# Financial Audit of the Department of Land and Natural Resources

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

Report No. 06-04
June 2006

**THE AUDITOR**
STATE OF HAWAI‘I

## Office of the Auditor

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

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

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

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

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

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

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

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

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

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

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

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

**THE AUDITOR**
STATE OF HAWAI'I
Kekuanao'a Building
465 S. King Street, Room 500
Honolulu, Hawai'i 96813

# OVERVIEW

## *Financial Audit of the Department of Land and Natural Resources*

**Report No. 06-04, June 2006**


## Summary

The Office of the Auditor and the certified public accounting firm of KMH LLP conducted a financial audit of the Department of Land and Natural Resources, State of Hawai‘i, for the fiscal year July 1, 2004 to June 30, 2005. The audit examined the financial records and transactions of the department; reviewed the related systems of accounting and internal controls; and tested transactions, systems, and procedures for compliance with laws and regulations.

In the opinion of the firm, except for the effects of any such adjustments that might have been determined to be necessary had the firm been able to examine evidence regarding the department's liability due to the state general fund as of June 30, 2005, reported in the Federal Grant Fund, the financial statements present fairly, in all material respects, the department's financial position and changes in its financial position for the fiscal year ended June 30, 2005, in conformity with generally accepted accounting principles.

With respect to the department's internal control over financial reporting and operations, we found several deficiencies, including two significant reportable conditions considered to be material weaknesses. The first material weakness is that the department lacks a comprehensive federal grant program management system. As a result, the firm was unable to obtain sufficient evidential matter supporting the department's liability due to the state general fund of $8,302,509 recorded in the Federal Grant Fund and therefore, the scope of the firm's work was not sufficient to enable it to express an opinion on the fund as a whole. The second material weakness relates to the department's inadequate accounting and financial reporting process, which led to misstatements and the omission of required disclosures in its June 30, 2005 financial statements.

We also found that the operation and management of the Division of Boating and Ocean Recreation needs improvement. At the small boat harbors under the division's care, the condition of some facilities pose serious safety hazards. Also, internal controls over the handling of cash and issuance of boating permits are insufficient. For instance, at one of the small boat harbors the combination lock for the safe was not in use and the key was left hanging nearby. Additionally, while the division is supposed to be self-sufficient, the small boat harbors' fee structure has not changed since 1995, making it difficult to cover increasing operating costs.

We further found that there is no department-wide, comprehensive cash management policy. There is no formal, written policy governing the investment and monitoring of cash, accelerated billing and collection, deposit procedures, monitoring of accounts receivables, and planning for cash flow requirements. For example, we noted that the Divisions of Forestry and Wildlife and State Parks do not document

a daily closing cash reconciliation of transactions to receipts. Finally, we found that the Bureau of Conveyances does not effectively manage its human resources.

## Recommendations and Response

We recommend that the department's management develop a centralized, comprehensive system to manage and be responsible for the department's federal programs; determine whether its federal program accounting policy complies with state law; and obtain documentation to support its assertion that the liability reflected in its financial statements as "Due to State Treasury" do not reflect actual moneys owed to the State. The department's management should also investigate the cause for the deficit in its Federal Grant Fund and implement an integrated accounting system for its federal programs.

We further recommend that the department improve the accuracy and effectiveness of its accounting and financial reporting processes by performing additional reviews of its financial statements and disclosures. The department should also perform periodic, supervisory reviews of fiscal staff; test leave record schedules more extensively; have its internal auditor report directly to the Board of Land and Natural Resources; perform periodic lease audits; and obtain and fill a procurement specialist position.

We also recommend that department management review the operations of the Division of Boating and Ocean Recreation, including performing safety inspections of all small boat harbors. Additionally, we recommend that the board and department develop a comprehensive cash management policy. Finally, the Bureau of Conveyances' administrator should work with the board and department director to resolve labor union issues, consider creating a customer service function, and consider streamlining certain functions.

In its written response, the department agrees with some of our findings and recommendations while strongly disagreeing with many of our comments and characterizations, especially with respect to the two material weaknesses noted. The department did point out an error contained in our draft report that we corrected. This led us to remove a qualification of our opinion on the fairness of the department's financial statements with respect to its Ocean-Based Recreation Fund as of June 30, 2005. However, we stand by our conclusions presented in the final report, including the classification of two findings as material weaknesses. Our Comments on Agency Responses that follows Chapter 3 discusses our respective points of view. We believe our audit report presents a balanced and accurate analysis of the department's financial operations.

**Marion M. Higa**
**State Auditor**
**State of Hawai'i**

Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawai'i 96813
(808) 587-0800
FAX (808) 587-0830

# Financial Audit of the Department of Land and Natural Resources

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

Submitted by

**THE AUDITOR**
STATE OF HAWAI‘I

Report No. 06-04
June 2006

# Foreword

This is a report of the financial audit of the Department of Land and Natural Resources, State of Hawai‘i, for the fiscal year July 1, 2004 to June 30, 2005. The audit was conducted pursuant to Section 23-4, Hawai‘i Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of KMH LLP.

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

Marion M. Higa
State Auditor

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## List of Exhibits

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# Chapter 1

## Introduction

This is a report of our financial audit of the Department of Land and Natural Resources. The audit was conducted by the Office of the Auditor and the certified public accounting firm of KMH LLP.

The audit was conducted pursuant to Section 23-4, Hawai‘i Revised Statutes, which requires the auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawai‘i and its political subdivisions.

### Background

In 1959, by Act 1 (the Hawaii State Government Reorganization Act of 1959), Second Special Session Laws of Hawai‘i, the State Legislature created a separate but temporary Department of Land and Natural Resources (DLNR) and charged it with the general duty “to manage and administer the public lands of the State and the water resources and minerals thereon.”

Under the provisions of Act 1, land and water management functions formerly exercised by various territorial commissions, boards, and authorities were to be centralized within a transitional DLNR. Then on July 1, 1962, DLNR was to be abolished as an executive department and its functions transferred to a newly designated Department of Agriculture and Natural Resources. However, in 1961, the Legislature enacted Act 132, Session Laws of Hawai‘i, that retained DLNR as a separate and permanent department.

Under Section 26-15, Hawai‘i Revised Statutes (HRS), DLNR is responsible for managing, administering, and exercising control over public lands, water resources, and minerals thereon, including soil conservation, forests and forest reserves, aquatic life and wildlife resources, aquaculture programs, state parks, and historical sites.

Approximately one-third of DLNR’s FY2004-05 operating budget is funded by state general funds. The remaining budget is funded by special and federal funds. For FY2004-05, DLNR’s payroll budget accounted for approximately 40 percent of the total budget, and its budgeted position count was approximately 660 employees.

## Organization of the Department

The department comprises four organizational parts:

- Board of Land and Natural Resources
- Commission of Water Resource Management
- Office of the Chairperson
- Operating divisions

The department's organizational chart is reported in Exhibit 1.1.

### *Board of Land and Natural Resources*

The department is headed by an executive board known as the Board of Land and Natural Resources. The board has the statutory responsibility for managing public lands under DLNR's control. The board is composed of seven members: one from each land district, two at large, the chairperson, and the executive head of the department. Members are nominated and, with the consent of the Senate, appointed by the governor for a four-year term.

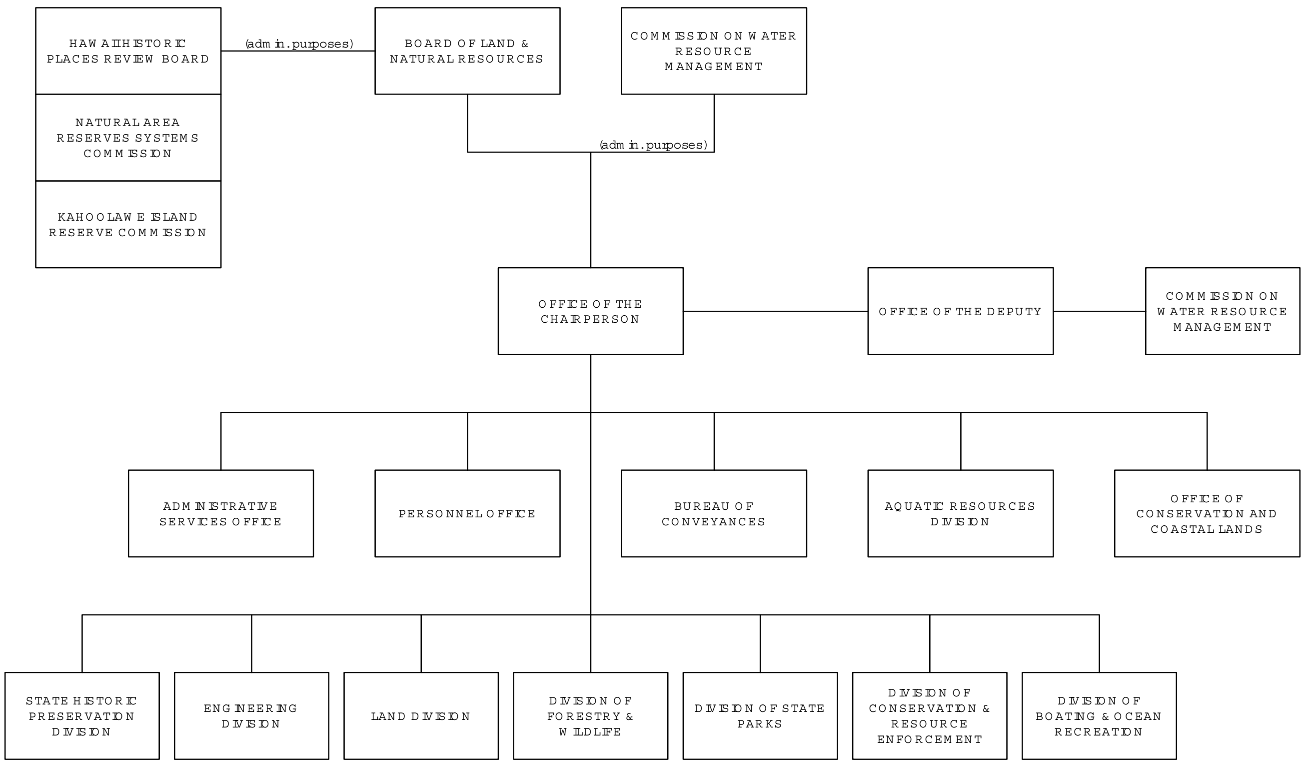
### *Commission of Water Resource Management*

The Commission of Water Resource Management has the exclusive jurisdiction and final authority over the State Water Code (Chapter 174C, Hawai'i Revised Statutes). The commission is responsible for overseeing and developing state policies for the management of surface and ground water supplies. The commission consists of seven members, five of whom are appointed by the governor and confirmed by the state Senate. The remaining two are the chairperson of the State Board of Land and Natural Resources, who serves as chairperson of the Water Commission, and the director of the state Department of Health. The State Water Code provides that the chairperson of the Board of Land and Natural Resources shall serve as the chairperson of the commission, while the director of health shall serve as an ex-officio voting member. Each member must have substantial experience in the area of water resource management.

### *Office of the Chairperson*

The Office of the Chairperson oversees the many programs conducted by the department to protect the natural and cultural resources of the State. It also provides support services for legislators and the operating divisions of DLNR. The office consists of the chairperson and two deputies, a public information specialist, a project coordinator, a legislative advisor, and administrative support staff. The Office of the Chairperson is divided into the following units:

## Exhibit 1.1
## Department of Land and Natural Resources' Plan of Organization




Source: Department of Land and Natural Resources

### Administrative Services Office

This office provides administrative support services, internal management, and comprehensive fiscal services to the chairperson and members of the board, and to the nine operating divisions and three staff offices of the department. Major services include processing the departmental payroll, processing all vendor encumbrances and payments, billing and collecting state land rentals and water licenses, collecting or accounting for all other revenues and deposits except those revenues collected by the Bureau of Conveyances, and preparing financial reports.

### Personnel Office

This office maintains a comprehensive personnel program for the department. The staff provides supportive services to the chairperson and to the department's operating divisions and staff offices. Major services include guidance and technical assistance in position classification, employee relations, and employee training and development.

### Public Information Office

This office disseminates information about the department's programs, accomplishments, goals, and the department's mandate to protect the special natural and cultural heritage of Hawai'i.

***Operating divisions***

The operating divisions include those department units that carry out DLNR programs. These operating divisions and their activities are as follows:

### Aquatic Resources

This division manages the State's marine and freshwater resources through programs in commercial fisheries and aquaculture; aquatic resources protection, enhancement, and education; and recreational fisheries. Major program areas include projects to maximize commercial fishery and aquaculture productivity, protecting native and resident aquatic species and their habitat, and providing facilities and opportunities for recreational fishing consistent with the interests of the State.

### Boating and Ocean Recreation

This division is responsible for the management and administration of statewide ocean recreation and coastal area programs pertaining to the ocean waters and navigable streams of the state (exclusive of commercial harbors) which include 21 small boat harbors, 54 launching ramps, 13 offshore mooring areas, ten designated ocean water areas, 108 designated ocean recreation management areas, associated aids to navigation throughout the State, and beaches encumbered with easements in favor of the public.

### Conservation and Resources Enforcement

This division is responsible for enforcement activities of the department. The division, with full police powers, enforces all state laws and rules involving state lands, state parks, historic sites, forest reserves, aquatic life and wildlife areas, coastal zones, conservation districts, and state shores, as well as county ordinances involving county parks. The division also enforces laws relating to firearms, ammunition, and dangerous weapons.

### Bureau of Conveyances

This division maintains an accurate, timely, and permanent record system for title to real property. The bureau examines, records, indexes, and microfilms over 344,000 Regular System and Land Court documents and maps annually; issues Land Court Certificates of Title; certifies copies of matters of record; and researches Uniform Commercial Code requests. Hawai‘i is the only state in the nation with a single statewide recording office.

### Forestry and Wildlife

This division is responsible for the management of state-owned forests, natural areas, public hunting areas, and plant and wildlife sanctuaries. Program areas cover watershed protection; native resources protection, including unique ecosystems and endangered species of plants and wildlife; outdoor recreation; and commercial forestry.

### Historic Preservation

This division works to preserve and sustain reminders of earlier times that link the past to the present. Its three branches, History and Culture, Archaeology, and Architecture, strive to accomplish this goal through a number of different activities.

### Land Division

This division is responsible for managing state-owned lands in ways that will promote the social, environmental, and economic well-being of Hawai‘i’s people and for insuring that these lands are used in accordance with the goals, policies, and plans of the State. Lands that are not set aside for use by other government agencies come within the direct purview of the division. These lands are made available to the public through fee sales, leases, licenses, grants of easement, rights-of-entry, and month-to-month tenancies, or kept as open space area.

Where acquisitions of privately-owned lands or lands owned by other government entities are required by the State for public purposes, the division is responsible for acquiring these lands through negotiations, condemnations, or land exchanges.

### State Parks

This division manages and administers 52 state parks encompassing nearly 25,000 acres on the five major islands. These parks offer varied outdoor recreation and heritage opportunities. The park environments range from landscaped grounds with developed facilities to wild land areas with trails and primitive facilities.

## Objectives of the Audit

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

2. To ascertain whether expenditures or deductions and other disbursements have been made and all revenues or additions and other receipts have been collected and accounted for in accordance with federal and state laws, rules, regulations, and policies and procedures.

3. To make recommendations as appropriate.

## Scope and Methodology

We examined the financial records and transactions and the related systems of accounting and internal controls of the department for the fiscal year July 1, 2004 to June 30, 2005. We tested financial data to provide a basis to report on the fairness of the department's financial statements. We also reviewed for compliance with applicable laws and regulations, those transactions, systems, and procedures tested.

The audit examined the accounting, reporting, and internal control structure to identify deficiencies and weaknesses and make appropriate recommendations for improvements. Covered were the forms and records, the management information system, and the accounting and operating procedures.

In addition, the audit reviewed the extent to which the recommendations made in Chapter 2 of the 2000 State Auditor's Report No. 00-11, *Financial Audit of the Department of Land and Natural Resources*, have been implemented.

The auditors' opinion as to the fairness of the financial statements presented is that of KMH LLP. The audit was conducted from July 2005 to February 2006 according to generally accepted government auditing standards.

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# Chapter 2

## Internal Control Deficiencies

Internal controls are steps instituted by management to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Department of Land and Natural Resources.

### Summary of Findings

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

Reportable conditions, which are less severe than material weaknesses, are significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The following matters are severe and considered material weaknesses:

1. The department lacks a comprehensive system to properly manage its federal grant programs.

2. The department's accounting and financial reporting process is inadequate.

We considered the following matters to be reportable conditions:

1. The operation and management of the Division of Boating and Ocean Recreation continues to need improvement.

2. The department lacks a comprehensive cash management policy.

3. The Bureau of Conveyances does not effectively manage its staff resources.

## The Department Lacks A Comprehensive System To Properly Manage Its Federal Grant Programs

The department currently has over 180 active federal grants with a total multi-year program budget of approximately $111 million, of which $71 million, or 64 percent, is the federal share of the budget. For FY2005, the department collected in excess of $7 million for federal reimbursements, which were deposited into the special fund appropriation account established for the respective program. The department has established a federal grant major fund to account for its federal grant expenditures and related reimbursements.

Our prior financial audit of the department for FY1999 revealed the department incorrectly credited its federal grant funds received to the subsequent year's general fund expenditures, enabling the department to exceed its legislatively authorized appropriation ceiling in that subsequent year and undermining legislative authority. We noted this condition still exists and department management has made very little progress towards resolving this finding in the almost six-year period since our previous report was issued. In addition to the prior year finding, we also noted that the department may not be properly reporting federal program financial activity and lacks an efficient system to account for its federal programs. Due to these serious deficiencies, KMH LLP was unable to, and did not, express an opinion on the fairness of the department's federal grant fund.

### *Federal program accounting may violate state law, undermine legislative intent, and misstate balances*

Many of the department's federal programs operate on a reimbursement basis under which the department finances program expenditures with state general funds and subsequently is reimbursed by the federal granting agency. However, the department does not properly process the federal reimbursements.

The department's accounting policy is to deposit the federal reimbursements into the special fund appropriation account established for the respective grant program, regardless of the source of the original funding. When the original funding source is the department's general fund, an interfund journal voucher is processed to credit, or eliminate, the expenditure in the general fund and appropriately transfer the expense, but not the related cash, to the respective special fund. This accounting practice may be in violation of applicable state laws and the governor's instructions. Section 207 of Act 328, Session Laws of Hawai'i (SLH) 1997, states, in part:

> Except as otherwise provided, or except as prohibited by specific grant conditions, *all federal fund reimbursements received by state programs shall be returned to the general fund, or other appropriate program fund.* [Emphasis added]

In addition, Executive Memo No. 98-04, issued by the governor, states:

> Pursuant to Section 207 of Act 328, SLH 1997, as amended by H.B. No. 2500, *all federal or other fund reimbursements shall be deposited into the general fund or the appropriate fund account that provided the original advance funding* except as otherwise provided by law. Expenditure of reimbursements without legislative or statutory authorization or appropriation may be considered in violation of Sections 37-31 and 37-42, Hawaii Revised Statues (HRS). [Emphasis added]

### Method of processing federal reimbursements results in misstated balances and allows expenditure ceiling to be exceeded

This practice becomes more problematic when the department uses general funds to finance federal program expenditures in one fiscal year but the reimbursement is not received until the following fiscal year. At the end of each fiscal year, general fund activity should be closed out and any unexpended general funds lapsed back to the state treasury. However, the department's current practices result in two problems: an overstatement of general fund expenditures in the preceding year and an understatement in the subsequent year.

General funds appropriated to the department are automatically lapsed by the Department of Accounting and General Services (DAGS) when the appropriation account is closed on July 15th of the subsequent year, based on the unexpended, unencumbered, and unreserved fund balance. Therefore, the overstatement of general fund expenditures in the preceding fiscal year will result in an understatement of the general funds lapsed at the end of that fiscal year. These misstatements are posted to the State's accounting system and affect the State's general fund balance and combined balances reported at the close of each fiscal year.

Additionally, the understatement of general fund expenditures in the subsequent year allows the department to exceed its appropriation ceiling as authorized by the Legislature for that fiscal year. The original general fund expense is closed out at the end of the preceding year; when the department processes the interfund journal voucher to transfer the general fund expenditure to the respective special fund in the subsequent year, it creates a credit, or negative, expense balance in the general fund. This negative balance will offset current general fund expenditures and allow the department to exceed its appropriation ceiling by a corresponding amount, undermining legislative authority. As stated in Article VIII, Section 8 of the State Constitution, the executive branch is prohibited from exceeding the general fund expenditure ceiling established by the Legislature.

The department indicated that the subsequent year's general fund is credited because the preceding year's appropriation account is closed too soon after year-end, leaving insufficient time to prepare the interfund journal voucher. Although the department may not be able to complete its billing to the federal agency by July 15th of the subsequent year, it should have no difficulty in preparing a journal voucher to credit the current year general fund for the expenditures recorded for federal programs prior to the end of the fiscal year, or June 30th. Doing so would ensure the general and respective special fund ending balances, and any related lapsed balances, for each fiscal year are properly stated.

### Dispute over liability to the State remains unresolved

Yet another problem created by the department's federal program accounting practices is whether the year-end misstatements described above represent a liability from the department to the State. As previously noted, when the department finances a federal program expense with general funds but the federal reimbursement is received in the subsequent fiscal year, the general fund balance that lapses back to the State at the end of the preceding fiscal year is understated. There is uncertainty as to whether this should be construed as a liability since the department is not returning all the general funds it should to the State at the end of each fiscal year through lapsed appropriations. The department has recorded a "Due to State Treasury" balance in its financial statements that represents the cumulative portion of federal reimbursements received relating to prior period general fund expenditures. However, despite being reflected in its own financial statements, the department does not feel that this amount is a true liability. At the time of our prior audit in FY1999, the recorded liability to the State was approximately $7.3 million. The liability reached a maximum of $8.9 million in FY2002 and has decreased to $8.3 million at the end of FY2005.

The fiscal management officer has asserted that the department does not believe it has a liability to the State because it does not receive advance funding from the state general fund (i.e., its federal program budget is funded "net" by the Legislature). If this were true, the department's audited financial statements, which are prepared based on the assertions and beliefs of management, should not reflect this liability. However, since management has not obtained evidence to support its assertion, it issued financial statements that include this liability. This unwillingness or inability to obtain support for this assertion indicates management's lack of responsibility for the preparation of accurate financial statements. Additionally, since management is responsible for the preparation of the biennial and supplemental budgets passed by the Legislature, the officials should be able to provide evidence to support these budgets.

To determine if the methodology used to compute the liability reflected in the department's financial statements is reasonable, we traced a selection of the federal reimbursements through the accounting system. We noted that the amount recorded in the liability did not agree with the amount of general fund expenditures in excess of the State's share of the program budget. This was due to payroll costs, which are typically the majority of the total expenditures, being funded by the general fund. We were unable to determine the extent to which the liability may be misstated because the department lacks a comprehensive, integrated system to account for its federal programs.

### *Financial results of federal programs raise questions*

According to the department's notes to its financial statements, the Federal Grant Fund was established to account for the department's federal grant expenditures and related reimbursements. Under accounting principles generally accepted in the United States of America (GAAP) for reimbursable federal programs, for each dollar expended, there is a corresponding dollar of intergovernmental revenue. Thus, the Federal Grant Fund should have no operating deficit or excess unless there are disallowed or unbilled costs, or excess reimbursements. The department reported the following results for its Federal Grant Fund for fiscal years 2004 and 2005:

| Federal Grant Fund: | FY2004 | FY2005 |
|---|---|---|
| Total revenues | $13,623,911 | $11,971,388 |
| Total expenditures | 13,159,743 | 12,501,092 |
| Excess (deficiency) of revenues over (under) expenditures | 464,168 | (529,704) |
| Other financing sources (uses) | (115,757) | 1,210 |
| Net change in fund balance | 348,411 | (528,494) |
| Unreserved fund balance | $(9,818,427) | $(9,944,229) |

Source: FY2004 and FY2005 Department of Land and Natural Resources financial statements

During FY2005, the department's Federal Grant Fund expenditures exceeded revenues by $529,704. This significant deficit may be due to disallowed or unbilled costs; however, the department's fiscal staff was not able to explain why federal expenditures exceeded federal revenues in FY2005. The department was also unable to explain why federal revenues exceeded federal expenditures by $464,168 in FY2004, or the cause of the significant deficit in fund balance. These discrepancies and the department's related lack of understanding raise serious questions regarding its ability to properly account for its federal grant activity.

### *Accounting for federal programs is inefficient*

The department's Administrative Services Office provides substantially all of the accounting and billing support services for the department's federal programs. We interviewed the fiscal staff responsible for the accounting and billing of its federal programs, noting that the department's current system is highly manual in nature, time-consuming, and prone to error. For example, we noted that payroll costs chargeable to federal programs are manually tracked, and billing statements and records are manually maintained. These activities reduce the time available for the fiscal staff to perform other assigned duties. This could be performed more efficiently and accurately with the help of an integrated system.

Department management is responsible for developing and enforcing controls and procedures and addressing problems in a timely manner to ensure the department can achieve its goals effectively and efficiently. The lack of progress in resolving the prior finding over the past six years and the additional current year findings are indicative of a lack of leadership and managerial responsibility in addressing the critical nature of this issue.

### *Recommendations*

We recommend that the department's management:

- Develop a centralized, comprehensive system to manage and be responsible for the department's federal programs.

- Determine whether its accounting policy for federal reimbursements is in compliance with Act 328, SLH 1997.

- Obtain written documentation to support its assertion that its programs are budgeted net by the Legislature and that the liability reflected in its financial statements as "Due to State Treasury" do not reflect actual moneys owed to the state general fund.

- Prepare journal vouchers to record an interfund reimbursement based on the amount of expenditures posted in the Financial Accounting and Management Information System (FAMIS) at each year end.

- Investigate the cause for the deficit in its federal grant fund and implement corrective measures to ensure all allowable costs are properly billed and recorded.

- Implement an integrated accounting system to reduce the burden on the department's fiscal staff.

## The Department's Accounting and Financial Reporting Process Is Inadequate

The Board of Land and Natural Resources and department management must have accurate and timely financial information and analyses in order to monitor performance, identify opportunities for improvement, and strategically plan for the future. We noted significant deficiencies in the department's financial reporting process that hinder its ability to produce accurate financial statements. As a result of these deficiencies, there are significant misstatements in the department's financial statements for the year ended June 30, 2005. We also noted internal control deficiencies over the department's leases and issues regarding compliance with the Hawai'i Public Procurement Code.

### *The department's financial statements are misstated*

We identified 15 misstatements in the department's statement of net assets and statement of activities as of and for the fiscal year ended June 30, 2005, summarized as follows:

| | Assets | Liabilities | Beginning Net Assets | Change in Net Assets |
|---|---|---|---|---|
| As reported | $361,785,430 | $45,207,006 | $295,155,617 | $21,422,807 |
| Prior period adjustment to accrued compensated absences liability | 0 | 0 | (238,436) | 238,436 |
| Prior period adjustment to accrued fringe benefits on compensated absences liability | 0 | 473,760 | (452,591) | (21,169) |
| Prior period adjustment to dispose of capital assets | 0 | 0 | (3,441,490) | 3,441,490 |
| Other misstatements | 90,562 | 1,975,057 | 0 | (1,884,495) |
| Total misstatements identified | 90,562 | 2,448,817 | (4,132,517) | 1,774,262 |
| As adjusted | $361,875,992 | $47,655,823 | $291,023,100 | $23,197,069 |

Certain misstatements identified are discussed in further detail below. The quantity and amount of these misstatements indicate that management does not have an effective process in place to ensure that financial statements can be prepared accurately. We also noted that the department's June 30, 2005 financial statements did not contain certain required disclosures and contained inaccurate budgetary comparison statements.

#### The accounting and recordkeeping for compensated absences is inaccurate

The department maintains leave records and schedules to track individual employee leave balances and support the amounts recorded in the department's financial statements. We examined these records during our audit and discussed their preparation and maintenance procedures with the department's personnel and fiscal office staff. Accounting principles generally accepted in the United States require that employers report a liability for compensated absences that is attributable to services rendered and not contingent on a specific event that is outside of the control of the employer and employee.

We noted the liability accrued is understated at June 30, 2005 and 2004 by approximately $474,000 and $672,000, respectively. In addition, the changes in net assets for FY2005 is understated by approximately $217,000. We also noted the department fails to enforce policies regarding vacation leave requests.

The department failed to accrue a liability for compensatory time off at June 30, 2004, although its records indicate a total accrued balance of approximately 13,000 hours. The department did accrue a liability of $297,000 at June 30, 2005; however, this accrual incorporates the balance at the beginning of the fiscal year, thereby misstating the effect on the statement of activities for FY2005. We discussed the error with the department's fiscal staff, noting that a liability was not recorded at June 30, 2004 because DAGS did not request the compensatory time balance in their annual memo to the department at fiscal year end. However, the purpose of this memo is to request information in connection with the preparation of the comprehensive annual financial report of the State rather than provide instruction or guidance on the preparation of the department's financial statements.

The department's liability for compensated absences at June 30, 2005 and 2004 also does not include an accrual for the related fringe benefits. Accounting principles generally accepted in the United States require the liability to include salary-related payments, which are typically the employer's share of Social Security, Medicare, and contributions to benefit plans. These misstatements are further indication that the financial statement preparation process is inadequate.

State employees are required to complete form HRD-G1, *Application for Leave of Absence*, to request and report time off for vacation, sick leave, administrative leave, etc. Under the terms of the current bargaining unit agreements with the United Public Workers and Hawaii Government Employees Association, employees are required to obtain approval from their direct supervisor in advance of planned vacation leaves. We noted 61 of 392 vacation leave applications were approved by the employee's supervisor or department head an average of six days after the start of the vacation leave. Late notice of planned vacation leaves does not allow management to properly plan and manage staffing levels to meet reporting and operational deadlines, efficiently service the public, and manage employee morale and well-being.

### The department's capital assets balance is misstated

The department's capital assets consist primarily of land and land improvements. At June 30, 2005, the department reported approximately $204 million in capital assets, net of accumulated depreciation. Based on our testing, it appears that capital assets reported on the financial statements and the balances reported to DAGS, which prepares the State's Comprehensive Annual Financial Report (CAFR), are both misstated.

The department's statement of activities for FY2005 includes the disposal of two assets: a desalination plant and a water catchment system, with an original cost of $8.6 million and a net book value of $3.4 million. Based on our testing, it appears these assets should have been disposed in the prior year, resulting in an overstatement of net assets at June 30, 2004. We examined documents and inquired about the desalination plant disposal with fiscal staff, noting that the approval and execution of the disposal by the board occurred on December 29, 2003, more than six months prior to the close of the department's 2004 fiscal year. We also inquired with fiscal staff about the disposal of the water catchment system, noting the disposal was recorded in FY2005 because the asset was erroneously double counted at June 30, 2004. These two misstatements clearly indicate that the financial statement preparation process is inadequate to ensure that all significant transactions are recorded and that error-free schedules are produced.

The Department of Accounting and General Services maintains an inventory of state property and equipment records. These records are used to support the capital assets balances reported in the combined, government-wide financial statements of the State and the amounts reported in the CAFR. We reconciled the property balances reported by the department at June 30, 2005 to the DAGS property records at June 30, 2005, noting the department's balances were $7.3 million higher than the balances reported to DAGS.

### Required disclosures are not included in the financial statements

Accounting principles generally accepted in the United States of America require that financial statements be accompanied by notes that provide additional disclosures for the amounts reported in the financial statements and provide the reader with necessary background information to make informed decisions. We noted certain required disclosures were omitted from the department's notes to the financial statements for the defeasance of the department's general obligation bonds and the details of the department's interfund transfer activities.

During FY2005, approximately $689,000 of the department's general obligation bonds were refinanced with the proceeds of new bonds. We reviewed the department's notes to the financial statements at June 30, 2005, noting that certain disclosures required under the Government Accounting Standards Board (GASB) Statement No. 7, "Advance Refundings Resulting in Defeasance of Debt," are not included. This statement requires the refunding entity to disclose in the notes to the financial statements a brief description of the refunding transaction, the aggregate difference in debt service between the refunded debt and the refunding debt, and the economic gain or loss on the transaction. Although we noted the department's general obligation bonds are managed and accounted for by the Department of Budget and Finance, department management is still responsible for ensuring that it has sufficient information to prepare the financial statements in accordance with GAAP.

According to the statement of revenues, expenditures, and changes in fund balances, the department's governmental funds recorded total operating transfers in and out for FY2005 of $68,271,236 and $68,735,641, respectively, yet the notes to the financial statements do not include certain disclosures required under Governmental Accounting Standards Board (GASB) Statement No. 38, "Certain Financial Statement Note Disclosures." This statement requires disclosure of the principal purposes of the transfers and the purpose and amount of significant transfers that do not occur on a routine basis, or are inconsistent with the activities of the transferring fund. The omission of these two disclosures required by GAAP is further indication of the deficiencies in the financial statement preparation process.

### The department's budgetary comparison statements are inaccurate

The department's basic financial statements include budgetary comparison statements that report the variance between the department's original and final budgets to the actual results for the fiscal year. Governmental Accounting Standards Board Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments," defines the term "original budget" as "the first complete appropriated budget" and "final budget" as "the original budget adjusted by all reserves, transfers, allocations, supplemental appropriations, and other legally authorized legislative and executive changes applicable to the fiscal year, whenever signed into law or otherwise legally authorized." Based on this definition, there should be a difference between the original and final budget amounts reported in the financial statements.

We examined the department's statements, noting the original budget amounts are identical to the final budget amounts. According to the department's fiscal office staff, the statements were prepared using the department's supplemental budget passed by the Legislature in the Supplemental Appropriations Act of 2004. As a result, the department's financial statements inaccurately indicate that there were no changes to the department's budget since inception. This demonstrates an inadequate managerial process for ensuring the financial statements are accurately prepared in accordance with GAAP.

### *Financial accounting and management controls are inadequate*

Proper procedures are essential to the financial statement preparation process to ensure that all transactions are reported in the proper period and financial statements can be accurately prepared. Due to the nature and significance of the misstatements we noted in the financial statements, we made additional inquiries with the Administrative Services Office and other divisions to determine the cause of the misstatements.

The Administrative Services Office is responsible for providing administrative support and preparing the annual financial statements and budgets for the department. We interviewed the office's personnel on various occasions throughout our audit and in the course of investigating the identified misstatements. We noted the office's internal controls and procedures to ensure that the department's activities and transactions are accurately and timely reported in the department's financial statements are poor and need improvement.

Throughout our audit of the department's financial statement balances, we noted the schedules and other work prepared by the accountants and staff in the Administrative Services Office are not reviewed on a periodic basis by someone other than the preparer. This practice contributes to the previously noted errors not being detected and corrected by the department in a timely manner. For example, we noted that neither was the final detailed schedule supporting the liability for compensated absences reviewed by someone other than the preparer nor was any significant testing or validation on the schedules submitted by the divisions to the Administrative Services Office performed by the department's internal auditor. Policies that require a work product be reviewed by an individual's supervisor or manager on a periodic basis to ensure that the work is free from error is an element of proper internal controls. Sound management practices also require periodic reviews to serve as a basis for the evaluation of an individual's performance.

We interviewed the internal auditor and noted that, due to a staffing shortage in the Administrative Services Office, this individual currently serves in an accountant role instead of an internal auditor role. We also reviewed the office's organization chart and noted that the internal auditor reports to the fiscal management officer. This structure creates a conflict of interest as the internal auditor should review the work of the fiscal management officer. The internal audit function of an organization is most effective when it reports directly to, and is under the control of, the governing board of an organization.

The fiscal management officer was unable to comment or discuss our prior financial audit findings relating to other divisions, or provide or discuss the divisions' operating policies and procedures. A fiscal management officer should have a thorough understanding of the operations and policies of the entire department in order to effectively discharge the duty to administer the fiscal and accounting program for the department. Knowledge of the department's operations is also necessary to ensure the department's financial statements are accurate and not misleading. These deficiencies noted in the Administrative Services Office contribute to the department's overall inadequacy to produce financial statements that are free from error.

### *The Land Division's lease accounting practices are deficient*

The Land Division leases unused state lands on a short- and long-term basis. However, we noted the division fails to perform periodic lease rent audits and obtain proof of insurance for its lessees. The division recorded approximately $9 million in lease rents for FY2005.

Periodic, independent verification of the amounts paid as lease rent is a necessary management tool to ensure that lease rents are fairly stated and management has sufficient information during the lease renewal process. We interviewed the division's administrator, who believes that the cost of these audits will outweigh the benefits, yet the division has not formally analyzed the cost of procuring or performing lease audits. Unless the division performs periodic audits of its lessees' rent payments, management has no assurance that lease rents are paid in accordance with the terms of the leases and that the department's financial statements are accurate.

We also found the division failed to obtain proof of insurance coverage from its lessees. We selected ten leases from the division's files and examined them for compliance with the requirements of Chapter 13-220, Hawai'i Administrative Rules (HAR), and the division's internal policies and procedures. We noted six files selected did not contain current insurance certificates. In two of the six files selected, current insurance certificates were obtained only after we made our initial request. We further noted that although the division's land management system has the ability to maintain and report on the status of lessee insurance coverage, the report is not reviewed periodically by the division's staff.

Adequate liability insurance coverage is critical to ensure the State's interest in leased property is protected and the State is not exposed to increased risk.

### *Compliance with the Hawai'i Public Procurement Code should be improved*

The Hawai'i Public Procurement Code, Chapter 103D, HRS, sets standards for all state agencies regarding the procurement of goods and services. The code seeks to promote fiscal integrity, accountability, and efficiency in procurement processes among state agencies. Our testing found instances of noncompliance with the rules on small purchase procurements and violations of procurement directives established by the State Procurement Office (SPO). In addition, we noted one instance where the department's procurement of services appeared to be parceled, which is strictly prohibited under Section 103D-305, HRS. Noncompliance with the procurement code may result in goods and services procured from vendors who are not in compliance with state law. In addition, there is no assurance that the best price was obtained and fair competition was encouraged.

#### Compliance with small purchase rules needs improvement

We tested a sample of 40 small purchases and noted 15 instances in which the department failed to comply with or properly document the procurement process in accordance with the rules for small purchases as follows:

- We noted nine selections totaling approximately $982,000 where the purchase order issued was dated subsequent to the invoice date;

- We noted the purchase order number was not properly documented for three selections totaling approximately $79,000;

- The department failed to obtain the required clearance forms from the vendor for two selections totaling approximately $20,000; and

- The department failed to complete SPO Form 10 to document the receipt of three verbal quotes for one selection of $1,200.

Without completing the proper small purchase forms and procurement documents, or without obtaining the required clearance forms, the department cannot ensure that it properly sought fair competition. Proper completion of SPO Form 10 is critical to document the receipt of verbal quotes.

### One selection had the appearance of parceling

We noted one selection that, upon further investigation, appears to be part of two procurements that were parceled to be under the $25,000 threshold for small purchases. According to the SPO Form 10 we examined, the same individual in the Land Division awarded two small purchase procurements for professional appraisal services of leased parcels on the Big Island on the same date, to the same firm. These two procurements together would have totaled $39,500.

Section 103D-305, HRS, establishes that procurements of less than $25,000 are small purchases and therefore not subject to the formal bid and offer process required under Section 103D-302, HRS. However, the statute also states that "multiple expenditures shall not be created at the inception of a transaction or project so as to evade the requirements of this chapter" and "procurement requirements shall not be artificially divided or parceled so as to constitute a small purchase under this section." When the procurement code is violated, there can be no assurance that the best possible price and service was obtained from qualified individuals or companies that are in compliance with state law.

Although contracted auditors generally provide assistance with the preparation of financial statements, management is ultimately responsible for ensuring that financial statements are fairly presented in accordance with GAAP. Department and division management have a responsibility to develop and enforce accounting and operating procedures that ensure financial reporting is accurate, risks are minimized, and assets are safeguarded. Deficient or absent procedures and policies are an indication of an inadequate process and irresponsible management.

## *Recommendations*

We recommend that the department:

- Take immediate steps to improve the accuracy and effectiveness of the department's accounting and financial reporting processes and controls.

- Perform additional oversight and review of the financial statements and supporting schedules to ensure they are in compliance with GAAP and all relevant and required disclosures have been included.

- Perform periodic, supervisory reviews of the work prepared by fiscal staff.

- Perform more extensive testing of the leave record schedules submitted by the divisions.

- Have its internal auditor report directly to the board.
- Perform periodic audits to ensure lease rents are fairly stated.
- Obtain and fill a procurement specialist position to monitor and ensure that compliance with the Hawai‘i Public Procurement Code is maintained.

## The Operation and Management of the Division of Boating and Ocean Recreation Continues To Need Improvement

The Division of Boating and Ocean Recreation was established in FY1993 to administer the small boat harbors and a comprehensive recreational boating program for the State. The division is responsible for 21 small boat harbors, 54 launching ramps, 13 offshore mooring areas, ten designated ocean water areas, 108 ocean management areas, navigation aids throughout the state, and beach easements. The division is almost entirely self-sufficient and funded through the Ocean-Based Recreation Fund, which collects mooring and other permitting fees from boaters, ramp permits, a percentage of revenues of commercial vessels using the division's facilities, and a portion of the state liquid fuels tax.

The division was previously audited by our office in 1993, 1998, and 2001. In all three audits, we reported on significant deficiencies in the operation and management of the division and on unsafe boating facilities that jeopardized public safety. We discussed the status of the prior audits' recommendations with the division and visited three small boat harbors during our current audit to determine if any improvements have occurred since the last audit. Although we noted some of the prior recommendations have been implemented, the absence of effective management oversight continues to plague the division. This is evidenced by the little progress made in the 12 years since the division was created to improve the poor condition of the small boat harbors as numerous safety issues continue to jeopardize the public. In addition, the division's harbor usage fee structure is outdated, management and financial controls are inadequate, and compliance with boating permit issuance and renewal policies is poor.

### *The poor condition of the harbors jeopardizes public safety*

During our current audit, we performed site visits at the Ala Wai, Ke‘ehi, and Wai‘anae small boat harbors and interviewed the harbor agent and other division personnel. Each of these harbors revealed serious safety issues as a result of the lack of maintenance by the division over the years. Many piers and moorings have been condemned by the division due to their unsafe condition and several have collapsed completely, with only the original pilings remaining to indicate what was once there. The personnel we interviewed indicated there have been "near misses" in the past, where piers and catwalks have collapsed into the water shortly after people have walked on them. During our tour of the Ke‘ehi Boat Harbor, we were instructed not to walk close together because of the danger of overloading and collapse.

We observed repairs that were performed by division personnel that do not appear to be in accordance with proper standards and actually increase the danger to the public. There were several areas where boards were placed over missing sections of catwalk that were not level and did not appear properly attached. Harbor agents also indicated that they perform more complex repairs, such as securing detached moorings in the harbor. Repairs should be performed by properly trained, qualified professionals with knowledge of the appropriate safety and engineering standards to ensure the work performed does not increase the risk of injury to the public.

**Exhibit 2.1**
**Condemned Pier**

These pilings are all that remain from a collapsed pier at the Ke‘ehi Boat Harbor.
*Photograph courtesy of KMH LLP.*

### Exhibit 2.2
### Hazardous Pier Conditions

This Keʻehi Boat Harbor pier poses a serious safety hazard.  *Photograph courtesy of KMH LLP*.

### Exhibit 2.3
### Multiple Attempts at Repair

This Keʻehi Boat Harbor pier has undergone numerous repairs after initial repairs failed. *Photograph courtesy of KMH LLP*.

The division personnel we interviewed also expressed concerns over insufficient security at the harbors, which results in vandalism and drug use. We observed one boat harbor where all of the required fire extinguishers were missing and presumed stolen, although the harbor agent was unable to determine when the theft occurred.

We note that the inadequate maintenance and poor security at the harbors are symptoms of inadequate resources, which can also be observed in the division's financial results. For FY2005, the division reported a net decrease in fund balance of approximately $316,000 and a deficit in ending fund balance of $1.2 million. Because the division is almost entirely self-supported, these results indicate that the harbor usage fee structure in place is inadequate and should be revised.

### *The division's fee structure has not changed in over ten years*

The current fee structure for the State's small boat harbors has not changed since March 1995. According to research performed by the division and included with a proposal to the board in November 2004, the current rates for the small boat harbors are less than half the cost of similar private facilities in the state and on the West Coast. Although the fee structure has not increased in over a decade, the cost of operating the division and maintaining the harbors has. The division's operating expenditures increased 20 percent from FY2004 to FY2005 alone, and the division notes that the consumer price index for Hawai'i has increased over 32 percent in the last ten years. Section 12-234-1(a), HAR, requires the fees charged for the use of small boat harbor facilities to be calculated to produce an amount at least sufficient to pay the expenses of operating, maintaining, and managing those facilities and services. However, because the division is self funded based on an outdated fee structure, the division lacks the resources necessary to operate the division and perform necessary repairs and capital improvements. As a result, it is forced to postpone or find alternative methods to maintain the harbors, which, in some cases, are not in accordance with proper safety standards and may actually increase the danger to the public.

Although the division has acknowledged the need to seek an increase in harbor fees, the accuracy of its methodology for determining the proposed fees is questionable. In November 2004, the division submitted its harbor fee proposal to the board, which was to then conduct public hearings to determine a new fee structure for the harbors. The division's proposal to increase fees by an average of 53 percent was driven by projected expenditures over a three-year period; however, the proposal failed to account for inflation. Under the division's assumptions, expenditures would remain constant over the three-year period used in the fee proposal and the harbors would generate positive revenues in each year. However, as previously noted, the division is quick to point out that the Hawai'i consumer price index has increased by 32 percent over the ten year period since the last fee increase, yet this is not accounted for in the division's proposal. Using an annual inflation factor of 3 percent, which appears reasonable based on the cited increase in the Hawai'i consumer price index, we recalculated the net income on the division's fee proposal. Our results below show a significant decrease in anticipated income, including a projected loss in the third year.

| | As Proposed | | Adjusted for Inflation (3%) | |
|---|---|---|---|---|
| | Total Expenditures | Net Income | Total Expenditures | Net Income (Loss) |
| Year 1 | $11,652,992 | $562,332 | $11,652,992 | $562,332 |
| Year 2 | 11,652,992 | 437,326 | 12,002,582 | 87,836 |
| Year 3 | 11,652,992 | 336,858 | 12,362,660 | (372,810) |
| Total | $34,958,976 | $1,336,516 | $36,018,234 | $277,358 |

Without an accurate projection of expenses, the new harbor fees proposed may still not be sufficient to cover expenses and allow the division to address basic needs such as harbor repairs. Additionally, the division should have reconsidered the assumptions used in the original analysis, given the significant delay between the submission of its proposal to the board in November 2004 and the related public hearings, which were not held until December 2005. As of April 2006, the public hearings have been concluded and the proposed harbor fee increase has been approved by the board. However, it is pending final approval by the Department of the Attorney General and the governor prior to adoption by the department.

## *Inadequate fiscal controls and monitoring put assets at risk*

We interviewed the division's fiscal personnel and noted the division has several weaknesses in its internal controls that increase the risk of theft and misappropriation of state property and assets. There is inadequate segregation of duties at the harbors, improper use of safes to secure cash, and ineffective financial analysis by division management.

### There is no segregation of duties at Wai'anae Boat Harbor

We observed there is no segregation of duties at the Wai'anae Boat Harbor; one individual is responsible for issuing permits, the custody and deposit of cash, and the preparation and transmittal of deposit slips for processing. A fundamental element of any internal control system is proper segregation of the duties of custody, recording, reconciliation, and authorization of transactions. Whenever one individual performs multiples or all of these functions in a given area, internal controls are severely weakened and the opportunity and potential for fraud to occur and remain undetected greatly increases. Division management indicated the division does not have sufficient staff to assign multiple employees at all harbors. We noted the division had 83 budgeted positions and 73 full-time positions in FY2005, compared with 96 and 66, respectively, in FY2004. Given the division's resource challenges and operating deficit, if the remaining vacant positions cannot be filled, the division should consider centralizing the processing of permit renewals to increase efficiency and enable proper segregation of duties.

### Physical controls over cash need improvement

Personnel at the Wai'anae harbor failed to properly secure cash at the end of the day. Although the harbor office has a safe, we observed that the combination lock was not in use and the key to the safe was left hanging nearby. We discussed our concerns with the harbor agent, who indicated that he did not believe the risk of theft was serious and that the existing procedure with the unlocked safe was sufficient.

### The division's financial analyses are ineffective

The division administrator relies on an analysis of historical revenues to determine the reasonableness of reported revenues. However, such an analysis methodology does not account for the effects of condemned or closed facilities and would not detect misappropriation of assets in a timely manner. The combination of ineffective financial analysis, inadequate segregation of duties, and weak physical controls compounds this problem and indicates a lack of responsibility by management to recognize and correct this deficiency. Use of a rent roll schedule would allow management to better monitor financial performance against anticipated and budgeted amounts.

## *Boating permits were issued in violation of policies and procedures*

We randomly selected a sample of 30 boating permits issued by the Ala Wai, Ke'ehi, and Wai'anae small boat harbors, noting that several issuances were not in compliance with established policies and procedures. Title 13, Subtitle 11, HAR, establishes rules that govern the issuance of boating permits and the operation of the small boat harbors. However, during our testwork, we noted six instances of noncompliance for four selections in our sample. The exceptions noted were for missing vessel identification, misfiled insurance certificates, undocumented mooring locations, or improperly completed applications for renewal.

We discussed these errors with the division administrator and harbor agent, who noted that the time spent by the harbor agent performing necessary repairs and maintenance decreased the time available to accurately perform vessel inspections, monitor and patrol the harbor, and perform administrative tasks. Although performing simple repairs and maintenance is a significant part of the duties of the harbor agent given the condition of the harbors, the issuance of permits to users who are not in compliance with minimum safety standards or state law jeopardizes the safety of the public, other boat operators, and increases the risk of litigation to the State.

Once again, we note that management is responsible for developing and enforcing controls and procedures to address problems in a timely manner to ensure that the department can achieve its goals effectively and efficiently while minimizing additional risk. The failure of the division to develop and implement a fee increase and the continued deficiencies in processes and procedures indicates a lack of responsibility and leadership.

### *Recommendations*

We recommend that the department's management:

- Inspect all small boat harbors to ensure they meet applicable safety and construction standards and do not pose a risk to the public or employees.
- Perform a cost-benefit analysis of all condemned piers to determine if potential lost revenues outweigh costs to rebuild.
- Continue efforts to have a new harbor fee structure approved by addressing concerns raised by the public at related hearings, and reevaluate the original assumptions used for the proposed fees to ensure that the revenues generated will be sufficient to fund operating costs as well as necessary repairs and capital improvement projects.
- Consider centralizing the processing of permits and collection of fees to allow for the proper segregation of duties, increase accuracy and efficiency, and reduce the administrative burden of the harbor agents.
- Utilize a rent roll or other similar analysis to monitor the division's performance against budget and verify the reasonableness of fees and charges collected and recorded.

## The Department Lacks A Comprehensive Cash Management Policy

The department reported approximately $155 million in cash and short-term cash investments held in the state treasury, or approximately 10 percent of the total carrying value of the State's total unrestricted deposits, as of June 30, 2005. Despite having a large volume of cash in the State Treasury and cash transactions with the public, the department lacks a formal, written cash management policy governing the investment and monitoring of cash balances, accelerated billing and collection procedures, deposit procedures, monitoring of accounts receivables, and planning of cash flow requirements. The lack of formal guidance and policies has resulted in the department's divisions creating their own undocumented policies which may not be in accordance with the board's strategic plans and, in some cases, increase the risk of misappropriation of cash.

In addition to the board, the fiscal management officer and department chairperson are responsible for the development and administration of the department's fiscal and accounting policies. The fiscal management officer explained that the Administrative Services Office has been understaffed for the past two years. Consequently, the office has not had the staff resources or time necessary to develop and implement a formal written policy. We noted the budget analyst position was filled in November 2005 and an additional accountant position was recently approved but has yet to be filled. Although the preparation of the department's financial reports and budgets are important priorities, the accuracy and timeliness of these items cannot be assured without proper policies and procedures in place. The lack of well-defined policies and procedures also results in ineffective accounting and physical controls over cash.

### *The department has ineffective accounting controls over cash*

We visited and reviewed the cash collection and processing procedures at the following divisions that collect cash from the public:

- Bureau of Conveyances
- Division of Aquatic Resources
- Division of Boating and Ocean Recreation
- Division of Forestry and Wildlife
- Division of State Parks

Collectively, these divisions reported cash balances of $21 million at June 30, 2005, and revenues from leases, licenses, and permit sales to the public of $22 million for FY2005. We found that the Divisions of Forestry and Wildlife and State Parks both fail to document a daily closing cash reconciliation of transactions to receipts. Although we noted a basic reconciliation is performed at the end of the day, this process is not formally documented and filed. If daily cash reconciliations are not performed and documented, there can be no assurance that cash is properly accounted for and the amount of receipts issued matches cash received.

To further compound the situation, we also noted the department's primary management information system lacks the capability to issue receipts for transactions at the point of sale, and the division offices are not equipped with terminals or registers to record sales at customer locations. Instead, the department uses multi-part application forms that are validated, signed, or stamped as evidence of the transaction. We further noted that while these application forms are pre-numbered, the division does not have procedures to track these numbers and ensure that all application forms are properly accounted for. The absence of effective reconciliation procedures, combined with manually issued cash receipts, increases the risk of fraud and error and opens the door for misappropriation. This also decreases the efficiency of the cash receipting process, as the manual documents issued to customers must be re-input into the department's systems as well as coded on the state treasury deposit receipt form.

### *Physical controls over cash are poor and ineffective*

The department lacks strong physical controls over the access to and processing of cash. We interviewed personnel from the Divisions of Aquatic Resources, State Parks, and Forestry and Wildlife to obtain an understanding of the existing internal controls over cash. We discovered that these divisions do not prepare individual bank deposits. Instead, cash is transmitted by the division to the Administrative Services Office cashier, who recounts and combines the deposits from the divisions into one deposit prior to pickup by the armored car service each day. In addition, these divisions do not utilize security pouches to transmit cash to the Administrative Services Office. Instead, we observed that cash is placed in an inter-office envelope or hand carried down to the Administrative Services Office cashier. We also noted that the Division of Aquatic Resources has an undocumented policy to deposit funds only when the accumulated balance exceeds $1,000. As previously noted, we also identified deficiencies in the physical controls at the Wai‘anae small boat harbor.

We discussed our concerns with the respective division administrators, who believe that the risk of theft or loss is minimized because the divisions are located in the same building as the Administrative Services Office. However, the existing procedures and controls are inefficient and increase the risk of misappropriation of cash. This risk is increased at the department's locations outside the civic center area. The re-processing of cash receipts by the Administrative Services Office cashier is outside her assigned responsibilities and decreases the efficiency of the department's administrative operations; the cashier estimated that this task consumes approximately three hours per day. The consolidation of individual deposits also removes the individual accountability for funds and decreases the efficiency of the deposit reconciliation process.

As previously noted, management is responsible for the development, implementation, and enforcement of proper internal controls to ensure that the department's operations are efficient, assets are safeguarded, and risks minimized. As the department controls a significant portion of the State's cash assets, the board has a duty to the State's taxpayers to ensure that proper controls and fiscal accountability exist.

### *Recommendations*

We recommend that the board and the department:

- Develop a comprehensive cash management policy and procedures manual that addresses, among other items, basic policies and procedures, required daily reconciliations of transactions to receipts, and procedures on the transmittal and handling of cash.
- Research and evaluate the modification of the current information system to enable system-generated receipts to be issued at the point of sale to customers to reduce the risk of errors and improve efficiency.
- Implement a procedure that places responsibility on the divisions for preparing and depositing their own cash to increase the accountability for funds and increase the efficiency of the Administrative Services Office staff.

## The Bureau of Conveyances Does Not Effectively Manage Its Staff Resources

The Bureau of Conveyances is responsible for maintaining an accurate, timely, and permanent record system for title to real property in the State of Hawai'i. The bureau consists of two systems – the Regular System and the Land Court. Governed by Chapter 502, HRS, the Regular System serves to give "notice" that something is on record. However, the Land Court, governed by Chapter 501, HRS, was established in 1903 and functions as a registration system for land ownership. Certificates of title are issued to owners of land registered in Land Court, under which their title to the land is guaranteed by the State of Hawai'i.

While observing the bureau's operations and offices and interviewing its administrator, we noted the bureau, and particularly the Land Court, is facing significant challenges in managing its staff resources and meeting customer service requirements. This has resulted in excessive overtime and significant backlogs in the processing of documents and opening of mail. We observed a backlog of unopened mail at the time of our audit in December 2005; the Land Court's registrar noted that filing fee payments received in the mail via check are sometimes stale dated by the time the mail is opened and processed. The bureau's administrator estimated that there is an 18-month backlog in the processing of documents.

We further observed significant animosity and lack of cooperation between the Land Court and Regular System staffs, which has also been highlighted recently by the media. We noted that the bureau recorded a disproportionately high amount of overtime, although the amount of documents processed decreased and the documentation backlog increased. Such significant amounts of overtime have contributed to poor staff morale, and negotiations with the union to resolve the challenges have been unsuccessful.

### *The bureau records excessive overtime*

We compiled an analysis of the payroll expenses for the bureau and compared the results to the department as a whole, noting the Land Court reported a disproportionately high amount of overtime as compared to the Regular System and the department as a whole. For FY2005, the Land Court's 27 employees recorded approximately 9,400 hours and $256,000 of overtime pay, compared with only 540 hours and $15,000 for the Regular System's 14 employees. The department incurred a total of $1.7 million in overtime compensation for its 783 employees. In addition, we noted two Land Court employees received in excess of $30,000 of overtime pay during FY2005. The following table emphasizes the discrepancy of overtime compensation and hours between the bureau's two systems, as well as the entire department, for the fiscal year ending June 30, 2005.

| | **Land Court** | **Regular System** | **Department-wide** |
|---|---|---|---|
| Overtime compensation | $256,000 | $15,000 | $1,700,000 |
| Number of employees | 27 | 14 | 783 |
| Average overtime compensation per employee | $9,481 | $1,071 | $2,171 |
| Overtime hours | 9,400 | 540 | |
| Average overtime hours per employee | 348 | 39 | |

The following table shows that similar levels of overtime were reported in FY2004 as well.

| | **Overtime ($)** | | | **Hours** | | |
|---|---|---|---|---|---|---|
| | FY2004 | FY2005 | Change | FY2004 | FY2005 | Change |
| Land Court | 221,679 | 255,991 | $34,312 | 8,590 | 9,350 | 760 |
| Regular System | 27,045 | 15,023 | (12,022) | 1,008 | 539 | (469) |
| Total | $248,724 | $271,014 | $22,290 | 9,598 | 9,889 | 291 |

We interviewed the bureau's administrator who explained that the increase in overtime is due to the increase in real estate transactions in the past several years, while the number of positions at the bureau has remained relatively constant. In addition, due to opposition from the union, management cannot shift resources between systems to meet demands during staffing shortages. This is unsettling and inefficient as personnel from each system are capable of performing the work of their counterparts. The excessive amount of overtime places stress and hardship on the bureau's staff and has exacerbated the poor morale and cooperation between the Land Court and Regular System.

### *Although overtime increased, productivity decreased*

In order to determine the reasonableness of the bureau administrator's justification of significant overtime, we obtained an analysis of the number of documents processed by the Land Court, noting that although overtime significantly increased in FY2005 as compared to FY2004, the number of documents processed decreased. According to the bureau's records, the Land Court processed approximately 185,000 documents during FY2004, as compared to 164,000 documents in FY2005, a decrease of 21,000 documents. However, as noted above, the Land Court's overtime increased by $34,000 and 760 hours in that same period. The bureau's administrator was unable to provide an explanation for this discrepancy.

We performed an additional analysis using statistics provided by the bureau on documents processed during the nine business days between December 23, 2005 and January 6, 2006. Based on our computations, it appears that the Land Court and Regular System staff productivity, measured by documents processed, increased by 91 and 168 percent, respectively, during overtime hours compared with productivity during regular time hours. If productivity was increased during regular hours, the overtime cost to the department would decrease.

### *Recommendations*

The bureau's administrator should:

- Work with the board and department director to develop a plan to address union labor issues.
- Consider creating a customer service function within the bureau to free up staff and increase productivity.
- Reevaluate processes to determine whether certain functions can be automated or streamlined to increase efficiency.

# Chapter 3
## Financial Audit

This chapter presents the results of the financial audit of the Department of Land and Natural Resources, State of Hawai‘i, as of and for the fiscal year ended June 30, 2005. This chapter includes the independent auditors’ report and the report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays the basic financial statements of the department together with explanatory notes and supplementary information required by accounting principles generally accepted in the United States of America.

### Summary of Findings

In the opinion of KMH LLP, based on their audit, except for the effects of such adjustments, if any, as might have been determined to be necessary had they been able to examine evidence regarding the department’s liability due to the State General Fund as of June 30, 2005 reported in the federal grant major fund, the financial statements present fairly, in all material respects, the respective financial position of the Department of Land and Natural Resources, State of Hawai‘i, as of June 30, 2005, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America. KMH LLP noted certain matters involving the department’s internal control over financial reporting and its operations that the firm considered to be reportable conditions, including material weaknesses as defined in the report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*. KMH LLP also noted that the results of its tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*.

### Independent Auditors’ Report

To the Auditor, State of Hawai‘i:

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Department of Land and Natural Resources, State of Hawai‘i, as of and for the year ended June 30, 2005, which collectively comprise the department’s basic financial statements. These financial statements are the responsibility of the department's management. Our responsibility is to express opinions on these financial statements based on our audit.

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

We were unable to obtain sufficient evidential matter supporting the department's liability due to the State General Fund of $8,302,509 recorded in the financial statements for the federal grant major fund. Accordingly, we were not able to determine the effects of adjustments, if any, which might have been necessary had we been able to examine such evidence.

Because of the significance of the information in the financial statements of the federal grant major fund that we were unable to audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements of the federal grant major fund of the department as of and for the year ended June 30, 2005

As discussed in Note 1, the financial statements of the department are intended to present the financial position and changes in financial position of only that portion of the governmental activities, each major fund, and the aggregate remaining fund information of the State of Hawai'i that are attributable to the transactions of the department. They do not purport to, and do not, present fairly the financial position of the State of Hawai'i as of June 30, 2005, and the changes in its financial position, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the general fund, water and land development fund, ocean-based recreation fund, Kaho‘olawe rehabilitation trust fund, capital projects fund, and the aggregate remaining fund information of the Department of Land and Natural Resources, State of Hawai‘i, as of June 30, 2005, and the respective changes in financial position thereof and the respective budgetary comparison for each major fund for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management’s discussion and analysis that accounting principles generally accepted in the United States of America require to supplement, although not be a part of, the basic financial statements has not been presented.

In accordance with *Government Auditing Standards,* we have also issued our report dated January 27, 2006, on our consideration of the department’s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

/s/
KMH LLP
Honolulu, Hawai‘i
January 27, 2006

## 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*

To the Auditor, State of Hawai‘i:

Except as discussed in the following paragraph, we have audited the financial statements of the Department of Land and Natural Resources, State of Hawai‘i as of and for the year ended June 30, 2005, and have issued our report thereon dated January 27, 2006, which includes a disclaimer of opinion on the financial statements of the department's federal grant major fund. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

As described in our report referred to above, we were unable to obtain sufficient evidential matter from the department to support the amount reported as due to the State General Fund as of June 30, 2005 in the department's financial statements for the federal grant major fund.

**Internal Control over Financial Reporting**

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

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions we reported to the Auditor, State of Hawai‘i, and described in Chapter 2 of this report, we consider the accounting for the department’s federal grant programs and the significant deficiencies in the financial reporting processes to be material weaknesses that have been reported to the Auditor, State of Hawai‘i, and have been described as material weaknesses in Chapter 2 of this report.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the department’s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawai‘i Public Procurement Code (Chapter 103D, Hawai‘i Revised Statutes) and procurement rules, directives, and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under Government Auditing Standards, and which we have reported to the Auditor, State of Hawai‘i, and are described in Chapter 2 of this report.

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

/s/
KMH LLP
Honolulu, Hawai‘i
January 27, 2006

## Description of Basic Financial Statements

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

### *Basic financial statements*

## Government-wide financial statements

**Statement of Net Assets (Exhibit 3.1)** – This statement presents assets, liabilities, and net assets of the department at June 30, 2005 using the full accrual basis of accounting. This approach includes reporting not just current assets and liabilities, but also capital assets and long-term liabilities. The department's net assets are classified as invested in capital assets, restricted or unrestricted. Net assets are reported as restricted when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, or laws and regulations of other governments or imposed by law through constitutional provisions or enabling legislation.

**Statement of Activities (Exhibit 3.2)** – This statement presents revenues, expenses, and the change in net assets of the department for the year ended June 30, 2005, using the accrual basis of accounting and presents a comparison between direct expenses and program revenues. Direct expenses are those that are specifically associated with a service or program and are therefore clearly identifiable to a particular function. Program revenues include charges paid by the recipients of the goods or services offered by the programs and grants and contributions that are restricted to meeting the operational or capital requirements of a particular program. The comparison of program revenues and expenses identifies the extent to which each program or business segment is self-financing. Under this approach, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

### *Governmental fund financial statements*

**Governmental Funds Balance Sheet (Exhibit 3.3)** – This statement presents assets, liabilities, and fund balances by major governmental fund and the aggregate remaining fund information using the current financial resources measurement focus and modified accrual basis of accounting. Because the emphasis of this statement is on current financial resources, capital assets and long-term liabilities are not reported.

**Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances (Exhibit 3.4)** – This statement presents revenues, expenditures, and changes in fund balances by major governmental fund and the aggregate remaining fund information using the current financial resources measurement focus and modified accrual basis of accounting. Under this approach, revenues are recognized when measurable and available, while expenditures are recorded when the related fund liability is incurred.

**Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets (Exhibit 3.5)** – This reconciliation identifies the types of differences reported in the governmental funds balance sheet in comparison to the statement of net assets.

**Reconciliation of the Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances to the Statement of Activities (Exhibit 3.6)** – This reconciliation identifies the types of differences reported in the statement of revenues, expenditures, and changes in fund balances in comparison to the statement of activities.

### Statement of fiduciary net assets (Exhibit 3.7)

This statement presents the assets and liabilities of the department's agency funds.

### Budgetary comparison statements (Exhibit 3.8)

These statements compare actual revenues and expenditures of the department's general and major special revenue funds on a budgetary basis to the budget passed by the Legislature for the year ended June 30, 2005.

## Notes to Basic Financial Statements

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

### *Note 1 - Summary of significant accounting policies*

The Department of Land and Natural Resources (DLNR), State of Hawai'i, is headed by the Board of Land and Natural Resources. The DLNR manages, administers, and exercises control over public lands, water resources, minerals and all other interests therein and exercises such powers of disposition thereof as authorized by law. The DLNR also manages and administers the State's parks, historical sites, forests, forest reserves, fisheries, wildlife sanctuaries, game management areas, public hunting areas, natural area reserves, and other functions assigned to it by law. In connection with the above, the DLNR leases certain lands and facilities under its jurisdiction to individuals and organizations under long-term and short-term agreements.

The accompanying financial statements of the DLNR have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). In June 1999 the GASB issued Statement 34, *Basic Financial Statements – and Management's Discussion and*

*Analysis – for State and Local Governments*. This Statement establishes new financial reporting requirements for state and local governments throughout the United States of America. They require new information and restructure much of the information that governments have presented in the past. Comparability with reports issued in prior years is affected.

Other GASB Statements are required to be implemented in conjunction with GASB Statement 34. Therefore, the DLNR has implemented, if applicable, the following GASB Statements: Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions*, Statement 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, Statement 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus* and Statement 38 – *Certain Financial Statement Note Disclosures*.

The accompanying financial statements present the financial position of the DLNR and the various funds and fund types and the changes in financial position of the DLNR and the various funds and fund types. The financial statements are presented as of June 30, 2005, and for the year then ended.

The following is a summary of significant accounting policies.

### Reporting entity

The DLNR is part of the executive branch of the State. The DLNR's financial statements are intended to present the financial position and changes in financial position of only that portion of the governmental activities, each major fund, and the aggregate remaining fund information of the State that is attributable to the transactions of the DLNR. The State Comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually which includes the DLNR's assets, liabilities, net assets, and financial activities.

### Departmental and governmental fund financial statements

The departmental financial statements (the statement of net assets and the statement of activities) report information of all of the non-fiduciary activities of the DLNR. The effect of interfund activity has been removed from these departmental financial statements.

The statement of activities demonstrates the degree to which the direct expenses of a given function are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include charges to customers who purchase, use or directly benefit from goods or services provided by a given function. Program revenues also include grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. Appropriations and other items not properly included among program revenues are reported instead as general revenues. Resources that are dedicated internally are reported as general revenues rather than as program revenues.

Net assets are restricted when constraints placed on them are either externally imposed or are imposed by constitutional provisions or enabling legislation. Internally imposed designations of resources are presented as reserves of fund balances.

Portions of fund balances are also reserved for the following:

- Encumbrances are recorded obligations in the form of purchase orders or contracts.

- Receivables are amounts owed to DLNR at year end and are shown as reserved to indicate that portion of the fund balance that is not available for funding current expenditures.

- Continuing appropriations, which include specific legislative appropriations which do not lapse at the end of the year.

- Unexpended federal awards received for the restoration of the Island of Kaho‘olawe as outlined in Title X of the Fiscal Year 1994 Department of Defense Appropriations Act, Public Law 103-139, 107 Stat. 1418.

Unreserved fund balances represent resources that have not been internally designated. Financial statements are provided for the DLNR's governmental and fiduciary funds. The DLNR has no proprietary funds. Major individual governmental funds are reported as separate columns in the governmental fund financial statements.

### Measurement focus, basis of accounting, and financial statement presentation

**Departmental Financial Statements** – The departmental financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

**Governmental Fund Financial Statements** – The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the DLNR considers revenues to be available if they are collected within 60 days of the end of the current fiscal year end. The DLNR has no principal revenue sources which are considered susceptible to accrual.

Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Exceptions include employees' vested annual leave which is recorded as an expenditure when utilized. The amount of accumulated annual leave unpaid at June 30, 2005, has been reported only in the departmental financial statements.

### Fund accounting

The accounts of the DLNR are organized on the basis of funds, each of which is considered a separate accounting entity. The financial activities of each fund are accounted for with a separate set of self-balancing accounts which represent each funds' assets, liabilities, fund equity, revenues and expenditures.

The financial activities of the DLNR that are reported in the accompanying governmental fund financial statements have been classified into the following major governmental funds:

General Fund – The general fund is used to account for all financial activities except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted for.

Special Revenue Funds – Special revenue funds are used to account for proceeds of specific revenue sources (other than expendable trust) that are restricted to expenditures for specified purposes. Revenues are primarily from assessments and fees. DLNR's major special revenue funds are as follows:

Federal Grant Fund – This fund was established by the DLNR to account for its federal grant expenditures and related federal grant reimbursements. It does not account for monies received from the federal government for the rehabilitation of the island of Kaho‘olawe.

Water and Land Development Fund – This fund was established to account for revenues to be used for engineering services related to the development and administration of the Capital Improvements Projects Program and Flood Control/Dam Safety Programs.

Ocean-Based Recreation Fund – This fund was established under Section 248-8, HRS. The fund receives its revenues from fuel taxes and rents from mooring permits at the State's small boat harbors. These revenues are used for the planning, development, management, operations or maintenance of the small boat harbors.

Expendable Trust Funds – Expendable trust funds account for cash collected and expended by the DLNR for designated purposes. DLNR's major expendable trust fund is described as follows:

Kaho'olawe Rehabilitation Trust Fund – This fund was established under Chapter 6K, HRS. The primary source of revenues to this fund are monies received from the federal government for the rehabilitation and environmental restoration of the island of Kaho'olawe.

Capital Projects Fund – The capital projects fund is used to account for financial resources used for the acquisition, construction, or improvement of major capital facilities. These resources are derived from State appropriations.

### Fiduciary fund

The DLNR presents as a fiduciary fund, assets held by the DLNR in a trustee or agent capacity for other state departments, individuals and organizations.

### Appropriations

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

### Encumbrances

Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of monies are recorded in order to reserve that portion of the applicable appropriation, is employed as an extension of formal budgetary integration in the governmental fund types. Encumbrances outstanding at fiscal year end are reported as reservations of fund balances since they do not constitute expenditures or liabilities.

### Cash and short-term cash investments

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

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

Hawai‘i law authorized the State Director of Finance to invest in obligations of or obligations guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit and repurchase agreements with federally-insured financial institutions.

### Accumulated vacation and sick leave

Beginning July 1, 2004, eligible employees are credited with vacation at a rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year-end. The governmental fund financial statements record expenditures when employees are paid for leave. The departmental financial statements present the cost of accumulated vacation leave as a liability. Liabilities for vacation pay are inventoried at the end of each accounting period and adjusted to current salary levels.

Beginning July 1, 2001, eligible employees are credited with sick leave at a rate of one and three-quarter days per month. Unused sick leave may be accumulated without limit but can be taken only in the event of illness or other incapacitation and is not convertible to pay upon termination of employment. Accordingly, accumulated sick leave is not included in the DLNR's statement of net assets or governmental fund balance sheet. However, an employee who retires or leaves government service in good standing with 60 days or more in unused sick leave is entitled to additional service credit in the Employee's Retirement System of the State of Hawai‘i (ERS). Accumulated sick leave as of June 30, 2005 was $19,054,202.

### Intrafund and interfund transactions

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

All interfund transfers are reflected in the governmental fund financial statements but are eliminated in the departmental financial statements.

### Inventory

Inventory of materials and supplies is recorded as expenditures when purchased.

### Capital assets

Capital assets, which include land, buildings, improvements, equipment and vehicles, are reported in the departmental financial statements. Capital assets are assets which have a cost of $5,000 or more at the date of acquisition and have an expected useful life of five or more years. Purchased and constructed capital assets are valued at historical cost or estimated historical cost. Donated fixed assets are recorded at their fair market value at the date of donation.

Capital assets utilized in the governmental funds are recorded as expenditures in the governmental fund financial statements. Depreciation expense is recorded in the departmental financial statements.

Capital assets are depreciated in the departmental financial statements on the straight-line method over the assets' estimated useful life. There is no depreciation recorded for land, certain land improvements and construction-in-progress. Generally, estimated useful lives are as follows:

| | |
|---|---|
| Furniture and equipment | 5 – 7 years |
| Vehicles | 5 years |
| Buildings and land improvements | 15 – 40 years |

### Grants

Federal awards made on the basis of entitlement periods are recorded as intergovernmental receivables and revenues when entitlement occurs, federal reimbursement type awards are recorded as intergovernmental receivables and revenues when the related expenditures or expenses are incurred.

### Use of estimates

In preparing financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosures 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.

## *Note 2 - Budgeting and budgetary control*

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

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations.

For purposes of budgeting, the DLNR's budgetary fund structure and accounting principles differ from those utilized to present the financial statements in conformity with accounting principles generally accepted in the United States of America. Since the budgetary basis differs from accounting principles generally accepted in the United States of America, budget and actual amounts in the statements of revenues and expenditures – budget and actual, are presented on the budgetary basis. A reconciliation of the general and major special revenue funds' revenues in excess of expenditures on a budgetary basis for the year ended June 30, 2005, to the general and major special revenue funds' revenues in excess of expenditures presented in conformity with accounting principles generally accepted in the United States of America, is set forth below.

Under Section 78-13, HRS, staff salaries and wages amounting to $698,327 and $267,926 in the general and major special revenue funds, respectively, for the period from June 16, 2005 through June 30, 2005, are to be funded with monies budgeted for fiscal 2006. In addition, at June 30, 2005, the DLNR accrued expenditures of $71,047 and $118,080 in the general and major special revenue funds, respectively, for certain goods and services received through June 30, 2005, which the DLNR will fund with monies budgeted for fiscal year 2006. Accordingly, these amounts are excluded from the statements of revenues and expenditures - budget and actual. For accounting purposes these amounts are reflected in the departmental and governmental fund financial statements at June 30, 2005, in accordance with accounting principles generally accepted in the United States of America.

In fiscal 2004 under Section 78-13, HRS, salaries and wages for the period from June 16, 2004 to June 30, 2004 were funded with monies budgeted for fiscal 2005. In addition, at June 30, 2004, the DLNR accrued certain salaries and wages for the period prior to June 16, 2004 and certain goods and services received through June 30, 2004, which the DLNR funded with monies budgeted for fiscal 2005. Accordingly, these amounts are included in the statements of revenues and expenditures – budget and actual, for the fiscal year ended June 30, 2005. These salaries, wages, goods and services aggregated $950,905 and $761,584 in the general and major special revenue funds, respectively.

The following schedule reconciles the general and major special revenue funds' budgetary amounts to the amounts presented in accordance with accounting principles generally accepted in the United States of America (GAAP basis) for the fiscal year ended June 30, 2005.

| | | Major Special Revenue Funds | | |
|---|---|---|---|---|
| | General Fund | Federal Grant Fund | Water and Land Development Fund | Ocean-Based Recreation Fund |
| Excess of revenues over (under) expenditures – actual on budgetary basis | $1,149,296 | $(616,447) | $3,811 | $696,984 |
| Current year's appropriations included in reserved for encumbrances at June 30, 2005 | 2,846,070 | 3,525,941 | - | 583,826 |
| Expenditures for liquidation of prior year's encumbrances | (870,614) | (3,460,892) | - | (537,147) |
| Fiscal 2004 salaries and wages and other expenditures funded by fiscal 2005 budget | 950,905 | 192,207 | - | 569,377 |
| Fiscal 2005 salaries and wages funded by fiscal 2005 budget under Section 78-13, HRS | (698,327) | (75,490) | - | (192,436) |
| Fiscal 2005 expenditures funded by fiscal 2006 budget | (71,047) | (95,023) | - | (23,057) |
| Excess of revenues over (under) expenditures – GAAP basis | $3,306,283 | $(529,704) | $3,811 | $1,097,547 |

### *Note 3 - Cash and short-term cash investments held in state treasury*

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

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

As of June 30, 2005, the carrying amount, which approximates the bank balance of the DLNR's cash and short-term cash investments, was $154,801,975 for its governmental funds and $4,446,290 for its fiduciary funds.

### *Note 4 - Receivables*

At June 30, 2005, receivables for general leases and licenses for governmental funds consisted of the following:

| | Ocean-Based Recreation Fund | Other Funds | Total |
|---|---|---|---|
| Rents, fees, and licenses | $809,895 | $3,108 | $813,003 |
| Less allowance for doubtful accounts | (702,034) | (2,780) | (704,814) |
| | $107,861 | $328 | $108,189 |

The Department has installment agreements with certain lessees for accounts receivable of the trust and agency fund which aggregated $371,171 at June 30, 2005. These agreements provide for interest rates from 0 percent to 9.75 percent and payment terms from 1 to 30 years.

At June 30, 2005, receivables for general leases and licenses for fiduciary funds consisted of the following:

| | |
|---|---|
| Rents, fees and licenses | $ 769,471 |
| Less allowance for doubtful accounts | (214,140) |
| | $ 555,331 |

### *Note 5 - Capital assets*

The changes in capital assets were as follows:

| | Beginning Balance July 1, 2004 | Additions, Adjustments, and Transfers | Disposals, Adjustments, and Transfers | Ending Balance June 30, 2005 |
|---|---|---|---|---|
| Capital assets, not being depreciated – | | | | |
| Land | $138,688,453 | $49,433 | $(8) | $138,737,878 |
| Land improvements | 688,400 | - | - | 688,400 |
| Construction in progress | 15,438,432 | 9,345,549 | (1,875,231) | 22,908,750 |
| Other assets | 31,590 | - | - | 31,590 |
| Total capital assets, not being depreciated | 154,846,875 | 9,394,982 | (1,875,239) | 162,366,618 |
| Capital assets, being depreciated – | | | | |
| Buildings | 30,479,697 | 1,436,406 | - | 31,916,103 |
| Land improvements | 79,216,438 | 1,777,286 | (10,589,256) | 70,404,468 |
| Furniture and equipment | 6,190,939 | 1,484,771 | (92,524) | 7,583,186 |
| Motor vehicles | 12,277,398 | 834,161 | (782,152) | 12,329,407 |
| Total capital assets, being depreciated – | 128,164,472 | 5,532,624 | (11,463,932) | 122,233,164 |
| Less: accumulated depreciation for – | | | | |
| Buildings | (18,393,584) | (1,008,985) | - | (19,402,569) |
| Land improvements | (48,028,939) | (3,391,585) | 6,134,377 | (45,286,147) |
| Furniture and equipment | (4,740,694) | (559,527) | 92,524 | (5,207,697) |
| Motor vehicles | (10,169,217) | (1,047,733) | 782,152 | (10,434,798) |
| Total accumulated depreciation | (81,332,434) | (6,007,830) | 7,009,053 | (80,331,211) |
| Total capital assets, being depreciated, net | 46,832,038 | (475,206) | (4,454,879) | 41,901,953 |
| Capital assets, net | $201,678,913 | $8,919,776 | $(6,330,118) | $204,268,571 |

Changes to capital assets consisted of the following:

| | |
|---|---|
| Additions: | |
| Capital outlays and equipment purchases | $11,517,813 |
| Disposals: | |
| Disposed capital assets, at cost | $874,684 |
| Accumulated depreciation of disposed capital assets | 874,676 |
| Loss on disposal of capital assets | $(8) |
| Adjustments: | |
| Reduce land and buildings for costs which should not have been capitalized | $(2,284,082) |
| Transfer-out of property and equipment | $(1,009,830) |
| Other income from transfer-in of equipment from the federal government | $284,631 |
| Expense completed construction contracts, less than the capitalization threshold | $(170,624) |

Depreciation expense for the year ended June 30, 2005, was charged to functions of the DLNR as follows:

| | |
|---|---|
| Economic development | $ 254,081 |
| Environmental protection | 2,394,566 |
| Culture and recreation | 2,829,936 |
| Public safety | 87,458 |
| Individual rights | 103,646 |
| Government-wide support | 78,554 |
| | $ 5,748,241 |

### Note 6 - Long-term obligations

The changes in long-term obligations were as follows:

| | Accrued Vacation | General Obligation Bonds |
|---|---|---|
| Balance at July 1, 2004 | $ 5,667,797 | $ 8,494,294 |
| Principal payments | - | (568,372) |
| Net increase in accrued vacation | 515,146 | - |
| Bonds refunded | - | (488,675) |
| New bonds issued | - | 480,495 |
| Balance at June 30, 2005 | $ 6,192,943 | $ 7,917,742 |

The following are portions of the State of Hawai'i general obligation bonds allocated to the DLNR under acts of various Session Laws of Hawai'i. These bonds are backed by the full faith, credit, and taxing power of the State. Repayment of allocated bond debts are made to the State general fund. The details of these general obligation bonds at June 30, 2005 are as follows:

| | |
|---|---|
| $1,867,548 series BW bonds dated March 1, 1992; due in annual installments of $103,742; final payment on March 1, 2012; partially refunded $209,259 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at 5.50% to 6.40% payable semi-annually | $ 516,937 |
| $1,648,311 series BZ bonds dated October 1, 1992; due in annual installments of $103,019 commencing October 1, 2000; final payment on October 1, 2012; interest at 5.00% to 6.00% payable semi-annually | 824,156 |
| $987,378 series CB refunding bonds dated January 1, 1993; due in annual installments of $75,945; final payment on January 1, 2008; interest at 4.30% to 5.75% payable semi-annually | 227,835 |
| $1,852,409 series CC refunding bonds dated February 1, 1993; due in annual installments of $132,323 through February 1, 2005 and $132,295 through final payment on February 1, 2009; interest at 3.85% to 7.75% payable semi-annually | 396,886 |
| $1,218,020 series CH bonds dated November 1, 1993; due in annual installments of $67,673 through November 1, 2010 and $67,649 through final payment on November 1, 2013; interest at 4.10% to 6.00% payable semi-annually | 608,962 |
| $2,540,742 series CI refunding bonds dated November 1, 1993; due in annual installments of $158,674; final payment on November 1, 2010; interest at 4.00% to 5.00% payable semi-annually | 951,816 |
| $756,420 series CK bonds dated September 1, 1995; due in annual installments of $42,019; final payment on September 1, 2005; partially refunded $42,019 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at 5.00% payable semi-annually | 42,019 |

| | |
|---|---|
| \$1,543,701 series CO bonds dated March 1, 1997; due in varying semi-annual installments; final payment on March 1, 2011; interest at 4.50% to 6.00% payable semi-annually | 902,088 |
| \$129,212 series CN bonds dated March 1, 1997; due in varying annual installments commencing March 1, 2002 through final payment on March 1, 2009; partially refunded \$11,135 by the issuance of refunding General Obligation Bonds, Series CS, dated April 1, 1998; interest at 5.25% to 6.25% payable semi-annually; partially refunded \$67,711 by the issuance of refunding General Obligation Bonds series DG, dated June 15, 2005; interest at 6.00% to 6.25% payable semi-annually | 28,224 |
| \$214 series CP bonds dated October 1, 1997; due in varying annual installments commencing April 1, 2002 through final payment on April 1, 2021; partially refunded \$102 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at 5.00% payable semi-annually | 97 |
| \$85,000 series CR bonds dated April 1, 1998; due in varying annual installments commencing April 1, 2006 through final payment on April 1, 2011; partially refunded \$63,699 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at 5.50% to 6.00% payable semi-annually | 21,601 |
| \$1,489,544 series CS bonds dated April 1, 1998; due in varying annual installments commencing April 1, 2003 through final payment on April 1, 2009; interest at 5.00% to 5.25% payable semi-annually | 922,143 |
| \$576,754 series CT bonds dated September 15, 1999; due in varying annual installments commencing September 1, 2005 through final payment on September 1, 2012; partially refunded \$87,215 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at 5.25% to 5.625% payable semi-annually | 141,016 |
| \$456,926 series CW bonds dated August 1, 2001; due in varying annual installments commencing August 1, 2005 through final payment on August 1, 2015; partially refunded \$14,662 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at various interest rates payable semi-annually | 442,264 |

| | |
|---|---|
| $887,628 series CY bonds dated February 2, 2002; due in varying annual installments commencing February 1, 2007 through final payment on February 1, 2015; partially refunded $4,309 by the issuance of refunding General Obligation Bonds, series DG, dated June 15, 2005; interest at various interest rates payable semi-annually | 883,319 |
| $396,612 series DB bonds dated September 16, 2003; due in varying annual installments commencing September 1, 2008 through final payment on September 1, 2016; interest at 5.00% to 5.25% payable semi-annually | 396,612 |
| $131,272 series DC bonds dated September 16, 2003; principal due on September 1, 2005; interest at 3.00% payable semi-annually | 131,272 |
| $468,352 series DG bonds dated June 15, 2005; due in varying annual installments commencing July 1, 2009 through final payment on July 1, 2017; interest at 5.00% payable semi-annually | 468,352 |
| $12,143 series DH bonds dated June 15, 2005; due in one payment on June 1, 2006; interest at 5.00% payable June 1, 2006 | 12,143 |
| Total | $ 7,917,742 |

Interest paid by the DLNR during the fiscal year ended June 30, 2005, approximated $371,000. The approximate annual requirements to amortize the general obligation bonds' debt and related interest are as follows:

| | Principal | Interest | Total |
|---|---|---|---|
| Fiscal year ending June 30, | | | |
| 2006 | $ 1,110,000 | $ 359,540 | $ 1,469,540 |
| 2007 | 1,144,757 | 295,243 | 1,440,000 |
| 2008 | 1,178,615 | 238,318 | 1,416,933 |
| 2009 | 1,063,777 | 180,186 | 1,243,963 |
| 2010 | 732,663 | 130,095 | 862,758 |
| 2011 | 828,803 | 95,553 | 924,356 |
| 2012 | 518,327 | 60,758 | 579,085 |
| 2013 | 416,846 | 38,046 | 454,892 |
| 2014 | 327,296 | 24,715 | 352,011 |
| 2015 | 273,854 | 15,688 | 289,542 |
| 2016 | 146,275 | 8,121 | 154,396 |
| 2017 | 113,472 | 4,429 | 117,901 |
| 2018 | 63,042 | 1,451 | 64,493 |

| | | | |
|---|---|---|---|
| 2019 | 5 | 1 | 6 |
| 2020 | 5 | - | 5 |
| 2021 | 5 | - | 5 |
| Total | $ 7,917,742 | $ 1,452,144 | $ 9,369,886 |

### *Note 7 - Retirement benefits*

#### Plan description

All eligible employees of the State and counties are required by Chapter 88, HRS, to become members of the Employees' Retirement System of the State of Hawai'i (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS is governed by a Board of Trustees. All contributions, benefits, and eligibility requirements are established by Chapter 88, HRS, and can be amended by legislative action. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at 201 Merchant Street, Suite 1400, Honolulu, Hawai'i 96813.

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

Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date is based on the three highest paid years of service, excluding the vacation payment.

#### Funding policy

Most covered employees of the contributory option are required to contribute 7.8 percent of their salary. Police officers, firefighters, investigators of the departments of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2 percent of their salary.

The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 27 years from June 30, 2002.

The State's contribution requirements as of June 30, 2004, 2003, and 2002 were approximately $181,614,000, $158,622,000, and $113,984,000, respectively. The State contributed 100 percent of its required contributions for those years. Changes in salary growth assumptions and investment earnings pursuant to Act 100, SLH 1999, decreased the June 30, 2002 and 2001 required contributions. Act 233, SLH 2002, increased the 2003 contribution by providing a one-time lump-sum pensioner bonus to retirees who were 70 years and older with at least 20 years of credited service as of June 30, 2002. Also Act 284, SLH 2001, provided an increase in the pension benefits effective 2004 to retirees with military service. Covered payroll for the fiscal year ended June 30, 2004 approximately $2,021,447,000.

### Post-retirement health care and life insurance benefits

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

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

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

There are currently approximately 24,200 state retirees receiving such benefits. Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive reimbursement of the basic medical coverage premium. Contributions are financed on a pay-as-you-go basis. During fiscal 2004, expenditures of $151,851,000 were recognized for post-retirement health care and life insurance benefits, approximately $35,136,000 of which is attributable to the Component Units.

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

### Cost of retirement benefits

The DLNR's general fund share of the retirement system expense for the fiscal year ended June 30, 2005 was included as an item to be expended by the Department of Budget and Finance, State of Hawai'i, and is not reflected in the DLNR's financial statements. The DLNR's special revenue funds, expendable trust finds and capital projects fund contributed approximately $1,065,900 to the ERS for the fiscal year ended June 30, 2005. The entire ERS's actuarial determination of the employer contribution requirements were met as of June 30, 2005.

## *Note 8 - Commitments and contingencies*

### Litigation

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

### Insurance

Insurance coverage is maintained at the State level. The State is substantially self-insured for all perils including workers' compensation. All payments for workers' compensation are reflected in the respective department or agency's financial statements. Workers' compensation payments made by the DLNR for the fiscal year ended June 30, 2005 approximated $157,200 and are reflected as expenditures of the general find. Amounts related to unpaid workers' compensation are reflected in the Statement of Net Assets. Expenditures for other insurance claims are made by the Department of Accounting and General Services, State of Hawai'i, and are not reflected in the DLNR's financial statements. Workers' compensation benefit claims reported, as well as incurred but not reported were reviewed at year end. In the opinion of management, the estimated losses from these claims are not material.

### Deferred compensation plan

In 1983, the State established a deferred compensation plan which enables State employees to defer a portion of their compensation. The Department of Human Resources Development, State of Hawai‘i, has the fiduciary responsibility of administering the plan. The plan assets are protected from claims of the State's creditors and from diversion to any uses other than paying benefits to participants and beneficiaries. The deferred compensation is not available to employees until termination, retirement, death, or an unforeseeable emergency.

### Due to state treasury

Included in the special revenue funds are approximately $7,763,000 of federal fund reimbursements received or receivable by the DLNR for program expenditures that were paid with previous year's general operating funds and $539,000 of federal fund reimbursements received by the DLNR for the acquisition or construction of major capital facilities that were paid with the proceeds of general obligation bonds. Under Act 328, SLH 1997, such monies are owed to the State Treasury.

### Other

At June 30, 2005, substantially all of the reserve for encumbrances in the capital projects fund relates to construction contracts.

## *Note 9 - Small Boat Harbors and Boat Ramps Program*

During the year ended June 30, 2005, the DLNR's special revenue funds were charged by the Department of Transportation, State of Hawai‘i, approximately $96,000 for services rendered during the year in connection with the Small Boat Harbors and Boat Ramps Program. At June 30, 2005, the DLNR owed the Department of Transportation, State of Hawai‘i, approximately $70,000 for these services.

## *Note 10 - Central service and administration fees*

During the fiscal year ended June 30, 2005, the DLNR's special revenue finds were charged by the Department of Budget and Finance, State of Hawai‘i, approximately $2,088,000 in central service and administration fees. At June 30, 2005, the DLNR owed the Department of Budget and Finance, State of Hawai‘i, approximately $1,311,000 in unpaid fees.

## *Note 11 - Due to other state agencies*

For the fiscal year ended June 30, 2004, the DLNR has recorded a liability of $6,180,795 in its Water and Land Development Fund, owed to the State of Hawai‘i, which in a previous year was reversed as it was believed that there was no further obligation to reimburse the State for the amount. However, the DLNR determined that the liability will continue to be reported until the status of this obligation can be formally resolved with the State. The liability is related to advances from the State during the 1950s and 1960s for the development of water and irrigation projects. The projects were completed and subsequently transferred to the Department of Agriculture, State of Hawai‘i; however, the liability remained with the DLNR. The DLNR’s attempts to resolve this matter with the State have not been successful but otherwise, the DLNR has never been notified of any requirement to repay the advances. This resulted in a $6,180,795 restatement to the July 1, 2003 unreserved fund balance of the Governmental Funds.

In addition, the DLNR receives revenue from numerous leases of State lands and properties. These include leases of ceded lands which are held in trust for native Hawaiians by the State. The State is required to pay 20 percent of revenues generated from ceded lands to the Office of Hawaiian Affairs (OHA), State of Hawai‘i, which administers and manages the proceeds related to the ceded lands. The DLNR accounts for the revenues derived from ceded lands and determines the amounts due which are paid to OHA.

During the fiscal year ended June 30, 2005, DLNR discovered that it may have been incorrectly calculating ceded land revenues related to its harbors. The result is that DLNR may have been underpaying OHA for amounts due on such revenue. As of June 30, 2005, DLNR has recorded a liability in the Ocean-Based Recreation Fund of approximately $2,154,700 for amounts due to OHA from revenues derived from its harbors. DLNR will be investigating this matter to determine the amount, if any, of the additional liability due to OHA.

Exhibit 3.1

# State of Hawai‘i, Department of Land and Natural Resources

Statement of Net Assets
June 30, 2005

| | | |
|---|---|---|
| **Assets** | | |
| Cash and short-term cash investments held in State Treasury | $ | 154,801,975 |
| Receivables: | | |
| Federal grants | | 2,606,695 |
| General leases and licenses, net of allowance for losses of $704,814 | | 108,189 |
| Capital assets: | | |
| Land, improvements, construction-in-progress and other capital assets, net of depreciation | | 204,268,571 |
| Total assets | | 361,785,430 |
| **Liabilities** | | |
| Vouchers and Contracts Payable | | 5,136,410 |
| Accrued Wages and Employee Benefits Payable | | 1,957,719 |
| Due to State Treasury | | 8,302,509 |
| Due to Other State Agencies | | 9,771,225 |
| Deferred Revenue | | 5,928,458 |
| General Obligation Bonds: | | |
| Due within one year | | 1,110,000 |
| Due in more than one year | | 6,807,742 |
| Accrued Vacation | | |
| Due within one year | | 1,997,463 |
| Due in more than one year | | 4,195,480 |
| Total liabilities | | 45,207,006 |
| Commitments and Contingencies | | |
| **Net Assets** | | |
| Invested in Capital Assets, net of related debt | | 196,350,829 |
| Unrestricted | | 120,227,595 |
| Total net assets | | 316,578,424 |
| Total liabilities and net assets | $ | 361,785,430 |

See accompanying notes to financial statements.

**Exhibit 3.2**

## State of Hawai‘i,
## Department of Land and Natural Resources

Statement of Activities
For the Year Ended June 30, 2005

| Functions/Programs | Expenses | Program Revenue: Interest, Rents and Fees | Program Revenue: Operating Grants and Contributions | Net (Expense) Revenue and Changes in Net Assets |
|---|---|---|---|---|
| Departmental Activities: | | | | |
| Economic development | $ 3,627,602 | $ 786,512 | $ 1,130,292 | $ (1,710,798) |
| Environmental protection | 35,866,863 | 6,767,489 | 8,626,047 | (20,473,327) |
| Culture and recreation | 23,137,764 | 14,062,920 | 4,645,951 | (4,428,893) |
| Public safety | 317,865 | - | 85,250 | (232,615) |
| Individual rights | 8,347,023 | 4,819,046 | - | (3,527,977) |
| Government-wide support | 8,562,068 | 7,071,423 | 248,480 | (1,242,165) |
| Capital outlays | 6,675,482 | - | - | (6,675,482) |
| Total departmental activities | $ 86,534,667 | $ 33,507,390 | $ 14,736,020 | (38,291,257) |
| General revenues: | | | | |
| Appropriations, net of lapsed appropriations | | | | 61,188,299 |
| Transfers, net (including $1,009,830 of capital assets transferred out) | | | | (1,474,235) |
| Total general revenues and transfers | | | | 59,714,064 |
| Change in net assets | | | | 21,422,807 |
| Net assets, July 1, 2004 | | | | 295,155,617 |
| Net assets, June 30, 2005 | | | | $ 316,578,424 |

See accompanying notes to financial statements.

Exhibit 3.3

## State of Hawai‘i,
## Department of Land and Natural Resources
Balance Sheet - Governmental Funds
June 30, 2005

| | General Fund | Federal Grant Fund | Water and Land Development | Ocean-Based Recreation Fund | Kaho'olawe Rehabilitation Trust Fund | Capital Projects Fund | Other Funds | Total |
|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | |
| Cash and Short Term Cash Investments Held in State Treasury | $ 3,887,561 | $ 9,403,648 | $ 533,699 | $ 2,209,994 | $ 30,882,560 | $ 79,338,895 | $ 28,545,618 | $ 154,801,975 |
| Receivables | | | | | | | | |
| Federal grants | - | 2,166,768 | - | - | - | 439,927 | - | 2,606,695 |
| General leases and licenses, net of allowance of $704,814 | - | - | - | 107,861 | - | - | 328 | 108,189 |
| Total assets | 3,887,561 | 11,570,416 | 533,699 | 2,317,855 | 30,882,560 | 79,778,822 | 28,545,946 | 157,516,859 |
| **Liabilities and Fund Balances** | | | | | | | | |
| Liabilities | | | | | | | | |
| Vouchers and contracts payable | 688,848 | 906,227 | - | 224,907 | 379,399 | 1,915,232 | 1,021,797 | 5,136,410 |
| Accrued wages and employee benefits payable | 922,918 | 99,587 | - | 222,067 | 61,948 | 101,155 | 550,044 | 1,957,719 |
| Due to State Treasury | - | 8,302,509 | - | - | - | - | - | 8,302,509 |
| Due to other State agencies | - | - | 6,180,795 | 2,783,351 | - | - | 807,079 | 9,771,225 |
| Deferred revenue | - | 5,264,048 | - | 309,273 | - | - | 355,137 | 5,928,458 |
| Total liabilities | 1,611,766 | 14,572,371 | 6,180,795 | 3,539,598 | 441,347 | 2,016,387 | 2,734,057 | 31,096,321 |
| Fund Balances: | | | | | | | | |
| Reserved for: | | | | | | | | |
| Encumbrances | 3,045,169 | 4,775,506 | - | 697,383 | 1,868,031 | 41,257,979 | 8,814,363 | 60,458,431 |
| Receivables | - | 2,166,768 | - | 107,861 | - | 439,927 | 328 | 2,714,884 |
| Continuing appropriations | - | - | - | - | - | 36,064,529 | - | 36,064,529 |
| Unexpended Federal awards | - | - | - | - | 28,573,182 | - | - | 28,573,182 |
| Total reserved fund balances | 3,045,169 | 6,942,274 | - | 805,244 | 30,441,213 | 77,762,435 | 8,814,691 | 127,811,026 |
| Unreserved | (769,374) | (9,944,229) | (5,647,096) | (2,026,987) | - | - | 16,997,198 | (1,390,488) |
| Total fund balances | 2,275,795 | (3,001,955) | (5,647,096) | (1,221,743) | 30,441,213 | 77,762,435 | 25,811,889 | 126,420,538 |
| Total liabilities and fund balances | $ 3,887,561 | $ 11,570,416 | $ 533,699 | $ 2,317,855 | $ 30,882,560 | $ 79,778,822 | $ 28,545,946 | $ 157,516,859 |

See accompanying notes to financial statements.

Exhibit 3.4

## State of Hawai‘i,
## Department of Land and Natural Resources

Statement of Revenues, Expenditures and Changes in Fund Balances
For the Year Ended June 30, 2005

| | General Fund | Federal Grant Fund | Water and Land Development | Ocean-Based Recreation Fund | Kaho'olawe Rehabilitation Trust Fund | Capital Projects Fund | Other Funds | Total |
|---|---|---|---|---|---|---|---|---|
| Revenues: | | | | | | | | |
| Appropriations | $ 25,562,671 | $ - | $ - | $ - | $ - | $ 41,596,003 | $ - | $ 67,158,674 |
| Intergovernmental revenues | - | 11,896,956 | - | - | 50,472 | 2,014,228 | - | 13,961,656 |
| General leases, licenses, and permits | - | 17,657 | - | 8,669,057 | - | - | 20,344,978 | 29,031,692 |
| Taxes, fuel, and other | - | - | - | 1,576,564 | - | - | 1,143,471 | 2,720,035 |
| Interest | - | 54,640 | 14,769 | 42,958 | 855,431 | 11,337 | 776,526 | 1,755,661 |
| Other | - | 2,135 | 47,889 | 33,127 | 5,200 | - | 401,381 | 489,732 |
| Total revenues | 25,562,671 | 11,971,388 | 62,658 | 10,321,706 | 911,103 | 43,621,568 | 22,666,356 | 115,117,450 |
| Expenditures: | | | | | | | | |
| Current: | | | | | | | | |
| Economic development | 1,570,205 | 1,271,472 | 58,847 | - | - | - | 527,166 | 3,427,690 |
| Environmental protection | 13,650,713 | 8,756,651 | - | - | 3,587,465 | - | 5,608,430 | 31,603,259 |
| Culture and recreation | 6,908,416 | 2,367,141 | - | 8,276,311 | - | - | 2,992,719 | 20,544,587 |
| Public safety | 123,723 | 105,828 | - | - | - | - | - | 229,551 |
| Individual rights | 3,331 | - | - | - | - | - | 8,593,275 | 8,596,606 |
| Government-wide support | - | - | - | - | - | - | 8,540,355 | 8,540,355 |
| Capital improvement projects | - | - | - | - | - | 16,021,031 | - | 16,021,031 |
| Debt service: | | | | | | | | |
| Principal on long-term debt | - | - | - | 576,551 | - | - | - | 576,551 |
| Interest on long-term debt | - | - | - | 371,297 | - | - | - | 371,297 |
| Total expenditures | 22,256,388 | 12,501,092 | 58,847 | 9,224,159 | 3,587,465 | 16,021,031 | 26,261,945 | 89,910,927 |
| Excess (deficiency) of revenues over (under) expenditures | 3,306,283 | (529,704) | 3,811 | 1,097,547 | (2,676,362) | 27,600,537 | (3,595,589) | 25,206,523 |
| Other Financing Sources (Uses) | | | | | | | | |
| Operating transfers in | - | 10,194,798 | 529,888 | 8,692,835 | 30,378,179 | 3,458,902 | 15,016,634 | 68,271,236 |
| Operating transfers out | (469,516) | (10,193,588) | (529,888) | (10,106,016) | (30,378,179) | (2,768,161) | (14,290,293) | (68,735,641) |
| Total other financing sources (uses) | (469,516) | 1,210 | - | (1,413,181) | - | 690,741 | 726,341 | (464,405) |
| Excess (deficiency) of revenues and other financing sources over (under) expenditures and other financing uses | 2,836,767 | (528,494) | 3,811 | (315,634) | (2,676,362) | 28,291,278 | (2,869,248) | 24,742,118 |
| Lapsed Appropriations | (855,228) | - | - | - | - | (5,115,147) | - | (5,970,375) |
| Net change in fund balances | 1,981,539 | (528,494) | 3,811 | (315,634) | (2,676,362) | 23,176,131 | (2,869,248) | 18,771,743 |
| Fund Balances, July 1, 2004 | 294,256 | (2,473,461) | (5,650,907) | (906,109) | 33,117,575 | 54,586,304 | 28,681,137 | 107,648,795 |
| Fund Balances, June 30, 2005 | $ 2,275,795 | $ (3,001,955) | $ (5,647,096) | $ (1,221,743) | $ 30,441,213 | $ 77,762,435 | $ 25,811,889 | $ 126,420,538 |

See accompanying notes to financial statements.

Exhibit 3.5

## State of Hawai‘i,
## Department of Land and Natural Resources

Statement of Fiduciary Net Assets
June 30, 2005

| | | |
|---|---|---|
| **Assets** | | |
| Cash and Short Term Cash Investments Held in State Treasury | $ | 4,446,290 |
| Receivables: | | |
| General leases and licenses, net of allowance for losses of $214,140 | | 555,331 |
| Total assets | | 5,001,621 |
| **Liabilities** | | |
| Due to State Treasury | | 443,660 |
| Due to Other State Agencies | | 678,976 |
| Total liabilities | | 1,122,636 |
| Commitments and Contingencies | | |
| **Net Assets** | | |
| Held in Trust For: | | |
| Individuals and organizations | | 3,878,985 |
| Total net assets | $ | 3,878,985 |

See accompanying notes to financial statements.

**Exhibit 3.6**

## State of Hawai‘i, Department of Land and Natural Resources

Reconciliation of Governmental Funds Balance Sheet to the Statement of Net Assets
June 30, 2005

| | | |
|---|---|---|
| Total Fund Balances, governmental funds | | $ 126,420,538 |
| Amounts Reported for Governmental Activities in the Statement of Net Assets are different because: | | |
| (1) Capital assets used in governmental activities are not financial resources and therefore are not reported in the governmental funds. These assets consist of: | | |
| Land improvements | 70,404,468 | |
| Other capital assets | 51,828,696 | |
| Accumulated depreciation | (80,331,211) | |
| Land | 138,737,878 | |
| Other capital assets, not depreciated | 719,990 | |
| Construction in progress | 22,908,750 | |
| Total capital assets | | 204,268,571 |
| (2) Bonds payable are not reported in the governmental funds | | (7,917,742) |
| (3) Accrued vacation is not reported in the governmental funds | | (6,192,943) |
| Total Net Assets | | $ 316,578,424 |

See accompanying notes to financial statements.

**Exhibit 3.7**

## State of Hawai‘i,
## Department of Land and Natural Resources

Reconciliation of Governmental Funds Statement of Revenues, Expenditures, and Changes in Net Assets to the Statement of Activities
June 30, 2005

| | | | |
|---|---|---|---|
| Net Change in Fund Balances, governmental funds | | | $ 18,771,743 |
| Amounts Reported for Governmental Activities in the Statement of Activities are different because: | | | |
| (1) | Capital outlays are reported as expenditures in governmental funds, however, in the statement of activities, the cost of capital assets is allocated over their estimated useful lives as depreciation expense. In the current period these outlays are: | | |
| | Capital outlays and equipment purchases | 11,517,813 | |
| | Loss on disposal of equipment | (8) | |
| | Depreciation expense | (5,748,241) | |
| | Adjustment of costs for depreciation | (2,284,082) | |
| | Transfer-out of property and equipment | (1,009,830) | |
| | Completed construction projects less than the capitalization threshold | (170,624) | |
| | Excess of capital outlays over depreciation expense | | 2,305,028 |
| (2) | Repayment of bond principal is reported as an expenditure in governmental funds, but the repayment reduces bonds payable in the statement of net assets | | 576,551 |
| (3) | The increase in accrued vacation is not reported in govermental funds | | (515,146) |
| (4) | The transfer-in of capital assets from the federal government is not reported in the governmental funds | | 284,631 |
| Change in Net Assets | | | $ 21,422,807 |

See accompanying notes to financial statements.

Exhibit 3.8

## State of Hawai'i,
## Department of Land and Natural Resources

Statement of Revenues and Expenditures - Budget and Actual - General Fund
For the Year Ended June 30, 2005

| | Budgeted Amounts | | Actual | Variance with Final Budget - Positive |
|---|---|---|---|---|
| | Original | Final | (Budgetary Basis) | (Negative) |
| Appropriations | $ 25,562,671 | $ 25,562,671 | $ 25,562,671 | $ - |
| Expenditures: | | | | |
| Economic development | 1,709,387 | 1,709,387 | 1,615,552 | 93,835 |
| Environmental protection | 16,359,430 | 16,359,430 | 15,484,748 | 874,682 |
| Culture and recreation | 7,368,414 | 7,368,414 | 7,189,243 | 179,171 |
| Public safety | 125,440 | 125,440 | 123,832 | 1,608 |
| Total expenditures | 25,562,671 | 25,562,671 | 24,413,375 | 1,149,296 |
| Excess of Revenues over Expenditures | $ - | $ - | $ 1,149,296 | $ (1,149,296) |

See accompanying notes to financial statements.

Exhibit 3.9

## State of Hawai‘i, Department of Land and Natural Resources

Statement of Revenues and Expenditures - Budget and Actual - Other Major Funds
For the Year Ended June 30, 2005

| | Budgeted Amounts | | Actual | Variance with Final Budget - Positive |
|---|---|---|---|---|
| | Original | Final | (Budgetary Basis) | (Negative) |
| **Federal Grant Fund** | | | | |
| Revenues | $ 23,543,681 | $ 23,543,681 | $ 11,971,388 | $ (11,572,293) |
| Expenditures: | | | | |
| Economic development | 4,187,469 | 4,187,469 | 1,255,048 | 2,932,421 |
| Environmental protection | 15,458,364 | 15,458,364 | 8,728,044 | 6,730,320 |
| Culture and recreation | 3,688,424 | 3,688,424 | 2,498,643 | 1,189,781 |
| Public safety | 136,790 | 136,790 | 106,100 | 30,690 |
| Government-wide support | 72,634 | 72,634 | - | 72,634 |
| Total expenditures | 23,543,681 | 23,543,681 | 12,587,835 | 10,955,846 |
| Excess of Revenues over Expenditures | $ - | $ - | $ (616,447) | $ (616,447) |

See accompanying notes to financial statements.

**Exhibit 3.10**

## State of Hawai‘i,
## Department of Land and Natural Resources

Statement of Revenues and Expenditures - Budget and Actual - Other Major Funds
For the Year Ended June 30, 2005

| | Budgeted Amounts | | Actual | Variance with Final Budget - Positive |
|---|---|---|---|---|
| | Original | Final | (Budgetary Basis) | (Negative) |
| **Water and Land Development Fund** | | | | |
| Revenues | $ 110,000 | $ 110,000 | $ 62,658 | $ (47,342) |
| Expenditures: | | | | |
| Economic development | 110,000 | 110,000 | 58,847 | 51,153 |
| Excess of Revenues over Expenditures | $ - | $ - | $ 3,811 | $ 3,811 |
| **Ocean-Based Recreation Fund** | | | | |
| Revenues | $ 15,207,988 | $ 15,207,988 | $ 10,321,706 | $ (4,886,282) |
| Expenditures: | | | | |
| Culture and recreation | 15,207,988 | 15,207,988 | 9,624,722 | 5,583,266 |
| Excess of Revenues over Expenditures | $ - | $ - | $ 696,984 | $ 696,984 |

See accompanying notes to financial statements.

Exhibit 3.11

# State of Hawai‘i,
# Department of Land and Natural Resources

Combining Balance Sheet - Nonmajor Governmental Funds
June 30, 2005

| | Bureau of Conveyances Fund | Special Land Development Fund | Commercial Fisheries Fund | Forest Stewardship Fund | Aquatic Resources Fund |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and short-term cash investments held in State Treasury | $ 2,529,592 | $ 7,848,905 | $ 434,952 | $ 582,737 | $ 79,142 |
| Receivables | | | | | |
| General leases and licenses, net of allowance for losses | - | - | - | - | - |
| Total assets | 2,529,592 | 7,848,905 | 434,952 | 582,737 | 79,142 |
| **Liabilities and Fund Balances** | | | | | |
| Liabilities: | | | | | |
| Vouchers and contracts payable | 16,549 | 488,485 | 18,861 | 43,194 | - |
| Accrued wages and employee benefits payable | 145,462 | 167,019 | 1,262 | - | - |
| Due to other State agencies | 324,731 | 97,943 | - | - | - |
| Deferred revenue | - | 241,048 | - | - | - |
| Total liabilities | 486,742 | 994,495 | 20,123 | 43,194 | - |
| Fund balances: | | | | | |
| Reserved for: | | | | | |
| Encumbrances | 174,514 | 2,113,323 | 184,032 | 195,709 | - |
| Receivables | - | - | - | - | - |
| Total reserved fund balances | 174,514 | 2,113,323 | 184,032 | 195,709 | - |
| Unreserved | 1,868,336 | 4,741,087 | 230,797 | 343,834 | 79,142 |
| Total fund balances | 2,042,850 | 6,854,410 | 414,829 | 539,543 | 79,142 |
| Total liabilities and fund balances | $ 2,529,592 | $ 7,848,905 | $ 434,952 | $ 582,737 | $ 79,142 |

See accompanying notes to financial statements.

**Exhibit 3.11 (continued)**

## State of Hawai'i,
## Department of Land and Natural Resources

Combining Balance Sheet - Nonmajor Governmental Funds
June 30, 2005

| Forests and Wildlife Fund | Water Resources Fund | Conservation Resource Enforcement Fund | Natural Area Reserves Fund | Historical Preservation Fund | Subtotal Carried Forward |
|---|---|---|---|---|---|
| $ 1,041,374 | $ 745,079 | $ 53,239 | $ 8,332,847 | $ 1,435 | $ 21,649,302 |
| - | - | - | - | - | - |
| 1,041,374 | 745,079 | 53,239 | 8,332,847 | 1,435 | 21,649,302 |
| 76,653 | 471 | 24,978 | 179,529 | - | 848,720 |
| 8,778 | 6,703 | 126,751 | - | 9,024 | 464,999 |
| - | - | - | 242,022 | - | 664,696 |
| - | 4,623 | - | - | - | 245,671 |
| 85,431 | 11,797 | 151,729 | 421,551 | 9,024 | 2,224,086 |
| 1,330,078 | 333,130 | 69,897 | 1,270,021 | - | 5,670,704 |
| - | - | - | - | - | - |
| 1,330,078 | 333,130 | 69,897 | 1,270,021 | - | 5,670,704 |
| (374,135) | 400,152 | (168,387) | 6,641,275 | (7,589) | 13,754,512 |
| 955,943 | 733,282 | (98,490) | 7,911,296 | (7,589) | 19,425,216 |
| $ 1,041,374 | $ 745,079 | $ 53,239 | $ 8,332,847 | $ 1,435 | $ 21,649,302 |

See accompanying notes to financial statements.

Exhibit 3.12

## State of Hawai‘i,
## Department of Land and Natural Resources

Combining Balance Sheet - Nonmajor Governmental Funds
June 30, 2005

| | Subtotal Brought Forward | Na Ala Hele Park Development Fund | Wildlife Revolving Fund | Sport-Fish Restoration Fund | Park Development Operations Fund | State Parks Fund |
|---|---|---|---|---|---|---|
| Assets | | | | | | |
| Cash and short-term cash investments held in State Treasury | $ 21,649,302 | $ 630,730 | $ 427,503 | $ 76,211 | $ 36,566 | $ 4,332,878 |
| Receivables | | | | | | |
| General leases and licenses, net of allowance for losses | - | - | - | - | - | 328 |
| Total assets | 21,649,302 | 630,730 | 427,503 | 76,211 | 36,566 | 4,333,206 |
| Liabilities | | | | | | |
| Vouchers and contracts payable | 848,720 | 3,841 | 20,713 | 721 | 10,295 | 137,507 |
| Accrued wages and employee benefits payable | 464,999 | 21,754 | 7,562 | - | - | 48,072 |
| Due to other State agencies | 664,696 | - | - | - | - | 142,383 |
| Deferred revenue | 245,671 | - | - | - | - | 109,466 |
| Total liabilities | 2,224,086 | 25,595 | 28,275 | 721 | 10,295 | 437,428 |
| Fund Balances: | | | | | | |
| Reserved for: | | | | | | |
| Encumbrances | 5,670,704 | 24,497 | 135,454 | - | 23,604 | 1,805,836 |
| Receivables | - | - | - | - | - | 328 |
| Total reserved fund balances | 5,670,704 | 24,497 | 135,454 | - | 23,604 | 1,806,164 |
| Unreserved | 13,754,512 | 580,637 | 263,774 | 75,490 | 2,667 | 2,089,614 |
| Total fund balances | 19,425,216 | 605,134 | 399,228 | 75,490 | 26,271 | 3,895,778 |
| Total liabilities and fund balances | $ 21,649,302 | $ 630,729 | $ 427,503 | $ 76,211 | $ 36,566 | $ 4,333,206 |

See accompanying notes to financial statements.

Exhibit 3.12 (continued)

# State of Hawai'i,
# Department of Land and Natural Resources

Combining Balance Sheet - Nonmajor Governmental Funds
June 30, 2005

| Natural Physical Environment Fund | Preservation of Endangered Plants Fund | Donations, Gifts and Grants Fund | OHA Kikakakeokea Trust Fund | Endangered Species Trust Fund | Total Other Governmental Funds |
|---|---|---|---|---|---|
| $ 20,024 | $ 3,164 | $ 10,111 | $ 1,270,491 | $ 88,638 | $ 28,545,618 |
| - | - | - | - | - | 328 |
| 20,024 | 3,164 | 10,111 | 1,270,491 | 88,638 | 28,545,946 |
| - | - | - | - | - | 1,021,797 |
| 7,657 | - | - | - | - | 550,044 |
| - | - | - | - | - | 807,079 |
| - | - | - | - | - | 355,137 |
| 7,657 | - | - | - | - | 2,734,057 |
| - | - | - | 1,154,268 | - | 8,814,363 |
| - | - | - | - | - | 328 |
| - | - | - | 1,154,268 | - | 8,814,691 |
| 12,367 | 3,164 | 10,111 | 116,223 | 88,638 | 16,997,197 |
| 12,367 | 3,164 | 10,111 | 1,270,491 | 88,638 | 25,811,888 |
| $ 20,024 | $ 3,164 | $ 10,111 | $ 1,270,491 | $ 88,638 | $ 28,545,945 |

See accompanying notes to financial statements.

Exhibit 3.13

## State of Hawai‘i,
## Department of Land and Natural Resources

Combining Statement of Revenues, Expenditures and Changes in Fund Balances - Nonmajor Governmental Funds
For the Year Ended June 30, 2005

| | Bureau of Conveyances Fund | Special Land Development Fund | Commercial Fisheries Fund | Forest Stewardship Fund | Aquatic Resources Fund | Forests and Wildlife Fund |
|---|---|---|---|---|---|---|
| Revenues | | | | | | |
| General leases, licenses, and permits | $ 4,763,943 | $ 6,761,336 | $ 226,646 | $ 538,095 | $ - | $ 94 |
| Taxes, fuel, and other | - | - | - | - | - | - |
| Interest | 55,103 | 310,087 | 11,187 | 10,584 | 2,095 | 36,284 |
| Other | - | 248,479 | - | 1,980 | - | 10,947 |
| Total revenues | 4,819,046 | 7,319,902 | 237,833 | 550,659 | 2,095 | 47,325 |
| Expenditures: | | | | | | |
| Current: | | | | | | |
| Economic development | - | - | 195,333 | 331,835 | - | - |
| Environmental protection | - | - | - | - | - | 627,667 |
| Culture and recreation | - | - | - | - | - | - |
| Individual rights | 8,593,275 | - | - | - | - | - |
| Government-wide support | - | 8,377,514 | - | - | - | - |
| Total expenditures | 8,593,275 | 8,377,514 | 195,333 | 331,835 | - | 627,667 |
| Excess (deficiency) of revenues over (under) expenditures | (3,774,229) | (1,057,612) | 42,500 | 218,824 | 2,095 | (580,342) |
| Other Financing Sources (uses) | | | | | | |
| Operating transfers in | 500,000 | 2,511,312 | 238,881 | 205,079 | - | 1,390,492 |
| Operating transfers out | (500,000) | (2,733,372) | (238,881) | (205,079) | - | (282,967) |
| Total other financing sources (uses) | - | (222,060) | - | - | - | 1,107,525 |
| Net change in fund balances | (3,774,229) | (1,279,672) | 42,500 | 218,824 | 2,095 | 527,183 |
| Fund Balances, July 1, 2004 | 5,817,079 | 8,134,082 | 372,329 | 320,719 | 77,047 | 428,760 |
| Fund Balances, June 30, 2005 | $ 2,042,850 | $ 6,854,410 | $ 414,829 | $ 539,543 | $ 79,142 | $ 955,943 |

See accompanying notes to financial statements.

**Exhibit 3.13 (continued)**

## State of Hawai‘i,
## Department of Land and Natural Resources

Combining Statement of Revenues, Expenditures and Changes in Fund Balances - Nonmajor Governmental Funds
For the Year Ended June 30, 2005

| | Water Resources Fund | Conservation Resource Enforcement Fund | Natural Area Reserves Fund | Historical Preservation Fund | Subtotal Carried Forward |
|---|---|---|---|---|---|
| | $ 59,124 | $ 50 | $ 5,579,510 | $ 78,488 | $ 18,007,286 |
| | - | - | - | - | - |
| | 20,524 | 740 | 160,757 | 28 | 607,389 |
| | 3,050 | 27,915 | - | 2,660 | 295,031 |
| | 82,698 | 28,705 | 5,740,267 | 81,176 | 18,909,706 |
| | - | - | - | - | 527,168 |
| | 208,517 | 1,350,341 | 3,047,509 | - | 5,234,034 |
| | - | - | - | 104,756 | 104,756 |
| | - | - | - | - | 8,593,275 |
| | - | - | - | - | 8,377,514 |
| | 208,517 | 1,350,341 | 3,047,509 | 104,756 | 22,836,747 |
| | (125,819) | (1,321,636) | 2,692,758 | (23,580) | (3,927,041) |
| | 537,439 | 1,275,336 | 4,360,719 | 21,388 | 11,040,646 |
| | (477,439) | (336) | (6,360,719) | (21,388) | (10,820,181) |
| | 60,000 | 1,275,000 | (2,000,000) | - | 220,465 |
| | (65,819) | (46,636) | 692,758 | (23,580) | (3,706,576) |
| | 799,101 | (51,854) | 7,218,538 | 15,991 | 23,131,792 |
| | $ 733,282 | $ (98,490) | $ 7,911,296 | $ (7,589) | $ 19,425,216 |

See accompanying notes to financial statements.

Exhibit 3.14

## State of Hawai‘i,
## Department of Land and Natural Resources

Combining Statement of Revenues, Expenditures and Changes in Fund Balances - Nonmajor Governmental Funds
For the Year Ended June 30, 2005

| | Subtotal Brought Forward | Na Ala Hele Park Development Fund | Wildlife Revolving Fund | Sport-Fish Restoration Fund | Park Development Operations Fund | State Parks Fund |
|---|---|---|---|---|---|---|
| Revenues: | | | | | | |
| General leases, licenses, and permits | $ 18,007,286 | $ 117,733 | $ 310,514 | $ 32,686 | $ - | $ 1,876,760 |
| Taxes, fuel, and other | - | 243,470 | - | - | - | 900,000 |
| Interest | 607,389 | 13,924 | 13,896 | 1,690 | - | 104,319 |
| Other | 295,031 | 1,939 | 525 | 1,875 | - | 374 |
| Total revenues | 18,909,706 | 377,066 | 324,935 | 36,251 | - | 2,881,453 |
| Expenditures: | | | | | | |
| Current: | | | | | | |
| Economic development | 527,168 | - | - | - | - | - |
| Environmental protection | 5,234,034 | - | - | - | - | - |
| Culture and recreation | 104,756 | 324,308 | 354,313 | 1,610 | 576,452 | 1,631,282 |
| Individual rights | 8,593,275 | - | - | - | - | - |
| Government-wide support | 8,377,514 | - | - | - | - | - |
| Total expenditures | 22,836,747 | 324,308 | 354,313 | 1,610 | 576,452 | 1,631,282 |
| Excess (deficiency) of revenues over (under) expenditures | (3,927,041) | 52,758 | (29,378) | 34,641 | (576,452) | 1,250,171 |
| Other Financing Sources (Uses) | | | | | | |
| Operating transfers in | 11,040,646 | 535,323 | 395,911 | 41,902 | 584,164 | 1,908,706 |
| Operating transfers out | (10,820,181) | (335,323) | (395,911) | (41,902) | (89,624) | (2,431,237) |
| Total other financing sources (uses) | 220,465 | 200,000 | - | - | 494,540 | (522,531) |
| Net change in fund balances | (3,706,576) | 252,758 | (29,378) | 34,641 | (81,912) | 727,640 |
| Fund Balances, July 1, 2004 | 23,131,792 | 352,376 | 428,606 | 40,849 | 108,183 | 3,168,138 |
| Fund Balances, June 30, 2005 | $ 19,425,216 | $ 605,134 | $ 399,228 | $ 75,490 | $ 26,271 | $ 3,895,778 |

See accompanying notes to financial statements.

**Exhibit 3.14 (continued)**

## State of Hawai‘i,
## Department of Land and Natural Resources

Combining Statement of Revenues, Expenditures and Changes in Fund Balances - Nonmajor Governmental Funds
For the Year Ended June 30, 2005

| Natural Physical Environment Fund | Preservation of Endangered Plants Fund | Donations, Gifts and Grants Fund | OHA Kikakakeokea Trust Fund | Endangered Species Trust Fund | Total Other Governmental Funds |
|---|---|---|---|---|---|
| $ - | $ - | $ - | $ - | $ - | $ 20,344,979 |
| - | - | - | - | - | 1,143,470 |
| - | - | - | 35,310 | - | 776,528 |
| - | - | 13,000 | - | 88,638 | 401,382 |
| - | - | 13,000 | 35,310 | 88,638 | 22,666,359 |
| - | - | - | - | - | 527,168 |
| 317,896 | - | 56,500 | - | - | 5,608,430 |
| - | - | - | - | - | 2,992,721 |
| - | - | - | - | - | 8,593,275 |
| - | - | - | 162,841 | - | 8,540,355 |
| 317,896 | - | 56,500 | 162,841 | - | 26,261,949 |
| (317,896) | - | (43,500) | (127,531) | 88,638 | (3,595,590) |
| 337,684 | 3,164 | 53,611 | 115,523 | - | 15,016,634 |
| (3,817) | (3,164) | (53,611) | (115,523) | - | (14,290,293) |
| 333,867 | - | - | - | - | 726,341 |
| 15,971 | - | (43,500) | (127,531) | 88,638 | (2,869,249) |
| (3,604) | 3,164 | 53,611 | 1,398,022 | - | 28,681,137 |
| $ 12,367 | $ 3,164 | $ 10,111 | $ 1,270,491 | $ 88,638 | $ 25,811,888 |

See accompanying notes to financial statements.

# Response of the Affected Agency

## Comments on Agency Response

We transmitted a draft of this report to the Department of Land and Natural Resources on May 24, 2006. A copy of the transmittal letter to the department is included as Attachment 1. The response of the department is included as Attachment 2.

The department concurred with many of our findings and recommendations, and provides additional information to explain its current procedures and corrective actions planned, or already taken, to address some of the internal control deficiencies identified in our report. However, the department disagrees with many of our report's comments and characterizations, especially with respect to the two material weaknesses.

The department disagreed with our concluding that its lack of a comprehensive system to properly manage federal grant programs constitutes a material weakness. The department also disagreed with our related decision to disclaim our opinion of the department's Federal Grant Fund balances. The department says it was surprised by and strongly disagrees with our opinion disclaimer and overall characterization of the situation. However, the department fails to recognize its contradictory stance on the situation. By recording $8.3 million as "Due to State Treasury" in its FY2005 financial statements, department management is asserting that this liability exists and is accurate. Nevertheless, the department strongly believes that a liability to the state treasury does not exist, and it does not have adequate support for the balance reflected in its financial statements. Our disclaimer of opinion stems from the impossible task of opining on a material balance that department management does not believe exists and cannot adequately support. The fact that this dispute over the state treasury liability results from a systematic accounting practice and has gone unresolved for ten years, combined with other findings noted in our report, supports our conclusion that the department's management of its federal grant programs is inadequate.

The department also disagreed with our second material weakness regarding the department's accounting and financial reporting process and our related qualification of opinion with respect to the department's Ocean-Based Recreation Fund as of June 30, 2005. The department did point out our erroneous interpretation of a financial statement adjustment to record ceded land revenues contained in our draft report. This error was subsequently corrected and led us to remove the qualification of our opinion with respect to the Ocean-Based Recreation Fund in our final report. However, our determination that the department's inadequate accounting and financial reporting process is a material weakness is still valid based on the numerous and significant misstatements contained in, and required disclosures omitted from, the department's June 30, 2005 financial statements. To further substantiate the severity of the finding, our report cited other internal control deficiencies related to financial accounting of the department, including the lack of a systematic supervisory review process over accounting schedules and the serving of an internal auditor in an accounting role. The department clarified that the internal auditor performs accounting tasks *in addition to* auditing tasks. While we understand that this situation may be driven by necessity or a staff shortage, we maintain that a single individual cannot fill both roles without impairing independence and rendering the internal audit role ineffectual.

The department further disagrees with our finding over the Division of Boating and Ocean Recreation. However, the department's response is somewhat confusing since, as the department notes, the division is a special funded operation. The spending of special funds may indeed require legislative approval, yet in its defense the department cites only the denials for additional funds from reimbursable general obligation bonds or capital improvement project funds. Moreover, our report is also critical of the potentially hazardous impact of the makeshift repairs that have been made. We also question whether addressing many of the unsafe conditions noted in our report, such as replacing a few boards on a pier, truly requires legislative approval. The department's response states that it was successful in having its small harbor fees schedule increased, which should generate additional moneys for operations; however, our report questions the sufficiency of the increase considering that the request was originally submitted in November 2004 but not approved until Spring 2006 and did not take inflation into consideration.

With respect to our reportable condition on the department's Bureau of Conveyances, the department's response acknowledges a backlog in the bureau, but also cites ongoing efforts made to resolve labor union issues and streamline work processes. We do agree with the department's criticism of our overtime pay analysis for the bureau, in that it does not take into account compensatory time, which is an alternative to overtime. However, department records indicated that the bureau incurred only approximately 1,000 hours, or $22,000 in compensatory time during FY2005. The potential impact that this factor would have on our FY2005 analysis of overtime or compensatory pay incurred by the bureau's Land Court (9,400 hours or $256,000) and Regular System (540 hours or $15,000) is minimal at best.

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

MARION M. HIGA
State Auditor

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

May 24, 2006

***COPY***

The Honorable Peter T. Young, Chairperson
Board of Land and Natural Resources
Department of Land and Natural Resources
Kalanimoku Building
1151 Punchbowl Street
Honolulu, Hawai'i 96813

Dear Mr. Young:

Enclosed for your information are nine copies, numbered 6 to 14, of our confidential draft report, *Financial Audit of the Department of Land and Natural Resources*. We ask that you telephone us by Friday, May 26, 2006, on whether or not you intend to comment on our recommendations. Please distribute the copies to the members of the board. If you wish your comments to be included in the report, please submit them no later than Friday, June 2, 2006.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

LINDA LINGLE
GOVERNOR OF HAWAII

PETER T. YOUNG
CHAIRPERSON
BOARD OF LAND AND NATURAL RESOURCES
COMMISSION ON WATER RESOURCE MANAGEMENT

ROBERT K. MASUDA
DEPUTY DIRECTOR

DEAN NAKANO
ACTING DEPUTY DIRECTOR - WATER

AQUATIC RESOURCES
BOATING AND OCEAN RECREATION
BUREAU OF CONVEYANCES
COMMISSION ON WATER RESOURCE MANAGEMENT
CONSERVATION AND COASTAL LANDS
CONSERVATION AND RESOURCES ENFORCEMENT
ENGINEERING
FORESTRY AND WILDLIFE
HISTORIC PRESERVATION
KAHOOLAWE ISLAND RESERVE COMMISSION
LAND
STATE PARKS

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
POST OFFICE BOX 621
HONOLULU, HAWAII 96809

June 2, 2006

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

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

Dear Ms. Higa:

SUBJECT: Financial Audit of the Department of Land and Natural Resources

Thank you for your comprehensive financial audit of the Department of Land and Natural Resources (DLNR). We appreciate the attention you gave to this task. Also, thank you for this opportunity to comment, as well as reinforce information on issues contained within your draft report.

While we agree with some of your findings and recommendations (and have already implemented actions to address them,) we strongly disagree with many of your comments and characterizations in your analysis especially in those two areas considered to be material weaknesses.

Concerning the federal grant program, your contracted auditors know that the DLNR has been working with Budget and Finance (B&F), Department of Accounting and General Services (DAGS) and the Department of the Attorney General (AG), as well as private audit firms, for nearly ten years resolving this issue – yet you reference them in a way that suggests nothing has been done. The auditor's qualified opinion for the Ocean - Based Recreation Fund is based on a completely erroneous statement. In addition, we note that your report has no finding of impropriety in our financial management or any special fund.

CHAPTER 2 - INTERNAL CONTROL DEFICIENCIES
SUMMARY OF FINDINGS

THE DEPARTMENT LACKS A COMPREHENSIVE SYSTEM TO PROPERLY MANAGE ITS FEDERAL GRANT PROGRAM

KMH LLP did not express an opinion on the financial statements of the DLNR's Federal Grant Fund because they were unable to obtain sufficient evidential matter supporting the department's liability due to the State General Fund. We are surprised by and strongly disagree with their decision to disclaim an opinion and the overall characterization of this situation.

We strongly disagree with your comments and characterization of this situation. As your auditors know, this issue has been in existence for ten years and DLNR has been working with B&F, DAGS and the Department of the Attorney General (AG), as well as private audit firms on multiple occasions to address this. The DLNR is responsible for ensuring that financial statements are properly prepared but we actively seek the advice of our contract auditors, and other state agencies. We listen to their suggestions before deciding what action to take.

Our department decided to take a conservative approach and list this liability because we cannot prove to the satisfaction of our auditors that no liability exists. It is important to note that this liability is to another state agency, not to the federal government nor an outside vendor.

Since the emergence of this issue ten years ago, our annual financial statements have recorded this liability and have been audited by independent certified public accounting firms selected by the State Comptroller.

For every one of those yearly audits, including the fiscal year (FY) which ended June 30, 2005, the DLNR has been issued an unqualified opinion that the "financial statements present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the department...in conformity with accounting principles generally accepted in the United States of America."

We recently met again with representatives from B&F, DAGS and the AG. As a result of that most recent meeting, B&F has provided us additional clarification concerning federal grants receipts, which we will provide to our FY 06 auditors.

The labeling of this first section as such is misleading because it implies that the DLNR is not complying with the financial management requirements of the many federal grants we receive. Nowhere in your report is there a finding of impropriety in our actual financial management of federal grants.

The issue being reported in this audit is a state budgeting and financial statement presentation issue and has nothing to do with the actual financial management of our individual federal grants. We do not have an automated federal grant accounting system, but we do have a process in place and capable personnel to comply with the requirements of the grants we are awarded.

Since the implementation of the Single Audit Act and related US Office of Management and Budget Circular A-133, the DLNR has never received anything other than a clean opinion from our independent auditors.

We agree with the auditor's comment that an integrated federal grant accounting system will reduce the burden on the Department's fiscal staff. Many of the worksheets prepared are on electronic spreadsheets and databases that are independent of each other. Recently DAGS has made available to state agencies Data Mart, an online financial and budget information system, which allows for viewing and downloading detailed financial transactions. We have requested the assistance of our Department's Data Processing Office to assist with the development of customized programs including federal grant accounting.

Recommendation - Develop a centralized, comprehensive system to manage and be responsible for the department's federal programs.

As explained above, we believe, and our extensive record of past unqualified audit reports strongly support that we do have a centralized comprehensive system to manage our federal programs. The federal grant fund is considered a "major fund" and therefore is clearly covered by the annual unqualified audit opinions.

Recommendation - Determine whether its accounting policy for federal reimbursements is in compliance with ACT 328, SLH 1997 and Recommendation - Obtain written documentation to support its assertion that its programs are budgeted net by the Legislature and that the liability reflected in it financial statements as "Due to State treasury" do not reflect actual money owned to the state general fund.

Since the emergence of this issue in FY 96, the DLNR has met with representatives from B&F, DAGS and the Department of the Attorney General (AG) as well as audit firms on multiple occasions specifically for the purpose of resolving these two issues, the policy for federal reimbursements and verification that our program budgets are budgeted at "net" by the Legislature. To date we have not been able to resolve the problem. We recently met again with representatives from B&F, DAGS and the AG. As a result of that most recent meeting, B&F has provided us additional clarification concerning federal grants receipts, which we will provide to our FY 06 auditors.

Recommendation - Prepare journal vouchers to record an interfund reimbursement based on the amount of expenditures posted in the Financial Accounting and Management Information System (FAMIS) at each year end.

This recommendation does not resolve the basic issue of the actual depositing of federal grant claims after the close of a fiscal year. In fact, the determination of the adjustment amount alone regardless of the actual receipt would be very difficult to determine within 15 days after year end as suggested by the auditor. For fiscal year ended June 30, 2005, FAMIS reports prepared by DAGS were not even available until July 27, 2005, which is normal.

In addition, the documentation required to support federal grant claims, especially in the area of personnel services, requires a much greater detail of accounting that is presently available from existing statewide accounting and payroll reports. A vast majority of our grants require that we incur costs first, and then submit a claim. Federal grants require that affected employees prepare individual timesheets recording their daily activities. These time sheets are then used to allocate a portion of their actual compensation to individual grants.

In actual practice, the preparation of, and subsequent receipt of funds from federal agencies take anywhere from one to three months, depending on the agency involved, the complexity of the individual grant and the method specified for paying out grant funds. The actual claim involves multiple organizations including the federal grantor agency, First Hawaiian Bank, the Department of Budget and Finance and then the Department of Accounting and General Services. The method of submitting claims is specified in each grant. Some allow for the on-line filing of claims while others require an actual form to be completed, signed and mailed.

The payment of grant funds also varies from grant to grant. Most are wired to the State's bank account at First Hawaiian while others send actual checks or copies of State journal vouchers.

<u>Recommendation - Investigate the cause for the deficit in its federal grant and implement corrective measures to ensure all allowable costs are properly billed and recorded.</u>

We will investigate the cause for the deficit in the fund but believe that it is simply the result of unbilled cost as suggested by the auditor. Most of the DLNR's federal grants require a match be provided and grant expenditure overmatches are not uncommon. Once the federal share of a grant is met, any costs incurred beyond the approved budget will be added to the State's share.

<u>Recommendation - Implement an integrated accounting system to reduce the burden on the department's fiscal staff.</u>

We agree with the auditor's recommendation that an integrated federal grant accounting system will reduce the burden on the department's and division's fiscal staff. Many of the worksheets prepared are on electronic spreadsheets and databases that are independent of each other. Recently DAGS has made available to state agencies Data Mart, an online financial and budget information system, which allows for viewing and downloading detailed financial transactions. We have requested the assistance of our Department's Data Processing Office to assist with the development of customized programs including federal grant accounting.

THE DEPARTMENT'S ACCOUNTING AND FINANCIAL REPORTING PROCESS IS INADEQUATE

<u>The department's financial statements are misstated.</u>

KMH LLP claims on Page 16 that "by running the entire $2.2 million adjustment through current year operations of the fund, the department overstated current expenditures, and understated the beginning fund balance, by $1.9 million." The audit continues, "Due to the significance of this misstatement, we expressed a qualified opinion on the fair presentation of the department's Ocean – Based Recreation Fund."

The auditor's contention is incorrect.

Because this incorrect analysis was the basis for the qualification of their opinion on the fair presentation of the Ocean - Based Recreation Fund, we expect that their qualified opinion will be reversed in the final report.

A significant portion of that $2.2 million liability does apply to years prior to FY 05. The auditor is incorrect that there was no liability accrued as of June 30, 2004. On multiple occasions our fiscal staff discussed our Note 11 to the June 30, 2005 financial statements with KMH.

We also provided the supporting worksheet prepared by the Division of Boating and Ocean Recreation (DOBOR) and indicated our concern about the amounts reported for certain years.

We further stated that our Administrative Services Office would be reviewing the procedure used to calculate the amounts due.

It was entirely the auditor's assumption that no liability was recorded as of June 30, 2004. This was also pointed out to representatives from the Office of the Auditor and KMH immediately after the exit conference on May 5, 2006, 19 days prior to receiving the draft report on May 24th.

We have attached a copy of Page 21 from our June 30, 2004 financial statements, that reports the liability "Due to other State agencies" under the Ocean - Based Recreation Fund. The entire June 30, 2004 financial statements were provided to KMH.

<u>The accounting and recordkeeping for compensated absences is inaccurate.</u>

The auditor's findings concerning our failure to include compensatory time off on our June 30, 2004 reports and our failure to include fringe benefits on our liability for all compensated balance is correct. This was an oversight on our part and will be corrected on future financial statements.

KMH also commented that 61 of 392 vacation leave applications were approved by the employee's supervisor or department head an average of six days after the start of the vacation leave. KMH thus recommends that we perform more extensive testing of the leave record schedules submitted by the divisions.

The following article covers Hawaii Government Employees Association (HGEA) members in bargaining units 02, 03, 04, and 13:

> "When a vacation is requested on a proper application by an Employee, it shall be granted and taken at such time or times as the department head may designate, provided, that it shall be as close to the requested period as conditions in the department will permit, and so as to prevent any forfeiture of vacation allowance."

The articles below cover United Public Workers (UPW) members in bargaining unit 01:

> "An Employee desiring to use vacation leave shall submit an application in advance of the beginning date of the vacation to enable the Employer to make necessary readjustment of work."
>
> "The requirement for advance notice may be waived for emergency situations or when the Employee does not have accumulated sick leave and elects to use accumulated vacation leave in place of authorized leave without pay for sick leave."
>
> "An Employee shall be granted vacation leave on the dates and times as approved by the Employer provided, that it shall be as close to the requested dates and times as conditions of the Employer will permit and will not cause forfeiture of vacation leave."

The UPW Unit 01 contract covers the possibility of vacation requests filed and approved after the fact. This response therefore refers to those employees belonging to HGEA units 02, 03, 04 and 13 within the department.

There may be a number of valid reasons for vacation request application forms being approved by the employee's supervisor after the start of the vacation leave. At this time, we are unable to provide comment on the 61 instances of vacation leave being approved after the start of a vacation leave without being provided the list for review.

The most commonly occurring reason may be that the leave is of an emergency nature. Examples may include last minute requests due an employee's immediate family member becoming ill or injured or an employee themselves being unable to arrive at work in a timely manner due to some unforeseen circumstance. Obviously these situations would require the request to be filed after the fact and the signatures would be obtained later. For larger divisions with more supervisory layers between an employee and a division administrator, more time would be required to obtain appropriate signatures.

Vacation credits are earned by employees and thus are a benefit for them to use. Further, they are forfeited if the credits accumulated above the maximum amount allowed to be saved is unused by the end of the calendar year. If the employee's supervisor is willing to allow the employee to charge their vacation leave credit to cover the cost of their absence, they do so as to not have to place the employee on authorized leave without pay. This is to the benefit of the employee, enhances employee morale and well-being and shows that the State is a compassionate employer. If the benefit becomes abused and used excessively, the supervisor will take appropriate action to manage the concern.

Without having reviewed the list of 61 instances out of 392 vacation leave requests approved after the fact, it is difficult for the department to support this criticism and conclusion in the processing of such leaves. As the audit noted, in accordance with their bargaining unit agreements, employees are required to obtain approval from their direct supervisor in advance of planned vacation leaves. As mentioned however, the UPW agreement allows for the waiver of advance approval in emergency situations. Also, the HGEA agreement indicates that vacation leave requests shall be as close to the requested period as conditions in the department will permit, and so as to prevent any forfeiture of vacation allowance. Since appropriate signatures are being obtained, clearly the supervisors are granting these requests, in consideration of staffing levels, operations, the employee's morale and well-being.

<u>The department's capital assets balance is misstated.</u>

The auditor notes that two assets with a combined net book value of $3.4 million were recorded as FY 05 transactions but should have been recorded as FY 04 transactions. The auditor concludes on Page 18 that, "These two misstatements clearly indicate that the financial statement preparation process is inadequate to ensure that all significant transactions are recorded and that error-free schedules are produced."

We do not agree that these two errors render our entire financial statement process inadequate. As stated earlier, we have never had anything but unqualified opinions on previous audit reports.

Since the implementation of GASB 34 in FY 03, the DLNR has made substantial improvements to our inventory accounting.

a) On a quarterly basis, property custodians are provided with a detailed worksheet, which lists all expenditure transactions coded as capital outlays. They use this worksheet as a guide to updating the Fixed Asset Inventory System (FAIS) maintained by the Inventory Management Branch of the State Procurement Office.

b) A training session conducted by the Inventory Management Office was held concurrent with the release of that Office's Inventory System User's Manual.

c) In order to account for capital improvement project additions, our Engineering Branch has implemented a notification process which reports all project costs (architectural, engineering and construction) for the responsible agency upon the completion of capital improvement projects.

<u>Required disclosures are not included in the financial statements and the department's budgetary comparison statements are inaccurate.</u>

Our objective is to include all required disclosures in our financial statements and to make all statements as accurate as possible. We will consult with our contract auditors concerning those two disclosures identified by the auditors and the definition of "final budget" in the budgetary comparison statements and make the appropriate corrections.

<u>Financial accounting and management controls are inadequate.</u>

Some, not all, of the schedules prepared for the department's annual financial statements are done and presented to our contract auditors without a second internal review within the Fiscal Office. In order to keep the cost of the audit manageable, we agree to prepare certain work papers that could be done by the auditor. Some schedules merely re-sort financial information from printed FAMIS reports and therefore a second review is not considered necessary.
As the office staffing stabilizes and workloads allow, we will get more individuals involved in the entire preparation of the financial statements' process.

The draft report statement that the internal audit position currently serves as an accountant <u>instead of</u> an internal auditor, is incorrect.

This individual performs accounting tasks <u>in addition to</u> any assigned audit tasks, which would take priority. Numerous staff turnovers in key positions over the past four years has required the involvement of this individual in many non-auditing temporary assignments including employee training, systems development and budgeting.

As noted in the draft report, the DLNR has a significant number of federal grants. This individual also oversees financial reporting and compliance for all federal grants throughout the department and the relocation of the position cannot be considered without providing for additional support in the Fiscal Office.

<u>The Land Division's lease accounting practices are deficient.</u>

The audit states "Periodic, independent verification of the amounts paid as lease rent is a necessary management tool that lease rents are fairly stated and management has sufficient information during the lease renewal process". It may be prudent and recommended practice, but not necessary.

Internally, before a new tenant account is established in SLIMS, the data is audited by our Land Division, Central Processing staff and by our Fiscal staff. Should a tenant have a rent reopening, again, that data is inputted into SLIMS, it is audited by our Land Division, Central Processing staff and our Fiscal staff. There are at least three (3) levels of auditing done by our staff.

We rely on the cash controls and internal audit and bank reconciliation practices of the Fiscal Office to verify that payments received on tenant accounts are deposited promptly and credited to the correct tenant for the appropriate charges. Since the Fiscal Office records receipts and prepares deposits using the same system that the Land Division uses to monitor tenant accounts, we are able to view current information based on these internally audited amounts.

Furthermore, monthly management reports are generated by Land Division staff highlighting various tenants contractual requirements.

There have been no complaints from tenants who received rent delinquency notices because their payments were not deposited and entered into SLIMS.

Regarding the audit's contention that the division failed to obtain proof of insurance coverage from its lessees, since 2000 compliance with insurance and performance bond requirements has been monitored and enforced by the district land offices on a monthly basis. However, there was no audit to verify that this review took place.

Furthermore, this was understood to be a temporary responsibility until the Central Processing staff in Honolulu was fully staff and could carry out its compliance monitoring function. While we acknowledge that there have been deficiencies and lack of follow-up on some leases, the procedures for the monthly review are in place and are fully documented. Starting in June 2006, compliance monitoring will be fully transitioned to the Central Processing Unit and the addition of a periodic audit is being discussed.

Furthermore, starting August 2005, a monthly management report is generated by Land Division staff on expired liability insurance accounts to ensure staff is monitoring tenants compliance.

<u>Compliance with the Hawaii Public Procurement Code should be improved.</u>

The auditor tested a sample of 40 small purchases and noted 15 instances in which the department failed to comply with or properly document the procurement process in accordance with the rules for small purchases. In addition, one selection had the appearance of parceling.

Our department constantly reminds our employees about the need to comply with the Procurement Code. We hold training, and we provide an explanation why certain purchase orders cannot be issued and we self-report violations we become aware of.

Upon our request, the Office of the Auditor has recently provided a list of the 15 transactions in question. We will be reviewing that list and will implement corrective action as appropriate. The transaction that was identified as having the appearance of parceling was already known to us and has been resolved with the assistance of the State Procurement Office.

We appreciate and concur with the auditor's finding that current staffing and workloads in our fiscal office justifies the addition of a procurement specialist.

Recommendation - Take immediate steps to improve the accuracy and effectiveness of the department's accounting and financial reporting processes and controls.

As stated above, the auditor's contention is incorrect in regards to the Ocean-Based Recreation Fund. Because this incorrect analysis was the basis for the qualification of their opinion on the fair presentation of the Ocean - Based Recreation Fund, we expect that their qualified opinion will be reversed in the final report.

Recommendation - Perform additional oversight and review of the financial statements and supporting schedules to ensure they are in compliance with GAAP and all relevant and required disclosures have been included.

As stated above, our objective is to include all required disclosures in our financial statements and to make all statements as accurate as possible. We will consult with our contract auditors concerning those two disclosures identified by the auditors and the definition of "final budget" in the budgetary comparison statements and make the appropriate corrections.

Recommendation - Perform periodic, supervisory reviews of the work prepared by fiscal staff.

As stated above, some, not all, of the schedules prepared for the department's annual financial statements are done and presented to our contract auditors without a second internal review within the Fiscal Office. In order to keep the cost of the audit manageable, we agree to prepare certain work papers that could be done by the auditor. Some schedules merely re-sort financial information from printed FAMIS reports and therefore a second review is not considered necessary. As the office staff stabilizes and workloads allow, we will get more individuals involved in the entire process of preparing financial statements.

Recommendation - Perform more extensive testing of the leave records schedules submitted by the divisions.

Without having reviewed the list of 61 instances out of 392 vacation leave requests approved after the fact, it is difficult for the department to support this criticism and conclusion in the processing of such leaves. If we are provided the list in question by the auditor and find that there is in fact a pattern of unjustified late notices by certain divisions, then we will direct our attention to correcting the errors with additional training and more extensive testing.

Recommendation - Have its internal auditor report directly to the board.

As noted above, this individual also oversees financial reporting and compliance for all federal grants throughout the department and the relocation of the position cannot be considered without providing for additional support in the Fiscal Office.

Recommendation - Perform periodic audits to ensure lease rents are fairly stated.

As stated above this may be a prudent and recommended practice, but we contend that these audits are not necessary to ensure lease rents are fairly stated.

Internally, before a new tenant account is established in SLIMS, the data is audited by our Land Division, Central Processing staff and by our Fiscal staff. There are at least three (3) levels of auditing done by our staff.

There have been no complaints from tenants who received rent delinquency notices because their payments were not deposited and entered into SLIMS.

Recommendation - Obtain and fill a procurement specialist position to monitor and ensure that compliance with the Hawaii Public Procurement Code is maintained.

We concur with the auditor's recommendation and would welcome the addition of a procurement specialist position.

THE OPERATION AND MANAGEMENT OF THE DIVISION OF BOATING AND OCEAN RECREATION CONTINUES TO NEED IMPROVEMENT

Recommendation - Inspect all small boat harbors to ensure that they meet applicable safety and construction standards and do not pose a risk to the public or employees.

DOBOR is a special funded operation; however CIP must be approved by the Legislature and, thus, without legislative approval DLNR cannot make needed improvements even if we have the money. Over the past several years, DLNR has repeatedly requested authorization to make improvements and repeatedly requested Legislative approval for CIP funding. However, the Legislature has continually denied our requests.

With respect to operating funds, we recently adopted a rule change that will provide for sufficient added funding for repairs and maintenance, as well as cover the cost of bond payments should the Legislature approve our bond request.

DOBOR performs regular inspections and spends between $750,000 to $900,000 annually statewide for repairs and maintenance at its 20 harbors and 56 boat ramps. Because this amount is not sufficient to ensure that the facilities meet public expectation, and slips, docks, and piers have been removed from service for safety reasons, we recently passed a new fee package that adds $1.5-million to repair and maintenance budget.

In 2004, DLNR requested $10-million, through reimbursable general obligation bonds, as the first of a multi-year program of necessary capital improvements to our harbors in our supplemental budget to the legislature.

This funding would have corrected health and safety deficiencies and replace some of the deteriorating facilities. Repayment of these funds would be through increased boaters' fees (enough to cover the bonds payments.)

However, the legislature denied our request and, rather, approved revenue bonds as the method of financing. The legislature knew the Boating Division did not have the capability to process revenue bonds, we told them so – their action was effectively the same as a non-approval. As an added action, the legislature cut fifteen staff positions in DLNR's Boating Division – including cutting the Boating Administrator position.

Prior to the budget passage, each legislator received letters from DLNR reiterating Boating needs, describing the projects to be completed and repeating the inappropriateness of the revenue funding approach.

In 2005, the legislature provided over $25 million in CIP funding, most going for Maui's intra-county ferry system, not general harbor improvements. In 2006, DLNR again requested $10-million for statewide harbor improvements, yet received significantly less.

<u>Recommendation - Perform a cost-benefit analysis of all condemned piers to determine if potential lost revenues outweigh costs to rebuild.</u>

DOBOR was established as a statewide program so that the revenue derived from more successful facilities could help defray the cost of construction, maintenance and operation of the smaller rural facilities on Oahu and the neighbor islands. This practice applies to both the State airports and commercial harbor programs, under the jurisdiction of the Department of Transportation, where revenues from Honolulu International Airport and Honolulu Harbor contribute to the support of outlying facilities. As such, DOBOR must balance the cost and benefit of operating profitable harbors with the public purpose of its mission. If DOBOR had to raise user fees for rural harbors to cover the cost of construction, maintenance and operation, the cost would be unaffordable to most residents.

<u>Recommendation - Continue efforts to have a new harbor fee structure approved addressing concerns raised by the public at related hearings, and reevaluate the original assumptions used for the proposed fees to ensure that the revenues generated will be sufficient to fund operating costs as well as necessary repairs and capital improvement projects.</u>

DOBOR worked in close conjunction with the Chairperson and recently developed a new fee structure. Based on the collaboration, the package is equitable to the boaters of the state and provides $1.5 million dollars in added annual funding for repair and maintenance, as well as covers additional debt service for $10 million in CIP for the first year. Subsequent years' increases are conditioned on the approval of $10 million of CIP by the legislature.

Recommendation - Consider centralizing the processing of permits and collection of fees to allow for the proper segregation of duties, increase accuracy and efficiency, and reduce the administrative burden of the harbor agents.

DOBOR will consider centralizing the processing of permits and fees and the collection of fees. However, some of the fees that are assessed must be paid at the time the service is rendered. DOBOR is currently working with a vendor to enable the public to pay for vessel registration and slip fees online.

DOBOR understands that there is no segregation of duties at some of its harbors; however, it believes that there are controls to ensure that funds are properly deposited. Slip and mooring fees must be deposited and credited to the proper account or the customer will receive a late fee. Additionally, DOBOR conducts harbor inventory and cash audits regularly to ensure that other harbor use fees are properly accounted for and deposited.

Recommendation - Utilize a rent role or other similar analysis to monitor the division's performance against budget and verify the reasonableness of fees and charges collected and recorded.

The division prepares an annual internal budget based on expected revenues and expenses. The budget incorporates expected slip fees increases (and decreases due to slip losses) as well as expected payroll increases. Utilizing FAMIS, SLIMS, and Data Mart, DOBOR prepares monthly financials that analyze and compare the actual revenues and expenses with the budgeted amounts. Variances are analyzed and researched to determine cause and adjustments are made to the budget and to the division's operations. Additionally, the data is used to make forecasts, projections, and other financial decisions that affect the division.

THE DEPARTMENT LACKS A COMPREHENSIVE CASH MANAGEMENT POLICY

The DLNR does not have a comprehensive, formal, written cash management manual that addresses among other items, basic policies and procedures, required daily reconciliations of transactions to receipts, and procedures on the transmittal and handling of cash. Instead of a formal manual, we have relied on excerpts from the State Accounting Manual, Comptroller Memoranda appended with additional clarification as they pertain to the DLNR and issuance of internal guidelines for specific cash related functions such as petty cash and credit cards. In the past we have also asked our annual contract auditors to review the cash management procedures of selected divisions.

Internal control activities are actions, supported by policies and procedures that, when carried out properly and in a timely manner, manage or reduce risks. These controls can be either preventive or detective. When considering internal controls for cash, our preference is clearly preventive. In this regard, we generally concur with all of your recommendations but with the following comments.

Recommendation - Develop a comprehensive cash management policy and procedure manual that addresses, among other items, basic policies and procedures, required daily reconciliations of transactions to receipts, and procedures on the transmittal and handling of cash.

Development of a comprehensive cash management policy and procedures manual would be a major project requiring staff resources and funds, which are currently not available. Our Administrative Services Office has been understaffed for many years and our efforts have been directed to basic functions and responsibilities in addition to training new personnel and implementing new programs. In all likelihood, such an endeavor could only be accomplished with the assistance of supplemental funding for a contracted consultant. At a minimum, we will perform a review of the procedures identified by the audit with the intent of reviewing cash procedures for all divisions on all islands.

Recommendation - Research and evaluate the modification of the current information system to enable system-generated receipts to be issued at the point of sale to customers to reduce the risk of errors and improve efficiency.

The department's primary revenue and land management information system, Yardi Enterprise from Yardi Systems, Inc. (YSI), is an off-the-shelf property management information system that was modified to accommodate DLNR's land management and governmental accounting needs. This system's main emphasis was the development of a land management system with the logical byproduct being a revenue system, since a significant portion of the department's revenue was generated by the accounts receivables from land leases and permits. YSI, an industry leader in real estate software solutions, indicated that Yardi Enterprise was not designed to handle point-of-sale (POS) transactions. Further, they have no plans to develop an integrated POS system nor are they aware of any third party POS system that has been integrated directly into their Enterprise product. Hundreds of property management companies use Yardi Enterprise worldwide, and such modifications would require significant development and testing resources.

Nevertheless, the department acknowledges the need for improved cash controls and a more automated and consistent approach to handling POS transactions. Research is underway to find an adaptable POS system that can accommodate the variety of transactions that the department handles. While it will not be integrated directly into the department's information system, it is anticipated that the data captured in this system will be regularly transferred into the Yardi Enterprise database.

Recommendation - Implement a procedure that places responsibility on the divisions for preparing and depositing their own cash to increase the accountability for funds and increase the efficiency of the Administrative Services Office staff.

Procedures will be implemented immediately to ensure that all divisions prepare their own bank deposits and document a daily closing cash reconciliation of transactions to receipts. They will then place the bank deposit slips, cash, and checks into a sealed plastic security pouch and hand carry it to the Administrative Services Office for armored car pickup to the bank. If a bank deposit cannot be hand carried to the Administrative Services Office, the division must deposit the funds directly to the nearest bank and validated bank deposit slips with a corresponding worksheet will be transmitted to the Administrative Services cashier for recordation in the State and DLNR accounting systems.

A record of receipts will be maintained showing the chain of custody for the security pouches as responsibility for the security of the pouches passes from the division personnel preparing the bank deposit to the cashier, and finally to the armored car personnel.

Divisions will be instructed to deposit collections daily but we will allow divisions to request exceptions under certain circumstances such as limited staffing and location issues. These exceptions will be reviewed individually to ensure the funds are relatively immaterial and that they are properly secured while pending deposits.

THE BUREAU OF CONVEYANCES DOES NOT EFFECTIVELY MANAGE ITS STAFF RESOURCES

We acknowledge the backlog of unopened mail at the Bureau and continue to work on managing staff resources to alleviate this backlog.

The audit analysis of payroll expense due to overtime is flawed because it does not take into consideration compensatory time (comp time), which is an alternative to overtime pay. Employees in the Regular System tend to take comp time instead of receiving overtime pay. In contrast employees of the Land Count tend to choose to receive overtime pay instead of comp time. The employees' ability to choose which compensation they take is guaranteed under their HGEA union contract.

While the audit compared dollar spending, a comparison of compensatory time accruals would somewhat narrow the difference and thus, the Land Count does not necessarily record a disproportionately high amount of overtime as compared to the Regular System. Additionally because the State guarantees ownership of property, the workload of the Land Count is more then the workload of the Regular System so their overtime expenses whether paid or compensatory will always be higher.

Factors which lead to an increase in overtime costs included staff shortages, staff on temporary assignments and difficulty finding qualified applicants for vacant positions.

The audit states that although overtime increased, productivity decreased. However the auditor failed to report that although the number of documents processed during this period decreased, over the past eight months, in an effort to decrease the backlog of the Receiving Section, many employees of the Review Section have been working overtime in the Receiving Section. By increasing work activity in the Receiving Section, documents can be recorded and the can be processed for Land Count.

<u>Recommendation - Work with the board and department director to develop a plan to address union labor issues.</u>

Issues are being addressed in consultation with HGEA.

Recommendation - Consider creating a customer service function within the Bureau to free up staff and increase productivity.

The Department of Land and Natural Resources, Bureau of Conveyances' responsibility is to maintain an accurate, timely and permanent record system for title to real property. The Bureau examines, records, indexes and microfilms over 344,000 Regular System and Land Court documents and maps annually. In addition, they issue Land Court Certificates of Title and certificate copies of matters on record, and conduct research requests. Hawaii is the only state that has a single statewide recording office.

The Bureau of Conveyances Operations Review Project was prepared in response to Section 61 of Act 200, Session Laws of Hawaii 2003, which requested the Department of Land and Natural Resources' Bureau of Conveyances to contract for a workflow study which shall encompass a review of all areas of the operation of the Bureau and include, but not be limited to evaluating the recording procedures, staffing, and performance so as to streamline the process to create efficiencies within the Bureau, recommendations by the consultant for changes to current job descriptions and identifying operational delays.

Hoike Consulting (Hoike) was chosen as the consultant for the project. The Hoike report consisted of two phases, the current processes and the re-design processes.

The final document, "Findings and Recommendation Report", was based upon workshop meetings, documentation, review, and analysis. This document identifies areas of "synergies" (to achieve more as a group or organization working together, than the sum total of each Section working on its own) within the organization and identifies operational improvement areas. It also addresses recommended organizational structure, staff changes and performance level improvements.

On August 12, 2005 the Land Board authorized the department to proceed with implementing the recommendations outlined in the Department of Land and Natural Resources, Bureau of Conveyances, Operation Review Project, Findings and Recommendation Report.

The Hoike Report addressed customer service under its Organization and Staffing - Recommendation #3 - Lack of a Customer Service Section. The report recommended the following:

1. Consider establishing a Customer Service Section, which will include the Will Call and any other Bureau staff. The Administrative Assistant can supervise the section.

2. Provide training to the Customer Service Section in order to provide better service to the customer.

3. Establish clear service level agreements in responding to Customer requests. By creating SLA's the public will be aware of turnaround times and have clear expectations of the Bureau. SLA's can be posted on the DLNR website for access by the public.

4. Cashiers to be moved to the Customer Service Section.

5. Consider having the Administrative Assistant the supervisor of the Customer Service section as this position currently supervises the clerical and microfilm sections.

Recommendation - Reevaluate processes to determine whether certain functions can be automated or streamlined to increase efficiency.

Changes to process flows and reorganization were further recommendations of the report. Specific recommendations included:

1. Implement best practice changes (any process or technique that, when executed, yields superior results both financially and competitively) identified during the re-design sessions.

2. Consider outsourcing certain functions that the Bureau performs.

3. Add missing internal control steps or reviews and/or eliminate non-value added procedures.

4. Consider restructuring the organization.

5. Provide customer service training to all Bureau staff.

6. Emphasize the importance of superior customer service.

In closing, I would like to reiterate that we are surprised by and strongly disagree with many of the findings presented and your overall characterization that the DLNR's financial statements are misleading and that numerous control weaknesses exists.

The financial statements of the DLNR are audited annually by independent certified public accounting firms. Each and every one of those audit reports have reflected an unqualified opinion that the financial statements of the DLNR are fairly stated in conformity with generally accepted accounting standards.

Having said that, I also want to express my appreciation for your financial audit of the DLNR.

Sincerely,

Peter T. Young
Chairperson

Attachment

DEPARTMENT OF LAND AND NATURAL RESOURCES
STATE OF HAWAII
Balance Sheet
Governmental Funds
June 30, 2004

| | General Fund | Federal Grant Fund | Water and Land Development | Ocean-Based Recreation Fund | Kaho'olawe Rehabilitation Trust Fund | Capital Projects Fund | Other Funds | Total |
|---|---|---|---|---|---|---|---|---|
| ASSETS | | | | | | | | |
| Cash and short-term cash investments held in State Treasury | $2,301,256 | $10,025,261 | $ 529,888 | $ 2,236,379 | $33,405,990 | $55,305,702 | $31,120,308 | $134,924,784 |
| Receivables: | | | | | | | | |
| Federal grants | - | 2,015,862 | - | - | - | - | - | 2,015,862 |
| General leases and licenses, net of allowance of $748,551 | - | - | - | 113,896 | - | - | 229 | 114,125 |
| Total assets | $2,301,256 | $12,041,123 | $ 529,888 | $ 2,350,275 | $33,405,990 | $55,305,702 | $31,120,537 | $137,054,771 |
| LIABILITIES | | | | | | | | |
| Vouchers and contracts payable | $1,109,828 | $ 1,025,881 | $ - | $ 524,240 | $ 228,147 | $ 632,739 | $ 1,128,116 | $ 4,648,951 |
| Accrued wages and employee benefits payable | 897,172 | 61,826 | - | 196,038 | 60,268 | 86,659 | 435,353 | 1,737,316 |
| Due to State Treasury | - | 7,974,560 | - | - | - | - | - | 7,974,560 |
| Due to other State agencies | - | - | 6,180,795 | 2,146,049 | - | - | 504,926 | 8,831,770 |
| Deferred revenue | - | 5,452,317 | - | 390,057 | - | - | 371,005 | 6,213,379 |
| Total liabilities | 2,007,000 | 14,514,584 | 6,180,795 | 3,256,384 | 288,415 | 719,398 | 2,439,400 | 29,405,976 |
| Commitments and contingencies | | | | | | | | |
| FUND BALANCES | | | | | | | | |
| Reserved for: | | | | | | | | |
| Encumbrances | 1,245,161 | 5,329,104 | - | 819,077 | 2,885,558 | 48,739,476 | 7,104,946 | 66,123,322 |
| Receivables | - | 2,015,862 | - | 113,896 | - | - | 229 | 2,129,987 |
| Continuing appropriations | - | - | - | - | - | 5,846,828 | - | 5,846,828 |
| Unexpended Federal awards | - | - | - | - | 30,232,017 | - | - | 30,232,017 |
| Total reserved fund balances | 1,245,161 | 7,344,966 | - | 932,973 | 33,117,575 | 54,586,304 | 7,105,175 | 104,332,154 |
| Unreserved: | | | | | | | | |
| Unreserved reported in major funds | (950,905) | (9,818,427) | (5,650,907) | (1,839,082) | - | - | - | (18,259,321) |
| Unreserved reported in nonmajor - Special revenue funds | - | - | - | - | - | - | 21,575,962 | 21,575,962 |
| Total unreserved fund balances | (950,905) | (9,818,427) | (5,650,907) | (1,839,082) | - | - | 21,575,962 | 3,316,641 |
| Total fund balances | 294,256 | (2,473,461) | (5,650,907) | (906,109) | 33,117,575 | 54,586,304 | 28,681,137 | 107,648,795 |
| Total liabilities and fund balances | $2,301,256 | $12,041,123 | $ 529,888 | $2,350,275 | $33,405,990 | $55,305,702 | $31,120,537 | $137,054,771 |

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