Financial Audit of the Department of Public Safety

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

Report No. 06-05
August 2006

THE AUDITOR
STATE OF HAWAI'I

Office of the Auditor

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

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

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

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

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

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

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

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

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

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

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

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

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OVERVIEW

Financial Audit of the Department of Public Safety

Report No. 06-05, August 2006

Summary

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

In the opinion of the firm, the financial statements present fairly, in all material respects, the department's financial position and changes in its financial position for the fiscal year ended June 30, 2005, in conformity with generally accepted accounting principles.

With respect to the department's internal control over financial reporting and operations, we found several deficiencies considered to be reportable conditions. The first reportable condition is that the department is not fulfilling its fiduciary responsibility to the inmates. The department continues to have difficulties in both reconciling and transferring inmate trust account balances accurately and timely. For example, the total gross unreconciled difference between the Inmate Trust Accounting system and bank balances for all correctional facilities and community correctional centers was $129,779 as of June 30, 2005. Also, the controls over advances to inmates need improving. We found that advances were made for unallowable purposes and advances for inactive inmates are not monitored and collected. Additionally, although there have been significant improvements, proper remittance of unclaimed or inactive inmate accounts continues to be problematic for the department.

Our second reportable condition is that ineffective internal controls allow significant overtime to remain unchecked. Although vacancies and potential staffing limitations may contribute to the inherency of some overtime costs, current policies and procedures are ineffective at limiting those costs. For example, the policies and procedures allowed an employee to be paid two years after the work was performed. Additionally, uninhibited sick leave usage continues to increase overtime costs.

We also found that although the collection of salary overpayments has improved significantly, uncollected balances remain. Enhancements in the collection process for recent staff overpayments have helped reduce the balances, but the department must continue its efforts to eliminate the remaining uncollected balances.

Finally, we found that the department's adherence to its operational internal controls and procedures needs improving. Specifically, we found two instances

in which the department did not comply with the state procurement code. We also found that its capital assets inventory listing was inaccurate and resulted in a restatement of the department's beginning net assets in the basic financial statements totaling approximately $4.3 million, net of related accumulated depreciation.

Recommendations and Response

We recommend that the department's business offices immediately reconcile inmate trust accounts to bank balances and the department advise each facility to comply with its policies as they pertain to the inmate fund transfers between facilities. The department should reiterate the importance of adherence to established policies related to inactive inmate accounts and advances and should also develop and implement policies and procedures over inactive suspense accounts.

We also recommend that the department's management consider the following to address significant overtime: establish more specific criteria for determining when overtime is necessary; focus efforts on preventing overtime costs; prepare exception reports; monitor the equitable allocation of overtime; ensure that the request and timesheet for overtime work is completed and approved in a timely manner; and revise policies. The department should also consider the following recommendations to address potential sick leave abuse: work with the bargaining units to implement a more stringent policy for determining patterns of sick leave abuse; implement realistic deadlines to complete sick leave abuse reviews; and consider automating leave records to facilitate detection of sick leave abuse patterns.

We further recommend that the department's management continue to perform timely audits of salary overpayments and reduce the backlog of pending audits. The department should also take action to reconcile discrepancies between bargaining agreements and state statutes to reduce delays in scheduling hearing dates. The department should also consider contracting out the salary collection process in order to expedite the process further.

Finally, we recommend that the department adhere to the state procurement code pertaining to small purchases. Also, the department's management should instruct facilities to accurately conduct annual physical inventory and reconcile it to the State's capital asset inventory listing.

In its written response to our draft report, the department agrees with many of our findings and recommendations while strongly disagreeing with our comments and characterizations regarding overtime. However, we stand by our conclusions in the final report and believe our audit report presents a balanced and accurate analysis of the department's financial operations.

Marion M. Higa
State Auditor
State of Hawai'i

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Financial Audit of the Department of Public Safety

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

Conducted by

The Auditor
State of Hawai‘i
and
KPMG LLP

Submitted by

THE AUDITOR
STATE OF HAWAI‘I

Report No. 06-05
August 2006

Foreword

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

We wish to express our appreciation for the cooperation and assistance extended by the officials and staff of the Department of Public Safety.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

This is a report of our financial audit of the Department of Public Safety, State of Hawai‘i. The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of KPMG LLP. The audit was conducted pursuant to Section 23-4, Hawai‘i Revised Statutes (HRS), which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawai‘i and its political subdivisions.

Background

The department is responsible for: providing for the custody, care, and assistance in the rehabilitation of all persons incarcerated by the courts or otherwise subject to confinement based on commitment or an alleged commitment of a criminal offense; guarding state property and facilities; preserving peace and protecting the public in designated areas; enforcing specified laws, rules, and regulations for the prevention of crime; and serving process papers in civil and criminal proceedings. Section 26-14.6, HRS, further describes the department's responsibilities.

The department shall be responsible for the formulation and implementation of state policies and objectives for correctional, security, law enforcement, and public safety programs and functions; the administration and maintenance of all public or private correctional facilities and services; the monitoring of contracted private correctional facilities and services; provision of law enforcement services at the Honolulu International Airport; and the security of state buildings.

The department manages the State's four correctional facilities (prisons) and four community correctional centers (jails). Exhibit l.l identifies the location and number of inmates in the State's correctional facilities and community correctional centers.

Exhibit 1.1
Hawai‘i’s Correctional Facilities and Community Correctional Centers

Island	Facility	Inmate Count*
O‘ahu	Hālawa Correctional Facility	1,115
	Waiawa Correctional Facility	328
	O‘ahu Community Correctional Center	1,105
	Women’s Community Correctional Center	321
Hawai‘i	Kūlani Correctional Facility	177
	Hawai‘i Community Correctional Center	320
Maui	Maui Community Correctional Center	387
Kaua‘i	Kaua‘i Community Correctional Center	178
	Total	3,931

* Inmate head count as of June 30, 2005

Source: Department of Public Safety, End of Month Population Report as of June 30, 2005

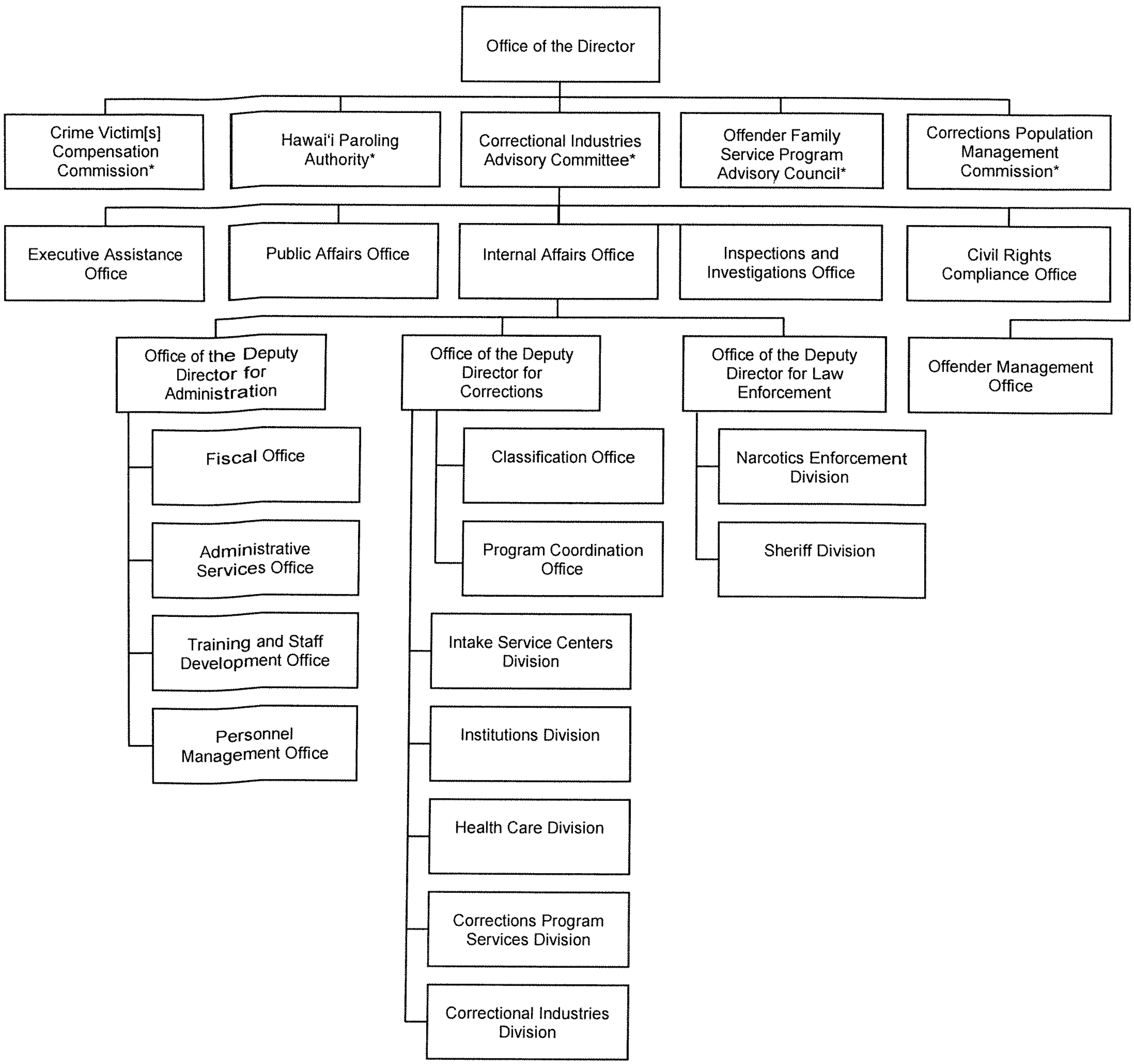
Additionally, in FY2004-05, the department contracted with the Corrections Corporation of America, the State of Oklahoma, and GRW, Inc. to house Hawai‘i inmates in private prisons located in Oklahoma, Arizona, Mississippi, and Colorado to alleviate prison overcrowding in the State of Hawai‘i. During FY2004-05, the department spent approximately $29 million to house about 1,730 inmates in these out-of-state facilities.

The department is funded primarily with state moneys. During FY2004-05, the department received approximately $199 million or about 96 percent of total funding from the State through appropriations and non-imposed employee fringe benefits. The remainder of the department’s funding is from federal grants as well as self-supporting special fund and revolving fund programs.

Organization

The director oversees, directs, and coordinates the plans, programs, and operations of the department to provide for the safety of people, both residents and visitors, from crimes against people and property. The director is assisted by three deputy directors for administration, corrections, and law enforcement; five administratively attached bodies; and five staff offices. Exhibit 1.2 displays the department’s approved

Exhibit 1.2
Organizational Structure of the Department of Public Safety



* Administratively attached to the department.

Source: Department of Public Safety Organization Chart.

organizational structure. The primary responsibilities of these units follow.

Administratively attached bodies

The Crime Victim Compensation Commission consists of three members appointed by the governor to mitigate the suffering and losses of victims and the dependents of deceased victims of certain crimes by compensating them for medical expenses, loss of earning power, pain and suffering, and other financial losses that were the direct result of injury or death of the victim; and to compensate private citizens for personal injury or property damage suffered in the prevention of a crime or the apprehension of a criminal.

The Hawai‘i Paroling Authority consists of three members nominated by a panel composed of members from the public and private sectors and appointed by the governor to: 1) evaluate and grant parole when there is reasonable probability that the prisoner concerned will live and remain at liberty without violating the law and that the prisoner's release is not incompatible with the welfare and safety of the public; and 2) utilize the agency and community resources as a link for parolees to reintegrate into society.

The Correctional Industries Advisory Committee consists of nine members appointed by the governor. The committee advises the department on the feasibility of establishing venture agreements with private sector businesses to utilize the services of qualified, able-bodied inmates.

The Offender Family Service Program Advisory Council consists of seven members appointed by the director. The council reviews and makes recommendations to the director to improve the types of services provided to inmates' families.

The Corrections Population Management Commission consists of 11 members from the public and private sectors. The commission establishes maximum inmate population limits for each correctional facility and formulates policies and procedures to prevent the inmate population from exceeding the capacity of each correctional facility.

Offices under the direction of deputy directors

The Office of the Deputy Director for Administration manages the administrative systems, services, and operations in and for the department pertaining to general program planning, evaluating, and budgeting; capital improvements and repairs; fiscal accounting and auditing; procurement and supply; personnel; training; information technology, administrative rule-making; duplicating services; and other relevant functions.

The Office of the Deputy Director for Corrections provides for the custody, care, and assistance in the rehabilitation of all persons incarcerated by the courts or otherwise subject to confinement based on an alleged commitment of a criminal offense.

The Office of the Deputy Director for Law Enforcement guards state property and facilities; preserves the peace and protects the public in designated areas; enforces specified laws, rules, and regulations for the prevention and control of crime; and serves warrants for criminal proceedings.

Other offices

The Executive Assistant Office assists the director by performing various staff functions in order to facilitate the director's oversight of departmental systems and operations.

The Public Affairs Office advises and assists the director in the management and conduct of a comprehensive program for effective public relations by informing the public of departmental plans, activities and accomplishments, and providing reliable and timely responses to the media or other public inquiries regarding matters of special interest; advises departmental staff on public affairs policies and procedures; and manages the preparation and distribution of the departmental annual report.

The Internal Affairs Office conducts criminal, administrative, and civil investigations of the employees of the department and the lawful use and disposition of departmental resources.

The Inspections and Investigations Office administers the proper execution of laws, rules, regulations, standards, and directives set forth for the operations of the department.

The Civil Rights Compliance Office advises departmental management, supervisors, and employees on compliance with civil rights and related laws, and develops, updates, and oversees implementation of the departmental affirmative action plan.

Objectives of the Audit

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

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

3. To make recommendations as appropriate.

Scope and Methodology

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

We examined the existing accounting, reporting, and internal control structure and identified deficiencies and weaknesses therein. We made recommendations for appropriate improvements including, but not limited to, the forms and records, the management information system, and the accounting and operating procedures.

The independent auditors' opinion as to the fairness of the department's financial statements presented in Chapter 3 is that of KPMG LLP. The audit was conducted from July 2005 through April 2006 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.

Chapter 2
Internal Control Deficiencies

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

Summary of Findings

We found several reportable conditions involving the department's internal control over financial reporting and operations. Reportable conditions are significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Similar issues were communicated to the department in our fiscal year 2001 financial audit Report No. 02-10, *Financial Audit of the Department of Public Safety*. None of the reportable conditions found are considered to be material weaknesses. A material weakness is a reportable 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.

We found the following reportable conditions:

1. The department is not fulfilling its fiduciary responsibilities to the inmates.

2. Ineffective internal controls allow significant overtime to remain unchecked.

3. Although the collection of salary overpayments has improved significantly, uncollected balances remain.

4. Adherence to operational internal controls and procedures needs improving.

The Department Is Not Fulfilling Its Fiduciary Responsibilities to the Inmates

The department is responsible for accounting for and safeguarding inmates' funds while they are incarcerated. Inmates can accumulate funds from various sources, including earnings from work and receipts from family and friends. These funds can be used by inmates to purchase basic goods and services while imprisoned. Section 353-20, Hawai'i Revised Statutes (HRS), states that all funds are required to be deposited by the department into an individual trust account to the credit of the committed person. The department shall maintain individual ledger accounts for each committed person and shall issue to each committed person a quarterly statement showing credits and debits. As such, the department has a fiduciary responsibility to properly account for and safeguard funds belonging to inmates. The department's inmate trust accounting (ITA) system is used to manage these inmate trust accounts, which totaled approximately $900,000 as of June 30, 2005.

Despite improvements made since our previous audit in 2001, we found that many problems still exist. Our current audit revealed that: 1) difficulties in reconciling inmate trust accounts to bank balances persist for the department; 2) despite overall improvements, proper remittance of unclaimed funds for paroled or released inmates continues to be problematic for certain facilities; 3) advances to inmates were made for unallowable purposes; 4) advances for inactive inmates are not monitored and collected; 5) funds of transferred inmates are not remitted to the receiving facility in a consistent and timely manner; and 6) inmates do not consistently authorize timesheets.

Difficulties persist in reconciling inmate trust accounts to bank balances

Consistent with the results of our fiscal year 2001 financial audit, the department is still unable to adequately reconcile inmate trust accounts to related bank statement balances. The reconciliation of accounting records to bank statements provides assurance that funds are properly accounted for and facilitates the timely detection of errors, theft, or misappropriation of funds. Of the three facilities selected for test work—the Hālawa Correctional Facility, Waiawa Correctional Facility, and O'ahu Community Correctional Center—we found that discrepancies between the ITA system balance and the reconciled bank balance totaled approximately $64,600. Exhibit 2.1 details the ITA system balances, bank reconciliation balances, and differences between the two for each of the department's facilities.

Exhibit 2.1
ITA System Balances, Bank Reconciliation Balances, and Differences Between the Balances for Each Facility as of June 30, 2005

Facility	ITA System Balance	Bank Reconciliation Balance	ITA in excess (less than) Bank Reconciliation
Hālawa Correctional Facility	$289,877	$339,443	$(49,566)
O‘ahu Community Correctional Center	152,717	152,627	90
Waiawa Correctional Facility	79,367	68,740	10,627
Women's Community Correctional Center	87,506	136,977	(49,471)
Kūlani Correctional Facility	87,935	86,513	1,422
Hawai‘i Community Correctional Center	60,155	62,444	(2,289)
Maui Community Correctional Center	78,341	92,317	(13,976)
Kaua‘i Community Correctional Center	108,306	110,644	(2,338)
Total	$944,204	$1,049,705	$(105,501)

Source: Department of Public Safety inmate account trial balance reports and bank reconciliations as of June 30, 2005.

The department claims its inability to reconcile inmate trust accounts stems from unreconciled and unadjusted differences carried over from prior years. The business office for each facility is responsible for reconciling the ITA system balances. The respective business offices then reconcile the current month’s inmate account transactions between their books and the bank balance, and finally to the ITA system balance. However, it is apparent that the monthly reconciliations are not accounting for all current reconciling items as the unreconciled differences vary from month to month, exclusive of past differences. The lack of proper reconciliation procedures makes it difficult to determine whether the unreconciled differences were caused by current accounting errors or possible misappropriation of funds.

Despite overall improvements, proper remittance of unclaimed funds for some inmates continues to be problematic for certain facilities

The department has significantly reduced the number and value of inactive inmate accounts since FY2000-01; however, certain facilities continue to improperly hold inmate funds. Upon parole or release of an inmate, the department prepares a check payable to the inmate for the balance in his/her account. However, in certain instances, transactions such as wages may not be posted to the inmate trust account prior to the inmate's parole or release. The department informs the inmate that this may occur and requests the inmate to return to collect the pending wages or leave a forwarding address for a check to be mailed. If the inmate fails to return to collect the remaining balance or if the mail is returned as undeliverable, the department's policy is to hold the balance for one year as it is common that inmates are readmitted within a year. Abandoned state property should be reviewed and remitted to the Department of Budget and Finance for escheatment to the State at least once a year.

The department has been able to reduce the total number of inactive accounts included in the ITA system since our 2001 financial audit. At that time, there were 2,554 inactive accounts for paroled or released inmates amounting to approximately $107,800. At June 30, 2005, there were 1,683 inactive accounts amounting to approximately $46,000. Despite this improvement, there were still 439 inactive accounts totaling approximately $15,000 which were outstanding for more than one year at June 30, 2005. Of these accounts, 353 totaling approximately $13,000 had been outstanding for over two years. These accounts were attributable to three facilities (Hawai‘i Community Correctional Center, Kūlani Correctional Facility, and the Women's Community Correctional Center), which failed to remit funds to the Department of Budget and Finance during the fiscal year ended June 30, 2005. Although the department has developed and implemented escheatment policies and procedures as a result of our findings from Report No. 02-10, we were informed that these three facilities either did not have the personnel resources to perform periodic reviews or were unaware of the escheatment process. For example, the Hawai‘i Community Correctional Center business office personnel were not properly trained and informed of the procedures as a result of employee turnover. The Kūlani Correctional Facility lacks the personnel resources and is unfamiliar with the escheatment procedures, and the Women's Community Correctional Center also lacks the personnel resources. As a result, the department still holds funds that should be remitted to the Department of Budget and Finance.

Additionally, we found that the Hālawa Correctional Facility maintains a total of 225 "unknown" named inmate accounts approximating $13,000, which could potentially be inactive accounts for paroled or released inmates. The status, whether active or inactive, is indeterminable by the facility. Determination requires a thorough research of archived records. Despite the facility's former efforts to resolve "unknown" accounts, which resulted in the write off or escheatment of certain accounts, the facility currently lacks the resources to conduct an investigation of remaining accounts. These "unknown" accounts were created upon completion of the facility's Y2K system conversion in 2000. We were informed that some of these accounts may represent balances of temporary inmates enroute from the federal prison to mainland facilities in previous years. Presumably, funds were physically transferred to the trust accounts of the mainland facilities; however, the transferred funds were not recorded into the system in use prior to the ITA system. "Unknown" accounts may affect the facility's inability to reconcile the inmate trust accounts as previously discussed.

Advances to inmates were made for unallowable purposes

Department policies and procedures provide that under no circumstances shall an inmate's trust account be charged to create a negative balance in their account. If an inmate does not have enough funds to finance allowable expenditures, the inmate's facility will advance the required funds and establish a related account receivable, known as a suspense account. Allowable expenditures for advancement are limited to the replacement cost for damage, destruction, or loss of state property caused by an inmate; photocopying or postage related to litigation; and medical costs. Advances are charged to the facility's general fund, which is reimbursed when funds, such as payroll compensation and donations, are credited to the inmate's trust account and become available.

We reviewed a total of 30 advances, of which five were attributable to inmates' postage costs. All five postage advances were provided to inmates for personal purposes and not for litigation. The facilities' business office personnel were not aware that postage advances provided to inmates are limited to litigation purposes. This creates opportunities for inmates to abuse the department's advancement policy when they discover that such policies are not being enforced by the facilities.

Advances for inactive inmates are not monitored and collected

As discussed above, facilities will advance funds for certain allowable expenditures to an inmate whose account is insufficient by establishing a suspense account under the inmate's name. The suspense account is cleared when funds become available in the inmate's trust account; however, some inmates have a remaining suspense account balance upon release or parole. The facilities will attempt to collect balances payable to the facility for advances provided during the inmate's incarceration when the inmate is discharged. Collection is generally unsuccessful as the inmate will not have the available funds upon discharge, and no subsequent attempts are made by the facilities to collect on amounts due to them. Additionally, the department lacks formalized monitoring and collection policies and procedures pertaining to inactive suspense accounts for released or paroled inmates. At June 30, 2005, there were

2,638 inactive suspense accounts amounting to approximately $43,800. If collected, financial resources could be used to finance operations of the facilities.

Transferred inmate funds are not remitted to the receiving facility in a consistent, timely manner

When an inmate is transferred to another facility, the receiving facility establishes an account for the inmate. The sending facility reviews the inmate's account to ensure that the inmate's balance is current and all transactions have been posted. In accordance with departmental policies, a check for the current balance should be forwarded to the receiving facility within 48 hours of the inmate transfer.

We reviewed a total of five deposit transfers and identified one instance whereby an inmate's funds were transferred to the receiving facility in an untimely manner. O'ahu Community Correctional Center, the sending facility, forwarded an inmate's funds to the Hālawa Correctional Facility, the receiving facility, six days subsequent to the inmate's date of transfer. In addition, we were informed that fund transfers from the O'ahu Community Correctional Center are batched and transferred weekly and are not transferred based on the 48-hour requirement. This practice effectively restricts inmates' immediate use of funds upon transfer and hinders ongoing compliance with related department policy.

Inmates do not consistently authorize timesheets

The department's goal is to provide inmates with reasonable opportunities for useful and productive employment and to enable them to acquire valuable experiences for securing and maintaining regular employment in the community upon their release. Such employment provides a means of maintaining and improving their morale and self-respect while under confinement. Every effort is made to provide a normal work day of constructive activity for each inmate and to provide compensation for their efforts. A daily timesheet is maintained of hours worked by each inmate. At the end of the pay period, which is at month-end, the timesheet should be verified and signed by both the inmate's workline supervisor and the inmate, and submitted to the business office for processing. Payroll is credited to the inmate's trust account within 15 days of the end of the pay period.

Out of the 13 timesheets reviewed, seven timesheets (two from the O'ahu Community Correctional Center; three from the Hālawa Correctional Facility; and two from the Waiawa Correctional Facility) lacked evidence of the inmate's review and authorization. For the O'ahu Community Correctional Center and the Hālawa Correctional Facility, these instances reflected the work line supervisor's lack of proper administration of inmates' timesheets. This precludes inmates' abilities to identify discrepancies prior to processing of their payroll. The Waiawa Correctional Facility does not require inmates to sign their timesheets. However, we were informed that inmates do review timesheets prior to payroll processing.

Recommendations

We recommend the following:

1. The business office of each facility should immediately reconcile inmate trust accounts to bank balances. Past unreconciled differences should be identified, researched, and disposed of. Each month, the business offices should prepare bank reconciliations to ensure that all reconciling items are identified and disposed of in a timely manner.

2. The department should reiterate the importance of the escheatment process to appropriate facility personnel. The department should adhere to established policies requiring each facility to identify inmate accounts outstanding over one year and remit those account balances to the Department of Budget and Finance. Further, the Hālawa Correctional Facility should investigate and determine the disposition of the “unknown” named inmate accounts.

3. Business office personnel should be made aware of and adhere to policies and procedures pertaining to suspense accounts. Advances to inmates should be made only for allowable costs.

4. The department should develop and implement policies and procedures over inactive suspense accounts. Policies and procedures should address the monitoring and collection of inactive suspense accounts and, if necessary, the disposition of uncollectible accounts.

5. The department should advise each facility to revise its procedures as they pertain to the inmate fund transfers between facilities for relocated inmates to comply with departmental policy requiring that those funds be transferred within 48 hours from inmates’ transfer dates.

6. Inmates within the work program should be allowed to review and authorize their timesheets for hours worked. The department should also enforce consistent timesheet policies and procedures among the various facilities and work line divisions.

Ineffective Internal Controls Allow Significant Overtime To Remain Unchecked

Prior audits performed by our office have highlighted the department's seemingly entrenched significant overtime costs and patterns of sick leave abuse among department employees, specifically the adult correctional officers (ACO) and medical and food service staff. Salaries and wages are the most significant facility expenditures, comprising 34 percent of total expenditures for all facilities, or approximately $61.2 million, for the fiscal year ended June 30, 2005. Between the fiscal years ended June 30, 2004 and 2005, overtime costs have increased from $6.7 million to $7.7 million and currently comprise 13 percent of total salaries and wages; thus indicating that it is a sizeable departmental expense that warrants vigilant monitoring and strong internal policies and controls to minimize overtime and prevent abuse. Exhibit 2.2 provides a three-year trend analysis summarizing total overtime costs in relation to total salaries and wages by facility and illustrates that significant overtime costs continue to be a problem. Although vacancies and potential staff limitations may have necessitated some overtime costs, the ineffectiveness of current policies and procedures, particularly over sick leave, have exacerbated the payments for overtime.

Overtime is driven by vacancies and potential staffing limitations

The department's operations are funded by state appropriations that are based on the nationally modeled Shift Relief Factor (SRF) of 1.65. The SRF is a staffing ratio that estimates the number of persons required to cover a security position and is commonly multiplied by the number of mandatory security work positions to determine how many security staff will be needed to fully cover all positions. The ratio itself is calculated by taking (1) the number of work days per year divided by (2) the average number of days per year worked by a security staff member. For example, a correctional security job must be covered 365 days of the year and the national model provided that correctional staff will work 220 days, resulting in a ratio of 1.66. Then, if the base number of security work positions is 500, the application of the SRF to the base would result in a required staff of 830 persons.

Since 1992 the department has argued that the current SRF does not provide sufficient staffing to sustain current security operations. Additionally, the department has had significant difficulty in recruiting and retaining qualified staff for the positions already established. Although the exact impact of the SRF on the department's significant overtime remains questionable, an insufficient number of positions available and qualified candidates to fulfill those positions suggest that some overtime may be required of current employees to support essential security positions.

Exhibit 2.2
Three-year Trend Analysis of Total Overtime Costs Compared to Salaries and Wages by Facility (amounts in thousands)

	June 30, 2003			June 30, 2004			June 30, 2005		
Facility	Total Overtime	Total Salaries and Wages	Overtime as a % of Salaries and Wages	Total Overtime	Total Salaries and Wages	Overtime as a % of Salaries and Wages	Total Overtime	Total Salaries and Wages	Overtime as a % of Salaries and Wages
Hālawa Correctional Facility	$2,170	$16,191	13%	$2,267	$17,000	13%	$2,255	$16,766	13%
O‘ahu Community Correctional Center	2,347	17,511	13%	2,166	19,035	11%	2,231	19,002	12%
Maui Community Correctional Center	537	5,980	9%	573	6,135	9%	935	6,106	15%
Hawai‘i Community Correctional Center	879	5,355	16%	683	5,476	12%	810	5,747	14%
Women’s Community Correctional Center	702	4,314	16%	667	4,576	15%	724	4,468	16%
Waiawa Correctional Facility	184	3,460	5%	163	3,617	5%	310	3,813	8%
Kūlani Correctional Facility	241	2,811	9%	20	2,830	1%	243	2,961	8%
Kaua‘i Community Correctional Center	254	2,164	12%	146	2,329	6%	151	2,385	6%
Total	$7,314	$57,786	13%	$6,685	$60,998	11%	$7,659	$61,248	13%

Source: Department of Public Safety, Financial Accounting and Management Information System Object by Expenditure Report and monthly facility KaMakani reports

Vacant ACO positions contribute to overtime costs

During the fiscal year ended June 30, 2005, there were approximately 130 vacant ACO positions, an increase of nearly 100 vacancies from the fiscal year ended June 30, 2004. High turnover and a lack of qualified applicants have contributed to position vacancies, resulting in remaining staff having to incur overtime to cover essential posts. The written, psychological, physical, and drug examinations of applicants have limited the pool of qualified candidates, and the mental and physical rigor of the position have limited the retention of the ACOs hired. Naturally, the extensive vacancies during the current year have required some overtime costs.

Insufficient resources may contribute to significant overtime

During the 1992 legislative session, the department asked to expand its correctional security staff by increasing its shift relief factor from 1.65 to 1.88. The department estimated that the $4.1 million increase in annual costs associated with the resulting 152 additional staff would be more than offset by a corresponding decrease in overtime costs of $6 million. Based on an internal analysis, the department indicated and continues to believe that the facilities should be staffed at a SRF level of 1.88 to effectively limit the overtime costs incurred. In 1988, a consultant with the National Institute of Corrections conducted a study of the department's individual facilities to determine security staffing requirements. The consultant concluded that the central tendency of the SRF for all facilities resulted in a 1.89 ratio. However, the Legislature did not approve the department's revised SRF and the department maintains that the subsequent deferral of its request for additional funding has inevitably led to overtime to cover essential positions.

Our office utilized the same consultant that the department used in 1988, in connection with both our Report Nos. 92-27, *A Review of a Formula for Security Staffing at the Department of Public Safety*, and 94-18, *A Follow-Up Review of Security Staffing in the Department of Public Safety*. However, the initial review determined that although the proposed SRF appeared reasonable "based on the available information," a definitive shift relief factor could not be determined because the underlying data to the calculation was questionable. The follow-up audit also concluded that the proposed SRF appeared reasonable enough to warrant further testing at one facility, but continued to caution that the reliability of the data supporting the revised factor and base remained ineffectual.

If the current shift relief factor of 1.65 were inadequate, it could explain some of the department's resulting significant levels of overtime. However, given the weaknesses of the supporting data for calculating the revised SRF, exactly what the SRF should be and its resulting impact on the department's overtime costs remains unclear.

Current policies and procedures are ineffective and can lead to high levels of overtime costs

The department should employ operational control procedures to ensure that overtime work is minimized and accurately recorded. However, current policies and procedures do not provide specific criteria for evaluating program posts or tools for monitoring individual overtime. Additionally, current control procedures pertaining to the authorization of overtime, the approval of timesheets, and the timely reporting of overtime were not properly enforced by the department and did not effectively monitor or mitigate overtime costs incurred during the fiscal year ended June 30, 2005.

Criteria are needed to evaluate program posts

When a post is vacant, an ACO will be called in to work overtime based on the watch commander's evaluation of the staff coverage for the facility's posts. Each facility has both essential and program posts. Essential posts are the minimum posts required to secure, house, clothe, and feed the inmates, and provide safety for the employees, inmates, and public. All essential posts must be staffed. Program posts are considered non-essential and exist to run such programs as recreation, education, and volunteer activities.

If an essential post is vacant, the watch commander first attempts to evaluate the staffing at program posts to determine if any program posts can be closed so the assigned ACO can be transferred to the essential post. However, there are no set criteria for determining which program posts can be closed. Additionally, the facility chief of security reviews the appropriateness of the decisions made only after the shift ends, program posts have been closed, and the overtime costs have been incurred. The lack of standard criteria for evaluating open posts and the after-the-fact review of decisions to incur overtime continue to leave the department susceptible to overtime abuse.

Monitoring of excessive overtime is needed for containment

If the watch commander decides to call in an ACO to work overtime when post shifts cannot be made, an ACO from the previous watch is asked to fill the vacancy. At the larger facilities (Hālawa Correctional Facility and Oʻahu Community Correctional Center), the watch commander selects employees from a volunteer pool of ACOs who have signed up for overtime consideration. The list is prioritized based on seniority and the previous number of opportunities for overtime the ACO has had. At the smaller facilities, replacement ACOs are selected from a call back list, which is similar to the volunteer pool except that the previous number of opportunities for overtime is not considered. Once the ACO on the top of the list is called, the ACO moves to the bottom of the list regardless of whether the ACO accepts, declines, or cannot be reached.

The selection of individuals for overtime is not based on monitored overtime patterns. Although the individuals selected for overtime are reviewed by the facilities' chief of security and a monthly aggregate overtime listing is reviewed by the captain or section head and the warden, the overtime listings provided do not include year-to-date information. As a result, supervisors and the warden are unable to identify, monitor, or prevent abuse by individuals with excessive overtime so that such individuals can be placed on a "do not call" list.

We tested a sample of 30 ACOs, medical and food service staff, and administrative staff with significant overtime compensation levels and found that approximately 40 percent of their total compensation was related to overtime. This equates to approximately $25,000 of overtime pay per employee. Two employees at the Hālawa Correctional Facility were actually paid more in overtime pay than for their regular salaries and wages. Another two employees at Hālawa received approximately 95 percent of their regular salaries and wages in overtime. Exhibit 2.3 details the base compensation and overtime compensation for these four employees. The large overtime compensation for these individuals is excessive considering the average overtime compensation for all employees at this facility and at all facilities during fiscal year ended June 30, 2005 was $6,110 and $5,400, respectively. If individuals with excessive overtime compensation go unrestrained, aggregate overtime costs for each facility will not be contained.

Exhibit 2.3
Detail of Base Compensation and Overtime Compensation for Four Employees at the Hālawa Correctional Facility

Employee	Base Compensation	Overtime Compensation
1	$36,263	$48,069
2	34,864	40,105
3	46,495	44,380
4	36,263	33,854

Source: Department of Public Safety payroll registers

Overtime work is not properly authorized

The use of Form 1210, "Request and Authorization for Overtime Work," was implemented as a preventative overtime control procedure for non-uniform employees such as administrative staff. Requesting departmental supervisors should complete the forms and include pertinent information, such as the estimated overtime hours, the reason for overtime work, and a description of duties to be performed. The division administrator should use and retain the information and justification provided on the form to make and document the informed decision regarding approval prior to the commencement of overtime work.

During our testwork of nine non-uniform employees, we found three instances of internal control deficiencies as the Form 1210 was not properly completed for employees working overtime. We also found that an additional five of the nine employees sampled submitted the completed and authorized forms during or subsequent to the overtime shift, thus circumventing the preventative intent of the control. Our testwork further revealed that the estimated hours approved and documented on the forms are not compared to the employees’ timesheets to ensure that the actual overtime taken was justified and approved. Instead, the forms are filed immediately, thus creating an opportunity for employees to record more overtime hours than those which were originally approved.

Departmental policy requires ACOs approved for overtime work to sign in and out on an overtime log to document the actual overtime hours worked. This log should be forwarded to the designated authority for review and signature documenting authorization of those hours. However, we found that the actual overtime work incurred by ACOs at the Waiawa Correctional Facility was not approved by watch commanders. Although the facility maintains that it has procedures in place to properly monitor actual overtime worked, evidence of such is not clearly documented. Hālawa Correctional Facility and O‘ahu Community Correctional Center employ the correct procedure of requiring watch commanders to sign overtime logs, commonly referred to as the Watch Sign In Report – Overtime, to ensure the reasonableness of the amount of overtime hours worked. Adherence to the department’s overtime approval process and limiting actual overtime taken to amounts previously authorized is essential to preventing and reducing unnecessary and excessive overtime costs.

Timesheets are not reviewed and approved by ACOs

All ten O‘ahu Community Correctional Center ACOs, out of 30 employees sampled from various facilities for overtime testwork, did not sign their timesheets for overtime claimed. Typically, ACOs complete and claim overtime worked on Form D55, “Individual Timesheet,” and forward it to their immediate supervisor for review and approval. The supervisor, in turn, submits the timesheet to the time and attendance clerks for processing. However, O‘ahu Community Correctional Center authorizes the time and attendance clerks to utilize overtime logs to complete employee timesheets. With evidence of ACOs signatures on the overtime logs and timesheets that state, “Employee Signature on Watch Sign In Report,” the facility decided that it was not necessary for the ACOs to sign off on their timesheets. Nevertheless, the review and approval process of timesheets for both the ACOs and supervisors is the final internal control procedure that affords both parties an opportunity to verify hours worked, prevent errors, or identify patterns of abuse.

Timesheet submission deadlines for overtime work are inadequate

Current departmental timesheet submission deadlines for overtime work will allow an employee to be paid two years after the date the work was performed. Although collective bargaining agreements require overtime work to be compensated within 30 days, or two pay periods, from the date the employee submits the appropriate documentation for overtime compensation, departmental policy allows employees a two-year window to claim and submit the documentation. It is only after two years that the employee forfeits unclaimed overtime hours and related compensation.

We discovered two employees out of a sample of 30 from whom the payroll department did not receive the timesheets within a reasonable time. The first employee worked overtime during the pay period June 7, 2004 through July 31, 2004, but the payroll department did not receive the employee's claim until October 1, 2004. The employee was properly compensated $5,077 on November 5, 2004, over three months later. We were informed that the division for which the employee works did not have the financial resources to compensate the employee, so it submitted the employee's timesheet when the funds became available. Such a practice is the result of unsound policies and procedures that are ineffective at monitoring and minimizing overtime.

The second employee noted during our testwork was paid two fiscal years later. The overtime claim for $3,006 was incurred during the pay period August 1, 2002 through August 15, 2002, but the employee did not submit his claim until August 6, 2004 and was paid on September 3, 2004. The department stated that this employee regularly submits his timesheets extremely late for unknown personal reasons, and since it was within the two-year threshold, the respective facility did not question his methods.

Although the department assured us that all belated overtime compensation claims are validated by reviewing past time and attendance records and are paid at the employee's effective salary at the time the work was incurred, the findings noted should have been prevented. The practice of incurring overtime when funds are not available and allowing an employee to habitually submit overtime claims late is indicative of weak policies and internal controls surrounding the overtime process. Such weaknesses could impact the financial statements and result in costs being reported in the wrong accounting period and an undeterminable amount of unrecorded liability for overtime services rendered but not yet claimed.

Uninhibited sick leave continues to increase overtime costs

Overtime for ACOs is normally necessitated when an ACO who is not scheduled to work is called in to replace a vacant essential security post for an employee absence due to illness. Therefore, there is a direct correlation between the total amount of sick leave taken and the total amount of overtime costs incurred. However, the department's tedious methods of tracking sick leave and detecting abuse, in order to prevent excessive overtime, needs improvement.

High sick leave usage results in significant overtime costs to the department

The amount of sick leave taken is excessive and is forcing already significant overtime costs to increase. Employees are allotted 21 days of sick leave per year; however, as Exhibit 2.4 indicates, an average of 29 sick leave days were taken during the fiscal year ended June 30, 2005, for all uniformed staff, which includes ACOs and medical and food services staff. This amount is significantly higher than: 1) the national average of nine online days for all protective services, which includes police officers and prison and security guards; and 2) the national average of 13 days for all government employees. This tendency to

Exhibit 2.4
Sick Leave Taken, Average Sick Leave Taken per Uniform Staff Overtime Hours Incurred, and Average Overtime per Uniform Staff by Facility for the Fiscal Year Ending June 30, 2005

Facility	Number of Uniform Staff	Sick Leave Hours	Sick Leave Days	Average Sick Leave Days per Uniform Staff	Overtime Hours	Overtime Days	Average Overtime Days Per Uniform Staff
Hālawa Correctional Facility	324	86,418	10,802	33	77,187	9,648	30
O‘ahu Community Correctional Facility	375	57,147	7,143	19	66,367	8,296	22
Maui Community Correctional Facility	130	40,540	5,068	39	84,316	10,540	81
Women's Community Correctional Facility	104	34,824	4,353	42	29,212	3,652	35
Hawai‘i Community Correctional Facility	119	25,984	3,248	27	30,899	3,862	32
Waiawa Correctional Facility	83	15,741	1,968	24	8,542	1,068	13
Kūlani Correctional Facility	54	14,655	1,832	34	8,168	1,021	19
Kaua‘i Community Correctional Facility	48	10,356	1,295	27	6,528	816	17
Total	1,237	285,665	35,709	29	311,219	38,903	31

Source: Department of Public Safety monthly facility KaMakani reports exceed the allotted amount of sick leave has resulted in a substantial amount of overtime costs.

During FY2004-05, the department incurred 311,219 hours of overtime and approximately 285,665 hours of sick leave (refer to Exhibits 2.4 and 2.5). The department's monthly KaMakani reports estimate that approximately 36 percent of overtime hours or 111,818 hours can be directly attributed to sick leave. The direct correlation between the total number of sick leave hours taken and the total overtime hours demonstrates how excessive sick leave leads to increased overtime costs.

Exhibit 2.5
Overtime Hours Incurred by Uniform Staff, Overtime Attributed to Sick Leave Taken by Uniform Staff, and Overtime Attributed to Sick Leave as a Percentage of Total Overtime Hours by Facility for the Fiscal Year Ending June 30, 2005

Facility	Overtime Hours	Overtime Attributed to Sick Leave	Overtime Attributed to Sick Leave as a Percentage of Total Overtime Hours
Hālawa Correctional Facility	77,187	34,743	45%
O‘ahu Community Correctional Facility	66,367	22,473	34%
Maui Community Correctional Facility	84,316	28,456	34%
Women's Community Correctional Facility	29,212	6,565	22%
Hawai‘i Community Correctional Facility	30,899	8,678	28%
Waiawa Correctional Facility	8,542	1,857	22%
Kūlani Correctional Facility	8,168	4,499	55%
Kaua‘i Community Correctional Facility	6,528	4,547	70%
Total	311,219	111,818	36%

Source: Department of Public Safety monthly facility KaMakani reports

Methods to detect sick leave abuse need improving

As sick leave is a direct driver of overtime, it is critical that the department have procedures to control excessive sick leave. However, the department currently has an inadequate program for monitoring sick leave patterns for abuse. The collective bargaining agreement with the ACOs and medical and food service staff allows the department to investigate unusual patterns of sick leave. According to the department's Institutions Division personnel, patterns indicative of abuse occur over a six-month period, with six or more occurrences in each of the following categories: sick leave of short durations or occurring before or after holidays, weekends, days off, paydays, or specific days of the week. Currently, labor intensive manual reviews and analyses entailing individually scanning all employee sick leave records are used to identify potential abnormal patterns indicative of abuse. When a pattern is detected, the employee is placed in a six-month follow-up evaluation program. Once in the program, the employee can be required by the department to undergo medical evaluations by a doctor specified by the department to verify all absences due to sickness.

During the year ended June 30, 2005, the department identified 111 instances of sick leave abuse patterns. However, during our testwork of 30 employees we identified two additional Hālawa Correctional Facility employees whose sick leave records indicated sick leave abuse patterns but who were not placed in the program during the fiscal year ended June 30, 2005. Facility personnel attributed the oversight to severe time constraints during the implementation of the program which led to human error. Department management gave the facility one month to complete both the manually intensive identification process, which entailed reviewing over 300 employee sick leave records, and the necessary notification process to discuss the identified abuse patterns with each of the employees. This stringent deadline further compromised the quality of the facility's review due to the relatively significant number of employees. Presumably, given the manually intensive nature of the task and the seemingly compromised quality of the program implementation, the potential risk that other employees with patterns of abuse went and will continue to go undetected is high.

The employee leave record process should be automated

The DPS-7 Form, Employee Leave Record, is the official basis for the determination of vacation and sick leave accruals at fiscal year end and for employee retirement credits upon separation of service. The form tracks all of the employee's activities such as regular and overtime hours worked, vacation and sick leave taken, and leave without pay. The form also maintains a running balance of accumulated vacation and sick leave hours available during a given month and at fiscal year end. The time and attendance clerks are responsible for recording all activities, which is performed at the end of each pay period. This is a tedious and manual process and, as with any manually intensive process, it is susceptible to a higher degree of human error.

We selected 30 employee leave records to verify mathematical accuracy and identified four employee records from the O‘ahu Community Correctional Center whose sick leave balances at year end were inaccurate. The discrepancies and their financial statement effects on sick leave costs are illustrated in Exhibit 2.6. Based on the known errors and given the entire population, there is a potential risk that there may be other inaccuracies on the employee leave record, causing misstatements to the department's financial statements for the fiscal year ended June 30, 2005.

Exhibit 2.6
Discrepancies and Financial Statement Effect of Employee Leave Records for Four Employees at the O‘ahu Community Correctional Center

Employee	Hours Overstated (Understated)	Financial Statement Effect
1	614.00	$13,201
2	0.22	4
3	0.84	15
4	(72.00)	(1,210)
Total	543.06	$12,010

Source: Department of Public Safety, Form DPS-7 Employee Leave Record

Recommendations

We recommend that the department consider the following:

1. Overtime

    a. Establish more specific criteria for determining when overtime is necessary.

    b. Focus efforts on preventing overtime costs by identifying watches consistently incurring unusual overtime costs and requiring that overtime for those watches be authorized by the chief of security or the warden prior to calling in ACOs to work overtime.

c. Prepare exception reports identifying employees and watches with unusually high sick leave usage and overtime pay. This information could be used to monitor and investigate sick leave abuse and minimize overtime costs.

d. Monitor overtime costs by individual to ensure that overtime is allocated equitably based on the department's policies.

e. Ensure that the request and authorization for overtime work form is completed and approved in a timely manner and reconciled to the employees' timesheets.

f. Ensure that ACOs review and authorize timesheets completed by the time and attendance clerks.

g. Revise policies and procedures, consistent with state rules, so that employees claim overtime hours and are compensated within 45 days after the overtime work is performed.

2. Sick Leave Abuse

a. Work with the bargaining units to implement a more stringent policy for determining unusual patterns of sick leave abuse subject to investigation. This could be accomplished by reducing the number of required occurrences of sick leave abuse indicators, terminating the policy of considering each type of pattern separately, and/or extending the review period for determining when an investigation into sick leave abuse is warranted.

b. Implement more reasonable and realistic deadlines for facilities, depending on the number of its employees, to complete sick leave abuse program reviews.

c. Automate the employee leave record process to facilitate the detection of sick leave abuse patterns.

Although the Collection of Salary Overpayments Has Improved Significantly, Uncollected Balances Remain

The recovery of salary overpayments to employees has historically been a problem for the department. However, recent changes in state law and department policy, as well as the write-off of 138 cases approximating $715,000, has led to a significant reduction in the number and related value, of outstanding salary overpayment cases. There was a total of 92 outstanding cases approximating $260,000, at June 30, 2005, as compared to 223 outstanding cases amounting to approximately $1.3 million at June 30, 2004.

Salary overpayments are inherent in the predicted payroll process

In accordance with Section 78-13, HRS, effective July 1, 1998, department employees are paid on the 5th and 20th of each month for services rendered. Section 78-13, HRS, also provides that new employees be paid for services rendered during the preceding semi-monthly period, essentially effecting the after-the-fact payroll payment basis which resulted in an approximate 20-day payroll lag. However, for employees hired prior to July 1, 1998, under the predicted payroll payment basis there is only a five-day time lag between the end of the pay period and the pay date. As a result, a portion of salaries and wages is based on projected time and attendance, which can result in salary overpayments.

Salary overpayments occur when employees call in sick with no sick leave available or when they do not obtain a doctor's note for sick leave absences of five or more consecutive days. For example, if an employee turns in a timesheet indicating that he will be working through the end of the pay period but instead calls in sick (even though he has no sick leave available), a salary overpayment will occur. Although these overpayments are usually identified within one month when time and attendance clerks at each facility review timesheets and update sick leave records, they cannot be prevented and have become inherent under the predicted payroll basis.

Time-consuming process for past overpayments delays collections

The process of collecting salary overpayments processed prior to July 2002 is time-consuming due to the department's lengthy mandatory hearing and audit process. Sections 91-9, 91-9.5, and 91-10, HRS, provide that employees must be afforded the opportunity to dispute the overpayment through a hearing process. Prior to the hearing, the department must audit the employee's payroll records going back to the employee's hire date or the end of the last audited period. Once the payroll records are audited, a hearing is scheduled with the employee but the department must still wait for the decision, address any appeals, and await the final decision. The department estimates that the entire process, under optimal conditions, takes 11 to 20 months.

As of June 30, 2005, of the department's 92 outstanding salary overpayment cases, only two cases, totaling approximately $20,700, were scheduled for hearings. Of the remaining 90 outstanding cases, we selected a sample of 30 and found that ten cases requested a hearing; however, only four of these ten cases were reviewed, and no hearings were scheduled. According to department personnel, hearings have not been scheduled due to conflicting schedules between the department and the employee. Additionally, the department was required to restart the overpayment review processes, due to a misunderstanding stemming from the bargaining agreement's stipulation of a 30-day window for the union to inform the department of a dispute, versus the 15-day period provided by state law, thus further prolonging the scheduling process. In one case, a hearing could not occur since the appropriate documentation, such as the application for leave of absence and leave record forms, could not be located.

All 30 cases tested have been delinquent for more than two years. Included are eight cases, amounting to $32,000 of unpaid indebtedness, for employees no longer employed by the department. Since they were deemed uncollectible, the department has referred these balances to the Department of the Attorney General for write off. The department also identified two salary overpayment cases, approximating $4,000, as uncollectible due to bankruptcy filings. These balances should be referred to the Department of the Attorney General for collection also, since failing to notify the attorney general on a timely basis thwarts the State's ability to file a proof of claim for the overpayments.

Collection process for recent staff overpayments has been enhanced

Recent changes to state law have facilitated the process of collecting employee salary overpayments. Effective July 2002, Section 78-12(f), HRS, provides that regardless of whether a contested determination of indebtedness is pending, the disbursing officer shall commence immediate recovery of the salary overpayments. Thus, the department has the authority to collect overpayments by means of payroll deductions without the consent of the employee. The department may garnish from the employee's paycheck the total amount due if the indebtedness is less than $1,000. If the amount is greater than $1,000, the department may deduct from the employee's subsequent paychecks either an amount agreed upon by the employee but not less than $100 per pay period or deduct up to 25 percent of the employee's compensation until the amount is repaid in full.

Accordingly, the outstanding cases initiated subsequent to July 2002 are minimal—only eight cases amounting to approximately $25,000. The department has initiated collection proceedings on three of those cases and is in the process of writing-off the remaining five cases. Such collections indicate that the department is effectively maximizing the powers afforded by the recent revisions to state law to minimize the amount of salary overpayments recorded to compensate for the inherent nature of overpayments in the payroll process.

Recommendations

We recommend that the department:

1. Continue to perform required audits of salary overpayments in a timely manner and in compliance with laws and regulations.

2. Reduce the backlog of pending audits by setting departmental goals as to the number of audits and hearings to be performed each month.

3. Take action to correct discrepancies between provisions of the collective bargaining agreement and state statute in order to improve delays in scheduling hearing dates.

4. Consider contracting out the salary collection process on a contingent basis in order to expedite the process and reduce the amount of uncollectible payments.

Adherence to Operational Internal Controls and Procedures Needs Improving

The Hawai'i Public Procurement Code, Chapter 103D, HRS, sets standards for all state agencies regarding the acquisition and maintenance of goods and services. The code seeks to promote fiscal integrity, accountability, and efficiency in procurement processes among state agencies. However, our audit found that the department has not consistently adhered to the code or to internal requirements and procedures pertaining to small purchases and capital assets.

The department did not comply with the procurement code

To help ensure compliance with the procurement code, the State Procurement Office issued Procurement Circular No. 2003-01, Amendment 1, which provides standardized procedures for all purchases less than $25,000 (small purchases), with the exception of price/vendor list items, exempt purchases, and sole source purchases. In accordance with the procurement circular, purchases of goods and services greater than or equal to $1,000 require the solicitation of at least three quotations. Verbal quotations must be obtained for purchases between $1,000 and $15,000, and written quotations must be obtained for purchases between $15,000 and $25,000. All quotations must be documented and maintained in a procurement file. The most advantageous quote is selected based on various factors such as quality, warranty, deliverability, and price. If the quote selected is not the lowest of those submitted, a written justification must be placed in the procurement file. If it is not practicable to solicit three quotes, the reason must be documented and placed in the procurement file.

We found two instances of non-compliance, out of 22 purchases tested, in which the department failed to evidence the solicitation of at least three quotations. A $2,300 purchase for automotive supplies by the Hālawa Correctional Facility and a $10,200 purchase for security equipment by the Sheriff's Division lacked a completed form SPO-10, "Record of Small Purchase," which documents the minimum quotations obtained. The department personnel indicated that they were aware of the guidelines set forth in the procurement code, but these instances were due to oversights on the part of the respective divisions' personnel. Such errors undermine the department's responsibility for ensuring that state funds are spent in the most cost effective and beneficial manner and that fair competition was encouraged. Without the required documentation, it is not determinable whether the department obtained the best possible price for goods and services procured.

The capital assets inventory listing is inaccurate

Section 103D-1206, HRS, requires the department to prepare and file an annual inventory return of all state property that the department has in its possession. This control is essential to maintaining reliable capital asset records and helps detect potential misappropriations. The department failed to properly record capital asset disposals for four of the ten items tested from the inventory listings of three facilities (Oʻahu Community Correctional Center, Hālawa Correctional Facility, and Waiawa Correctional Facility). Three of the inventory items tested, with a total original cost of approximately $57,000, were previously replaced and did not physically exist. A fourth inventory item, with an original cost of approximately $18,000, did exist but was inoperable and should have been disposed of.

Additionally, the department reflected certain capital assets and disposals in inventory during the current fiscal year which have been placed in service and demolished, respectively, in previous fiscal years. These assets consisted primarily of buildings and improvements. This resulted in a restatement of the department's beginning net assets in the basic financial statements totaling approximately $4.3 million, net of related accumulated depreciation.

Although Section 103D-1206, HRS, requires the department to prepare and file an annual inventory return of all state property in the department's possession, we were informed that the annual physical inventories and the annual inventory return were not performed and accurately completed. The respective facilities did not properly reconcile their physical inventories with the State's inventory listing, resulting in an inaccurate return being filed with the State Procurement Office. In addition to overstating the state capital assets inventory listing, an inaccurate return will not provide the necessary foundation to safeguard the State's inventory and detect any misappropriations of those assets.

Recommendations

We recommend that the department:

1. Adhere to the documentation requirements of the state procurement code pertaining to small purchases.

2. Instruct the facilities to accurately conduct annual physical inventory and to reconcile annual physical inventory to the State's capital asset inventory listing in order to identify any discrepancies.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Department of Public Safety as of and for the year ended June 30, 2005. This chapter includes the independent auditors' report and the report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*. It also displays the department's basic financial statements together with explanatory notes and supplementary information required by U.S. generally accepted accounting principles.

Summary of Findings

In the opinion of KPMG LLP, based on its audit, the financial statements present fairly, in all material respects, the financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information for the department as of June 30, 2005, and the respective changes in financial position and, where applicable, cash flows thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP noted certain matters involving the department's internal control over financial reporting and its operations that the firm considered to be reportable conditions. KPMG LLP also noted that the results of its tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

The Auditor
State of Hawai'i:

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, State of Hawai'i (the department), as of and for the year ended June 30, 2005, which collectively comprise the department's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the department's management. Our responsibility is to express opinions on these financial statements based on our audit.

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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 department 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 Hawai‘i (the State) that are attributable to the transactions of the department. They do not purport to, and do not, present fairly the financial position of the State as of June 30, 2005, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

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 department, as of June 30, 2005, and the respective changes in financial position and, where applicable, cash flows thereof, and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

As discussed in note 3, the net assets of the governmental activities as of June 30, 2004 have been restated.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 21, 2006 on our consideration of the department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

/s/ KPMG LLP

Honolulu, Hawai'i
April 21, 2006

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

The Auditor
State of Hawai'i:

We have audited the 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, State of Hawai'i (the department), as of and for the year ended June 30, 2005, which collectively comprise the department's basic financial statements, and have issued our report thereon dated April 21, 2006. Our report refers to the department's restatement of the net assets of its governmental activities as of June 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 department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions 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 department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions have been reported to the Auditor, State of Hawai'i, and described in Chapter 2 of this report.

A material weakness is a reportable 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 believe that none of reportable conditions described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and have been reported to the Auditor, State of Hawai'i, and described in Chapter 2 of this report.

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

/s/ KPMG LLP

Honolulu, Hawai'i
April 21, 2006

Description of Basic Financial Statements

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

Management's Discussion and Analysis (Exhibit 3.1)

Management's discussion and analysis introduces the basic financial statements and provides a narrative overview and analysis of the department's financial activities for the fiscal year ended June 30, 2005.

Government-wide Financial Statements

Statement of Net Assets (Exhibit 3.2) - This statement presents assets, liabilities, and net assets of the department at June 30, 2005 using the accrual basis of accounting. This approach includes reporting not just current assets and liabilities, but also capital assets and long-term liabilities. The department's net assets are classified as invested in capital assets, restricted, or unrestricted.

Statement of Activities (Exhibit 3.3) - This statement presents revenues, expenses, and changes in net assets of the department for the year ended June 30, 2005, using the accrual basis of accounting and presents a comparison between direct expenses and program revenues in a format that focuses on the cost of each department function. Direct expenses are those that are specifically associated with a service or program and are therefore clearly identifiable to a particular function. Program revenues include charges paid by the recipients of the goods or services offered by the programs and grants and contributions that are restricted to meeting the operational or capital requirements of a particular program. The comparison of program revenues and expenses identifies the extent to which each program or business segment is self-financing. Under this approach, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

Fund Financial Statements

Balance Sheet – Governmental Funds (Exhibit 3.4) - This statement presents assets, liabilities, and fund balances by major governmental fund and the aggregate remaining fund information using the current financial resources measurement focus and modified accrual basis of accounting. Because the emphasis of this statement is on current financial resources, capital assets and long-term liabilities are not reported.

Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets (Exhibit 3.5) - This statement presents a reconciliation of the department's fund balance reported in the Balance Sheet – Governmental Funds to the net assets of governmental activities reported in the Statement of Net Assets.

Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds (Exhibit 3.6) - This statement presents revenues, expenditures, and changes in fund balances by major governmental fund and the aggregate remaining fund information using the current financial resources measurement focus and modified accrual basis of accounting. Under this approach, revenues are recognized when measurable and available, while expenditures are recorded when the related fund liability is incurred.

Reconciliation of the Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances to the Statement of Activities (Exhibit 3.7) - This statement presents a reconciliation of the department's net change in fund balances reported in the Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds to the change in net assets reported in the Statement of Activities.

Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) (Exhibit 3.8) - This statement compares actual revenues and expenditures of the department's general fund on a budgetary basis to the original and final budgets adopted by the State Legislature for the year ended June 30, 2005.

Statement of Net Assets – Proprietary Fund (Exhibit 3.9) - This statement presents the assets and liabilities of the department's proprietary fund using the accrual basis of accounting.

Statement of Revenues, Expenses and Change in Fund Net Assets - Proprietary Fund (Exhibit 3.10) - This statement presents the revenues, expenses and change net assets of the department's propriety fund using the accrual basis of accounting.

Statement of Cash Flows – Proprietary Fund (Exhibit 3.11) - This statement presents the cash flows for the department's proprietary fund, classified between operating activities and capital and related financing activities.

Statement of Assets and Liabilities – Agency Fund (Exhibit 3.12) - This statement presents the assets and liabilities of the department's agency fund.

Notes to Basic Financial Statements

Explanatory notes, which are pertinent to an understanding of the basic financial statements and financial position of the department, are discussed in this section.

Note 1 – Financial Reporting Entity

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

The department is part of the executive branch of the State of Hawai‘i. The department's basic financial statements reflect only its portion of the fund type categories attributable to the transactions of the department. The state comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually, which includes the department's financial activities.

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

Departmental Administration

Departmental Administration includes management, accounting, data processing, and other administrative services provided by the department. 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.

Law Enforcement

Law Enforcement assists in guarding state property and facilities, 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.

Corrections

Corrections administers, through the following 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.

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

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.

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.

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.

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 department, other state agencies, and the private sector. Its operations are reported in the enterprise fund.

Crime Victim Compensation Commission (administratively attached to the department)

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.

Hawai'i Paroling Authority (administratively attached to the department)

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.

Note 2 – Significant Accounting Policies

Government-wide and Fund Financial Statements

The government-wide financial statements report all assets, liabilities, and activities of the department as a whole. The fiduciary funds are excluded from the government-wide financial statements because the department cannot use those assets to finance its operations. The effect of interfund activity has been removed from these government-wide financial statements.

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

The financial transactions of the department 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. The department's major fund, the general fund, is reported in a separate column, and all other nonmajor funds are combined in one column.

Measurement Focus, Basis of Accounting and Financial Statement Presentation

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 department 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.

Governmental Fund Financial Statements

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.

Federal grants are considered available if they are collected within 12 months of the end of the current fiscal year. The department considers state allotted appropriations to be available if they are collected within 60 of the end of the current fiscal year.

Expenditures are generally recorded when a liability is incurred, as under accrual accounting, except for accumulated vacation, which is recorded when due and payable.

Proprietary and Agency Fund Financial Statements

All proprietary and agency funds are accounted for on a flow of economic resources measurement focus and accrual basis of accounting.

In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the department has elected not to apply Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

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

Governmental Fund Types

General Fund – The general fund is the general operating fund of the department. 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.

The nonmajor governmental funds are comprised of the following: 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.

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, noncapital financing activities, or investing activities, if any.

Fiduciary Fund Type

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

Use of Estimates

The preparation of basic financial statements in conformity with U.S. generally accepted accounting principles 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.

Receivables

Receivables in the general fund consist primarily of amounts due from individuals for whom salaries were overpaid by the department. 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.

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.

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.

The department has adopted the following capitalization policy:

Asset Type		Minimum Capitalization Amount	Estimated Useful Life Governmental	Estimated Useful Life 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

Deferred Revenues

Deferred revenues reported in governmental activities on the statement of net assets and in other governmental funds on the balance sheet arise when the department receives resources before it has a legal claim to them, as when grant monies are received prior to the incurrence of qualifying expenditures. In subsequent periods, when the department has a legal claim to the resources, the liability for the deferred revenue is removed from the statement of net assets and balance sheet and revenue is recognized.

Due to Individuals

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

Accumulated Vacation

It is the department's policy to permit employees to accumulate earned but unused vacation and sick leave benefits. There is no liability for unpaid accumulated sick leave since sick leave is not convertible to pay upon termination of employment. All vacation pay is accrued when incurred in the government-wide and proprietary fund financial statements. A liability for these amounts is reported in the governmental funds only if they have matured, for example, as a result of employee resignations and retirements.

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 department generally applies unrestricted resources before restricted resources for expenses incurred.

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. State allotted appropriations reported in the accompanying statement of activities and statement of revenues, expenditures, and changes in fund balances are shown net of lapsed appropriations related to previous years.

Program Revenues

Program revenues derive directly from the programs of the department or from parties outside of the department 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.

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 transfers in the basic financial statements.

Note 3 – Restatement

During the current year, the department discovered that certain capital assets were not recorded in its capital assets inventory system as of June 30, 2004. These capital assets had a carrying value of $4,354,152, net of accumulated depreciation of $1,611,489 at June 30, 2004. The recording of these assets resulted in the following adjustments to net assets for the governmental activities at June 30, 2004:

		Governmental Activities
Net assets as of June 30, 2004, as previously reported	$	82,456,696
Addition of capital assets, net of accumulated depreciation		4,354,152
Net assets as of June 30, 2004, as restated	$	86,810,848

Note 4 – 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 (budgetary basis) – 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 Hawai‘i. 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.

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

For purposes of budgeting, the department’s budgetary fund structure and accounting principles differ from those utilized to present the governmental fund financial statements in conformity with U.S. generally accepted accounting principles (GAAP). The department’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, 2005:

Excess of revenues over expenditures and other uses – actual on budgetary basis	$	971,923
Reserved for encumbrances at fiscal year-end		9,430,783
Expenditures for liquidation of prior fiscal year encumbrances		(6,816,025)
Lapsed appropriations related to prior years		(1,421,954)
Reserved for receivables		151,794
Net change in unreserved liabilities		37,337
Net adjustment for commissary revenue accrual		5,078
Net change in fund balance - GAAP basis	$	2,358,936

Note 5 – Cash and Cash Equivalents

Cash in State Treasury

The state director of finance is responsible for the safekeeping of all moneys paid into the state treasury. The state director of finance pools and invests any monies of the State, which in the director's judgment, are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of, or guaranteed by, the U.S. government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

The State established a policy whereby all unrestricted and certain restricted cash is invested in the State's investment pool. Cash accounts that participate in the investment pool accrue interest based on the average weighted cash balances of each account.

For demand or checking accounts and time certificates of deposit, the State requires that the depository banks pledge collateral based on daily available bank balances. The use of daily available bank balances to determine collateral requirements results in the available balances being under-collateralized at various times during the fiscal year. 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.

For the purposes of the statement of cash flows, cash and cash equivalents includes cash in state treasury.

Interest Rate Risk - As a means of limiting its exposure to fair value losses arising from rising interest rates, the State's investment policy generally limits maturities on investments to not more than five years from the date of investment.

Credit Risk - The State's investment policy limits investments to state and U.S. Treasury securities, time certificates of deposit, U.S. government or agency obligations, repurchase agreements, commercial paper, bankers' acceptances, and money market funds and student loan resource securities maintaining a Triple-A rating.

Custodial Risk - For an investment, custodial risk is the risk that, in the event of the failure of the counterparty, the State will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The State's investments are held at broker/dealer firms which are protected by the Securities Investor Protection Corporation (SIPC) up to a maximum amount. Excess-SIPC coverage is provided by the firms' insurance policies. In addition, the State requires the institutions to set aside in safekeeping certain types of securities to collateralize repurchase agreements. The State monitors the market value of these securities and obtains additional collateral when appropriate.

Concentration of Credit Risk - The State's policy provides guidelines for portfolio diversification by placing limits on the amount the State may invest in any one issuer, types of investment instruments, and position limits per issue of an investment instrument.

The carrying value of the department's cash in the state treasury at June 30, 2005 was $22,412,721 ($21,670,352 for the governmental and proprietary funds and $742,369 for the fiduciary fund). Information relating to the cash in state treasury is determined on a statewide basis and not for individual departments or divisions. Information regarding the carrying amount and corresponding bank balances of the cash (which includes the department's cash in state treasury) and collateralization of the cash balances is included in the comprehensive annual financial report of the State. The department's share of the cash in the state treasury, as summarized in the table below, is 0.6%:

		Maturity (in years)		
	Fair Value	**Less than 1**	**1 - 5**	**30**
		(Amounts expressed in thousands)		
State treasury:				
Cash and cash equivalents	$ 2,074,860	$ 2,074,860	$ —	$ —
Investments:				
Certificates of deposit	68,299	53,299	15,000	—
U.S. government securities	1,374,711	—	1,374,700	11
Repurchase agreements	361,065	345,408	15,657	—
Total investments	1,804,075	398,707	1,405,357	11
Total state treasury	$ 3,878,935	$ 2,473,567	$ 1,405,357	$ 11

Cash in Bank

The department's fiduciary fund also maintains cash in banks and time certificates of deposit, which are held separately from cash in the state treasury. As of June 30, 2005, the carrying amount of total bank deposits, including time certificates of deposit, was approximately $1,087,000 and the corresponding bank balances were approximately $1,220,000. Such a balance primarily represents the department's bank accounts maintained for inmates while they are incarcerated.

Note 6 – Receivables

Receivables of the department, net of an allowance for doubtful accounts, consisted of the following at June 30, 2005:

	General Fund	Enterprise Fund
Salary overpayments	$ 261,794	$ —
Accounts receivable	—	277,169
Less allowance for doubtful accounts	(110,000)	(98,599)
Receivables, net	$ 151,794	$ 178,570

Note 7 – Capital Assets

	Balance July 1, 2004 (as previously reported	Adjustments (note 3)	Balance July 1, 2004 (as restated)	Additions	Deductions	Transfers from other departments	Balance June 30, 2005
Governmental activities:							
Nondepreciable assets – land	$ 107,570	$ —	$ 107,570	$ —	$ —	$ —	$ 107,570
Depreciable assets:							
Building and improvements	172,084,272	4,003,144	176,087,416	—	—	—	176,087,416
Furniture and equipment	4,464,302	183,936	4,648,238	337,498	51,652	—	4,934,084
Vehicles	3,730,514	—	3,730,514	264,811	135,674	148,486	4,008,137
Land improvements	—	1,778,561	1,778,561	—	—	—	1,778,561
Total capital assets	180,386,658	5,965,641	186,352,299	602,309	187,326	148,486	186,915,768
Less accumulated depreciation:							
Building and improvements	82,196,984	1,137,951	83,334,935	5,764,725	—	—	89,099,660
Furniture and equipment	3,510,766	144,009	3,654,775	325,794	46,422	—	3,934,147
Vehicles	3,355,775	33,102	3,388,877	204,083	127,012	139,986	3,605,934
Land improvements	—	296,427	296,427	59,285	—	—	355,712
Total accumulated depreciation	89,063,525	1,611,489	90,675,014	6,353,887	173,434	139,986	96,995,453
Governmental activities – capital assets, net	$ 91,323,133	$ 4,354,152	$ 95,677,285	$ (5,751,578)	$ 13,892	$ 8,500	$ 89,920,315

	Balance July 1, 2004	Additions	Deductions	Balance June 30, 2005
Business-type activities:				
Building and improvements	$ 2,579,000	$ —	$ —	$ 2,579,000
Equipment	730,100	—	—	730,100
Equipment under capital lease	649,758	25,826	—	675,584
Total capital assets	3,958,858	25,826	—	3,984,684
Less accumulated depreciation:				
Building and improvements	773,700	64,475	—	838,175
Equipment	652,882	92,989	—	745,871
Equipment under capital lease	520,764	47,489	—	568,253
Total accumulated depreciation	1,947,346	204,953	—	2,152,299
Governmental activities – capital assets, net	$ 2,011,512	$ (179,127)	$ —	$ 1,832,385

Depreciation expense was charged to functions as follows:

Governmental activities:	
Confinement	$ 5,967,629
Law enforcement	99,640
Crime victim compensation	2,313
General support	284,305
Total governmental activities depreciation	$ 6,353,887
Business-type activities – correctional industries	$ 204,953

Note 8 – 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, 2005 was as follows:

Balance at July 1, 2004	$ 15,403,945
Additions	8,949,993
Reductions	(10,267,705)
Balance at June 30, 2005	$ 14,086,233

The amount of governmental activities compensated absences liability due within one year is $5,499,153. 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, 2005 was as follows:

		Balance July 1, 2004		Additions		Reductions		Balance June 30, 2005		Amount due within one year
Capital lease obligations	$	30,617	$	25,826	$	38,912	$	17,531	$	14,277
Accrued compensated absences		225,968		71,728		126,038		171,658		67,013
Total	$	256,585	$	97,554	$	164,950	$	189,189	$	81,290

Note 9 – Nonimposed Employee Fringe Benefits

Payroll fringe benefit costs of the department's employees funded by state appropriations (general fund) are assumed by the State and are not charged to the department's operating funds. These costs, totaling $32,224,817 for the fiscal year ended June 30, 2005, have been reported as revenues and expenditures in the general fund of the department.

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

Note 10 – Lease Commitments

Capital Leases

The department's Correctional Industries Program has long-term equipment leases expiring through October 2006 that are 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 $47,500 for the fiscal year ended June 30, 2005.

At June 30, 2005, the future minimum lease payments together with the present value of net minimum lease payments (obligations under capital leases) were as follows:

Fiscal year ending June 30:		
2006	$	14,277
2007		3,254
Total minimum lease payments		17,531
Lease amounts representing interest at 5.50% – 7.58%		684
Present value of minimum lease payments	$	16,847

Operating Leases

The department 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 noncancelable operating leases with terms of one year or more at June 30, 2005, were as follows:

Fiscal year ending June 30:		
2006	$	441,000
2007		192,000
2008		76,000
2009		48,000
2010		7,000
Thereafter		1,000
	$	765,000

Total rent expense for the fiscal year ended June 30, 2005 was approximately $510,000.

Note 11 – Retirement Benefits

Employees' Retirement System

Substantially all eligible employees of the department are required by Chapter 88, Hawai'i Revised Statutes (HRS), to become members of the Employees' Retirement System of the State of Hawai'i (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS 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, Hawai'i 96813.

Members of the ERS belong to either a contributory or noncontributory option. Only employees of the department hired on or before June 30, 1984 are eligible to participate in the contributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

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

Most covered employees of the contributory option are required to contribute 7.8% of their salary. Police officers, firefighters, investigators of the departments of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2% of their salary. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 27 years from June 30, 2002.

Contributions by the department for the fiscal years ended June 30, 2005, 2004 and 2003 were approximately $11,269,000, $8,893,000 and $8,568,000, respectively, which are equal to the required contributions. The contribution rate for the fiscal year ended June 30, 2005 was 10.82%. The contribution rate was 9.14% and 8.87% for the fiscal years ended June 30, 2004 and 2003, respectively.

Postretirement 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 department's share of the postretirement health care and life insurance benefits expense for the fiscal year ended June 30, 2005 was approximately $6,863,000.

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 department's basic financial statements.

Note 12 – Risk Management

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. Losses not covered by insurance are paid from legislative appropriations of the State's general fund and are not included in the department's basic financial statements.

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 by the State 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.

Note 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 are not convertible to pay upon termination of employment. However, a public employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2005 amounted to approximately $20,581,000.

Note 14 – New Pronouncements for Financial Reporting

The Governmental Accounting Standards Board (GASB) has issued the following statements applicable to the department:

- 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 other post employment benefits (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 effect on the financial statements of adopting Statement No. 45.

- Statement No. 46, *Net Assets Restricted by Enabling Legislation – An Amendment of GASB Statement No. 34,* clarifies the definition of the legal enforceability of an enabling legislation restriction, specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated, and requires governments to disclose the portion of total net assets that is restricted by enabling legislation. This statement is effective for financial statements for periods beginning after June 15, 2005 and is not expected to have a material effect on the department's financial statements.

- Statement No. 47, *Accounting for Termination Benefits,* establishes standards for the measurement, recognition, and display of termination 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 periods beginning after June 15, 2005 and is not expected to have a material effect on the department's financial statements.

Exhibit 3.1

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAI'I
Management's Discussion and Analysis
June 30, 2005

As management of the Department of Public Safety, State of Hawai'i (the department), we offer readers of the department's basic financial statements this narrative overview and analysis of the department's financial activities for the fiscal year ended June 30, 2005. 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 department exceeded its total liabilities at June 30, 2005 by approximately $87.3 million. Net assets invested in capital assets, net of related debt, accounted for nearly this entire amount.

- During the fiscal year ended June 30, 2005, the department incurred approximately $213.5 million of expenses, of which approximately $208.7 million or 98% pertained to governmental activities. These expenses were primarily funded by state allotted appropriations, net, of $165.4 million and state provided payroll fringe benefits of $32.2 million.

- The department expended approximately $178.0 million of governmental funds for incarceration and related inmate programs.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the department's basic financial statements. The department's basic financial statements are comprised of 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 department 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 department's overall financial status. The statement of net assets includes all of the department'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 department's net assets and how they have changed. Over time, increases or decreases in the department'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 department as follows:

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

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

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 department uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the department 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 department 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. The department has one Proprietary Fund type, an enterprise fund used to account for CI's operations.

Fiduciary Funds – Fiduciary Funds are used to account for assets held in a trustee or agency capacity. The department, 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 Hawai'i under a federal program, and repayments by employees for salaries overpaid by the State. These activities are excluded from the department's government-wide financial statements because the department cannot use these assets to finance its operations.

Government-wide Financial Analysis

The following table presents a condensed government-wide statement of net assets of the department as of June 30, 2005 and 2004:

Net Assets

June 30, 2005 and 2004

	Governmental Activities		Business-Type Activities		Total	
	2005	**2004 (as restated) ***	**2005**	**2004**	**2005**	**2004 (as restated) ***
Assets:						
Current and other assets	$ 23,446,891	$ 22,316,058	$ 1,108,190	$ 856,733	$ 24,555,081	$ 23,172,791
Capital assets	89,920,315	95,677,285	1,832,385	2,011,512	91,752,700	97,688,797
Total assets	113,367,206	117,993,343	2,940,575	2,868,245	116,307,781	120,861,588
Liabilities:						
Current liabilities	19,794,794	21,486,154	557,217	555,526	20,352,011	22,041,680
Other liabilities	8,587,080	9,696,341	107,899	152,556	8,694,979	9,848,897
Total liabilities	28,381,874	31,182,495	665,116	708,082	29,046,990	31,890,577
Net assets:						
Invested in capital assets, net of related debt	89,920,315	95,677,285	1,814,854	1,980,895	91,735,169	97,658,180
Unrestricted (deficit)	(4,934,983)	(8,866,437)	460,605	179,268	(4,474,378)	(8,687,169)
Total net assets	$ 84,985,332	$ 86,810,848	$ 2,275,459	$ 2,160,163	$ 87,260,791	$ 88,971,011

* These amounts have been restated. See note 3 for further explanation.

The department's combined total net assets decreased by 2% from $89.0 million as of June 30, 2004 to $87.3 million as of June 30, 2005. Governmental net assets accounted for 97% of total net assets that consisted primarily of correctional facilities.

The deficit in unrestricted net assets for governmental activities was approximately $4.9 million and $8.9 million as of June 30, 2005 and 2004, respectively. This deficit in unrestricted net assets results primarily from program liabilities incurred as of June 30, 2005 for which State allotted appropriations were not yet available. The largest liability stems from accrued wages payable totaling $7.6 million and $9.5 million as of June 30, 2005 and 2004, respectively, as a result of the State's payroll lag and after-the-fact payroll.

Changes in Net Assets

Years ended June 30, 2005 and 2004

	Governmental Activities		Business-Type Activities		Total	
	2005	2004 (as restated) *	2005	2004	2005	2004 (as restated) *
Revenues:						
Program revenues:						
Charges for services	$ 5,972,188	$ 5,707,777	$ 4,929,550	$ 3,640,335	$ 10,901,738	$ 9,348,112
Operating grants and contributions	3,182,228	1,952,750	—	—	3,182,228	1,952,750
General revenues:						
State allotted appropriations, net	165,440,357	153,146,622	—	—	165,440,357	153,146,622
Other	32,266,982	29,586,846	—	—	32,266,982	29,586,846
Total revenues	206,861,755	190,393,995	4,929,550	3,640,335	211,791,305	194,034,330
Expenses:						
Confinement	178,019,384	162,380,749	—	—	178,019,384	162,380,749
Law enforcement	17,718,973	17,291,097	—	—	17,718,973	17,291,097
Parole	3,242,989	2,691,989	—	—	3,242,989	2,691,989
Crime victim compensation	1,317,625	1,274,812	—	—	1,317,625	1,274,812
General support	8,384,791	12,136,196	—	—	8,384,791	12,136,196
Correctional industries	—	—	4,814,254	3,600,546	4,814,254	3,600,546
Total expenses	208,683,762	195,774,843	4,814,254	3,600,546	213,498,016	199,375,389
Excess (deficiency) before transfers, and contributions	(1,822,007)	(5,380,848)	115,296	39,789	(1,706,711)	(5,341,059)
Transfer out, net	(3,509)	(332,750)	—	—	(3,509)	(332,750)
Contributions	—	—	—	5,000	—	5,000
Changes in net assets	$ (1,825,516)	$ (5,713,598)	$ 115,296	$ 44,789	$ (1,710,220)	$ (5,668,809)

* These amounts have been restated. See note 3 for further explanation.

Total net assets decreased by approximately $1.7 million during the fiscal year ended June 30, 2005 as shown above.

Total revenues for the department increased by approximately $17.8 million during the fiscal year ended June 30, 2005. The revenue increase is attributed primarily to:

- Funding augmentation to cover collective bargaining costs ($6.6 million)
- Increasing inmate health care costs and corresponding Medicaid reimbursements ($3.0 million)
- Increased appropriations for contracting mainland prison bed space ($5.7 million).

Expenses for the fiscal years ended June 30, 2005 and 2004 totaled approximately $213.5 million and $199.4 million, respectively. The $14.1 million increase stems from increases in collective bargaining costs, inmate health care costs, and mainland prison expenses.

Governmental Activities
Expenses of the governmental activities accounted for over 98% of total expenses in each fiscal year, with program expenses for the confinement of inmates accounting for approximately 85% of total expenses for governmental activities for the year ended June 30, 2005. Approximately $31.0 million and $29.0 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, 2005 and 2004, respectively.

Business-type Activities
Total operating revenue for CI increased by $1.3 million for the fiscal year ended June 30, 2005. Sales and services increased by $1.3 million. Operating expenses increased by $1.2 million for the fiscal year ended June 30, 2005. As shown in the condensed changes in net assets, CI's expenses increased by 34% from $3.6 million in fiscal year 2004 to $4.8 million in fiscal year 2005. At the same time, revenues increased by 35% from $3.6 million in fiscal year 2004 to $4.9 million in fiscal year 2005. A net profit of $115,296 was recorded for fiscal year 2005.

Financial Analysis of the Fund Financial Statements
As noted earlier, the department uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Following are financial analyses of the Department's Governmental and Proprietary Funds.

Governmental Funds
The department's principal funding source is the General Fund, which accounted for approximately $20.3 million or 86% of total Governmental Fund assets as of June 30, 2005, and $19.4 million or 87% of total Governmental Fund assets for the fiscal year ended June 30, 2004. The General Fund revenues consisted primarily of State allotted appropriations.

Proprietary Fund
The CI Revolving Fund is the department's only Proprietary Fund. As of June 30, 2005, the CI reported $2.3 million in total net assets, of which approximately $1.8 million was accounted for by investment in capital assets, net of related debt. The $1.3 million increase in sales and services resulted in a $1.2 million increase in operating expenses, yielding a profit of $115,296 for fiscal year 2005.

Budgetary Analysis
As of May 2004, the Council on Revenues retained its previous forecast of General Fund tax revenue growth for fiscal year 2004 and thereafter. However, the State General Fund's annual budget had not been in balance since fiscal year 2002. That is, General Fund expenditures were greater than General Fund revenues, resulting in annual deficits that continued to erode the State's once-prudent balance in the General Fund.

Therefore, the fiscal year 2005 budget execution policies were formulated under the following overall themes:

- Actions to reduce overall spending in fiscal year 2005 were deemed a necessary first step in addressing the structural imbalance in the budget. State agencies were cautioned to expect further spending reductions for the upcoming fiscal biennium 2005 - 2007 as the State developed a plan to bring recurring expenses to a level that could be supported by recurring revenues.

- Utmost care and prudence must be taken in all expenditure and hiring decisions as every expenditure must compete for its priority in the State spending plan relative to all other funding requirements of the State.

Accordingly, the following measures were imposed in fiscal year 2005:

- A 1% across-the-board efficiency savings restriction on the full-year fiscal year 2005 departmental allocation

- Targeted restrictions on specific items or categories

- As in the past, allotment of only 90% of General Fund collective bargaining appropriations

- Unless specifically addressed, all other provisions of the fiscal year 2004 Budget Execution Policies and Instructions continued to be in force.

General Fund Budgetary Comparison

Year ended June 30, 2005

	Original	Final	Actual on Budgetary Basis	Variance Favorable (Unfavorable)
Expenditures:				
Confinement	$ 137,977,420	$ 144,380,878	$ 144,275,102	$ 105,776
Law enforcement	14,911,838	15,663,578	13,912,691	1,750,887
Parole	3,311,755	3,207,556	2,866,356	341,200
General support	10,296,204	10,296,204	9,200,306	1,095,898
Total expenditures	$ 166,497,217	$ 173,548,216	$ 170,254,455	$ 3,293,761

The difference between the original budget of $166.5 million and the final budget of $173.5 million was $7.1 million due to an increase in salaries. The final total budget of $173.5 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 department is limited to spending up to the expenditure ceiling or the cash balance, whichever amount is lower. For the fiscal year ended June 30, 2005, the $3.3 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 department experienced personnel recruitment and retention difficulties in certain areas.

3. Certain programs were able to reduce overtime payroll expenditures.

Capital Assets, Net of Depreciation

June 30, 2005 and 2004

	Governmental Activities		Business-type Activities		Total	
	2005	2004 (as restated) *	2005	2004	2005	2004 (as restated) *
Land	$ 107,570	$ 107,570	$ —	$ —	$ 107,570	$ 107,570
Buildings and improvements	86,987,756	92,752,481	1,740,825	1,805,300	88,728,581	94,557,781
Furniture, equipment, and vehicles	2,824,989	2,817,234	91,560	206,212	2,916,549	3,023,446
Total	$ 89,920,315	$ 95,677,285	$ 1,832,385	$ 2,011,512	$ 91,752,700	$ 97,688,797

* These amounts have been restated. See note 3 for further explanation.

Capital Assets

As of June 30, 2005, the department had approximately $91.8 million invested in capital assets. Capital assets for governmental activities accounted for 98% of total capital assets. Building and building improvements at correctional facilities totaled approximately $87.0 million, net of accumulated depreciation.

Capital assets, net of depreciation, decreased by $5.9 million or a 6.1% from June 30, 2004 to 2005 due primarily to depreciation expense of $6.6 million in fiscal year 2005.

Economic Factors

The Council on Revenues in September 2005 estimated that the State's General Fund tax growth rate would be 6.0% in fiscal 2006, 6.6% in fiscal 2007, and 7.3% in fiscal 2008. The Governor's budget policy mandates that all departments maintain fiscal discipline in managing its resources. Consultant and personal services contracts greater than $25,000 and the filling of positions continue to require the approval of the Governor and other expenditure controls implemented in fiscal 2005 continue to be in force.

Updates to revenue projections issued by the Council on Revenues will impact the Governor's policy on budget formulation and, accordingly, the department's future budget.

Request for Information

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

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

Exhibit 3.2

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Statement of Net Assets

June 30, 2005

Assets		Governmental Activities		Business-type Activities		Total
Current assets:						
Cash in state treasury	$	21,373,976	$	296,376	$	21,670,352
Petty cash		23,950		—		23,950
Receivables, net		151,794		178,570		330,364
Due from State of Hawaii		2,044,044		—		2,044,044
Internal balances		(185,187)		185,187		—
Due from other funds		38,314		—		38,314
Inventories		—		448,057		448,057
Total current assets		23,446,891		1,108,190		24,555,081
Capital assets:						
Nondepreciable		107,570		—		107,570
Depreciable, net		89,812,745		1,832,385		91,645,130
Total capital assets		89,920,315		1,832,385		91,752,700
Total assets		113,367,206		2,940,575		116,307,781
Liabilities						
Current liabilities:						
Accrued wages and employee benefits		7,626,672		49,657		7,676,329
Vouchers payable		6,511,317		405,698		6,917,015
Deferred revenues		91,663		18,980		110,643
Capital lease obligations		—		14,277		14,277
Accrued compensated absences		5,499,153		67,013		5,566,166
Due to other funds		65,989		1,592		67,581
Total current liabilities		19,794,794		557,217		20,352,011
Capital lease obligations, net of current portion		—		3,254		3,254
Accrued compensated absences, net of current portion		8,587,080		104,645		8,691,725
Total liabilities		28,381,874		665,116		29,046,990
Net Assets						
Invested in capital assets, net of related debt		89,920,315		1,814,854		91,735,169
Unrestricted (deficit)		(4,934,983)		460,605		(4,474,378)
Total net assets	$	84,985,332	$	2,275,459	$	87,260,791

See accompanying notes to basic financial statements.

Exhibit 3.3

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Statement of Activities

Year ended June 30, 2005

		Program Revenues		Net (Expense) Revenue and Changes in Net Assets		
Functions/Programs	**Expenses**	**Charges for Services**	**Operating Grants and Contributions**	**Governmental Activities**	**Business-Type Activities**	**Total**
Governmental activities:						
Confinement	$ 178,019,384	$ 297,345	$ 1,992,064	$ (175,729,975)	$ —	$ (175,729,975)
Law enforcement	17,718,973	4,735,489	689,180	(12,294,304)	—	(12,294,304)
Parole	3,242,989	—	—	(3,242,989)	—	(3,242,989)
Crime victim compensation	1,317,625	939,354	500,984	122,713	—	122,713
General support	8,384,791	—	—	(8,384,791)	—	(8,384,791)
Total governmental activities	208,683,762	5,972,188	3,182,228	(199,529,346)	—	(199,529,346)
Business-type activities:						
Correctional industries	4,814,254	4,929,550	—	—	115,296	115,296
Total business-type activities	4,814,254	4,929,550	—	—	115,296	115,296
Total	$ 213,498,016	$ 10,901,738	$ 3,182,228	(199,529,346)	115,296	(199,414,050)
General revenues:						
State allotted appropriations, net of lapsed appropriations related to previous years of $1,421,954				165,440,357	—	165,440,357
State-provided payroll fringe benefits				32,224,817	—	32,224,817
Unrestricted investment earnings				5,242	—	5,242
Miscellaneous				36,923	—	36,923
Transfers in				571	—	571
Transfers out				(4,080)	—	(4,080)
Total general revenues, and transfers				197,703,830	—	197,703,830
Changes in net assets				(1,825,516)	115,296	(1,710,220)
Net assets at July 1, 2004, as restated (note 3)				86,810,848	2,160,163	88,971,011
Net assets at June 30, 2005				$ 84,985,332	$ 2,275,459	$ 87,260,791

See accompanying notes to basic financial statements.

Exhibit 3.4

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Governmental Funds

Balance Sheet

June 30, 2005

Assets	General	Other Governmental Funds	Total
Cash in state treasury	$ 18,057,017	$ 3,316,959	$ 21,373,976
Petty cash	23,950	—	23,950
Receivables, net	151,794	—	151,794
Due from State of Hawaii	2,044,044	—	2,044,044
Due from other funds	56,202	5,753	61,955
Total assets	$ 20,333,007	$ 3,322,712	$ 23,655,719
Liabilities and Fund Balances			
Accrued wages and employee benefits	$ 7,585,008	$ 41,664	$ 7,626,672
Vouchers payable	6,306,564	204,753	6,511,317
Deferred revenues	—	91,663	91,663
Due to other funds	253,271	21,546	274,817
Total liabilities	14,144,843	359,626	14,504,469
Fund balances:			
Reserved for:			
Encumbrances	9,430,783	1,829,120	11,259,903
Receivables	151,794	—	151,794
Unreserved	(3,394,413)	1,133,966	(2,260,447)
Total fund balances	6,188,164	2,963,086	9,151,250
Total liabilities and fund balances	$ 20,333,007	$ 3,322,712	$ 23,655,719

See accompanying notes to basic financial statements.

Exhibit 3.5

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Reconciliation of the Governmental Funds Balance Sheet
to the Statement of Net Assets

June 30, 2005

Total fund balances — Governmental Funds		$ 9,151,250
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	$ 186,915,768	
Accumulated depreciation	(96,995,453)	
		89,920,315
Accrued compensated absences liability is not due in the current period and, therefore, is not reported in the Governmental Funds		(14,086,233)
Net assets of governmental activities		$ 84,985,332

See accompanying notes to basic financial statements.

Exhibit 3.6

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Governmental Funds

Statement of Revenues, Expenditures, and Changes in Fund Balances

Year ended June 30, 2005

	General	Other Governmental Funds	Total
Revenues:			
State allotted appropriations, net of lapsed appropriations related to previous years of $1,421,954	$ 165,440,357	$ —	$ 165,440,357
State-provided payroll fringe benefits	32,224,817	—	32,224,817
Charges for services	4,331,059	1,641,129	5,972,188
Operating grants and contributions	—	3,182,228	3,182,228
Unrestricted investment earnings	5,242	—	5,242
Miscellaneous	36,923	—	36,923
Total revenues	202,038,398	4,823,357	206,861,755
Expenditures:			
Confinement	170,983,414	2,407,412	173,390,826
Law enforcement	17,179,249	836,042	18,015,291
Parole	3,188,465	—	3,188,465
Crime victim compensation	—	1,325,668	1,325,668
General support	8,324,254	—	8,324,254
Total expenditures	199,675,382	4,569,122	204,244,504
Excess of revenues over expenditures	2,363,016	254,235	2,617,251
Other financing sources (uses):			
Transfers in	—	571	571
Transfers out	(4,080)	—	(4,080)
Total other financing sources (uses)	(4,080)	571	(3,509)
Net change in fund balances	2,358,936	254,806	2,613,742
Fund balance, July 1, 2004	3,829,228	2,708,280	6,537,508
Fund balance, June 30, 2005	$ 6,188,164	$ 2,963,086	$ 9,151,250

See accompanying notes to basic financial statements.

Exhibit 3.7

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Reconciliation of the Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances to the Statement of Activities

Year ended June 30, 2005

Total net change in fund balances – Governmental Funds		$ 2,613,742
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	$ 602,309	
Net transfer of capital assets	8,500	
Depreciation	(6,353,887)	
		(5,743,078)
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 the Governmental Funds		(13,892)
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 the Governmental Funds		1,317,712
Change in net assets of governmental activities		$ (1,825,516)

See accompanying notes to basic financial statements.

Exhibit 3.8

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

General Fund

Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis)

Year ended June 30, 2005

	Original	Final	Actual on Budgetary Basis	Variance Favorable (Unfavorable)
Revenues:				
State allotted appropriations	$ 160,114,506	$ 166,862,311	$ 166,862,311	$ —
Charges for services	6,307,646	6,610,840	4,331,059	(2,279,781)
Miscellaneous	75,065	75,065	37,088	(37,977)
Total revenues	166,497,217	173,548,216	171,230,458	(2,317,758)
Expenditures:				
Confinement	137,977,420	144,380,878	144,275,102	105,776
Law enforcement	14,911,838	15,663,578	13,912,691	1,750,887
Parole	3,311,755	3,207,556	2,866,356	341,200
General support	10,296,204	10,296,204	9,200,306	1,095,898
Total expenditures	166,497,217	173,548,216	170,254,455	3,293,761
Excess of revenues over expenditures	—	—	976,003	976,003
Other financing uses – transfers out	—	—	4,080	(4,080)
Excess of revenues over expenditures and other uses	$ —	$ —	$ 971,923	$ 971,923

See accompanying notes to basic financial statements.

Exhibit 3.9

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Proprietary Fund

Statement of Net Assets

June 30, 2005

Assets		
Current assets:		
Cash in state treasury	$	296,376
Receivables, net of allowance for doubtful accounts		178,570
Internal balances		185,187
Inventories		448,057
Total current assets		1,108,190
Capital assets, net of depreciation		1,832,385
Total assets		2,940,575
Liabilities		
Current liabilities:		
Accrued wages and employee benefits		49,657
Vouchers payable		405,698
Deferred revenues		18,980
Capital lease obligations		14,277
Accrued compensated absences		67,013
Due to other funds		1,592
Total current liabilities		557,217
Noncurrent liabilities:		
Capital lease obligations, net of current portion		3,254
Accrued compensated absences, net of current portion		104,645
Total liabilities		665,116
Net assets		
Invested in capital assets, net of related debt		1,814,854
Unrestricted		460,605
Total net assets	$	2,275,459

See accompanying notes to basic financial statements.

Exhibit 3.10

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Proprietary Fund

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

Year ended June 30, 2005

Operating revenues:	
Charges for sales and services	$ 4,929,550
Operating expenses:	
Cost of sales and services	4,580,996
Depreciation and amortization	204,953
Provision for uncollectible accounts	25,749
Total operating expenses	4,811,698
Operating income	117,852
Nonoperating expense:	
Interest expense	(2,556)
Change in net assets	115,296
Net assets, July 1, 2004	2,160,163
Net assets, June 30, 2005	$ 2,275,459

See accompanying notes to basic financial statements.

Exhibit 3.11

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Proprietary Fund

Statement of Cash Flows

Year ended June 30, 2005

Cash flows from operating activities:		
Receipts from customers	$	4,587,145
Receipts from interfund services provided		268,240
Payments to suppliers		(3,871,929)
Payments to employees		(760,101)
Net cash provided by operating activities		223,355
Cash flows from capital and related financing activities:		
Principal payments on capital lease obligations		(38,912)
Interest paid on capital lease obligations		(2,556)
Net cash used by capital and related financing activities		(41,468)
Net increase in cash and cash equivalents		181,887
Cash and cash equivalents at July 1, 2004		114,489
Cash and cash equivalents at June 30, 2005	$	296,376
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$	117,852
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense		204,953
Provision for uncollectible accounts		25,749
Change in assets and liabilities:		
Receivables		46,952
Inventories		(144,573)
Vouchers payable		(57,115)
Accrued wages and compensated absences		152,865
Deferred revenues		(121,117)
Due to other funds		(2,211)
Net cash provided by operating activities	$	223,355

Supplemental disclosure of noncash financing activity:
The Department entered into a capital lease obligation amounting to $25,826 in 2005.

See accompanying notes to basic financial statements.

Exhibit 3.12

DEPARTMENT OF PUBLIC SAFETY
STATE OF HAWAII

Agency Fund

Statement of Assets and Liabilities

June 30, 2005

Assets		**Agency Fund**
Cash and cash equivalents	$	1,829,117
Due from other funds		67,581
Total assets	$	1,896,698
Liabilities		
Due to other funds	$	38,314
Due to individuals		1,161,862
Due to others		696,522
Total liabilities	$	1,896,698

See accompanying notes to basic financial statements.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Public Safety on July 5, 2006. A copy of the transmittal letter to the department is included as Attachment 1. The response of the department is included as Attachment 2.

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

Although we commend the department on the corrective actions already taken or planned to address many of the findings in our report, we have not had an opportunity to validate those actions. The department's ability to tout such progress is also due to the department having over a year to address such issues since the close of the fiscal year June 30, 2005. It is because of this length of time that we find it necessary to note that throughout the audit we have experienced several significant departmental delays in obtaining essential information and responses. For example, our contract auditors were not provided with the department's June 30, 2005 final trial balances, reports, and supporting schedules until April 6, 2006. In addition, the department required several extensions before finally responding to our draft report on July 26, 2006.

The department disagreed with our reportable condition regarding how its ineffective internal controls allow significant overtime to remain unchecked. The department felt our report grossly oversimplified the issue by forming unsupported conclusions. First, the department apparently disagrees with our finding that overtime is driven by vacancies and potential staffing limitations, yet it then lists several factors governing overtime that appear to fall under the category of "staffing limitations," including active military duty for personnel, gender specificity of some posts, and assignment of personnel to inmate transport or court duties. More importantly, the department misses the point of the comment, which is to acknowledge there are several factors driving overtime that are not within the department's control.

Second, the department disagrees with our conclusion that current policies and procedures are ineffective and can lead to high overtime costs. We believe that general structured criteria while still affording operational flexibility are necessary. Without such, the department is susceptible to overtime abuse and collusion between ACOs and watch commanders. Therefore, our conclusion is based on the lack of design or effectiveness of internal controls to prevent and detect overtime errors and abuse. This conclusion is based on our notation that there are no standard criteria for determining which program posts can be closed to avoid overtime; there is no effective process for monitoring individuals with high levels of overtime or ensuring overtime is distributed equitably; overtime authorization forms for three out of nine non-uniform employees tested were improperly completed; timesheets for ten out of 30 correctional officers reviewed were not signed by the employee to indicate review of overtime claimed; and department policy allows employees to submit timesheets for overtime work up to two years after performance of the work.

Third, the department disagrees with our finding that uninhibited sick leave continues to increase overtime costs. The department further disagrees with our "sweeping interpretation" of sick leave data, noting that our analysis includes extended sick leave that inflates the analysis. However, presentation of sick leave data in the aggregate, including long-term leaves, is necessary to demonstrate the direct correlation with significant overtime. It is also appropriate to include long-term leaves in the data since the responsibilities of such individuals must still be fulfilled even during their absence. Therefore, as noted in our report, sick leave is a direct driver of overtime and the department's method of tracking sick leave and detecting abuse is tedious and needs improvement. During our review of 30 random employees, we noted two employees whose sick leave records indicated a potential pattern of abuse but who were not placed in the sick leave monitoring program.

Finally, the department repeatedly mentions that it is a "24/7" operation and therefore incurring significant overtime is inevitable. Additionally, the department's response mentions that the inclusion of "holiday overtime (HOT)" in our analysis of overtime costs to total salaries demonstrates our "lack of understanding" regarding corrections operations. However, since all organizations will incur overtime due to holidays to varying degrees and the exclusion of such does not result in a significant decrease in overtime costs, we stand by our conclusion and illustration that overtime continues to be a significant component of payroll costs. Additionally, we have, on numerous occasions, requested benchmarking data from the department to identify how the department's overtime compares with other similar institutions. Such benchmarks would not only indicate whether the department's overtime is excessive, but would also demonstrate the department's efforts to conform to industry standards and limit overtime to only what is necessary. Such data was unavailable or not provided by the department.

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

MARION M. HIGA
State Auditor

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

July 5, 2006

COPY

The Honorable Frank Lopez
Interim Director
919 Ala Moana Boulevard
Honolulu, Hawai`i 96814

Dear Mr. Lopez:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Financial Audit of the Department of Public Safety*. We ask that you telephone us by Friday, July 7, 2006, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Friday, July 14, 2006.

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

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

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

LINDA LINGLE
GOVERNOR

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

CLAIRE Y. NAKAMURA
INTERIM DIRECTOR

Deputy Director
Administration

FRANK J. LOPEZ
Deputy Director
Corrections

JAMES L. PROPOTNICK
Deputy Director
Law Enforcement

No. ____________

July 25, 2006

RECEIVED
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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to respond to the findings and recommendations in your draft report, *Financial Audit of the Department of Public Safety,* for FY 2005. We feel that the report is generally an accurate representation of what the Department of Public Safety (PSD) has or has not been able to achieve since your Report No. 02-10 on the FY 2001 *Financial Audit of the Department of Public Safety.* While the summary states that none of the reportable conditions found are considered to be material weaknesses, we take the report very seriously and wish to comment on certain findings that seem to reflect either misunderstanding or misrepresentation of the functional requirements of our 24/7 corrections and law enforcement operations.

INMATE TRUST ACCOUNTS

The inmate trust accounting (ITA) system reflects inmate transactions including but not limited to: child support payments, court fees/fines, legal fees, postage costs, photocopy costs, victim restitution payments, medical/dental copayments or prostheses, monthly work program/workline wages, monetary gifts from authorized individuals, and weekly commissary purchases.

- **Reconciling inmate trust accounts to bank balances**. The ITA Users' Group, comprising the correctional institutions' business services supervisors and account clerks Statewide, was reconvened in FY 2006 for the purposes of: (a) developing a standardized form of all reconciling items, (b) diagramming workflow, and (c) preparing a detailed FY 2007 calendar of work sessions and milestones for synchronizing the ITA reconciliation process across all eight facilities. The standardized reconciliation form is currently being tested at selected facilities in an effort to isolate variables that may contribute to the widely fluctuating balances in each facility's monthly reconciliation, and to facilitate timely writeoff or escheatment of funds as appropriate. Upon achieving the foregoing basic objectives and stabilizing ITA reconciliation discrepancies, the Department will be better equipped to evaluate organizational and staffing alternatives.

- **Escheatment of unclaimed funds**. PSD, through its Inmate Trust Accounting Users' Group, will conduct training sessions for appropriate facility personnel to reiterate the importance of the escheatment process. Staff from the Halawa Correctional Facility (HCF) and the Oahu Community Correctional Center (OCCC) will assist the Hawaii Community Correctional Center (HCCC), Kulani Correctional Facility (KCF), and Women's Community Correctional Center (WCCC) in identifying inactive accounts as of December 31, 2005 to meet the November 30, 2006 deadline for escheatment of abandoned State property to the Department of Budget and Finance. The Department of Public Safety continues its efforts to reduce the number of inactive and "unknown" inmate accounts. HCF, for example, has since reduced its unnamed inmate accounts from a total of 225 during the audit, to a total of 68 "unknown" accounts and will strive to eliminate all such accounts.

- **Allowable funding advances to inmates.** The correctional institutions will be reminded by memorandum of allowable expenditures for which institutional funds may be advanced to inmates without sufficient funds, through the establishment of suspense accounts. Such expenditures are restricted to: (a) the replacement cost for damage, destruction, or loss of State property caused by an inmate; (b) photocopying or postage related to litigation; and (c) medical costs.

- **Monitoring and collection of inactive suspense accounts**. Policies and procedures will be developed for inmate suspense accounts, which will address the monitoring and collection of inactive suspense accounts, and the disposition of uncollectible accounts.

- **Remittance of funds to inmates upon transfer**. Transactions in the ITA system are posted electronically, making funds immediately available for an inmate's use upon transfer to another facility. The facilities will be advised to comply with Departmental policy by processing inmate fund transfers within 48 hours after an inmate's transfer date.

- **Authorization of timesheets by inmates to identify any discrepancies**. Currently, supervisors of the inmate worklines are responsible for the accounting of each assigned inmate worker's hours daily, and for totaling all hours monthly. The number of inmate worklines and work programs varies by facility based on the unique characteristics of the facility and its population; e.g., prison vs. jail, inmate custody level, and work opportunities. Workline supervisors prepare listings of inmates' State identification number, full name, hourly wage, and hours worked for the month. The workline supervisor is required to verify and sign completed monthly payroll records for submittal to the facilities' business offices for auditing and posting to the inmate trust accounting system. Inmates may review their payroll records at any time by request to the workline supervisor, and may request a monthly statement of the number of hours worked and total pay.

MONITORING OF OVERTIME COSTS AND SICK LEAVE ABUSE

We agree that there are significant overtime costs incurred and patterns of sick leave abuse particularly among the adult correctional officers (ACOs), health care staff, and food service staff. However, we feel that the report grossly oversimplifies the issue of significant overtime costs by drawing the following unsupported conclusions: (a) "overtime is driven by vacancies and potential staffing limitations" alone, (b) "current policies and procedures are ineffective and can lead to high levels of overtime costs," and (c) "uninhibited sick leave continues to increase overtime costs." In fact, sick leave is only one of more than 20 factors that drive overtime work.

- **Analysis of "total" overtime costs vs. salaries and wages by facility.** Exhibit 2.2 of the draft audit report compares total overtime costs to total payroll costs by facility over a three-year period, FY 2003 – FY 2005. We feel that this analysis demonstrates a lack of understanding of the most basic characteristics of 24/7 operations in general, and paramilitary corrections operations in particular. The comparison of "total" overtime costs with total payroll costs incorrectly assumes that the Department has control over "holiday" overtime (HOT) costs, which it does not. Statutes and collective bargaining agreements determine our State holidays. Because we must provide security seven days per week, there will of necessity be staff that are unable to observe holidays and must report to work on a "holiday" overtime basis. Because PSD has no discretion over HOT costs, a valid comparison can be made only between "ordinary" overtime pay (total overtime pay less holiday overtime pay) and total payroll, as shown in the Department's worksheets provided as Exhibit A.

- **Factors affecting the number of employees available to work on any given shift.** As previously discussed in the Department's May 1, 2002 response to the draft Report No. 02-10, *Financial Audit of the Department of Public Safety,* we implemented new reporting systems in 1999 that were designed to improve accountability among managers. To reiterate, one of the goals was to institute controls on overtime costs. We identified more than 20 factors that govern overtime work, with sick leave being only one factor. The first group includes factors that affect the number of employees available to work on any given shift, including sick leave, position vacancies, vacation leave, worker's compensation leave, maternity leave, and military leave. For example, in CY 2005, 7 of 67 (or nearly 10% of) ACO IIIs at Waiawa Correctional Facility were out on active military duty. Following activation at various times based on unit call up, 3 had returned by November 2005, all had returned by May 2006, and one has since been reactivated as of July 2006.

- **Need for unforeseen (unbudgeted) temporary security posts.** The second group of factors concerns the number of posts that must be filled over and above the regular posts on the established schedule. These special duty posts are unforeseen temporary requirements that often arise after a shift has begun. For example, an inmate may be placed on suicide watch, requiring one-on-one supervision by an ACO. An inmate may be hospitalized, requiring the presence of an ACO at the hospital. Occasionally, there is an unexpected number of inmates who must be transported from the facility to court appearances following receipt of the court calendar only one day in advance. In addition, facilities are sometimes required to establish additional unbudgeted posts to meet operational security and population needs. For example, the Hawaii Community Correctional Center was required to establish three unbudgeted ACO posts (which equates to a need for eight positions to staff each post daily over three shifts) to meet the expanding needs of the male pretrial population that experienced significant growth.

- **Gender-specific posts.** For some facilities, particularly the Women's Community Correctional Center, controlling overtime costs presents a special challenge.

Historically, WCCC has had difficulty filling its high number of gender-specific posts, as do other facilities with gender-specific posts; i.e., posts that can be staffed only by female officers. If a gender-specific post is not staffed due to the absence of a designated ACO, we must identify another female ACO to fill the vacant post, even if that female ACO must be compensated on an overtime basis, and even if there is a male ACO available at regular pay.

- **Need for inmate transport by ACOs to court, and safeguarding in court.** On the Big Island, the HCCC transports inmates from its Hilo facility to distant courts in Kona, Waimea, Puna, and Kau involving 200-mile or longer roundtrips, as well as within the Hilo area, with a minimum of two ACO escorts. Because the Department's Sheriff Division is inadequately staffed by deputy sheriffs to cover these courts, HCCC must not only provide transport but also security for inmates who need to appear in court by order of the presiding judges. In contrast, the transport of inmates to court, and security of inmates in court, is provided by the Sheriff Division in other circuits. Not surprisingly, court duty accounted for approximately 30% of HCCC's FY 2006 total overtime costs, exclusive of holiday overtime pay which is neither discretionary nor avoidable in any 24/7 operation, and since court is not held on holidays.

- **Inadequate Shift Relief Factor (SRF) since 1992.** The Department has argued since 1992 that its Shift Relief Factor (SRF) of 1.65, then and now, does not provide sufficient staffing to sustain current security operations. The Auditor's Office used the same consultant from the National Institute of Corrections for Report No. 92-27, *A Review of a Formula for Security Staffing at the Department of Public Safety,* and Report No. 94-18, *A Follow-Up Review of Security Staffing in the Department of Public Safety,* as the Department did in its 1988 study of security staffing needs. However, the Auditor's reports conclude that while the consultant's "proposed SRF [of 1.88] appeared reasonable enough to warrant further testing at one facility," the Auditor's Office maintains "that the reliability of the data supporting the revised factor and base remained ineffectual." Unfortunately, this argument has continued over the past 14 years since 1992 while PSD continues to be understaffed in poorly designed facilities and continues to endure charges of "seemingly entrenched significant overtime costs," "significant overtime to remain unchecked," and "significant overtime costs continue to be a problem."

  Moreover, the Legislature has repeatedly ignored requests for additional positions needed to implement the recommended 1.88 Shift Relief Factor for calculating the number of ACO positions necessary to cover a specified number of posts over the required shifts per day and the required days per week. For example, the 1992 Legislature responded to PSD's request for 182.00 new positions Statewide by directing that the Department implement a pilot project through the establishment of temporary positions at the Oahu Community Correctional Center to be funded by "savings" in overtime costs, without appropriating additional position counts or funds. Such directive reflects a failure to recognize the added difficulty of recruiting for temporary positions in a correctional setting, and the need to continue incurring overtime costs while applicants undergo physical and psychological testing as well as background checks, and while successful ACO recruits undergo mandatory Basic Corrections Training for eight weeks.

  To facilitate a general understanding of the SRF concept, Exhibit B is provided to illustrate the basic Shift Relief Factor computation (unadjusted for the more generous Hawaii State employee entitlements) prescribed in the *Guidelines for the Development* *of a Security Program,* published by the American Correctional Association. Further, because 14 years have elapsed since PSD originally proposed the implementation of a new SRF, the Department may consider reexamining more current data to develop a new SRF that may be higher than the 1992 SRF of 1.88.

- **Vacant ACO positions.** The Department is well aware of its ACO vacancies, which have occurred historically at an average vacancy rate of approximately 10%. However, there can be considerable variation by island. For example, the current upturn in the State's economy, and the low unemployment on Maui in particular, has resulted in severe recruitment difficulties in filling ACO positions at the Maui Community Correctional Center (MCCC). The State Administration has been proactive in its FY 2007 Executive Supplemental Budget Request to establish a shortage differential for MCCC ACOs, which the 2006 Legislature approved and funded.

  In 1995, with the assistance of the Department of Human Resources Development, PSD upgraded the minimum qualifications for the ACO Recruit class of work. While the upgraded entry requirements have limited the pool of applicants, our correctional institutions now benefit from better-qualified and trained ACOs which strengthens our security and public safety operations.

- **Criteria needed to evaluate program posts.** The current work schedule, including the establishment of essential and special assignment posts, was negotiated with the United Public Workers to allow each Warden to safely operate the correctional facility with the appropriate command structure, while minimizing overtime work. The Warden, Chief of Security, and Watch Commanders are responsible for effectively monitoring or mitigating overtime costs. The managers are also responsible for reevaluating the need for certain essential and special assignment posts, and recommending changes through the chain of command.

  Prior to the December 1999 implementation of current work schedules, the Department did examine a structured closure of posts to minimize overtime work. However, we found that such structured closure did not meet the facilities' daily operational needs. Depending on security or program situations and circumstances, as well as staffing, the Warden required flexibility to operate the facility. As a result, the structured closure of posts was suspended, and the containment of overtime costs left to the discretion of the Warden, through the Chief of Security and Watch Commanders. The nature of 24/7 correctional operations, and the need to immediately address any security gaps, results in after-the-fact reviews by the Chief of Security and Warden of overtime work assignments made by the Watch Commander. In this regard, the Department has been proactive in holding managers and employees accountable, and suspected abuse is subject to investigation and disciplinary action.

- **Monitoring of excessive overtime work needed for containment.** The draft audit report seems to reflect a misunderstanding of the manner in which PSD assigns overtime work pursuant to provisions of the Unit 10 collective bargaining agreement (CBA). To clarify, overtime work is first assigned to ACOs from the previous shift. If this coverage is still inadequate, then ACOs on a voluntary list are called back to work overtime. The voluntary list is based on ACO position classification and seniority applied in rotational order. If an ACO accepts or rejects the offer of overtime work, the ACO is moved to the bottom of the list. If an ACO is not available, then the ACO is given top priority for the next available opportunity for overtime work. The exceptions are the

Oahu Community Correctional Center and Halawa Correctional Facility, where employees who desire overtime work either sign up in advance or report prior to the start of a shift for any assignment of overtime work. Any call back for overtime work at either OCCC or HCF would be instituted only after exhausting such process.

Further, the misunderstanding continues on staff availability to perform overtime work. The Unit 10 CBA provides that the Employer shall endeavor to assign overtime work in a fair and equitable manner. The Department's process of assigning overtime work is consistent with the CBA. However, there are employees who do not wish to work overtime. As a result, the pool of overtime workers decreases and certain employees inevitably perform considerably more overtime work than others, creating a false perception of inequitable distribution of, or excessive earnings of, overtime pay for certain individuals.

We also recognize that certain shifts are perceived as less desirable and, of necessity, must be staffed on an overtime basis. For example, (evening) Shift 3 is not the preferred choice of ACOs and is thus plagued by a number of posts that go unselected during shift selection. Further, most daily security and program activities occur during (day) Shift 2.

It should come as no surprise that overtime earnings may approximate or even exceed an individual's base pay. Placing such employees on a "do not call" list as recommended in the audit report would be contrary to collective bargaining agreement language and practice. Moreover, the absence of employees with high overtime compensation does not necessarily equate to containment of aggregate overtime costs at a facility.

Again, the Wardens, Chiefs of Security, and Watch Commanders are responsible and accountable for identifying operational problems and appropriate remedies, including such issues as minimizing overtime work.

- **Overtime work not properly authorized.** As the draft audit report recognizes, the Form 1210, *Request and Authorization for Overtime Work,* applies only to non-uniformed staff. Based on audit findings, the Department will reexamine the use and application of the Form 1210 for prior supervisory approval, and for comparison of authorized against actual overtime hours.

  The draft report alleges that Watch Commanders did not approve the actual overtime work performed by ACOs at the Waiawa Correctional Facility. According to the facility's Acting Warden, it is the Watch Commanders who authorize and assign overtime work. Therefore, the basis for such allegation is questionable, since a situation involving an unauthorized ACO would certainly be detected and appropriately handled by the Watch Commander.

- **Timesheets not reviewed and approved by ACOs.** The OCCC served as a pilot site for the State's now-defunct Kronos time and attendance (T&A) automation project. Under the Kronos project, the Form D55, *Individual Timesheet,* was mechanically produced for payroll processing without employee signatures. PSD, the Department of Accounting and General Services (DAGS), and the labor unions felt confident that the T&A reporting system, founded on a systematic sign-in/sign-out sheet that was completed daily by employees for regular and overtime work and verified by the Watch Commander, was sufficient to mechanically produce a Form D55 for each employee.

These forms were submitted at the end of each pay period for payroll processing. As such, employee signatures on the Form D55 were not required. Claimants were furnished with the employee copy of the form, permitting detection and resolution of any discrepancy or dispute in a timely manner.

Following the October 2003 termination of the Kronos project due to vendor performance issues, in Summer 2005, PSD developed a partially mechanized time and attendance database application to streamline and better manage employee payroll claims for other than base salary. A pilot project was implemented in Fall 2005 beginning with the Neighbor Island correctional institutions.

PSD's T&A system centers on the use of standardized sign-in/sign-out logs for daily T&A recordkeeping for non-shift workers as well as three employee shifts per day. In the case of uniformed officers, the Watch Commander submits the sign-in/sign-out logs, through the Chief of Security and the Warden, to the Time and Attendance Unit (TAU) clerk. Similarly, supervisors of civilian employees would submit the logs, through the chain of command, to the TAU clerk. The TAU clerk enters the time worked into a database that performs calculations based on the TAU clerk's <u>specialized knowledge and application of</u> seven collective bargaining agreements, and corresponding entry of appropriate data elements. The semi-automated processing of compensation claims produces a machine-generated Form D55 and Form 10, *Notification of Temporary Assignment*. The success of this in-house system is due in large part to the deliberate exclusion of programmed work rules necessary to implement complex CBA provisions, including those of the Unit 10 contract in particular.

PSD's new time and attendance system has effectively demonstrated that ACO review and certification of the Form D55 is unnecessary. However, ACOs may still review and sign D55s, provided that they remit the signed forms to the TAU clerks within 24 hours of the mechanical production of the form. The centralized, semi-automated production of such payroll forms has curbed salary overpayments, minimized manual computation errors, resulted in the timely payment of employee compensation within a 45-day period, and facilitated the alignment of budgets allotments with expenditures. That is, the centralized preparation of timesheets following a work shift has curtailed employee "banking" of overtime payroll claims for payment in a much later fiscal period. The centralized process also minimizes the possibility of ACOs queuing to review and sign timesheets on an overtime basis following conclusion of the shift, since they cannot abandon their security posts until relieved by the succeeding shift.

This T&A program represents work in progress for the Department in concert with the labor unions for seven CBAs. Based on the favorable results thus far, we will expand the project in CY 2006 to include PSD's Oahu correctional facilities, Statewide law enforcement programs, and central administration offices. The new T&A program is expected to provide sufficient internal controls to eliminate the problems cited in the audit report.

- **<u>Uninhibited sick leave continues to increase overtime costs</u>.** As we have repeatedly stated, any 24/7 operation responsible for the care and custody of individuals will experience employee attendance issues. While we do not dispute the Department's high use of sick leave, we disagree with the sweeping interpretation of the sick leave data. The draft audit report fails to recognize that inclusion of employees who are out on extended sick leave, due to legitimate illness or non-work-related injury, inflates the overall sick leave usage data.

PSD's *Patterns of Absences Due to Sickness (Patterns)* program for Bargaining Unit 1 (Blue Collar, Non-Supervisory) and Bargaining Unit 10 (Institutional, Health, and Correctional Workers) addresses those employees exhibiting patterns of absences due to sickness, as opposed to employees who exhibit significant cumulative absences due to sickness. The latter group is addressed through other means including, but not limited to, fitness for duty examinations, employment intention disclosure for possible job abandonment, and other types of investigation.

The Department proactively developed the *Patterns* program and took it to labor negotiations in 1993, resulting in the United Public Workers' support of PSD's implementation in 1995. Assisted by the Office of Collective Bargaining (OCB), PSD also negotiated and implemented a timely investigation process and standardized disciplinary action. Following the successful program implementation in 1996, the Department has assisted other State and county agencies in implementing similar programs by training managers and supervisors, advising administrators, and the like. Moreover, with the assistance of OCB, the Department also took the next step of negotiating a provision to address unauthorized leave, including standardized disciplinary action.

As previously noted, the Hawaii correctional institutions have successfully administered the *Patterns of Absences* program since 1996. Guidelines for the six-month historical review and analysis have not changed. Therefore, the Department cannot agree with the assertions that the deadline for completing this part of the process is "stringent," and that program quality is compromised by current deadlines. We were not previously aware of such staff concerns alleged in the audit report, and will follow up accordingly.

At the same time, however, the draft audit report recommends that the Department work with labor unions to implement a "more stringent policy" for determining unusual patterns of sick leave abuse subject to investigation. While we can submit such a proposal to the unions, there is no assurance of bilateral agreement.

- **Employee leave record process should be automated.** The DPS Form 7, *Leave Record,* is a Statewide document for which there is no mechanized processing. PSD's implementation of its very basic, semi-automated Time and Attendance system that began in Summer 2005 should: (a) decrease human error, (b) improve mathematical accuracy, (c) force timely submission of payroll claims for compensation other than base pay, and (d) promote more consistent application of collective bargaining agreements for seven bargaining units, including complex provisions governing "18 hours of work," "12 hours rest," "6 consecutive days," "10 hours pay," and "working condition differential," to name a few.

COLLECTION OF SALARY OVERPAYMENTS

- **Time-consuming process for overpayments prior to July 1, 2002.** As the audit report points out, amendments to §78-12, Hawaii Revised Statutes (HRS) facilitated the recovery of salary overpayments that were processed effective July 1, 2002. The statutory revision, combined with a focus on writing off uncollectible accounts as approved by the Department of the Attorney General (ATG), has allowed PSD to dramatically reduce its salary overpayment balance. However, overpayment cases that were processed prior to that date are still subject to hearings in contested cases before collection can begin. We disagree with the audit recommendation to contract the services of a collection agency on a contingent basis, given the aggressive and successful recovery efforts of the ATG in long-outstanding salary overpayment (excluding bankruptcy) cases that were previously written off. The ATG Civil Recoveries Division has been able to locate former employees and arrange for payment in full or a repayment plan, or take legal action against uncooperative debtors. Moreover, it is unlikely that the use of private collection services would expedite the long process of overpayment recovery.

- **Reduce backlog of pending audits.** The tedium of manually researching and photocopying historical payroll registers for all payroll adjustments made over 24 pay periods per year for each applicable year, illustrating the computation of pay adjustments, auditing actual payments against time and attendance records, comparing actual payments against corrected payments based on personnel transactions as well as time and attendance data, and auditing sign-in/sign-out logs requires uninterrupted periods of concentration. Accordingly, the auditing of salary overpayment records can be expedited only by assigning additional staff on an overtime basis to assist an Account Clerk who also has other duties.

  During the last six months of FY 2006, PSD settled three salary overpayment cases during the pre-hearing phase; conducted a hearing on a case that resulted in a repayment plan; conducted a pre-hearing meeting where the debtor expressed a desire to settle; and is prepared to conduct yet another pre-hearing. Progress in the last case has been delayed as a result of difficulties in serving notice to the debtor by registered mail, combined with the employee's absence from work allegedly due to illness.

  As of May 31, 2006, 69 overpayment cases remain active, representing a total overpayment of approximately $203,000. This compares favorably with the June 30, 2005 balance of 92 cases reflecting a total overpayment of $260,000. The Department has developed a schedule for resolving the 69 cases by June 2008. Execution of the plan is contingent on the availability of payroll and vouchering staff to perform the overtime work necessary to research historical manual payroll registers maintained under the State's payroll system. We have been unable to recruit other employees to assist, as very few possess an adequate working knowledge of the highly complex provisions of the Bargaining Unit 10 agreement.

- **Discrepancy between collective bargaining and statutory provisions for scheduling hearing dates.** The Department shall endeavor to take a proposal to negotiations with the union, for the purpose of eliminating the conflict between the statutory 15-day window provided by HRS §78-12 for the union to inform PSD of a salary overpayment dispute, and the 30-day period stipulated in the Unit 10 agreement. As previously noted, the outcome of labor negotiations is neither predictable nor completely under the employer's control.

ADHERENCE TO OPERATIONAL INTERNAL CONTROLS

- **Compliance with Hawaii Public Procurement Code on small purchases.** We have issued a Department-wide reminder on the need for compliance with the small purchase requirements of PSD procedures, HRS §103D-305, and HAR Chapter 3-122, Subchapter 8. Compliance will be monitored by centralized preaudit review of delegated purchases.

- **Accuracy of capital assets inventory.** The DAGS-Public Works Division makes expenditures for capital assets involving buildings and improvements on behalf of PSD, and is therefore the custodian of such information. PSD has been working with DAGS-Public Works staff to ensure the timely transmittal to PSD of all data that would identify capital asset valuations including work in progress. Further, PSD will develop a crosswalk between such capital assets and information custodians to facilitate review of the capital assets inventory. Finally, PSD will develop a training module on the recordation of capital assets for staff at the correctional facilities that are tasked with managing the inventory of buildings and improvements. Training of all appropriate staff shall be completed in FY 2007.

OTHER COMMENTS

Finally, we noted that page 1 of the draft audit report contains a parenthetical citation that should be corrected to reflect jails (not prisons) as being synonymous with "community correctional centers."

Should there be any questions on this matter, please contact me at 587-1350. Again, thank you for the opportunity to comment.

Sincerely,

Claire Y. Nakamura

CLAIRE Y. NAKAMURA
Interim Director

Attachments:

Exhibit A - Payroll and Ordinary Overtime Costs by Facility, Department of Public Safety, July 7, 2006
Exhibit B - Guidelines *for the Development of a Security Program,* American Correctional Association

EXHIBIT A

Three-year Trend of Total Overtime Costs by Facility									
Information Prepared for: Leg Auditor Draft Financial Audit of PSD (Copy 6)									
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	FY 2003			FY 2004			FY 2005		
Facility	Ord OT	Hol OT	Sub Ttl	Ord OT	Hol OT	Sub Ttl	Ord OT	Hol OT	Sub Ttl
HCF	1,759,897	410,394	2,170,291	1,877,853	388,913	2,266,766	1,824,186	430,415	2,254,601
KCF	192,129	48,522	240,651	165,249	43,102	208,351	194,384	49,019	243,403
WCF	70,933	113,342	184,275	65,527	97,274	162,800	191,820	118,659	310,479
HCCC	729,773	149,037	878,810	551,356	131,439	682,795	643,578	166,314	809,891
MCCC	376,628	159,946	536,574	430,898	141,986	572,884	777,290	157,382	934,672
OCCC	1,730,643	616,378	2,347,021	1,653,187	513,107	2,166,294	1,691,890	538,978	2,230,867
KCCC	208,004	45,819	253,823	109,129	37,049	146,179	103,461	47,283	150,744
WCCC	587,032	114,938	701,970	562,991	103,731	666,721	633,257	95,894	729,150
Total	5,655,039	1,658,376	7,313,415	5,416,190	1,456,601	6,872,791	6,059,866	1,603,943	7,663,809

Three-year Trend of Total Overtime Costs by Facility									
Information Prepared for: Leg Auditor Draft Financial Audit of PSD (Copy 6)									
Payroll and Ordinary Overtime by Facility (amounts in thousands)									
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	FY 2003			FY 2004			FY 2005		
Facility	Ord OT	Ttl Payroll	OT as %	Ord OT	Ttl Payroll	OT as %	Ord OT	Ttl Payroll	OT as %
HCF	1,760	16,191	11%	1,878	17,000	11%	1,824	16,766	11%
KCF	192	2,811	7%	165	2,830	6%	194	2,961	7%
WCF	71	3,460	2%	66	3,617	2%	192	3,813	5%
HCCC	730	5,355	14%	551	5,476	10%	644	5,747	11%
MCCC	377	5,980	6%	431	6,135	7%	777	6,106	13%
OCCC	1,731	17,511	10%	1,653	19,035	9%	1,692	19,002	9%
KCCC	208	2,164	10%	109	2,329	5%	103	2,385	4%
WCCC	587	4,314	14%	563	4,576	12%	633	4,468	14%
Total	5,656	57,786	10%	5,416	60,998	9%	6,059	61,248	10%
Avg %			9%			8%			9%

Shift Relief Factor

Post coverage:

7-day post, coverage provided for 365 days per year [4]	(52 weeks x 7 days)
6-day post, coverage provided for 312 days per year	(52 x 6)
5-day post, coverage provided for 260 days per year	(52 x 5)
4-day post, coverage provided for 208 days per year	(52 x 4)
3-day post, coverage provided for 156 days per year	(52 x 3)
2-day post, coverage provided for 104 days per year	(52 x 2)
1-day post, coverage provided for 52 days per year	(52 x 1)

Using this information, the relief factor for an agency or an individual institution can be calculated using the following process:

STEP		
1.	Number of days per year that the agency is closed, and no services offered	0 (a)
2.	Number of days per year post is active	365 (b)
3.	Number of regular days off per employee per week (usually 52 weeks/year x 2 days off per week)	104 (c)
4.	Number of vacation days off/employee/year	14.6 (d)
5.	Number of holidays off per employee per year	12 (e)
6.	Number of sick days off per employee per year (should be actual average for facility staff)	8 (f)
7.	Number of other days off per employee per year (including time off for injuries on the job, filling vacancies, military leave, funeral leave, unexcused absences, disciplinary time off, special assignments, and so forth)	0.6 (g)
8.	Number of training days per employee per year	8.3 (h)
9.	Total number of days off per employee per year [(c) + (d) + (e) + (f) + (g) + (h)] = (i)	147.5 (i)
10.	Number actual work days/employee/year[365-(i)]	217.5 (j)
11.	Lunches and breaks (j) x 0.0625 downtime factor	0 (k)
12.	Actual work days per employee = (j) - (k)	217.5 (l)
13.	Shift relief factor = (b) divided by (l)	1.68 - 7 day posts

[4] Base year: The base year is 365 days.

Source: James D. Henderson, W. Hardy Rauch, Richard L. Phillips; *Guidelines for the Development of a Security Program,* 2nd ed. (American Corrections Association, 1997), p. 37