from the redemption centers the detailed supporting records for the respective DR-1 form.

For the redemption centers visited, we requested copies of supporting records for the DR-1 form. The supporting records varied between the redemption centers. Generally, the supporting records were daily redemption transaction logs that detailed the type of material, weight and/or counts of the container, the price and amounts paid. For those redemption centers using a "mechanical device," the supporting redemption transaction logs were computer generated, whereas the other redemption centers manually prepared redemption transaction logs.

We compared the receipts from the redemptions received from our visits and traced them to the supporting redemption transaction logs requested from the redemption centers.

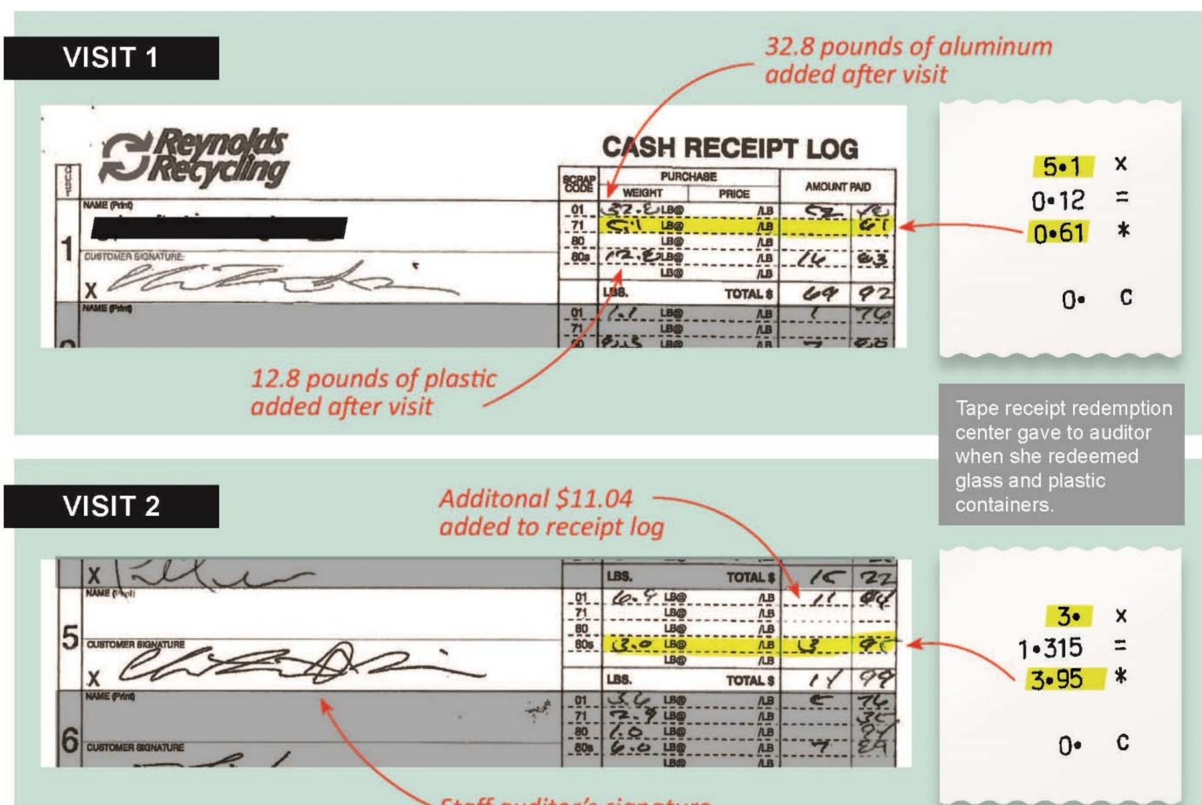
We found that in 2 out of 15 redemption center visits, the amounts provided in the redemption transaction logs, noted as the manually prepared Cash Receipts Log, did not match to our receipts and the amount paid. Both of the discrepancies were at the **Reynolds Recycling location at 1106 University Avenue** on October 2, 2018 and October 4, 2018. During those visits, our staff member was required to sign a Cash Receipts Log, which was submitted by the redemption center as detailed support for its DR-1 form. The staff auditor also received a "10-key" tape receipt that detailed the calculation of the amount received.

As the October 2, 2018 receipt indicates, our staff auditor was paid 61 cents for 5.1 pounds of glass bottles redeemed; however, after the visit, 32.8 pounds of aluminum cans and 12.8 pounds of plastic containers were added to the Cash Receipts Log, adding $52.48 and $16.83, respectively, to the total. See Exhibit 2.3. As a result, **instead of $0.61, the redemption center**

was reimbursed $69.31 by the Program. Two days later, our staffer submitted three pounds of plastic containers and was paid $3.95, but 6.9 pounds of aluminum cans were added to the Cash Receipts Log, which added $11.04 to the total. **The redemption center was reimbursed $14.99 instead of $3.95.** In both instances, the Cash Receipts Logs appear to have been altered after we had visited the location to reflect additional material type containers, resulting in an increase in amounts reimbursed. We reported our findings to the Office of the Auditor and the Director of the Department of Health on November 20, 2018.

During FY 2018, the total deposit amounts reimbursed to Reynolds Recycling was approximately $7.96 million. Although no specific information was available for the University location, the total amount reimbursed to Reynolds Recycling, coupled with the fact that only a small sample was tested, raises concerns as to the potential amount of overpayments that may have been paid to the redemption center.

Exhibit 2.3
Redemption Center Altered Cash Receipt Logs to Receive Higher Program Reimbursements



Source: Department of Health, KMH

Conclusions

The Program’s lack of oversight over self-reporting by distributors and redemption centers expose the Program to a greater risk of fraud and incorrect reporting. Plans to address these program weaknesses are pending and have yet to be implemented. Until the Program implements effective preventative and detective activities to verify reports submitted, under reported 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 Program, including questions regarding the container fee rate necessary to operate the Program.

Recommendations

The Deposit Beverage Container Program management should:

1. Develop a risk-based process to select distributor and redemption center reports submitted to the Program to audit on a periodic basis. The Program should continue to 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. In addition to hiring personnel or external consultants to perform audits, below are additional considerations when developing a risk-based process to monitor distributors and redemption centers:

    - Require distributors to send Monthly Distribution Report Form supporting records (e.g., schedule of invoices, shipping documents, point-of-sale reports, etc.) to the Program on a periodic and/or cycle basis. Having distributors “show their work” even at a summary level will encourage more oversight at the distributor level in maintaining adequate records, thereby reducing errors and deterring fraud. This may also expose differences that the Program can address quickly as noted in our testing results.

    - Ensure that the audit process developed includes a risk assessment derived from distributor and redemption center data based on the reports submitted. This includes but is not limited to performing analytics and trend analysis to target certain distributors and redemption centers with unusual fluctuations. This will increase the effectiveness and efficiency of the Program’s limited resources.

2. Summarize the results of distributor and redemption center audits and assess whether enforcement actions should be considered to ensure amounts that are being reported are appropriate. Consider conducting follow-up audits. The Program may also want to consider public announcements of violations to heighten awareness of penalties and potentially hurt distributors’ reputations, creating an incentive to comply with Program laws and encourage distributors to accurately pay deposits and container fees.

3. Modify the Program requirements in order to increase distributors' accountability for information provided to the Program, including but not limited to the following modifications:

   - Require distributors to develop and submit to the Program for approval an internal control process to ensure that accurate data is entered on the Monthly Distribution Report and that adequate records are maintained.
   - Require distributors to obtain independent audits for years ending in odd-numbers.

4. For redemption centers, the Program should consider having all redemption centers install reverse vending machines or some type of "mechanical devices" at all of the locations. This would significantly reduce any potential fraud or errors related to manually prepared redemption transaction logs and receipts by removing the ability to alter or write-in the amounts and type of beverage containers received.

Chapter 3
Financial Statement Audit

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 Special Fund (the Fund), which comprise the balance sheet – governmental fund as of June 30, 2018, 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.

1003 Bishop Street ■ Suite 2400 ■ Honolulu, HI 96813 ■ Telephone: 808-526-2255 ■ Fax: 808-536-5817 ■ www.kmhllp.com

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, 2018, 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 Hawai‘i or the State of Hawai‘i, Department of Health that are attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the respective financial position of the State of Hawai‘i or the State of Hawai‘i, Department of Health as of June 30, 2018, and the respective 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 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 18, 2019 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 the effectiveness of the Fund’s 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.

KMH LLP

KMH LLP

Honolulu, Hawai‘i
January 18, 2019

Department of Health

State of Hawai`i

Deposit Beverage Container Deposit Special Fund
Balance Sheet - Governmental Fund
June 30, 2018

Assets

Equity in Cash and Cash Equivalents and Investments in State Treasury	$ 41,941,940
Accounts Receivable	69,071
Interest Receivable	323,066
Total assets	$ 42,334,077

Liabilities and Fund Balance

Liabilities:	
Vouchers and contracts payable	$ 2,670,665
Accrued wages and employee benefits	32,987
Beverage container deposits	1,931,164
Total liabilities	4,634,816
Fund Balance--	
Committed to Deposit Container Program	37,699,261
Total liabilities and fund balance	$ 42,334,077

See accompanying notes to the financial statements.

Department of Health

State of Hawai`i

Deposit Beverage Container Deposit Special Fund
Statement of Revenues, Expenditures and
Change in Fund Balance - Governmental Fund
For the Fiscal Year Ended June 30, 2018

Revenues:	
Deposit beverage container fees	$ 9,427,523
Unredeemed deposits	14,746,567
Interest income	426,678
Non-imposed fringe benefits	3,963
Total revenues	24,604,731
Expenditures:	
Handling and redemption fees	16,305,300
Operating expenditures	1,158,840
Administrative expenditures	48,718
Total expenditures	17,512,858
Change in fund balance	7,091,873
Fund Balance at July 1, 2017	30,607,388
Fund Balance at June 30, 2018	$ 37,699,261

See accompanying notes to the financial statements.

Department of Health
Deposit Beverage Container Deposit Special Fund
State of Hawai`i
Budgetary Comparison Statement
For the Fiscal Year Ended June 30, 2018

	Budgeted Amounts			
	Original	Final	Actual on Budgetary Basis	Variance Favorable (Unfavorable)
Revenues--				
Current-year Funds	$ 71,174,271	$ 71,225,267	$ 56,956,777	$ (14,268,490)
Expenditures--				
Environmental Health Administration	71,174,271	71,225,267	60,880,981	10,344,286
Deficiency of revenues under expenditures	$ -	$ -	$ (3,924,204)	$ (3,924,204)

See accompanying notes to the financial statements.

NOTE A - ESTABLISHMENT AND PURPOSE OF THE FUND

In 2002, the State of Hawaiʻi 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 Hawaiʻi 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 Hawaiʻi (the State) collects from manufacturers and distributors, a $0.05 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 DBC Fund assessed a per container handling fee of $0.015 per container until August 31, 2015. Effective September 1, 2015, the handling fee was lowered to $0.01 per container.

The DBC Fund is administered by employees of the Solid Waste Branch, Environmental Management Division of the State of Hawaiʻi, 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, 2018, 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 $0.01 per beverage container sold. In

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

addition, the amounts for deposits of $0.05 are deferred when collected, and the amount estimated to be forfeited is recognized as revenue at the end of the fiscal year.

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, 2018, the DBC Fund's portion of these accruals was as follows:

Total fund balance on the modified-accrual basis of accounting	$ 37,699,261
Capital assets used in governmental activities are not financial resources and therefore are not reported as an asset in the governmental funds	3,655
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	(236,251)
Total net assets on the full accrual basis of accounting	$ 37,466,665

At June 30, 2018, the DBC Fund's portion of the department-wide activities is not materially different from the DBC Fund's activity.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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) 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.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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, 2018, 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 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, 2018.

6. Beverage Container Deposits

Deposits of $0.05 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.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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:

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 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.

NOTE C - BUDGETING AND BUDGETARY CONTROL (Continued)

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.

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.

NOTE C - BUDGETING AND BUDGETARY CONTROL (Continued)

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 2018, to the change in fund balance presented in conformity with U.S. GAAP follows:

Deficiency revenue under expenses - actual on a budgetary basis	$ (3,924,204)
Reserve for encumbrances at year end	13,421,049
Expenditures for liquidation of prior year encumbrances	(5,122,538)
Accruals and other adjustments	2,717,566
Change in fund balance - U.S. GAAP basis	$ 7,091,873

NOTE D - BEVERAGE CONTAINER DEPOSITS

The changes to the beverage container deposits liability during fiscal year 2018 were as follows:

Balance as of July 1, 2017	$ 1,698,494
Increase: Deposits received from distributors	46,976,905
Decrease: Payments made to recycling centers, net of refunds	(31,997,668)
Decrease: Unredeemed deposits recognized as revenue	(14,746,567)
Balance as of June 30, 2018	$ 1,931,164

NOTE E - EMPLOYEE BENEFIT PLANS

Substantially all eligible employees of the DBC Fund participate in the State's retirement and other post-employment benefit plans. The State's plans include the Employee's Retirement System (ERS) of the State, the Hawaii Employer-Union Health Benefits Trust Fund (EUTF), a deferred compensation plan, and sick leave benefits. For information on the State's benefit plans, refer to the State of Hawaiʻi, ERS's, and EUTF'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. The EUTF CAFR can be found at the EUTF website: http://eutf.hawaii.gov.

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, 2018, 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, 2018.

A Hawaii Limited Liability Partnership

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, 2018, and the related statements of revenues, expenditures and change in fund balance – governmental fund, budgetary comparison for the fiscal year then ended, and the related notes to the financial statements, and have issued our report thereon dated January 18, 2019.

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 opinions 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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

1003 Bishop Street ■ Suite 2400 ■ Honolulu, HI 96813 ■ Telephone: 808-526-2255 ■ Fax: 808-536-5817 ■ www.kmhllp.com

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 results 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.

KMH LLP

KMH LLP

Honolulu, Hawai‘i
January 18, 2019

KMH LLP's Comments on the Department of Health's Response

KMHLLP

A Hawaii Limited Liability Partnership

To the Auditor
State of Hawai‘i

The Office of the Auditor transmitted a draft of this report to the Department of Health (DOH) on February 15, 2019. DOH's written response, provided to us on February 21, 2019, is included in its entirety on pages 44 - 45.

DOH concurred with our overall findings and recommendations, acknowledging the Deposit Beverage Container Program (Program) has been unable to overcome long-term and systemic issues that have affected operations "over the years." According to DOH, fraud is a serious and real risk, and it will pursue outsourcing as many of the Program's functions as feasible. In particular, DOH identified outsourcing auditing services, which it claimed would allow the Program staff to focus on inspections and enforcement to improve accountability.

We note that DOH did not provide any specifics on these efforts. In addition, such monitoring controls detect fraud after it occurs. As we mentioned in our recommendations, the Program should consider requiring that distributors and redemption centers take a more active role in monitoring efforts by implementing controls to improve the accuracy and completeness of supporting records and to prevent and/or detect fraud.

Moreover, in response to our recommendation that the Program consider having all redemption centers install reverse vending machines or some type of mechanical device at all locations, DOH pointed out that no certified redemption centers utilize the reverse vending machines, and have been phased out of operations due to numerous shortcomings. However, as we noted in our report, "mechanical devices" is a broad term that also refers to machines generate detailed receipts for redemption center records, as opposed to the manually prepared transaction logs and receipts that redemption centers currently rely on. Such devices would significantly reduce the risk of fraud or errors by eliminating the ability of staff to alter or write-in the amount and type of beverage containers received.

We appreciate DOH's concurrence with our overall findings and recommendations. We believe that the implementation of our recommendations will improve the accuracy of the deposits and container fees paid to the Program by the distributors and the deposits and handling fees paid to the redemption centers.

KMH LLP

KMH LLP

Honolulu, Hawai‘i
February 25, 2019

1003 Bishop Street ■ Suite 2400 ■ Honolulu, HI 96813 ■ Telephone: 808-526-2255 ■ Fax: 808-536-5817 ■ www.kmhllp.com

Response of the Department of Health

DAVID Y. IGE
GOVERNOR OF HAWAII

BRUCE S. ANDERSON, Ph.D.
DIRECTOR OF HEALTH

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

In reply, please refer to:
File:

February 21, 2019

Mr. Leslie H. Kondo
State Auditor
Office of the Auditor
465 South King Street, Suite 500
Honolulu, Hawaii 96813

Dear Mr. Kondo:

Thank you for sharing the findings of the Financial and Program Audit of the Hawaii Department of Health Deposit Beverage Container Special Fund. We appreciate the opportunity to comment on the audit report's recommendations for strengthening Hawaii's recycling efforts.

As a publicly-funded entity, the Department of Health is responsible for carefully administering state funds and preventing fraud by our contractors. The Department concurs with the overall findings and recommendations of the report and recognizes the Deposit Beverage Container (DBC) Program must implement a comprehensive auditing program and increase reporting requirements, enforcement, and inspection activities.

Long-term, systemic issues have seriously affected this program over the years, and the DBC Program has been unable to overcome challenges related to staffing, workload, and complex fiscal and accounting requirements. The Department of Health will pursue outsourcing as many functions of the DBC Program as feasible to keep the program viable and accountable. In particular, we believe outsourcing auditing services will allow the program staff to focus on inspections and enforcement to improve accountability.

Fraud is a serious and real risk for this program. To address the potential theft discovered during the audit, the DBC Program is utilizing an existing Memorandum of Agreement with the Department of the Attorney General's criminal investigation division to investigate the alleged theft by Reynolds Recycling as described on pages 20-22.

In its fourth recommendation, the audit report refers to a "mechanical device" similar to a Reverse Vending Machine (RVM) as being a viable alternative to increase accuracy for redemptions. While in concept this seems reasonable, there are no certified redemption centers that utilize such a device or a RVM. Over time, RVMs were phased out due to their high purchase cost and maintenance, need for a power source, low storage capacity, flawed database, slow transaction rate, lack of available repair services and frequent jams.

We hope you and your staff will continue to work with the Department of Health to improve the DBC Program as we believe the Auditor's expertise may be an invaluable asset for developing an auditing process that will increase accountability for beverage container distributors and recyclers. On behalf of the Department of Health, I would like to thank you for your support and the opportunity to comment on the audit report. If you have any follow-up questions, please feel free to email or call me.

Sincerely,

BRUCE S. ANDERSON, Ph.D.
Director of Health