

Department of Public Safety, State of Hawaii

Financial Statements

Fiscal Year Ended June 30, 2004



KARN S YEE MURAKAMI HANASHIRO CHOY

March 25, 2005

Mr. Richard Bissen, Jr.
Acting Director
Department of Public Safety
State of Hawaii

Dear Mr. Bissen:

This is our report on the financial audit of the Department of Public Safety of the State of Hawaii (PSD) as of and for the fiscal year ended June 30, 2004. Our audit was performed in accordance with the terms of our contract with the State of Hawaii and with the requirements of the U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

OBJECTIVES OF THE AUDIT

The primary purpose of our audit was to form an opinion on the fairness of the presentation of the PSD's basic financial statements as of and for the fiscal year ended June 30, 2004, and to comply with the requirements of OMB Circular A-133. More specifically, the objectives of the audit were as follows:

1. To provide a basis for an opinion on the fairness of the presentation of the PSD's basic financial statements.
2. To determine whether expenditures and other disbursements have been made and all revenues and other receipts to which the PSD is entitled have been collected and accounted for in accordance with the laws, rules and regulations, and policies and procedures of the State of Hawaii and the federal government.
3. To determine whether the PSD has established sufficient internal controls to properly manage federal financial assistance programs and to comply with the applicable laws and regulations.
4. To determine whether the PSD has complied with the laws and regulations that may have a material effect on the basic financial statements and on its major federal financial assistance programs.

SCOPE OF THE AUDIT

Our audit was performed in accordance with auditing standards generally accepted in the United States of America as prescribed by the American Institute of Certified Public Accountants; *Government Auditing Standards*, issued by the Comptroller General of the United States; and the provisions of OMB Circular A-133. The scope of our audit included an examination of the transactions and accounting records of the PSD for the fiscal year ended June 30, 2004.

ORGANIZATION OF THE REPORT

This report is presented in six parts as follows:

- Part I - The basic financial statements and related notes of the PSD as of and for the fiscal year ended June 30, 2004, and our opinion on the basic financial statements.
- Part II - Our report on compliance and on internal control over financial reporting.
- Part III - Our report on compliance with requirements applicable to each major program and internal control over compliance.
- Part IV - The schedule of findings and questioned costs.
- Part V - The summary schedule of prior audit findings.
- Part VI - Response of the affected agency.

We wish to express our sincere appreciation for the excellent cooperation and assistance extended by the officers and staff of the PSD.

Sincerely,



Wilcox Choy
Partner

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PART I
FINANCIAL SECTION



KARN S YEE MURAKAMI HANASHIRO CHOY

Report of Independent Public Accountants

To the Director
Department of Public Safety
State of Hawaii

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Department of Public Safety of the State of Hawaii (PSD), as of and for the fiscal year ended June 30, 2004, which collectively comprise the PSD's basic financial statements as listed in the preceding table of contents. These financial statements are the responsibility of the PSD's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free 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.

As discussed in Note 1, the financial statements of the PSD are intended to present the financial position and the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State of Hawaii that is attributable to the transactions of the PSD. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2004, and the changes in its financial position and its cash flows, where applicable, for the fiscal 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 business-type activities, each major fund, and the aggregate remaining fund information for the PSD, as of June 30, 2004, and the respective changes in financial position and cash flows, where applicable, and the respective budgetary comparison for the general fund thereof for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 30, 2004, on our consideration of the PSD's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 9 through 17 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the PSD's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

KMH LLP

KMH LLP

Honolulu, Hawaii
December 30, 2004

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

The Management's Discussion and Analysis (MD&A) offers readers of the PSD's basic financial statements a narrative overview and analysis of the PSD's financial activities for the fiscal year ended June 30, 2004. We encourage readers to consider the information presented here in conjunction with the basic financial statements and notes to the basic financial statements.

FINANCIAL HIGHLIGHTS

- Total assets of the PSD exceeded its total liabilities at June 30, 2004 by approximately \$84 million. Net assets invested in capital assets accounted for nearly this entire amount.
- During the fiscal year ended June 30, 2004, the PSD incurred approximately \$199 million of expenses of which approximately \$183 million was funded by general fund revenues.
- Approximately \$162 million of governmental funds were expended for incarceration and related inmate programs.

OVERVIEW OF THE FINANCIAL STATEMENTS

This MD&A serves as an introduction to the PSD's basic financial statements. The basic financial statements comprise three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements.

Government-wide Financial Statements

The government-wide financial statements report information about the PSD as a whole using the economic resources measurement focus and accrual basis of accounting, which is similar to those used by private-sector companies. It provides both long-term and short-term information about the PSD's overall financial status. The Statement of Net Assets includes all of the PSD's assets and liabilities. All of the current fiscal year's revenues and expenses are accounted for in the Statement of Activities regardless of when cash is received or paid.

The two statements report the PSD's net assets and how they have changed. Over time, increases or decreases in the PSD's net assets are an indicator of whether its financial health is improving or deteriorating, respectively.

Both statements distinguish between the governmental and business-type activities of the PSD as follows:

Governmental activities – reflect the PSD's basic services including confinement (incarceration of law offenders), law enforcement, parole, crime victim compensation, and general support (administration). Allotments from the State of Hawaii (State) and federal grants finance most of these activities.

Business-type activities – reflect the business-type operations of the Correctional Industries, which charges fees for goods and services that cover its operating costs including depreciation.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The PSD uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the PSD are divided into three categories: governmental funds, proprietary funds, and fiduciary funds. Governmental funds are used to account for most, if not all, of a government entity's tax-supported activities. Proprietary funds are used to account for a government entity's business-type activities, where all or part of the costs of activities are supported by fees and charges that are paid directly by those who benefit from the activities. Fiduciary funds are used to account for resources that are held by a government entity as a trustee or agent for parties outside of the government entity. The resources of fiduciary funds cannot be used to support the government entity's own programs.

The fund financial statements of the PSD include the following types of funds:

Governmental funds – Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on current sources and uses of spendable resources and balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

By comparing the governmental fund and government-wide financial statements, readers may better understand the long-term impact of the entity's near-term financing decisions. In order to facilitate a comparison between the governmental fund and government-wide financial statements, reconciliation between the two is provided following the governmental fund financial statements.

Proprietary funds – Proprietary funds are used to account for the same functions reported as business-type activities in the government-wide financial statements but the fund financial statements report in more detail and with additional information such as cash flows. As in the government-wide financial statements, the accrual basis of accounting is applied to the proprietary funds. There are two types of proprietary funds.

Enterprise funds – Enterprise funds are used to report activity for which a fee is charged to external users for goods or services. The PSD uses an enterprise fund to account for its Correctional Industries' operations.

Internal service funds – Internal service funds, the second type of proprietary fund, are used to report activity that provides goods or services to other funds, departments, agencies, or other governments on a cost-reimbursement basis in which the reporting government entity is the predominant participant in the activity. The PSD currently does not have any funds classified as internal service funds.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

Fiduciary funds – Fiduciary funds are used to account for assets held in a trustee or agency capacity. The PSD, as a fiduciary, temporarily holds monies for prison inmates and process servers, monies for law enforcement related equipment purchases for the State, cities, and counties of Hawaii under a federal program, and repayments by employees for salaries overpaid by the State. These activities are excluded from the PSD's government-wide financial statements because the PSD cannot use these assets to finance its operations.

FINANCIAL ANALYSIS OF THE GOVERNMENT-WIDE FINANCIAL STATEMENTS

The following table presents a condensed government-wide Statement of Net Assets of the PSD as of June 30, 2004 and June 30, 2003.

Condensed Statement of Net Assets

	<u>Governmental Activities</u>		<u>Business-Type Activities</u>		<u>TOTAL</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Current and other assets	\$ 22,316,058	\$ 20,280,219	\$ 856,733	\$ 739,797	\$ 23,172,791	\$ 21,020,016
Capital assets	<u>91,323,133</u>	<u>97,143,191</u>	<u>2,011,512</u>	<u>2,195,501</u>	<u>93,334,645</u>	<u>99,338,692</u>
Total Assets	<u>\$113,639,191</u>	<u>\$117,423,410</u>	<u>\$2,868,245</u>	<u>\$2,935,298</u>	<u>\$116,507,436</u>	<u>\$120,358,708</u>
Long-term debt outstanding	\$ 21,486,154	\$ 19,513,236	\$ 555,526	\$ 657,932	\$ 22,041,680	\$ 20,171,168
Other liabilities	<u>9,696,341</u>	<u>9,964,880</u>	<u>152,556</u>	<u>161,992</u>	<u>9,848,897</u>	<u>10,126,872</u>
Total Liabilities	<u>\$ 31,182,495</u>	<u>\$ 29,478,116</u>	<u>\$ 708,082</u>	<u>\$ 819,924</u>	<u>\$ 31,890,577</u>	<u>\$ 30,298,040</u>
Net Assets						
Invested in capital assets, net of related debt	\$ 91,323,133	\$ 97,143,191	\$1,980,895	\$2,070,001	\$ 93,304,028	\$ 99,213,192
Restricted	-	1,761,583	-	-	-	1,761,583
Unrestricted (deficit)	<u>(8,866,437)</u>	<u>(10,959,480)</u>	<u>179,268</u>	<u>45,373</u>	<u>(8,687,169)</u>	<u>(10,914,107)</u>
Total Net Assets	<u>\$ 82,456,696</u>	<u>\$ 87,945,294</u>	<u>\$2,160,163</u>	<u>\$2,115,374</u>	<u>\$ 84,616,859</u>	<u>\$ 90,060,668</u>

**Department of Public Safety
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**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

The PSD's combined total net assets decreased by 6% from \$90 million as of June 30, 2003 to \$85 million as of June 30, 2004. The decrease in net assets is attributed to:

1. Decrease in net depreciable assets
2. Increase in accrued wages and employee benefits payable
3. Increase in accrued vacation adjustment

Governmental net assets accounted for 97% of total net assets that consisted primarily of buildings and improvements to correctional facilities.

The deficit in unrestricted net assets for governmental activities was approximately \$9 million and \$11 million as of June 30, 2004 and June 30, 2003, respectively. This deficit in unrestricted net assets is primarily the result of liabilities for programs incurred as of June 30, 2004 for which State allotted appropriations were not yet available. The largest liability is for compensated absences totaling \$15.5 million and \$15 million as of June 30, 2004 and June 30, 2003, respectively, and which are not funded by State allotted appropriations until the earned leave is used by the employee or—in the case of accrued vacation leave—is paid in lump sum upon termination. Therefore, there are no assets currently available to the PSD to pay for the compensated absence liability as of June 30, 2004.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

Condensed Changes in Net Assets

	<u>Governmental Activities</u>		<u>Business-Type Activities</u>		<u>TOTAL</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Revenues						
Program revenues	\$ 7,660,527	\$ 6,754,373	\$3,640,335	\$4,210,187	\$ 11,300,862	\$ 10,964,560
General revenues	<u>186,426,419</u>	<u>180,715,798</u>	<u>-</u>	<u>3,597</u>	<u>186,426,419</u>	<u>180,719,395</u>
Total Revenues	<u>\$194,086,946</u>	<u>\$187,470,171</u>	<u>\$3,640,335</u>	<u>\$4,213,784</u>	<u>\$197,727,281</u>	<u>\$191,683,955</u>
Expenses						
Confinement	\$162,155,749	\$161,787,740	\$ -	\$ -	\$162,155,749	\$161,787,740
Law Enforcement	17,291,097	17,024,599	-	-	17,291,097	17,024,599
Parole	2,691,989	2,651,642	-	-	2,691,989	2,651,642
Crime victim comp	1,274,812	1,736,187	-	-	1,274,812	1,736,187
General Support	12,136,196	9,220,485	-	-	12,136,196	9,220,485
Correctional Industries	<u>-</u>	<u>-</u>	<u>3,600,546</u>	<u>4,526,650</u>	<u>3,600,546</u>	<u>4,526,650</u>
Total Expenses	<u>\$195,549,843</u>	<u>\$192,420,653</u>	<u>\$3,600,546</u>	<u>\$4,526,650</u>	<u>\$199,150,389</u>	<u>\$196,947,303</u>
Excess (deficiency) before transfers, lapsed appropriations and contributions	\$ (1,462,897)	\$ (4,950,482)	\$39,789	\$(312,866)	\$(1,423,108)	\$(5,263,348)
Transfer out	(332,750)	(555,290)	-	-	(332,750)	(555,290)
Lapsed appropriations	(3,692,951)	(4,237,604)	-	-	(3,692,951)	(4,237,604)
Contributions	<u>-</u>	<u>-</u>	<u>5,000</u>	<u>-</u>	<u>5,000</u>	<u>-</u>
Change in Net Assets	<u>\$ (5,488,598)</u>	<u>\$ (9,743,376)</u>	<u>\$ 44,789</u>	<u>\$(312,866)</u>	<u>\$(5,443,809)</u>	<u>\$(10,056,242)</u>

Total net assets decreased by approximately \$5 million during the fiscal year ended June 30, 2004 as shown above.

Total revenues for PSD increased by \$6 million. The revenue increase is attributed primarily to increase in funding to cover collective bargaining costs and increasing inmate healthcare costs.

Expenses for the fiscal year ended June 30, 2004 and June 30, 2003 totaled approximately \$199 million and \$197 million, respectively. The \$2 million increase stems from increases in collective bargaining costs and inmate healthcare costs.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

Governmental Activities

Governmental activities accounted for over 98% of total expenses in each fiscal year, with program expenses for the confinement of inmates accounting for approximately 83% for the fiscal year ended June 30, 2004 and 84% for the fiscal year ended June 30, 2003, respectively, of total expenses for governmental activities. Approximately \$31 million and \$29 million was expended for the housing and care of inmates in the Federal Detention Center and in out-of-State correctional facilities for the fiscal years ended June 30, 2004 and June 30, 2003, respectively.

Business-type Activities

Pressed by a poor economy and State agency spending restrictions, Correctional Industries was forced to cut expenses including payroll, stock items, and operating supplies. As can be seen in the Condensed Changes in Net Assets, CI's expenses dropped by 20% (\$4,526,650 to \$3,600,546) for the fiscal years ended June 30, 2004 and June 30, 2003. At the same time; however, our revenues also decreased by 13% (\$4,213,784 to \$3,640,335) for the fiscal years ended June 30, 2004 and June 30, 2003. A net profit of \$39,789 was recorded for the fiscal year ended June 30, 2004.

FINANCIAL ANALYSIS OF THE FUND FINANCIAL STATEMENTS

As noted earlier, the PSD used fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Following are financial analyses of the PSD's governmental and proprietary funds.

Governmental Funds

The PSD's major fund is the general fund, which accounted for approximately \$19 million or 87% of total governmental fund assets as of June 30, 2004 and \$17 million or 84% of total governmental fund assets for the fiscal year ended June 30, 2003. The general fund revenues consisted primarily of state allotted appropriations.

Proprietary Fund

The Correctional Industries Revolving Fund is the PSD's only enterprise fund. As of June 30, 2004 the Correctional Industries reported over \$2 million in total net assets of which approximately \$2 million was accounted for by investment in capital assets, net of related debt.

The decrease in revenues for Correctional Industries was addressed by a reduction in expenditures that resulted in a small net profit of \$39,789 for the fiscal year ended June 30, 2004.

BUDGETARY ANALYSIS

As of September 2003, the Council on Revenues projected that economic conditions in Hawaii would improve and be relatively favorable through Fiscal Biennium 2003-2005. Based on those encouraging projections, no statewide restrictions on funding were extended or imposed on the full-year FY 2004 Departmental allocation.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

However, the Department was cautioned that while projected State revenues were expected to increase, we were still obligated to be prudent and disciplined in our expenditures, and to ensure that government services were provided in a consistently manageable and affordable manner. Accordingly, we were tasked with ensuring a disciplined and balanced budget that did not impose further financial burdens on the citizens of the State, while continuing to provide essential services of government. We were therefore expected to carefully monitor all our expenditures, and review our program and financial requirements relative to the fiscal condition and funding priorities of the State.

At the beginning of May 2004, in anticipation of substantial collective bargaining costs that would have a serious impact on the State's financial condition, an immediate spending moratorium was imposed on all spending except for non-discretionary obligations. Between May and June 2004, spending restrictions were applied to all discretionary operating appropriations for equipment and furniture, training, supplies, motor vehicles, and new consultant and personal service contracts.

General Fund Budgetary Comparison

	<u>Original</u>	<u>Final</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Expenditures:				
Confinement	\$136,057,881	\$136,953,268	\$133,488,871	\$3,464,397
Law enforcement	14,877,119	15,070,539	13,536,635	1,533,904
Parole	2,391,066	2,419,066	2,418,895	171
General support	<u>9,943,338</u>	<u>8,093,051</u>	<u>10,132,434</u>	<u>(2,039,383)</u>
Total Expenditures	<u>\$163,269,404</u>	<u>\$162,535,924</u>	<u>\$159,576,835</u>	<u>\$2,959,089</u>

The amount for the total final budget of \$162 million reflects an expenditure ceiling. Generally, expenditure ceilings are formulated based on anticipated program needs. Optimally, expenditure ceilings should be close or equal to actual expenditures. However, actual expenditures are limited to the availability of funds. Therefore, the PSD is limited to spending either the expenditure ceiling or the cash balance, whichever amount is lower. For the fiscal year ended June 30, 2004, the \$3 million variance between the final budget and actual expenditures on a budgetary basis is attributed to a combination of the following factors:

1. The overall cash balance was less than the expenditure ceiling.
2. The PSD experienced employee recruitment and retention difficulties.
3. Certain programs were able to reduce overtime expenditures.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

Capital Assets, Net of Depreciation

	Governmental Activities		Business-Type Activities		Total	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Land	\$ 107,570	\$ 107,570	\$ -	\$ -	\$ 107,570	\$ 107,570
Buildings and improvements	89,887,288	95,518,575	1,805,300	1,869,775	91,692,588	97,388,350
Furniture, equipment and vehicles	<u>1,328,275</u>	<u>1,517,046</u>	<u>206,212</u>	<u>325,726</u>	<u>1,534,487</u>	<u>1,842,772</u>
TOTAL	<u>\$91,323,133</u>	<u>\$97,143,191</u>	<u>\$2,011,512</u>	<u>\$2,195,501</u>	<u>\$93,334,645</u>	<u>\$99,338,692</u>

CAPITAL ASSETS

As of June 30, 2004, the PSD had approximately \$93 million invested in capital assets. Capital assets for governmental activities accounted for 98% of total capital assets. Building and improvements for correctional facilities totaled approximately \$90 million net of accumulated depreciation.

There was approximately \$6 million or a 6% decrease in capital assets, net of depreciation, between June 30, 2003 and June 30, 2004. This decrease is primarily a result of annual depreciation of approximately \$6 million.

ECONOMIC FACTORS

As discussed earlier in the budgetary analysis section, at the beginning of May 2004 an immediate spending moratorium was imposed on all spending except for non-discretionary obligations in anticipation of projected collective bargaining costs. The moratorium was needed to accommodate the anticipated authorized increase in payroll in FY 2005 and subsequent years. Between May and June 2004, spending restrictions were applied to all discretionary operating appropriations for equipment and furniture, training, supplies, motor vehicles, and new consultant and personal service contracts.

**Department of Public Safety
State of Hawaii**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004 (UNAUDITED)**

REQUEST FOR INFORMATION

This financial report is designed to provide a general overview of the PSD's finances and to demonstrate the PSD's accountability for the money it receives. Questions concerning any of the information provided in this report or request for additional information should be addressed in writing to the following:

Office of the Deputy Director for Administration
Department of Public Safety
State of Hawaii
919 Ala Moana Boulevard, Suite 400
Honolulu, HI 96814

Department of Public Safety, State of Hawaii

Statement of Net Assets

June 30, 2004

	Governmental Activities	Business-Type Activities	Total
<u>Assets</u>			
Current Assets:			
Cash and cash equivalents	\$ 19,724,033	\$ 114,489	\$ 19,838,522
Receivables, net	370,737	241,539	612,276
Due from State of Hawaii	2,163,707	-	2,163,707
Internal balances	(76,897)	76,897	-
Due from other funds	41,058	120,324	161,382
Due from others	93,420	-	93,420
Inventories	-	303,484	303,484
Total current assets	<u>22,316,058</u>	<u>856,733</u>	<u>23,172,791</u>
Capital Assets:			
Non-depreciable	107,570	-	107,570
Depreciable, net	91,215,563	2,011,512	93,227,075
Total capital assets	<u>91,323,133</u>	<u>2,011,512</u>	<u>93,334,645</u>
Total assets	<u>113,639,191</u>	<u>2,868,245</u>	<u>116,507,436</u>
<u>Liabilities</u>			
Current Liabilities:			
Accrued wages and employee benefits payable	9,484,114	52,462	9,536,576
Vouchers payable	6,229,018	252,833	6,481,851
Deferred revenues	-	140,097	140,097
Capital lease obligations	-	17,392	17,392
Accrued compensated absences	5,707,604	86,637	5,794,241
Due to other funds	65,418	6,105	71,523
Total current liabilities	<u>21,486,154</u>	<u>555,526</u>	<u>22,041,680</u>
Capital lease obligations	-	13,225	13,225
Accrued compensated absences	9,696,341	139,331	9,835,672
Total liabilities	<u>31,182,495</u>	<u>708,082</u>	<u>31,890,577</u>
<u>Net Assets</u>			
Invested in capital assets, net of related debt	91,323,133	1,980,895	93,304,028
Unrestricted (deficit)	(8,866,437)	179,268	(8,687,169)
Total net assets	<u>\$ 82,456,696</u>	<u>\$ 2,160,163</u>	<u>\$ 84,616,859</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Statement of Activities

For the Fiscal Year Ended June 30, 2004

Functions/Programs	Program Revenues			Net (Expense) Revenue and Changes in Net Assets		
	Expenses	Charges for Services	Operating Grants and Contributions	Governmental Activities	Business-Type Activities	Total
Governmental activities:						
Confinement	\$ 162,155,749	\$ 293,780	\$ 1,345,633	\$ (160,516,336)	\$ -	\$ (160,516,336)
Law enforcement	17,291,097	4,509,065	107,536	(12,674,496)	-	(12,674,496)
Parole	2,691,989	-	-	(2,691,989)	-	(2,691,989)
Crime victim compensation	1,274,812	904,932	499,581	129,701	-	129,701
General support	12,136,196	-	-	(12,136,196)	-	(12,136,196)
Total governmental activities	195,549,843	5,707,777	1,952,750	(187,889,316)	-	(187,889,316)
Business-type activities --						
Correctional industries	3,600,546	3,640,335	-	-	39,789	39,789
Total business-type activities	3,600,546	3,640,335	-	-	39,789	39,789
Total	\$ 199,150,389	\$ 9,348,112	\$ 1,952,750	(187,889,316)	39,789	(187,849,527)
General revenues:						
State				156,839,573	-	156,839,573
State-provided payroll fringe benefits				29,563,045	-	29,563,045
Unrestricted investment earnings				2,482	-	2,482
Miscellaneous				21,319	-	21,319
Lapsed appropriations				(3,692,951)	-	(3,692,951)
Capital contributions				-	5,000	5,000
Transfers, net				(332,750)	-	(332,750)
Total general revenues and transfers				182,400,718	5,000	182,405,718
Changes in net assets				(5,488,598)	44,789	(5,443,809)
Net assets at July 1, 2003				87,945,294	2,115,374	90,060,668
Net assets at June 30, 2004				\$ 82,456,696	\$ 2,160,163	\$ 84,616,859

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Governmental Funds

Balance Sheet

June 30, 2004

	<u>General</u>	<u>Other Governmental Funds</u>	<u>Total</u>
<u>Assets</u>			
Cash and cash equivalents	\$ 16,822,531	\$ 2,901,502	\$ 19,724,033
Receivables	370,737	-	370,737
Due from State of Hawaii	2,163,707	-	2,163,707
Due from other funds	50,495	3,451	53,946
Due from others	-	93,420	93,420
Total assets	<u>\$ 19,407,470</u>	<u>\$ 2,998,373</u>	<u>\$ 22,405,843</u>
<u>Liabilities and Fund Balances</u>			
Accrued wages and employee benefits payable	\$ 9,439,833	\$ 44,281	\$ 9,484,114
Vouchers payable	5,994,229	234,789	6,229,018
Due to other funds	144,180	11,023	155,203
Total liabilities	<u>15,578,242</u>	<u>290,093</u>	<u>15,868,335</u>
Fund balances:			
Reserved for:			
Encumbrances	6,983,955	1,721,419	8,705,374
Receivables	370,737	-	370,737
Unreserved	<u>(3,525,464)</u>	<u>986,861</u>	<u>(2,538,603)</u>
Total fund balances	<u>3,829,228</u>	<u>2,708,280</u>	<u>6,537,508</u>
Total liabilities and fund balances	<u>\$ 19,407,470</u>	<u>\$ 2,998,373</u>	<u>\$ 22,405,843</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets
June 30, 2004

Total fund balances - governmental funds \$ 6,537,508

Amounts reported for governmental activities in the statement
of net assets are different because:

Capital assets used in governmental activities are not financial
resources and therefore are not reported in the funds. These
assets consist of:

Governmental capital assets	180,386,658	
Less accumulated depreciation	<u>(89,063,525)</u>	91,323,133

Accrued compensated absences liability is not due in the
current period and therefore is not reported in the
governmental funds

(15,403,945)

Net assets of governmental activities

\$ 82,456,696

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Governmental Funds

Statement of Revenues, Expenditures, and Changes in Fund Balances

For the Fiscal Year Ended June 30, 2004

	<u>General</u>	<u>Other Funds</u>	<u>Total</u>
Revenues:			
State allotted appropriations	\$ 156,839,573	\$ -	\$ 156,839,573
State-provided payroll fringe benefits	29,563,045	-	29,563,045
Operating grants and contributions	-	1,952,750	1,952,750
Charges for services	4,163,351	1,544,426	5,707,777
Unrestricted investment earnings	2,482	-	2,482
Miscellaneous	21,319	-	21,319
	<u>190,589,770</u>	<u>3,497,176</u>	<u>194,086,946</u>
Expenditures:			
Confinement	155,086,476	1,746,871	156,833,347
Law enforcement	16,236,388	727,560	16,963,948
Parole	2,720,101	-	2,720,101
Crime victim compensation	-	1,259,889	1,259,889
General support	11,879,140	-	11,879,140
	<u>185,922,105</u>	<u>3,734,320</u>	<u>189,656,425</u>
Excess (deficiency) of revenues over expenditures	<u>4,667,665</u>	<u>(237,144)</u>	<u>4,430,521</u>
Other financing sources (uses)			
Transfers in	-	250	250
Transfers out	<u>(333,000)</u>	<u>-</u>	<u>(333,000)</u>
Total other financing sources (uses)	<u>(333,000)</u>	<u>250</u>	<u>(332,750)</u>
Excess (deficiency) of revenues over expenditures and other uses	<u>4,334,665</u>	<u>(236,894)</u>	<u>4,097,771</u>
Other changes in fund balances --			
Lapsed appropriations	<u>(3,692,951)</u>	<u>-</u>	<u>(3,692,951)</u>
Net change in fund balances	641,714	(236,894)	404,820
Fund balance, July 1, 2003	<u>3,187,514</u>	<u>2,945,174</u>	<u>6,132,688</u>
Fund balance, June 30, 2004	<u>\$ 3,829,228</u>	<u>\$ 2,708,280</u>	<u>\$ 6,537,508</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Reconciliation of the Changes in Fund Balances of Governmental Funds to the Statement of Activities

For the Fiscal Year Ended June 30, 2004

Net change in fund balances - total governmental funds		\$	404,820
Amounts reported for governmental activities in the statement of activities are different because:			
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets is depreciated over their estimated useful lives.			
Expenditures for capital assets	\$	155,482	
Less current fiscal year depreciation		<u>(5,974,069)</u>	(5,818,587)
Loss on the disposition of capital assets reported in the statement of activities does not require the use of current financial resources and therefore is not reported as an expenditure in governmental funds.			
			(1,471)
Change in long-term compensated absences reported in the statement of activities does not require the use of current financial resources and therefore is not reported as an expenditure in governmental funds.			
			<u>(73,360)</u>
Change in net assets of governmental activities		\$	<u>(5,488,598)</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

General Fund

Statement of Revenues and Expenditures - Budget and Actual

For the Fiscal Year Ended June 30, 2004

	<u>Original</u>	<u>Final</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Revenues:				
State allotments	\$ 156,839,573	\$ 156,839,573	\$ 156,839,573	\$ -
Charges for services	6,354,766	5,621,286	4,163,351	(1,457,935)
Miscellaneous	75,065	75,065	23,251	(51,814)
	<u>163,269,404</u>	<u>162,535,924</u>	<u>161,026,175</u>	<u>(1,509,749)</u>
Expenditures:				
Confinement	136,057,881	136,953,268	133,488,871	3,464,397
Law enforcement	14,877,119	15,070,539	13,536,635	1,533,904
Parole	2,391,066	2,419,066	2,418,895	171
General support	9,943,338	8,093,051	10,132,434	(2,039,383)
	<u>163,269,404</u>	<u>162,535,924</u>	<u>159,576,835</u>	<u>2,959,089</u>
Excess of revenues over expenditures	-	-	1,449,340	1,449,340
Other financing uses -- Transfers out	<u>-</u>	<u>-</u>	<u>333,000</u>	<u>(333,000)</u>
Excess of revenues over expenditures and other uses	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,116,340</u>	<u>\$ 1,116,340</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Proprietary Fund
Statement of Net Assets
June 30, 2004

Assets

Current assets:	
Cash	\$ 114,489
Receivables, net of allowance for doubtful accounts	241,539
Internal Balances	76,897
Due from other funds	120,324
Inventories	303,484
Total current assets	856,733
Capital assets, net of depreciation	2,011,512
Total assets	2,868,245

Liabilities

Current liabilities:	
Accrued wages and employee benefits	52,462
Vouchers payable	252,833
Due to other funds	6,105
Deferred revenues	140,097
Capital lease obligations	17,392
Accrued compensated absences	86,637
Total current liabilities	555,526
Noncurrent liabilities:	
Capital lease obligations	13,225
Accrued compensated absences	139,331
Total liabilities	708,082

Net assets

Invested in capital assets, net of related debt	1,980,895
Unrestricted	179,268
Total net assets	\$ 2,160,163

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Proprietary Fund

Statement of Revenues, Expenses, and Changes in Fund Net Assets

For the Fiscal Year Ended June 30, 2004

Operating revenues:	
Charges for sales and services	\$ 3,640,335
Less: provision for uncollectible accounts	<u>(12,850)</u>
Total operating revenues	<u>3,627,485</u>
Operating expenses:	
Cost of sales and services	3,388,122
Depreciation and amortization	<u>192,475</u>
Total operating expenses	<u>3,580,597</u>
Operating income	<u>46,888</u>
Non-operating expenses:	
Interest expense	(6,180)
Loss on disposal of assets	<u>(919)</u>
Income before contributions	39,789
Capital contributions	<u>5,000</u>
Change in net assets	44,789
Net assets, July 1, 2003	<u>2,115,374</u>
Net assets, June 30, 2004	<u>\$ 2,160,163</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Proprietary Fund
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2004

Cash Flows from Operating Activities:	
Receipts from customers	\$ 3,374,676
Receipts from interfund services provided	139,307
Payments to suppliers	(2,670,251)
Payments to employees	<u>(738,381)</u>
Net cash provided by operating activities	<u>105,351</u>
Cash Flows from Capital and Related Financing Activities	
Purchases of capital assets	(4,405)
Principal payments on capital lease obligations	(94,883)
Interest paid on capital lease obligations	<u>(6,180)</u>
Net cash used by capital and related financing activities	<u>(105,468)</u>
Net decrease in cash	(117)
Cash at July 1, 2003	<u>114,606</u>
Cash at June 30, 2004	<u><u>\$ 114,489</u></u>

Reconciliation of operating income to net cash flows provided by operating activities

Operating income	\$ 46,888
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation expense	192,475
Provision for uncollectible accounts	12,850
Change in assets and liabilities:	
Receivables, net	(97,091)
Inventories	(3,086)
Vouchers payable	20,182
Accrued wages and compensated absences	6,035
Deferred revenues	(29,261)
Other liabilities	<u>(43,641)</u>
Net cash provided by operating activities	<u><u>\$ 105,351</u></u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Agency Fund
Statement of Assets and Liabilities
June 30, 2004

	<u>Assets</u>	<u>Agency Fund</u>
Cash		\$ 2,168,645
Due from others		<u>71,523</u>
Total assets		<u>\$ 2,240,168</u>
	<u>Liabilities</u>	
Due to other funds		\$ 161,382
Due to individuals		989,067
Due to others		<u>1,089,719</u>
Total liabilities		<u>\$ 2,240,168</u>

See accompanying notes to the basic financial statements.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

1. Financial Reporting Entity

Effective July 1, 1990, Act 211, Session Laws of Hawaii (SLH) 1989, established the Department of Public Safety of the State of Hawaii (PSD). This Act transferred to the PSD, the administration of the state correctional facilities and related services formerly administered by the State Department of Corrections. This Act also transferred to the PSD on July 1, 1990, all functions and powers to administer the Sheriffs Office, formerly administered by the State Judiciary, and the Narcotics Enforcement Division, formerly administered by the State Department of the Attorney General.

The PSD is part of the executive branch of the State of Hawaii (State). The PSD's basic financial statements reflect only its portion of the fund type categories. The State Comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually which includes the PSD's financial activities.

The accompanying basic financial statements reflect the financial position, results of operations and cash flows of the following divisions of the PSD:

a. Departmental Administration

Departmental Administration includes management, accounting, data processing and other administrative services provided by the PSD. Also included in Departmental Administration is activity related to certain federal financial assistance programs. Its operations are reported in both the general and special revenue funds.

b. Law Enforcement

Law Enforcement assists in guarding state property and facility, preserving the peace and protecting the public in designated areas, and serving process papers in civil and criminal proceedings. Included in Law Enforcement are the Protective Services, Narcotics Enforcement and Sheriff Divisions, and the Executive Protective Services. Its operations are reported in both the general and special revenue funds.

c. Corrections

Administers, through subordinate staff offices and line divisions programs, services and facilities for the detention, custody, care and redirection of persons committed to the control of the department pursuant to law.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

1. Financial Reporting Entity (Continued)

i. Institutions Division

This division operates the state correctional facilities (prisons), and the state community correctional centers (jails). Its public safety mission includes the confinement, care, supervision, rehabilitation and release of persons committed to those facilities. Its operations are reported in both the general and special revenue funds.

Inmate Stores

The inmate stores are operated by the PSD within the state correctional facilities. The PSD contracts with an outside vendor to provide consumer goods for sale to the inmate population. The stores' operations are reported in the general fund.

ii. Intake Service Centers Division

This division provides service delivery coordination to the State's criminal justice agencies through intake, assessment, program services and administrative functions. Its operations are reported in both the general and special revenue funds.

iii. Corrections Program Services Division

This division develops operational guidelines and standards and provides technical and administrative support and assistance to all correctional institutions for the effective and efficient conduct of programs and services. It also assists in coordinating and maintaining oversight of institutional operations, programs and services. Its operations are reported in both the general and special revenue funds.

iv. Health Care Division

This division develops and maintains a program of health care services involving both in-house and community resources (public health, contract and volunteer) for all correctional institutions. It also oversees the operation of such services to ensure adherence to contemporary standards and fiscal responsibility, uniformity of quality health care, and integration/coordination among health care providers. Its operations are reported in the general fund.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

1. Financial Reporting Entity (Continued)

v. Correctional Industries Division

This division employs inmates who receive employment training and who provide printing, sewing, construction and miscellaneous services to other operations of the PSD, other state agencies, and the private sector. Its operations are reported in the enterprise fund.

d. Crime Victim Compensation Commission (administratively attached to the PSD)

This commission assists victims of criminal acts by providing compensation to victims or survivors of deceased victims of certain crimes. Its operations are reported in the special revenue funds.

e. Hawaii Paroling Authority (administratively attached to the PSD)

This authority is a quasi-judicial body which establishes minimum terms of imprisonment, considers requests for parole and provides supervision for those granted parole. Its operations are reported in the general fund.

2. Significant Accounting Policies

a. Basis of Presentation

The government-wide financial statements report all assets, liabilities, and activities of the PSD as a whole. The fiduciary funds are excluded from the government-wide financial statements because the PSD cannot use those assets to finance its operations.

The financial transactions of the PSD are recorded in individual funds that are reported in the fund financial statements and are described in the following sections. Each fund is considered a separate accounting entity. The operations of each are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, retained earnings, revenues, and expenditures.

The fund financial statements focus on major funds rather than reporting funds by type. Each major fund is reported in separate columns and non-major funds are combined in one column. Major funds are funds which have total assets, liabilities, revenues or expenditures that are at least ten percent of the same element for all funds of its fund type or at least five percent of the same element for all governmental and enterprise funds combined.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

2. Significant Accounting Policies (Continued)

b. Governmental Fund Types

General Fund - The general fund is the general operating fund of the PSD. It 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.

Special Revenue Funds - Special revenue funds are used to account for the proceeds of specific revenue sources (other than expendable trusts) that are legally restricted to expenditures for specified purposes.

Capital Projects Fund - The capital projects fund is used to account for financial resources to be used for the acquisition or construction of major capital facilities.

c. Proprietary Fund Type

Enterprise Fund - The enterprise fund is used to account for operations for which a fee is charged to external users for goods or services and the activity (a) is financed with debt that is solely secured by a pledge of the net revenues, (b) has third party requirements that the cost of providing services, including capital costs, be recovered with fees and charges, or (c) establishes fees and charges based on a pricing policy designed to recover similar costs.

Proprietary fund operating revenues are those that result from providing goods and services. It also includes revenues not related to capital and related financing activities, non-capital financing activities, or investing activities, if any.

d. Fiduciary Fund Type

Agency Fund - The agency fund is used to account for assets held by the PSD on behalf of outside parties, including other governments, or on behalf of individuals.

e. Government-Wide Financial Statements

The economic resources measurement focus and accrual basis of accounting is used for reporting the government-wide financial statements. With this measurement focus, all assets and liabilities associated with the operations of the PSD are included in the statement of net assets. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are recorded when they are incurred.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

2. Significant Accounting Policies (Continued)

f. Governmental Funds

All governmental funds are accounted for using a current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized in the accounting period when they become both measurable and available. Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after fiscal year-end to liquidate liabilities existing at the end of the fiscal year. Revenues susceptible to accrual include federal grants and funds appropriated by the State Legislature and allotted by the Governor. Expenditures are generally recorded when the related fund liabilities are incurred.

g. Proprietary and Agency Funds

All proprietary and agency funds are accounted for on a flow of economic resources measurement focus and accrual basis of accounting. In accordance with standards promulgated by the Governmental Accounting Standards Board, the PSD has elected not to apply the Financial Accounting Standards Board pronouncements on accounting and financial reporting that were issued after November 30, 1989.

The agency fund is purely custodial (assets equal liabilities) and thus does not involve the measurement of results of operations.

h. Use of Estimates

The preparation of basic financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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.

i. Cash and Cash Equivalents

Cash and cash equivalents, for the purpose of the statement of cash flows, includes all cash and investments with original maturities of three months or less.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

2. Significant Accounting Policies (Continued)

j. Receivables

Receivables in the general fund consist primarily of amounts due from individuals for whom salaries were overpaid by the PSD. Receivables in the enterprise fund consist primarily of amounts due from other state agencies for services provided to those agencies for a fee. The amounts reported as net receivables were established based on management's estimate of amounts collectible.

Any residual balances outstanding between the governmental activities and business-type activities are reported in the government-wide financial statements as internal balances.

k. Inventories

Inventory of goods, materials and supplies is valued at cost (first-in, first-out method). Inventory in the enterprise fund consists primarily of printing, construction, and sewing supplies to be used in the Correctional Industries Program.

l. Capital Assets

The accounting treatment over capital assets depends on whether the assets are used in governmental fund or proprietary fund operations and whether they are reported in the government-wide or fund financial statements.

Capital assets include land, improvements to land, buildings, building improvements, vehicles, machinery, equipment, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.

When capital assets are purchased, they are capitalized and depreciated in the government-wide financial statements. Capital assets are recorded as expenditures of the current period in the governmental fund financial statements. Capital assets used in proprietary fund operations are accounted for on the same basis as in the government-wide financial statements.

Capital assets are valued at cost where historical cost records are available and at estimated historical cost where no records exist. Donated capital assets are valued at their estimated fair value on the date received.

Improvements to capital assets that materially add to the value or extend the life of the assets are capitalized. Other repairs and normal maintenance are not capitalized. Major outlays for capital assets and improvements are capitalized as projects are constructed.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

2. Significant Accounting Policies (Continued)

l. Capital Assets (Continued)

The State has adopted the following capitalization policy:

Asset Type	Minimum Capitalization Amount	Estimated Useful Life	
		Governmental	Proprietary
Land improvements	\$100,000	15 years	Not applicable
Buildings and improvements	\$100,000	30 years	40 years
Furniture and equipment	\$5,000	7 years	5 years
Motor vehicles	\$5,000	5 years	5 years

m. Due to Individuals

Due to individuals represents assets held by the PSD primarily in an agency capacity for the inmate population.

n. Accumulated Vacation

Employees are credited with vacation at the rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year-end and is convertible to pay upon termination of employment. Such accumulated vacation has been accrued and reflected in the statement of net assets.

o. Restricted Net Assets

Net assets are restricted when constraints placed on net assets are imposed by grantors, contributors, or laws and regulations of authorizing governments. When both restricted and unrestricted net assets are available, the PSD generally applies unrestricted resources before restricted resources for expenses incurred.

p. Appropriations

Appropriations represent the authorizations granted by the State Legislature that permit 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.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

2. Significant Accounting Policies (Continued)

q. Program Revenues

Program revenues derive directly from the programs of the PSD or from parties outside of the PSD and are categorized as charges for services, operating grants and contributions, or capital grants and contributions.

Charges for services - Charges for services include revenues based on exchange or exchange-like transactions. These revenues arise from charges to customers or applicants who purchase, use, or directly benefit from the goods, services, or privileges provided. Revenues in this category include fees charged for specific services, such as controlled substance registration fees, security service fees and state law and court imposed crime victim compensation fees. Payments from other governments that are exchange transactions are also reported as charges for services.

Operating grants and contributions - Program-specific operating and capital grants and contributions include revenues arising from mandatory and voluntary nonexchange transactions with other governments, organizations, or individuals that are restricted for use in a particular program. Governmental grants and assistance awards made on the basis of entitlement periods are recorded as intergovernmental receivables and revenues when entitlement occurs. All other federal reimbursement-type grants are recorded as intergovernmental receivables and revenues when the related expenditures or expenses are incurred.

r. Intrafund and Interfund Transactions

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

s. Risk Management

The PSD is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if information indicates that it is probable that a liability has been incurred at the date of the basic financial statements and the amount of the loss is reasonably estimable.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

3. Budgeting and Budgetary Control

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues and budgeted expenditures in the statement of revenue and expenditures - budget and actual - general fund are derived primarily from acts of the State Legislature and from other authorizations contained in other specific appropriation acts in various Session Laws of Hawaii. 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 such as those related to the special revenue funds.

For purposes of budgeting, the PSD's budgetary fund structure and accounting principles differ from those utilized to present the governmental fund financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP). The PSD's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to (1) the encumbrance of purchase order and contract obligations, (2) the recognition of certain receivables, and (3) special revenue fund operating grant accruals and deferrals. These differences represent a departure from GAAP. The following schedule reconciles the budgetary amounts to the amounts presented in accordance with GAAP for the general fund for the fiscal year ended June 30, 2004:

Excess of revenues over expenditures and other uses - actual on budgetary basis	\$ 1,116,340
Reserved for encumbrances at fiscal year-end	6,983,955
Reserved for receivables	370,737
Net change in unreserved liabilities	285,732
Expenditures for liquidation of prior fiscal year encumbrances	(4,421,549)
Net adjustment for commissary revenue accrual	<u>(550)</u>
Excess of revenues over expenditures and other uses - GAAP basis	<u>\$ 4,334,665</u>

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

4. Cash and Cash Equivalents

The State Director of Finance is responsible for safekeeping of all monies paid into the State Treasury (cash pool). The Hawaii Revised Statutes authorize the State Director of Finance to invest in 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. Cash and deposits with financial institutions are collateralized in accordance with state statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State. The PSD also maintains cash in banks and time certificates of deposit, which are held separately from cash in the State Treasury. As of June 30, 2004, the carrying amount of total bank deposits including time certificates of deposit was approximately \$1,043,000 and the corresponding bank balances was approximately \$1,153,000.

5. Receivables

Receivables of the PSD, net of an allowance for doubtful accounts, consisted of the following at June 30, 2004:

	General Fund	Enterprise Fund
Salary overpayments	\$ 1,296,737	\$ -
Accounts receivable	-	314,389
Less: allowance for doubtful accounts	(926,000)	(72,850)
Receivables, net	<u>\$ 370,737</u>	<u>\$ 241,539</u>

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

6. Capital Assets

	<u>Balance July 1, 2003</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance June 30, 2004</u>
Governmental activities:				
Nondepreciable assets --				
Land	\$ 107,570	\$ -	\$ -	\$ 107,570
Depreciable assets:				
Building and improvements	172,084,272	-	-	172,084,272
Furniture and equipment	4,468,864	144,534	123,919	4,464,302
Vehicles	3,709,899	10,948	15,510	3,730,514
Total capital assets	<u>180,370,605</u>	<u>155,482</u>	<u>139,429</u>	<u>180,386,658</u>
Less accumulated depreciation:				
Building and improvements	76,565,697	5,631,287		82,196,984
Furniture and equipment	3,350,610	168,587	123,919	3,510,766
Vehicles	3,311,107	174,195	14,039	3,355,775
Total accumulated depreciation	<u>83,227,414</u>	<u>5,974,069</u>	<u>137,958</u>	<u>89,063,525</u>
Governmental activities - capital assets, net	<u>\$ 97,143,191</u>	<u>\$ (5,818,587)</u>	<u>\$ 1,471</u>	<u>\$ 91,323,133</u>

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

6. Capital Assets (continued)

	Balance July 1, 2003	Additions	Deductions	Balance June 30, 2004
Business-type activities:				
Building and improvements	\$ 2,579,000	\$ -	\$ -	\$ 2,579,000
Equipment	2,112,721	9,405	1,392,026	730,100
Equipment under capital lease	649,758	-	-	649,758
Total capital assets	<u>5,341,479</u>	<u>9,405</u>	<u>1,392,026</u>	<u>3,958,858</u>
Less accumulated depreciation:				
Building and improvements	709,225	64,475	-	773,700
Equipment	2,012,911	31,078	1,391,107	652,882
Equipment under capital lease	423,842	96,922	-	520,764
Total accumulated depreciation	<u>3,145,978</u>	<u>192,475</u>	<u>1,391,107</u>	<u>1,947,346</u>
Business-type activities - capital assets, net	<u>\$ 2,195,501</u>	<u>\$ (183,070)</u>	<u>\$ 919</u>	<u>\$ 2,011,512</u>

Depreciation expense was charged to functions as follows:

Governmental activities:		
Confinement		\$ 5,621,968
Law enforcement		98,022
Parole		645
Crime victim compensation		2,714
General support		250,720
Total governmental activities depreciation		<u>\$ 5,974,069</u>
Business-type activities --		
Correctional industries		<u>\$ 192,475</u>

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

7. Long-Term Liabilities

The only long-term liability for governmental activities is for accrued compensated absences. Long-term liability activity during the fiscal year ended June 30, 2004, was as follows:

Balance at July 1, 2003	\$15,330,585
Additions	9,792,742
Reductions	<u>(9,719,382)</u>
Balance at June 30, 2004	<u>\$15,403,945</u>

The amount of governmental activities compensated absences liability due within one year is \$5,707,604. The compensated absences liability has been paid primarily by the general fund in the past.

Long-term liability activity for business-type activities during the fiscal year ended June 30, 2004, was as follows:

	<u>Balance July 1, 2003</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance June 30, 2004</u>	<u>Amount Due Within One Year</u>
Capital lease obligations	\$ 125,500	\$ -	\$ 94,883	\$ 30,617	\$ 17,392
Accrued compensated absences	<u>211,866</u>	<u>130,256</u>	<u>116,154</u>	<u>225,968</u>	<u>86,637</u>
Total business-type activities long-term liabilities	<u>\$ 337,366</u>	<u>\$ 130,256</u>	<u>\$ 211,037</u>	<u>\$ 256,585</u>	<u>\$ 104,029</u>

8. Non-Imposed Employee Fringe Benefits

Payroll fringe benefit costs of the PSD's employees funded by state appropriations (general fund) are assumed by the State and are not charged to the PSD's operating funds. These costs, totaling approximately \$29,563,000 for the fiscal year ended June 30, 2004, have been reported as revenues and expenditures in the general fund of the PSD.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

8. Non-Imposed Employee Fringe Benefits (Continued)

Payroll fringe benefit costs related to federally-funded salaries are not assumed by the State and are recorded as expenditures in the PSD's special revenue funds.

9. Fund Balance Deficits

The general fund had a deficit in the unreserved fund balance at June 30, 2004, of \$3,525,464. The deficit resulted primarily from expenditures being recorded on the accrual basis when incurred, and revenues being recognized only when the funds are measurable and available.

10. Lease Commitments

a. Capital Leases

The PSD's Correctional Industries Program has long-term equipment leases expiring through October 2006 that is accounted for as capital leases in the enterprise fund. The leased equipment is amortized using the straight-line method over the estimated useful lives of the equipment. The amortization is included in depreciation and amortization expense of the enterprise fund and amounted to approximately \$97,000 for the fiscal year ended June 30, 2004.

Interest expense of \$6,180 is included as a direct function expense of the Correctional Industries Program on the statement of activities for the fiscal year ended June 30, 2004.

At June 30, 2004, the future minimum lease payments together with the present value of net minimum lease payments (obligations under capital leases) were as follows:

Fiscal Year <u>Ending June 30.</u>	
2005	\$ 18,782
2006	10,443
2007	<u>3,481</u>
Total minimum lease payments	32,706
Less amounts representing interest at 7.42% - 7.58%	<u>2,089</u>
Present value of minimum lease payments	<u>\$ 30,617</u>

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

10. Lease Commitments (Continued)

b. Operating Leases

The PSD leases office facilities from third party lessors as well as equipment on a long-term basis that are reported in the general and enterprise funds. Future minimum lease rentals under non-cancelable operating leases with terms of one year or more at June 30, 2004, were as follows:

Fiscal Year <u>Ending June 30,</u>	
2005	\$ 510,000
2006	441,000
2007	192,000
2008	76,000
2009	48,000
Thereafter	<u>8,000</u>
	<u>\$ 1,275,000</u>

Total rent expense for the fiscal year ended June 30, 2004, was approximately \$509,000.

11. Retirement Benefits

a. Employees' Retirement System

Substantially all eligible employees of the PSD are required by Chapter 88, Hawaii Revised Statutes (HRS), to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained by writing to the ERS at City Financial Tower, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Members of the ERS belong to either a contributory or noncontributory option. Only employees of the PSD hired on or before June 30, 1984 are eligible to participate in the contributory option. Members are required by state statute to contribute 7.8% of their salary to the contributory option and the PSD is required to contribute to both options at an actuarially determined rate. Contributions by the PSD for the fiscal years ended June 30, 2004, 2003 and 2002 were approximately \$444,000, \$445,000 and nil, respectively. The contribution rate for the fiscal year ended June 30, 2004 was 9.14%. The contribution rate was 8.87% for the fiscal year ended June 30, 2003, and nil for the fiscal year ended June 30, 2002.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

11. Retirement Benefits (Continued)

b. Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to retired state employees. Contributions are financed on a pay-as-you-go basis. The PSD's special revenue fund share of the post-retirement health care and life insurance benefits expense for the fiscal year ended June 30, 2004, was approximately \$343,000.

c. Deferred Compensation Plan

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all state employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but does have the duty of due care that would be required of an ordinary prudent investor. Accordingly, the assets and liabilities of the State's deferred compensation plan are not reported in the State's or the PSD's basic financial statements.

12. Risk Management

The PSD is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; and workers' compensation. The State generally retains the first \$250,000 per occurrence of property losses and the first \$4 million with respect to general liability claims. Losses in excess of those retention amounts are insured with commercial insurance carriers. The limit per occurrence for property losses is \$100 million for named hurricane, \$25 million for earthquake, and flood, \$50 million for terrorism, and the annual aggregate for general liability losses per occurrence is \$10 million. The State also has an insurance policy to cover medical malpractice risk in the amount of \$30 million per occurrence with no annual aggregate limit.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

12. Risk Management (Continued)

The State is generally self-insured for workers' compensation and automobile claims. The State's estimated reserve for losses and loss adjustment costs includes the accumulation of estimates for losses and claims reported prior to fiscal year-end, estimates (based on projections of historical developments) of claims incurred but not reported, and estimates of costs for investigating and adjusting all incurred and unadjusted claims. Amounts reported are subject to the impact of future changes in economic and social conditions. The State believes that, given the inherent variability in any such estimates, the reserves are within a reasonable and acceptable range of adequacy. Reserves are continually monitored and reviewed, and as settlements are made and reserves adjusted, the differences are reported in current operations. A liability for a claim is established if information indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is reasonably estimable.

13. Commitments and Contingencies

Accumulated Sick Leave

Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service without limit, but can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a public employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2004, amounted to approximately \$20,125,000.

14. New Pronouncements for Financial Reporting

The Governmental Accounting Standards Board (GASB) has issued the following Statements applicable to the Department:

- Statement No. 40, "Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3," updates the custodial credit risk disclosure requirements of GASB Statement No. 3 and establishes more comprehensive disclosure requirements addressing other common risks of the deposits and investments of state and local governments and is effective for financial statements for the period beginning after June 15, 2004. This Statement is not expected to have a material effect on the Department's financial statements.

Department of Public Safety, State of Hawaii

Notes to the Basic Financial Statements
For the Fiscal Year Ended June 30, 2004

14. New Pronouncements for Financial Reporting (Continued)

- Statement No. 42 “Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries,” establishes accounting and financial reporting standards for the impairment of capital assets and clarifies and establishes accounting requirements for insurance recoveries. This Statement is effective for financial statements for periods beginning after December 15, 2004 and is not expected to have a material effect on the Department’s financial statements.
- Statement No. 45 “Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions” establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities/assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. This Statement is effective for financial statements for periods beginning after December 15, 2007. The Department has not yet analyzed the potential effect on the financial statements, if any, of adopting Statement No. 45.

SUPPLEMENTARY INFORMATION

Department of Public Safety, State of Hawaii

Schedule of Expenditures of Federal Awards
For the Fiscal Year Ended June 30, 2004

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-through Entity Identifying Number	Federal Expenditures ¹
U.S Department of Justice			
Serious Violent Offender Re-entry Initiative	16.202	--	<u>\$ 413,283</u>
Public Safety Partnership and Community Policing Grants	16.710	--	<u>38,610</u>
Federal Equitable Sharing Program	N/A	--	<u>88,713</u>
Pass-through State Department of the Attorney General:			
Crime Victim Compensation	16.576	00-VC-GX-4015	1,745
		01-VC-GX-0015	389,824
		02-VX-GX-0015	160,502
		03-VX-GX-0045	<u>3,799</u>
			<u>555,870</u>
Byrne Formula Grant Program	16.579	01-DB-16	30,212
		02-DB-06	29,550
		02-DB-12	20,319
		02-DB-15	25,978
		02-DB-14	75,753
		03-DB-08	<u>54,113</u>
			<u>235,925</u>
Residential Substance Abuse Treatment for State Prisoners (RSAT)	16.593	00-RT-1	297,019
		01-RT-1	<u>2,445</u>
			<u>299,464</u>
Total U.S. Department of Justice			<u>\$ 1,631,865</u>

Department of Public Safety, State of Hawaii

Schedule of Expenditures of Federal Awards
For the Fiscal Year Ended June 30, 2004

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-through Entity Identifying Number	Federal Expenditures ¹
U.S. Department of Education			
Grants to States for Incarcerated Youth Offenders	84.331	--	<u>\$ 44,020</u>
Pass-through State Department of Education:			
Title I Program for Neglected and Delinquent Children	84.013	S013A990011	<u>79,628</u>
Pass-through University of Hawaii:			
Vocational Education - Basic Grants to States	84.048	V048A40011	<u>63,640</u>
Total U.S. Department of Education			<u>187,288</u>
U.S. Department of Defense			
Pass-through Hawaii Army National Guard:			
Master Cooperative Agreement	N/A	DAHA50-03-H1003	12,208
		DAHA50-04-H1003	<u>33,656</u>
Total U.S. Department of Defense			<u>45,864</u>
Total Federal Expenditures			<u><u>\$ 1,865,017</u></u>

¹ The accompanying schedule of expenditures of federal awards is prepared on the cash basis of accounting.

PART II

**AUDITORS' REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND ON
COMPLIANCE AND OTHER MATTERS**



KARN S YEE MURAKAMI HANASHIRO CHOY

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Basic Financial Statements Performed in Accordance with *Government Auditing Standards*

To the Director
Department of Public Safety
State of Hawaii

We have audited the basic financial statements of the Department of Public Safety of the State of Hawaii (PSD), as of and for the fiscal year ended June 30, 2004, and have issued our report thereon dated December 30, 2004. 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the PSD'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. 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 PSD's ability to record, process, summarize and report financial data consistent with the assertions of management in the basic financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 04-1 through 04-4.

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, we consider items 04-1 through 04-3 of the reportable conditions described above to be material weaknesses. We also noted other matters involving the internal control over financial reporting that we have reported to the management of the PSD in a separate letter dated December 30, 2004.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the PSD's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

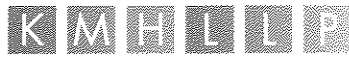
KMH LLP

KMH LLP

Honolulu, Hawaii
December 30, 2004

PART III

**AUDITORS' REPORT ON COMPLIANCE
WITH REQUIREMENTS APPLICABLE TO EACH MAJOR
PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE**



KARN S YEE MURAKAMI HANASHIRO CHOY

Report on Compliance with Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance with OMB Circular A-133

To the Director
Department of Public Safety
State of Hawaii

Compliance

We have audited the compliance of the Department of Public Safety of the State of Hawaii (PSD) with the types of compliance requirements described in the U. S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the fiscal year ended June 30, 2004. The PSD's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the PSD's management. Our responsibility is to express an opinion on the PSD's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the PSD's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the PSD's compliance with those requirements.

In our opinion, the PSD complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the fiscal year ended June 30, 2004.

Internal Control Over Compliance

The management of the PSD is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the PSD's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. 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 noncompliance with applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of management, federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KMH LLP

KMH LLP

Honolulu, Hawaii
December 30, 2004

PART IV

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Department of Public Safety
State of Hawaii

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FISCAL YEAR ENDED JUNE 30, 2004**

Section I – Summary of Auditors’ Results

Financial Statements

Type of auditors’ report issued: Unqualified

Internal control over financial reporting:

- Material weakness (es) identified? yes no
- Reportable condition(s) identified that are not considered to be material weaknesses? yes none reported
- Noncompliance material to financial statements noted? yes no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? yes no
- Reportable condition(s) identified that are not considered to be material weaknesses? yes none reported

Type of auditor’s report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? yes no

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster
16.202	Serious and Violent Offender Re-entry Initiative
16.576	Crime Victim Compensation

Dollar threshold used to distinguish between type A and type B programs? \$300,000

Auditee qualified as low-risk auditee? yes no

**Department of Public Safety
State of Hawaii**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004**

Section II - Financial Statement Findings

Ref

No. Internal Control Findings

04-1 Improve Controls Over Inmate Agency Fund Accounts

As noted in the prior years, the controls over the inmate agency fund accounts need improvement. We realize that PSD is aware of the needed improvements and efforts have been made to rectify the problems. The prior year's corrective action plan by the PSD was to explore the possibility of contracting with a vendor who could assist the facilities with the reconciliation process and complete a review of each inactive inmate account to the point where the PSD could properly escheat these funds to the State. From our discussion with management, management concluded that hiring a consultant is not feasible based on the current situation due to a lack of funding. Management also stated that segregation of duties for the Oahu Community Correctional Center has been implemented, which was verified during the audit.

We noted the following conditions regarding the inmate trust accounts for the fiscal year ended June 30, 2004:

- We were unable to reconcile the inmate trust account balance, which provides detail on the balance of each inmate, per the Inmate Trust Accounting (ITA) system's printed trial balance report to the reconciled cash balance as of June 30, 2004. The unreconciled difference totaled approximately \$84,000.
- The Women's Community Correctional Center did not prepare bank reconciliations during the current fiscal year. The Women's Community Correctional Center has not performed monthly bank reconciliations since May 31, 1996. One other facility prepared the bank reconciliation as of June 30, 2004, that was not accurate.
- Inactive inmate accounts remained on the PSD's financial records.
- Stale-dated checks over one-year old were not escheated to the State Treasury for two facilities.
- The total cash balance of inmate accounts reported to the State of Hawaii exceeded the adjusted bank balances by approximately \$99,000 as of June 30, 2004.

It is important to keep accurate and complete accounting records to ensure that the PSD can uphold its fiduciary duty to maintain current and accurate inmate trust account balances. Since transactions in this area are not subject to the centralized internal controls of the State Department of Accounting and General Services (DAGS), it is imperative that the PSD implement and enforce strict internal controls over these transactions. Immediate attention should be given to this area by the PSD's management to reduce the possibility of misappropriation of cash.

**Department of Public Safety
State of Hawaii**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004**

Recommendation

The findings listed above have been occurring for many years despite the efforts of the PSD to make certain changes like the installation of software to maintain the trust accounts, regular monitoring of the progress of the findings and even the establishment of a working group to tackle the many problems each facility encounters with reconciling the inmate trust accounts. We can appreciate the PSD's concern with a recommendation that "reconciling items should be investigated and resolved" would not be useful nor actionable.

During our audit, we noted that the reconciling differences from prior year have changed. This is an indication that the current reconciling process is creating additional items to consider. In order to stabilize this situation, the PSD needs to assess its current processes to isolate and address any current year "reconciling" items. Once the unreconciled differences are identified, the PSD can start with a static balance and move forward. In consideration of this, we believe that the PSD should take the following steps towards reconciling its inmate trust accounts and prevent future differences. The process can be summarized as follows:

1. Restructure/Centralize the Process
2. Standardize Reconciliations
3. Performance of Reconciliations
4. Monitoring/Process Reengineering

Restructure/Centralize the Process

Currently, each facility is responsible for its own reconciliation process. Ultimately, each facility reports to the Deputy Director of Corrections. The PSD should consider whether there is any need for reorganization of roles and responsibilities to ensure that there is adequate oversight over the reconciliation process. Options that the PSD may consider is having adequate and appropriate level of Administration or Corrections provide the guidance and oversight of the reconciliation process. Adequate and appropriate level means that there is staff with available time and the accounting background to identify and fix problems in the reconciliation process that currently exist or occur in the future.

In addition, the PSD should consider centralizing the reconciliation function regardless of which Division has governance over the process (i.e., Administration or Corrections). Currently, each facility is responsible for its own reconciliations and despite the progress made by each facility, transfers of inmates between facilities causes timing differences that make the reconciliation process more difficult. The centralization of the reconciliation process would eliminate the timing differences caused by inmate transfers.

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SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004

Standardize Reconciliations

The ITA working group has taken steps towards the standardization of the reconciliation process. However, there are facilities that continue to prepare the reconciliations differently. The Department should continue to develop a standard reconciliation form that lists all potential reconciling items to help ensure that all reconciling items are identified. The centralization of the process as mentioned above will aid in the implementation of a standard form.

Performance of Reconciliations

The performance of accurate and timely reconciliations for the facilities is a key part of the process. The Department should see increased accuracy and more timely reconciliations as a result of the previous steps. Any unreconcilable differences should be reported for monitoring purposes as discussed below.

Monitoring/Process Reengineering

Under the governance established under the restructuring of the process, those charged with monitoring the reconciliation should ensure that reconciliations are performed accurately and timely. Any unreconcilable difference should also be investigated and the reconciliation process should be modified accordingly.

This process will eventually identify all reconciling items such that the unreconciled difference remains the same from period to period. Once the difference has not changed for a defined period (e.g., six months to one year) the Department should write-off or escheat, as applicable, the unreconciled difference. The Department should consult with the State of Hawaii Attorney General's office for the appropriate disposition of the unreconciled difference.

The aforementioned process is based on our high-level understanding of the process and further analysis is necessary to effectively implement the above process. Our consideration of the Department's internal control and processes over financial reporting of the inmate liability accounts was primarily to determine our auditing procedures. A detailed study of the process was not performed. Consequently we recommend that the Department consider hiring an outside consultant to assist with the execution of this recommendation.

Ref

No.

04-2

Internal Control Findings
Strengthen Controls Over Compensated Leaves of Absence

The PSD acknowledges a need to strengthen the controls over the compensated leave of absence process. The corrective action plan for the prior year's findings was to conduct periodic audits of leave records maintained by program units in order to promote accurate and timely recordation of leaves and to conduct scheduled training sessions on the leave records maintenance procedures for all programs. As of June 30, 2004, the audit of one program has been completed and another is in

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**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004**

progress. Also, there has been no training provided on the maintenance procedures to properly complete the leave records.

The following conditions were noted during our review of leave records for the fiscal year ending June 30, 2004:

- The salary overpayment receivable balance as of June 30, 2004, was approximately \$1,296,000. Prior to January 1995, the PSD deducted any overpaid wages from the employees' next paycheck. However, in 1995, according to HRS Section 78-12, the PSD must conduct a hearing prior to recovering overpayments to employees. This law was changed by Act 253 in the 2000 legislative session and was made effective July 1, 2002. The changes to HRS Section 78-12 now allows PSD to immediately recover any overpayments prior to a hearing. The PSD submitted a list of overpayments of former employees to the State Department of the Attorney General (AG) for collection service. Most of the salary overpayments occurred because of the timing requirements for processing payroll data under the State's payroll system. For employees hired effective July 1, 1998, paychecks are prepared after the payroll period rather than before the end of the payroll period to provide time to make any payroll adjustments to prevent salary overpayments. We noted that the occurrences of salary overpayments have stabilized from the fiscal year ended June 30, 2000.
- In 29 instances, the wage rate used in calculating the employees vacation, did not agree to the Employee Personnel Action Report (EPAR).
- In seven instances, the employee leave schedule prepared by the PSD did not agree to the Form DPS-7, "Employee Leave Record." The discrepancies generally resulted from corrections to the Form DPS-7 after the employee leave schedule was prepared.
- In one instance, the Form DPS-7, "Employee Leave Record," had a negative balance.
- In four instances, the Form G-1, "Application for Leave of Absence," did not have the approval signature, date, and/or hours.
- In two instances, the Form DPS-7, "Employee Leave Record," was not mathematically accurate.
- There was one instance where the approval date on the Form G-1, "Application for Leave of Absence," was several days after the vacation period requested.

Leave records should be maintained accurately to ensure that each employee is compensated for absences as allowed by the employment agreement and paid the correct amount of unused credits upon termination of employment.

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**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004**

Recommendation

The PSD should strengthen controls over compensated leaves of absence by performing the following procedures:

- Continue collection efforts in the repayment of salary overpayments.
- Ensure that leave information for financial statement reporting purposes is accurately prepared, reviewed, and corrected, if necessary, by responsible personnel prior to submission to the PSD Fiscal Office.
- To ensure that each program is completing the leave information accurately and correctly, training should be provided to all personnel with this responsibility.

**Ref
No.**

Internal Control Findings

04-3 Properly Account for Capital Assets

The PSD's corrective action plan in the prior year for these issues was to establish a procedure where the Capital Improvements Programs (CIP) Coordinator would submit documentation of completed CIP projects to the respective program for inventory recordation and submit an informational copy to the PSD Fiscal Office for use in monitoring the change in inventory. We did note that the procedures have been established to ensure that requests to add or delete inventory items are submitted to DAGS on a timely basis.

However, during our review of the capital asset records of the PSD, we noted the following:

- Capital asset transactions were not reported to the State in a timely manner. As a result, approximately \$64,000 in capital assets actually acquired prior to the fiscal year ended June 30, 2004, was recorded as current fiscal year additions.
- Building and building improvement costs amounting to approximately \$60 million were not recorded on the State's Annual inventory Report of Property as of June 30, 2004. Most of the costs were for the construction of capital assets for which the PSD was not the expending agency.
- A demolished building with a recorded cost of approximately \$2.6 million was not removed from the State's property inventory records. The delay appears to be due to the PSD being unable to locate the proper documentation to provide DAGS to support the removal of the asset.

Department of Public Safety
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SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004

Recommendation

The PSD should record all acquired capital assets in its possession, custody, control, or use, including completed capital projects paid by another state department, and remove disposed assets from the state property records, as appropriate in a timely manner. Each program should take inventory of capital assets and inform the fiscal office of any discrepancies.

**Ref
No.**

Internal Control Findings

04-4 Maintain Current and Accurate Financial Records for Correctional Industries

During our review of the accounting records at the Correctional Industries, we noted the following conditions as of June 30, 2004:

- There was an unreconciled difference in cash of approximately \$36,000 between the Correctional Industries' internal general ledger and the financial reports printed from the Financial Accounting and Management Information System (FAMIS). The Correctional Industries was unable to explain the difference.
- In several instances, inventory items tested, the unit cost per the inventory listing as of June 30, 2004, did not agree to the invoice.
- There were several instances where invoices could not be found for the inventory items tested. It appears that invoices for inventory items purchased prior to fiscal year 2004 were not easily located. The PSD has indicated that the primary cause is due to a change in accounting personnel during the year.

Recommendation

Correctional Industries should maintain current and accurate financial records to facilitate proper analysis and management decisions that are critical to maintaining a self-supporting operation. This includes maintaining the integrity of the historical, financial information in their internal general ledger, reconciling their internal financial information to the reports printed from FAMIS on a monthly basis, investigating unreconciled differences for correction or write-off, and developing procedures to coordinate the recording of capital assets into their internal general ledger software with the reporting of capital asset information to DAGS. Correctional Industries should ensure that proper documentation is maintained to support financial transactions. A filing system should be established and maintained to ensure that supporting documentation is available regardless of personnel turnover.

**Department of Public Safety
State of Hawaii**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
FISCAL YEAR ENDED JUNE 30, 2004**

Section III - Federal Award Findings

None.

PART V

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

STATUS REPORT

This section contains the current status of our prior audit recommendations. The recommendations are referenced to the pages of the previous audit report for the fiscal year ended June 30, 2003, dated January 16, 2004.

Recommendations

Status

Section II - Financial Statement Findings

03-1 Improve Controls Over Inmate Agency Fund Accounts

Management should take corrective action to strictly enforce the policy requiring monthly reconciliations to be submitted to the PSD Fiscal Office in a timely manner. Required monthly reconciliations include a bank reconciliation and reconciliation between the reconciled bank balance and the inmate ledger balance. Reconciling items should be investigated and resolved by the facilities each month. Existing unreconciled differences should be investigated and should be corrected or written-off.

Not accomplished. See Reference No. 04-1.

Internal controls over inmate trust account transactions should be strengthened. This includes adequate segregation of duties and timely reconciliations of inmate trust account balances to the bank balances. Management should consider having independent reviews performed by the PSD Audit and Compliance Office to ensure that internal controls are functioning properly and that departmental procedures are followed.

03-2 Strengthen Controls Over Compensated Leaves of Absence

The PSD should strengthen controls over compensated leaves of absence by performing the following procedures:

- Continue collection efforts in the repayment of salary overpayments.
- Ensure that leave information for financial statement purposes is accurately prepared and reviewed by responsible personnel prior to being submitted to the PSD Fiscal Office.

Partially accomplished. The number of salary overpayment occurrences have stabilized. However, errors in the compensated leaves of absence records continued to occur during the fiscal year ended June 30, 2004. See Reference No. 04-2.

Recommendations

Activity Fund.

Status

03-3 Maintain Current and Accurate Financial Records for Correctional Industries

Correctional Industries should maintain current and accurate financial records to facilitate proper analysis and management decisions that are critical to maintaining a self-supporting operation. This includes maintaining the integrity of the historical financial information in their internal general ledger, reconciling their internal financial information to the recording of capital assets into their internal general ledger software with the reporting of capital asset information to DAGS.

Partially accomplished. Correctional Industries has implemented procedures to reconcile their internal financial records to the Financial Accounting and Management Information System (FAMIS). However there continues to be unreconciled differences in financial records. See Reference No. 04-4.

03-4 Adhere to Established Policies and Procedures for Inmate Stores

The PSD should send written reminders to the facilities to ensure the following:

Accomplished.

- All facilities must comply with established PSD policies and procedures pertaining to inmate stores.
- The HCF and OCCC should transfer net profits earned from commissary operations retroactively to the Administrator Inmate

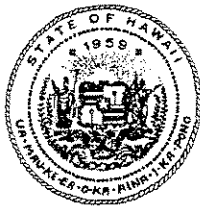
03-5 Properly Account for Capital Assets

The PSD should record all acquired capital. Not accomplished. See Reference No. assets in its possession, custody, control, or use, 04-3. including completed capital projects paid by another state department, and remove disposed assets from the state property records, as appropriate in a timely manner.

Not accomplished. See Reference No. 04-3.

PART VI
AFFECTED AGENCY RESPONSE

LINDA LINGLE
GOVERNOR



STATE OF HAWAII
DEPARTMENT OF PUBLIC SAFETY
919 Ala Moana Boulevard, 4th Floor
Honolulu, Hawaii 96814

RICHARD T. BISSEN, JR.
INTERIM DIRECTOR

CLAIRE Y. NAKAMURA
Deputy Director
Administration

FRANK J. LOPEZ
Deputy Director
Corrections

JAMES L. PROPOTNICK
Deputy Director
Law Enforcement

No. _____

March 24, 2005

Mr. Wilcox W.K. Choy, Partner
KMH LLP
737 Bishop Street, Suite 2900
Honolulu, HI 96813

Dear Mr. Choy:

SUBJECT: State Department of Public Safety's Response to the Financial Audit Findings for the Fiscal Year Ended June 30, 2004; Part IV—Schedule of Findings and Questioned Costs

In response to the subject audit findings on internal controls, the State Department of Public Safety (PSD) provides the following comments:

04-1 Improve Controls Over Inmate Agency Fund Accounts

The Department agrees that controls over inmate agency fund accounts need improvement. As noted in the audit report, PSD has taken corrective action including the installation of software to maintain the trust accounts, regular monitoring of progress made on prior findings, and establishment of a working group to address problems each facility encounters in reconciling inmate trust accounts.

Discrepancies in the inmate trust accounts have been cited since the FY 1988 audit of the Department of Corrections, which pre-dated the Department of Public Safety. The greatest hurdle in reconciling inmate trust accounts is the sheer volume of transactions involved. More than 10,000 inmates move through the Corrections system each year. The inmate trust accounts reflect the inmates' monthly payroll, monetary gifts received from authorized friends and family members, and weekly commissary purchases. Reconciling this volume of transactions in a cost effective manner may not be feasible.

PSD appreciates the auditor's effort to provide useful and actionable recommendations for process improvements. We agree that centralization of the reconciliation function, which is currently the responsibility of each correctional facility, may strengthen controls. We further agree that a detailed feasibility study must be conducted in order to determine the organizational, logistical, and cost

impacts of centralization. PSD plans to complete such feasibility study by September 30, 2005. We will consider the auditor's recommendation to engage an outside consultant to assist in implementing a centralized reconciliation process, depending on outcomes of the study.

04-2 Strengthen Controls Over Compensated Leaves of Absence

Administration and Corrections staff have collaboratively drafted policy and procedures for time and attendance recordkeeping in order to standardize such processes within the Department of Public Safety. While promoting standardization, the new guidelines also consider: (1) the unique conditions specific to the disparate program areas of Law Enforcement and Corrections, respectively; (2) uniformed and non-uniformed employees; and (3) shift workers and non-shift workers. The Department believes that these comprehensive guidelines constitute the first step in improving controls over compensated leaves of absence. The proposed regulations have been distributed for internal review, and forwarded to affected labor unions for consultation. Finalization of the policy and procedures is targeted for June 1, 2005. Other milestones include August 1, 2005 for implementation within the Corrections Division, and December 1, 2005 for the Law Enforcement Division as well as General Administration units.

The Department has been actively pursuing past and present auditors' recommendations to continue collection efforts for the recovery of salary overpayments. PSD's unrecovered salary overpayments totaled \$999,978.60 as of December 31, 2003, and decreased to \$505,927.72 as of December 31, 2004. The reduction in salary overpayment balances is attributable primarily to writeoffs approved by the Department of the Attorney General (ATG) in the case of former employees who terminated more than two years ago. By June 30, 2005, we plan to complete auditing time and attendance personnel records against actual payroll records for all former employees, and transmitting writeoff requests to ATG for approval.

We will then be able to focus the part-time efforts of a clerical staff member on auditing the overpayment records of current employees, who are entitled to hearings if they do not agree to a salary repayment plan.

04-3 Properly Account for Capital Assets

Typically, the State Department of Accounting and General Services (IDAGS) is the expending agency for PSD's capital improvements program (CIP) projects. In the absence of electronic links between the State's expenditure files and inventory files, PSD must rely on receipt of the DAGS MCD Report 300, "Project Cost by Appropriation, and by Job," as both the trigger and the basis for updating the PSD inventory of capital assets. That is, unless we receive the hardcopy report indicating the cost basis for and completion of a CIP project, we would not be aware of the need to manually update the inventory. As the audit report noted, while PSD did establish procedures to account for capital assets, we were not entirely successful in the implementation of timely recordation. Going forward, the Department will enforce supervisory controls over those programs responsible for the recordation of capital

assets within the Statewide Corrections system. With respect to previous amendments that were not timely recorded in the capital assets inventory, we will review the past three years' MCD Report 300 to ensure that all necessary inventory updates are recorded.

04-4 Maintain Current and Accurate Financial Records for Correctional Industries

As alluded to in the audit report, it is the Department's understanding that there is an unreconciled difference of \$36,000, wherein the Correctional Industries (CI) records reflect \$36,000 less than the official DAGS reports indicate as the cash balance. We also understand that the discrepancy was detected more than ten years ago under CI administrators who have long since left PSD. If historical CI records could even be located, CI estimates that a minimum of 2,500 staff hours would be necessary to retrieve, sort through, and review records stored in hundreds of bankers boxes. Current CI management has implemented proper internal controls and is confident of the accuracy of current financial records effective in FY 2004. It does not seem practicable to focus on disorganized historical records at the expense of current operations that are required to be self-sustaining. Therefore, with assistance by the auditors, the Department will seek approval to make an adjusting entry to the CI records, thereby eliminating the alleged discrepancy which no one has been able to identify in the recent past.

Effective July 2004, CI strengthened internal controls for inventory ordering and accounting, and made process improvements to reduce the number of items in inventory by maintaining only standard stock. Further, purchase and accounting of inventory has been centralized at the CI Business Office (with its staff of two) effective March 2005.

Correctional Industries has also implemented a filing system for its financial records effective FY 2004. By December 31, 2005, a system for filing historical information will be established to organize records currently in storage, and to dispose of unnecessary records pursuant to applicable disposal procedures.

Should you have any questions on this matter, please call Ms. Claire Nakamura, Deputy Director for Administration, at 587-1251. Thank you for the opportunity to comment.

Very truly yours,



for

Richard T. Bissen, Jr.
Interim Director