Financial Audit of the
Department of Land and Natural Resources
A Report to the Governor and the Legislature of the State of Hawai'i

THE AUDITOR STATE OF HAWAI'I
Report No. 06-04 June 2006

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

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financial impact of the proposed measure.
6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.
7. Procurement compliance audits and other procurement-related monitoring assist the Legislature in overseeing government procurement practices.
8. Fiscal accountability reports analyze expenditures by the state Department of Education in various areas.
9. Special studies respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions. Hawai'i's laws provide the Auditor with broad powers to examine all books, records, files,
papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

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The Auditor State of Hawai'i
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

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Recommendations and Response

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

Financial Audit of the Department of Land and Natural Resources Report No. 06-04 June 2006
A Report to the Governor and the Legislature of the State of Hawaiʻi

Conducted by
The Auditor
State of Hawaiʻi and KMH LLP

THE AUDITOR
STATE OF HAWAIʻI
Submitted by

Foreword

This is a report of the financial audit of the Department of Land and Natural Resources, State of Hawaiʻi, for the fiscal year July 1, 2004 to June 30, 2005. The audit was conducted pursuant to Section 23-4, Hawaiʻi 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. 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.

Background
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Chapter1: Introduction
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. 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. 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. 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:

Organization of the Department Board of Land and Natural Resources

Commission of Water Resource Management Office of the Chairperson

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Chapter 1: Introduction
Exhibit 1.1
Department of Land and Natural Resources' Plan of Organization
Source: Department of Land and Natural Resources
STATE HISTORIC PRESERVATION DIVISION
ENGINEERING DIVISION
LAND DIVISION
DIVISION O F FORESTRY & WILDLIFE
DIVISION OF STATE PARKS
DIVISION OF CONSERVATION & RESOURCE ENFORCEMENT
DIVISION OF BOATING & OCEAN RECREATION ADMINISTRATIVE SERVICES OFFICE
PERSONNEL OFFICE
BUREAU O F CONVEYANCES
AQUATIC RESOURCES DIVISION
OFFICE OF CONSERVATION AND COASTAL LANDS
OFFICE OF THE CHAIRPERSON
OFFICE OF THE DEPUTY COMMISSION ON WATER RESOURCE MANAGEMENT
COMMISSION ON WATER RESOURCE MANAGEMENT
BOARD OF LAND & NATURAL RESOURCES
HAWAII HISTORIC PLACES REVIEW BOARD
NATURAL AREA RESERVES SYSTEMS COMMISSION
KAHOOLAWE ISLAND RESERVE COMMISSION
(admin. purposes)

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Chapter1: Introduction
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. 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 Operating divisions

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

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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.

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. 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.

Objectives of the Audit
Scope and Methodology

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Chapter 1: Introduction

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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Chapter1: Introduction

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Chapter 2: Internal Control Deficiencies

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.

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.

Summary of Findings

Chapter 2: Internal Control Deficiencies

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. 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]

The Department Lacks A Comprehensive System To Properly Manage Its Federal Grant Programs
Federal program accounting may violate state law, undermine legislative intent, and misstate balances

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. 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. Financial results of federal programs raise questions

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.

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.

Accounting for federal programs is inefficient
Recommendations

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Chapter 2: Internal Control Deficiencies
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. 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:

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

The department's financial statements are misstated

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

our audit and discussed their preparation and maintenance procedures with

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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.***

Chapter 2: Internal Control Deficiencies 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.

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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. 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 Financial accounting and management controls are
inadequate

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*** 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

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

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

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. 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.

Recommendations

• 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 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. 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 The Operation and Management of the Division of Boating and Ocean Recreation Continues To Need Improvement The poor condition of the harbors jeopardizes public safety

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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.

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Exhibit 2.2
Hazardous Pier Conditions
This Ke'ehi Boat Harbor pier poses a serious safety hazard. Photograph

courtesy of KMH LLP.
Exhibit 2.3
Multiple Attempts at Repair
This Ke'ehi 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 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 The division's fee structure has not changed in over ten years

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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. 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. 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

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
Inadequate fiscal controls and monitoring put assets at risk

all harbors. We noted the division had 83 budgeted positions and 73 fulltime 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. 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***
Boating permits were issued in violation of policies and procedures

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. 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 reported approximately $155 million in cash and shortterm 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 Recommendations
The Department Lacks A Comprehensive Cash Management Policy

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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. 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 The department has ineffective accounting controls over cash

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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. 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 Physical controls over cash are poor and ineffective

 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. 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 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. ***Recommendations The Bureau of Conveyances Does Not Effectively Manage Its Staff Resources***

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.

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

The bureau records excessive overtime

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

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

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Chapter 2: Internal Control Deficiencies 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. 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.

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. Although overtime increased, productivity decreased

Recommendations

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Chapter 3: Financial Audit
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. 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.

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

Summary of Findings Independent Auditors' Report

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Chapter 3: Financial Audit 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

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

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Chapter 3: Financial Audit
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. Explanatory notes that are pertinent to an understanding of the basic financial statements and financial condition of the department are discussed in this section.

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 Notes to Basic Financial Statements

Note 1 - Summary of significant accounting policies

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

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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 shortterm 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. 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 Note 2 - Budgeting and budgetary control

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

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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

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 nvestments, was $154,801,975 for its governmental funds and $4,446,290 for its fiduciary funds. At June 30, 2005, receivables for general leases and licenses for governmental funds consisted of the following: 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 3 - Cash and short-term cash investments held in state treasury
Note 4 - Receivables 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 changes in capital assets were as follows: Note 5 - Capital assets
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:
Depreciation expense for the year ended June 30, 2005, was charged to

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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
The changes in long-term obligations were as follows:
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
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)
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
Note 6 - Long-term obligations

Chapter 3: Financial Audit 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
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 noncontributory options, respectively. Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date 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.

Note 7 - Retirement benefits

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.

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' ompensation. 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.

Note 8 - Commitments and contingencies

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Chapter 3: Financial Audit
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.
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. 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. 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
Note 9 - Small Boat Harbors and Boat Ramps Program
Note 10 - Central service and administration fees
Note 11 - Due to other state agencies

Chapter 3: Financial Audit 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 NR 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.

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Chapter 3: Financial Audit
Exhibit 3.1
State of Hawai'i,
Department of Land and Natural Resources
Statement of Net Assets June 30, 2005
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

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
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 $
Assets
Liabilities
Net Assets
See accompanying notes to financial statements.

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Chapter 3: Financial Audit
Exhibit 3.2
State of Hawai'i, Department of Land and Natural Resources
Statement of Activities For the Year Ended June 30, 2005
Net (Expense) Functions/Programs Expenses Interest, Rents and Fees
Operating Grants and Contributions 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:

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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 $
Program Revenue
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
Federal Water and Ocean-Based Kaho'olawe Capital
General Grant Land Recreation Rehabilitation Projects Other Fund Fund
Development Fund Trust Fund Fund 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

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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
Federal Water and Ocean-Based Kaho'olawe Capital
General Grant Land Recreation Rehabilitation Projects Other
Fund Fund Development Fund Trust Fund Fund 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

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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.

Chapter 3: Financial Audit
Exhibit 3.5
State of Hawai'i,
Department of Land and Natural Resources
Statement of Fiduciary Net Assets
June 30, 2005

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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
Due to State Treasury 443,660
Due to Other State Agencies 678,976
Total liabilities 1,122,636
Commitments and Contingencies
Held in Trust For:
Individuals and organizations 3,878,985
Total net assets 3,878,985 $
Assets
Liabilities
Net Assets
See accompanying notes to financial statements.

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Chapter 3: Financial Audit
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.

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Chapter 3: Financial Audit
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
Variance with
Final Budget -
Actual 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) $
Budgeted Amounts
See accompanying notes to financial statements.

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Chapter 3: Financial Audit
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
Variance with
Final Budget -
Actual 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) $
Budgeted Amounts
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
Variance with
Final Budget -
Actual 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 $
Budgeted Amounts
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

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June 30, 2005
Bureau of Special Land Commercial Forest Aquatic
Conveyances Development Fisheries Stewardship Resources
Fund Fund Fund Fund 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
Conservation Natural
Forests and Water Resource Area Historical Subtotal
Wildlife Resources Enforcement Reserves Preservation Carried
Fund Fund Fund Fund Fund 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
Na Ala Hele Park
Subtotal Park Wildlife Sport-Fish Development State
Brought Development Revolving Restoration Operations Parks
Forward Fund Fund Fund Fund 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:

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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.

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Chapter 3: Financial Audit
Exhibit 3.12 (continued)
State of Hawai'i,
Department of Land and Natural Resources
Combining Balance Sheet - Nonmajor Governmental Funds
June 30, 2005
Natural Preservation Donations,
Physical of Endangered Gifts and OHA Endangered Total Other
Environment Plants Grants Kikakakeokea Species Governmental
Fund Fund Fund Trust Fund Trust Fund 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.

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Chapter 3: Financial Audit
Exhibit 3.13

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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 Special Land Commercial Forest Aquatic Forests and
Conveyances Development Fisheries Stewardship Resources Wildlife
Fund Fund Fund Fund Fund 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
Conservation Natural
Water Resource Area Historical Subtotal
Resources Enforcement Reserves Preservation Carried
Fund Fund Fund Fund 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
Na Ala Hele Park
Subtotal Park Wildlife Sport-Fish Development State

Brought Development Revolving Restoration Operations Parks
Forward Fund Fund Fund Fund 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 Preservation Donations,
Physical of Endangered Gifts and OHA Endangered Total Other
Environment Plants Grants Kikakakeokea Species Governmental
Fund Fund Fund Trust Fund Trust Fund 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.

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Comments on
Agency Response
Response of the Affected Agency
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.