Examination of the Treasury Function of the Department of Finance

Report No. 14-01
April 2015

Office of the County Auditor
County of Maui

Table of Contents

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Office of the County Auditor

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- Serve as a catalyst for positive change in County government through focused independent audits and examination.
- Advocate for the efficient and appropriate use of public resources.
- Increase government transparency for the purpose of bringing a higher quality of life to the citizens of Maui County.

The Office of the County Auditor consists of a County Auditor and necessary staff, and is responsible for promoting economy, efficiency, and improved service in the transaction of the public business in both the legislative and executive branches.

To ensure the objectivity of the Office of the County Auditor, the Revised Charter of the County of Maui (1983), as amended, requires that the County Auditor be independent of the Mayor and the County Council. As such, the County Auditor is appointed to a six-year term.

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Preface

This audit was initiated by the Office of the County Auditor pursuant to Section 3-9.1 of the Revised Charter of the County of Maui (1983), as amended, and the Plan of Audits for Fiscal Year 2014 issued by the Office of the County Auditor. This audit was selected because of the high dollar value of cash and investments under the Treasury's custody. Prior audit findings and turnover of Treasury staff were also considered. The audit was conducted from May 2014 through March 2015.

We wish to express our appreciation for the cooperation and assistance extended by the director and staff of the Department of Finance, as well as others who assisted us throughout the course of the audit.

Lance T. Taguchi
County Auditor

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EXECUTIVE SUMMARY

Examination of the Treasury Function of the Department of Finance

Report No. 14-01, April 2015

BACKGROUND

The Treasury Division of the Department of Finance of the County of Maui is responsible for tax and fee collections and banking and investments. This examination focuses on the Treasury's Banking and Investment section which is made up of an Accountant III and an Accountant II, both of who are supervised by the Treasurer. At the conclusion of Fiscal Year ending June 30, 2011 through Fiscal Year ending June 30, 2014, the Treasury's cash and investment balances on average exceeded $375 million. For the purpose of this report, the term "Treasury" is used to collectively refer to the Banking and Investment section and the Treasurer.

This report examines the effectiveness and adequacy of the financial management of the Treasury's cash and investments, and when appropriate, makes recommendations for improvement.

FINDINGS

Funds held in the County's Treasury lost out on over $21 million of interest earnings

Funds held by the Treasury were not sent to the Hawaii Employer Union Health Benefits Trust Fund ("EUTF") for nearly five years. While those funds sat in the County's Treasury earning less than one percent per year, the EUTF could have invested those funds on behalf of the County and earned over 10 percent per year.[1] Although those funds were eventually sent at the end of June 2014, the delay resulted in the County losing out on over $21 million in interest earnings. Those earnings could have paid down some of the County's $344 million unfunded liability for health benefits already earned by current and retired County employees.

We recommend funds appropriated to the County's Other Post-Employment Obligations Fund ("OPEB Fund") be sent to the EUTF at the beginning of the fiscal year in order to 1) take advantage of the potentially higher investment earnings of the EUTF; and 2) pay down the County's unfunded liabilities.

[1] 3-year average return of the EUTF from FY 2012 through FY 2014.

The Treasury holds questionable investments

Large portions[2] of the Treasury's investment portfolio were made up of securities which do not appear to be in compliance with State law and the County's own Investment Policy. Specifically, securities issued by the Federal Agricultural Mortgage Corporation and Federal Farm Credit Bank are not listed in Hawaii Revised Statues ("HRS") Section 46-50, the section of State law which restricts the investment of County money to 16 specific investment types.

We recommend the Treasury obtain clarification from legal counsel if continued investment in these securities is appropriate. We also recommend the Treasury create procedures to address situations where the descriptions of potential investments or issuers do not readily agree with the plain meaning of the law.

The County's investment portfolio was overconcentrated in a single business sector

On average 92 percent of the County's investment portfolio, or $250 million, was in the securities of a single business sector: the mortgage industry. Overconcentration in a single business sector could expose County funds to unnecessary risks.

We recommend the County's Investment Policy be reviewed to consider best practices issued by the Government Finance Officers Association. If best practices relating to overconcentration of investments in a single business sector are not feasible, management should incorporate that decision and any related rationale into the County's Investment Policy.

The delegation of multiple critical tasks to a single staff accountant exposes the Treasury to uncertainty; further review by management is warranted

We observed the delegation of multiple critical tasks to a single staff accountant in the Treasury. In addition to managing the over $375 million of the Treasury's cash and investments, the staff accountant is also responsible for the creation, maintenance, and day-to-day operation of very complex cash flow and investments spreadsheets which are used to ensure the County has enough cash on hand to fund continued operations.

We recommend management ensure adequate managerial oversight and support be provided to the Treasury given the sizable amounts of cash and investments in its custody.

[2] At the conclusion of FY 2013 and FY 2014, the Treasury held over $46 million and $47 million, respectively, of securities issued by the Federal Agricultural Mortgage Corporation. At the conclusion of FYs 2011, 2012, 2013, and 2014, the Treasury held over $8 million, $11 million, $68 million, and $38 million, respectively, of securities issued by the Federal Farm Credit Bank.

Certain cash handling activities of the Treasury lack adequate segregation

The cash handling tasks for the processing of Sewer Exception Payments lacks adequate segregation of duties. Specifically, the same staff accountant is assigned to generate customer bills, receive payment from customers, enter payment into the County's cashiering system, deposit payments with banks, enter payment into the County's accounting system, and reconcile accounting system cash receipt reports to validated bank deposit slips.

We recommend the cash handling activities of the Treasury be reviewed by management to ensure the written policies and procedures adequately address any potential weaknesses in internal controls. We also recommend management develop and implement appropriate mitigating controls to address the segregation of duties related to Sewer Exception Payments. Adequate internal controls are important because they: 1) protect employees against inappropriate accusation or charges of mishandling funds; and 2) minimize the potential for loss of revenue to the County.

Management's Comments

The management of the Department of Finance ("Management") disagreed with three of the audit findings and recommendations. Although Management expressed its concerns in written comments on our draft report, a careful review of those comments against the large body of evidence collected throughout the course of our audit allows us to conclude that substantive changes to our report are not warranted. Therefore, we stand by all our findings and recommendations.

A more detailed review of the Office of the County Auditor's response to Management's comments is found on page 15.

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Chapter 1
Introduction

This audit was initiated by the Office of the County Auditor pursuant to Section 3-9.1 of the Revised Charter of the County of Maui (1983), as amended, and the Plan of Audits for Fiscal Year ("FY") 2014 issued by the Office of the County Auditor on January 8, 2014. This audit was selected because of the high dollar value of cash and investments under the Treasury's custody. Prior audit findings and turnover of Treasury staff were also considered.

BACKGROUND

The Treasury Division of the Department of Finance of the County of Maui is made up of two sections: Real Property Tax Collections and Banking and Investments. The Banking and Investment section is made up of an Accountant III and an Accountant II, both of which are supervised by the Treasurer. The Treasurer serves as the chief financial advisor to the Director of Finance. The Treasurer, Accountant III, and Accountant II were appointed to their current positions on September 1, 2011; March 19, 2012; and January 10, 2011, respectively.

The Treasury as a whole is responsible for issuance of debt to fund capital improvements, collection of deposits made by the County, and investment of excess funds. Related to the investment of excess funds is the Treasury's objective to assure the availability of funds for authorized County expenditures through "prudent management of its cash and investments."

The ultimate authority to invest excess funds lies with the Director of Finance. The Treasurer has been delegated authority to operate the County's investment program. The County's investment program is guided by the County's Investment Policy and applies to all financial assets of the County. It is the authoritative County document that sets forth the scope, objectives, and investment types allowed. The County's Investment Policy is reviewed at least annually by the Investment Committee which is made up of the Director of Finance, Deputy Director of Finance, Managing Director, Budget Director, and Accounting System Administrator of the Department of Finance. The Investment Committee is tasked with reviewing policy matters relating to the County's Investment Policy, but does not get involved in the day-to-day activities of the Treasury.

At the conclusion of FY 2011 through FY 2014, the Treasury's cash and investment balances on average exceeded $375 million. Notable balances held by the Treasury and presented in the FY 2014 budget ordinance include: Affordable Housing Fund, $16 million; Open Space, Natural Resources, Cultural Resources, and Scenic Views Preservation Fund, $17 million; Emergency Fund, $24 million; Post-Employment Obligations Fund, $97 million.

AUDIT OBJECTIVES

The audit objectives were to:

1. Assess effectiveness and adequacy of the financial management of the Treasury's cash and investments; and

2. Make recommendations as appropriate.

AUDIT SCOPE AND METHODOLOGY

The scope of our audit covered the period from FY 2011 through FY 2014. For the purposes of comparison and quantification of recommendations, information from FY 2010 and FY 2014 was used when appropriate. This audit focuses on the cash and investments under the custody of the Treasury, and as such, does not include a review of the collection of real property tax or the issuance of debt.

The evidence gathering and analysis techniques used to meet our audit objectives included, but were not limited to:

Interviews
- Treasury personnel, and when appropriate, those tasked with management of the Department of Finance; and
- Officials of the State of Hawaii, personnel from other counties in the State of Hawaii, and accounting and finance industry professionals with direct knowledge of the EUTF and the topic of unfunded liabilities.

Document review
- Hawaii Revised Statues; the Revised Charter of the County of Maui (1984), as revised; the Maui County Code; and resolutions adopted by the Maui County Council;
- County of Maui Fiscal Year Budget documents, including meeting minutes and presentation materials;
- Legal opinions issued by the Department of the Corporation Counsel;

- Legislation, committee reports, and other documents reviewed and approved by the Legislature of the State of Hawaii;
- Acts signed into law by the Governor of the State of Hawaii;
- Presentations made to Committees of the Legislature of the State of Hawaii;
- Reports issued by the EUTF and their consultants;
- Best practices and guidance issued by the Government Finance Officers Association ("GFOA");
- Reports issued by municipal bond rating agencies;
- County of Maui Investment Policy and its accompanying Investment Procedures document;
- Investment reports prepared by the Treasury and submitted to the Maui County Council;
- System-generated investment reports provided by the Treasury;
- County contracts related to the Treasury function;
- Departmental communications, reports, and other related documents; and
- Audit reports.

Analysis

- Investment performance of funds held by the Treasury versus the investment performance of the EUTF;
- Comparison of Treasury investment performance to various benchmarks and alternatives;
- Review of the Treasury's portfolio by investment type and business sector;
- Review of the Treasury's cash and investment holdings against applicable laws and best practices;
- Comparison of Maui County to other counties in the State of Hawaii as it relates to sending pre-payments to the EUTF; and
- Comparison of the County's Investment Policy to best practices issued by the GFOA.

Our audit was performed from May 2014 through March 2015 and was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Chapter 2
Audit Findings

FINDING 1

Funds held in the County's Treasury lost out on over $21 million of interest earnings

Although sent to the EUTF at the end of FY 2014, appropriations made to the County's OPEB Fund from FY 2010 through FY 2014 were not sent to the EUTF for nearly five years; these appropriations were made for the purpose of making pre-payments[1] against the County's unfunded liability. Instead, these funds were held in the County's Treasury where they earned less than one percent per year. Had they been sent to the EUTF, those funds would have earned on average 10 percent per year.

It is our opinion, given the facts and circumstances surrounding this issue, it was fiscally prudent to send the funds held in the County's OPEB Fund to the EUTF at the start of FY 2013. This opinion is based on consideration of the combined effect of the following:

1. The County was committed to pre-pay its unfunded liability as shown by the continuous annual appropriation of taxpayer funds to the County's OPEB Fund;

2. The EUTF itself is established as a secured trust pursuant to HRS Section 87A-30;

3. As reported on the audited financial statements of the EUTF since FY 2008, pre-payments received from the counties were held in a separate agency account. Accordingly, interest earned on those pre-payments was allocated to each county's balance;

4. The EUTF had the potential to earn higher returns than the Treasury given its greater flexibility in making investments and the retention of professional investment managers;

5. The enactment of Act 304 (2012) aligned the State's legislative intent with the EUTF's ongoing practice of recording pre-payments and earnings separately by authorizing the EUTF to establish separate trusts; and

[1] In the context of this audit, the term "pre-payment" is used for simplicity to describe payments against the County's actuarially accrued unfunded liability for post-employment healthcare benefits already earned by current and retired County employees. Pre-payments do not include the normal costs of current year health benefits.

6. The actions of the City & County of Honolulu, County of Hawaii, and County of Kauai in their sending sizable pre-payments to the EUTF between FY 2010 and FY 2013.

By our calculations using the actual investment returns of both the Treasury and the EUTF[2], had funds held in the County's OPEB Fund been sent annually to the EUTF at the beginning of FY 2013, the County could have earned over $21 million more than what was actually earned by the Treasury during that same time frame. These earnings could have paid down the County's $344 million unfunded liability for health benefits already earned by current and retired County employees.

To illustrate the impact timing can have on pre-payments sent to the EUTF, a presentation of the amounts of additional interest earnings[3] at various points in time is presented below in Exhibit 2-1.

Exhibit 2-1
Additional interest earnings at various points in time

Had funds been sent to the EUTF annually at the beginning of Fiscal Year…	…then the additional interest earned on those funds as of June 30, 2014 could have been
2011	$25,992,499
2012	$25,675,704
2013	**$21,620,727**
2014	$13,277,545

Source: Office of the County Auditor

Some may feel that FY 2011 and its related $26 million calculation is reasonable, while others may feel FY 2014 and its related $13 million calculation, is appropriate. We believe FY 2013 and its related $21 million is the most reasonable and appropriate of these choices.

We recommend funds appropriated to the County's OPEB Fund be sent to the EUTF at the beginning of the fiscal year in order to 1) take advantage of the potentially higher investment earnings of the EUTF; and 2) pay down the County's $344 million unfunded

[2] Treasury returns: 0.25% for FY 2013 and 0.52% for FY 2014. EUTF returns: 9.40% for FY 2013 and 15.30% for FY 2014.

[3] The difference between what was actually earned on OPEB Funds held by the Treasury and what could have been earned on those funds had they been sent to the EUTF as intended.

liabilities for health benefits already earned by current and retired County employees. If our recommendation is applied going forward, a $13 million appropriation to the County's OPEB Fund sent to the EUTF at the beginning of the fiscal year could earn up to $1.2 million[4] more than if those same funds were held by the Treasury until the end of the fiscal year.

Additional background

Unfunded liabilities and the origin of the County's OPEB Fund, in general

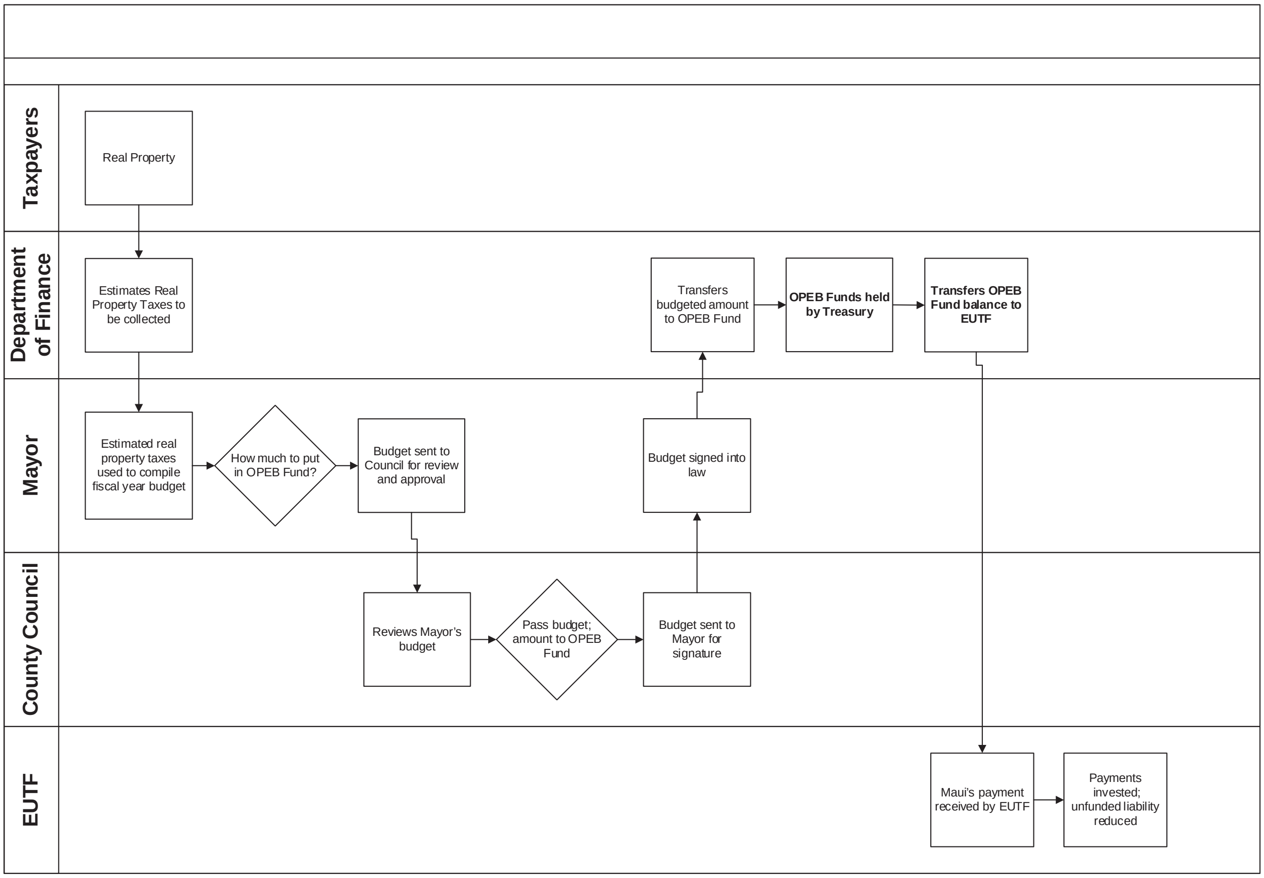
An unfunded liability exists when the amount of benefits earned and owed to employees exceeds the amount the employer currently has available to pay for those benefits. The goal is to be fully funded. As presented during the FY 2015 budget session, the County's unfunded liabilities for health benefits are approximately $344 million. And, while not within the scope of this audit, we note the County's unfunded liabilities for pension benefits is an additional $340 million.

In an effort to get ahead of rapidly increasing unfunded liabilities, the County created an OPEB Fund during its FY 2008 budget session. According to Maui County Code Section 3.97.020, the purpose of the OPEB Fund is to fund the County's unfunded liabilities for the cost of retirement benefits of both the Employee Retirement System (the State agency which provides employee/retiree pension benefits) and the EUTF (the State agency which provides employee/retiree health benefits). However, at the present time, only the EUTF accepts pre-payments from the State and counties ("Employers") for the purpose of paying down unfunded liabilities.

Each year beginning with FY 2008, the County's budget ordinances (signed into law by the Mayor), contained appropriations to the County's OPEB Fund. In the past, these funds were sent to the EUTF on an annual basis. However, more recent annual appropriations to the County's OPEB Fund were not sent to the EUTF for nearly five years. Exhibit 2-2 shows the general process of how taxes flow to the County's OPEB Fund and then to the EUTF.

[4] 1 year simple interest. Treasury 3-year average return, 0.40%. EUTF 3-year average return, 10%. $13 million pre-payment sent to the EUTF on July 1, 2014 compared to holding funds in the Treasury until June 30, 2015.

Exhibit 2-2
Overview of how funds flow to the EUTF



Source: Office of the County Auditor

The EUTF

The EUTF is the State agency that provides eligible State and County employees and retirees with health and life insurance benefits. The EUTF is administered by a board of ten noncompensated trustees who are appointed by the Governor. Pursuant to HRS Section 87A-5, the board is composed of five trustees who represent employee-beneficiaries and five trustees who represent public Employers. Meetings of the EUTF are subject to open meeting laws prescribed in HRS Chapter 92, and as such its meetings and any accompanying minutes are open to the public.

Beginning FY 2008, the EUTF has received and held pre-payments from Employers for the purpose of funding their unfunded liabilities. Pre-payments received from Employers where held in a separate agency account and any interest earned on those pre-payments were allocated to each respective Employer accordingly. The cumulative balances (pre-payments and earned interest) of each Employer were reported separately on the audited financial statements of the EUTF since FY 2008.

The EUTF has greater flexibility to make investments than the County, who is restricted primarily to low-yielding securities issued by the United States government, certificates of deposits, and approved Government Sponsored Enterprise. In addition to this flexibility, beginning FY 2012 the EUTF retained the services of a professional investment consulting firm. Guided by the Statement of Investment Policy and Guidelines adopted by the EUTF's Investment Committee, the investment consulting firm is tasked with managing the investment of the pre-payments received from Employers. Although the investment consulting firm was tasked with achieving a target investment return of 7 percent per year, they were able to achieve actual investment returns during FY 2012, FY 2013, and FY 2014, of 5.9 percent, 9.4 percent, and 15.3 percent per year, respectively. During those same periods, the Treasury's average investment return was approximately 0.40 percent.

As impressive as the investment returns are, if pre-payments are not sent to the EUTF, the Employer loses out; such was the case for Maui County.

Actions of the State Legislature and the Governor

Act 304 (2012); A Trust within a Trust

On November 23, 2011, the EUTF informed Employers that their pre-funding contributions do not meet the parameters of Government Accounting Standards Board ("GASB") Statement No. 43, *Financial reporting for Postemployment Benefit Plans Other Than Pension Plans*. This accounting standard requires that, in order for pre-payments to be reported as OPEB contributions on those Employers' financial statements, funds should be held in an irrevocable trust separate from other EUTF funds. Compliance with this accounting standard essentially required the State to establish trusts within a trust.

In order to comply with GASB 43 and allow for Employers to correctly report pre-payments as OPEB contributions on their financial statements, the Legislature passed HB2491 HD1, SD1, to authorize the EUTF to establish a separate irrevocable trust for pre-payments. HB2491 HD1, SD1, was signed into law by the Governor on July 9, 2012. The enactment of Act 304 (2012) formalized the mechanism of recording pre-payments and earnings by Employers, a practice of the EUTF since 2008.

The GASB 43 compliant trusts were approved by EUTF Trustees, effective June 30, 2013.

Act 268 (2013); Unfunded Liability Task Force and Mandated Pre-payments

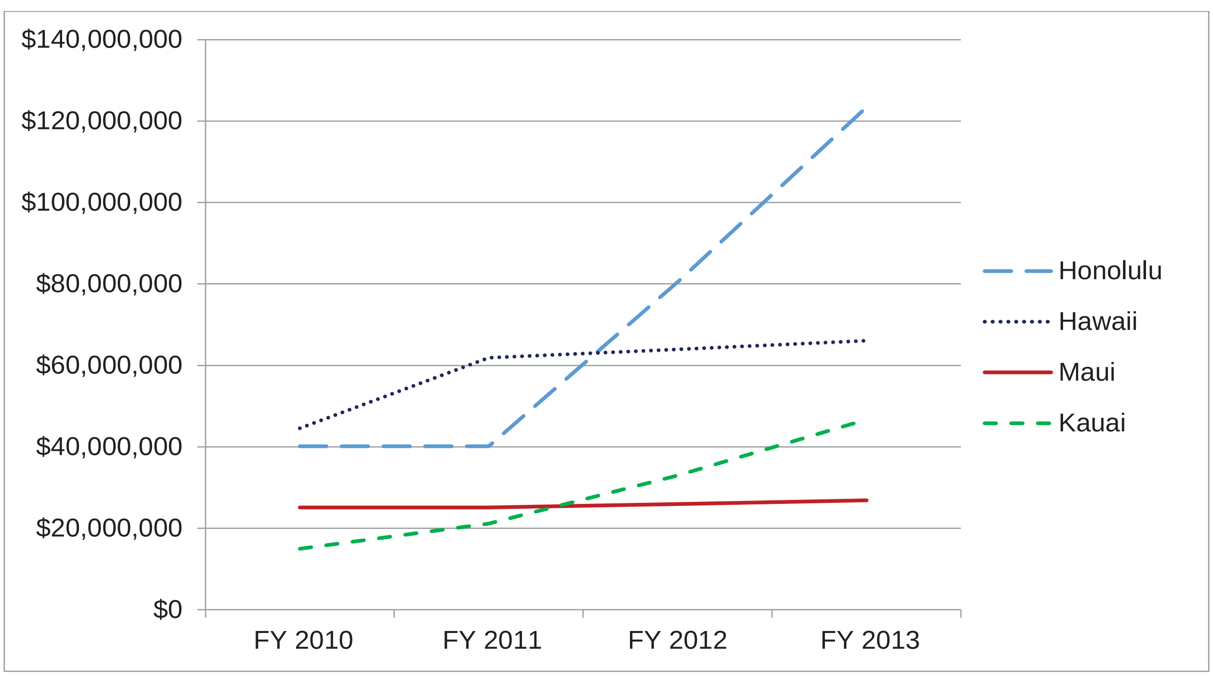
Amid growing concerns of the escalating healthcare costs and related unfunded liabilities, HB546, HD2, SD2, CD1, was passed by the Legislature for the purpose of establishing an unfunded liability task force to examine the larger topic of unfunded liabilities and the EUTF. The Bill also added clarifying language to HRS Section 87A-42, for the separate trusts, even though authority to establish the separate irrevocable trusts within the EUTF was already authorized through the enactment of Act 304 (2012) in the previous year. More importantly, the Bill mandates that pre-payments of a portion of each Employer's unfunded liability be sent to the EUTF on an annual basis. Additionally, if the County does not make the required pre-payment to the EUTF, the State is authorized to deduct the shortfall from the County's portion of the Transient Accommodations Tax. HB546, HD2, SD2, CD1, was signed into law by the Governor on July 3, 2013.

Actions of other Counties

The actions of the other Counties differ from those of the County of Maui because their pre-payments were actually sent to the EUTF. Exhibit 2-3 shows the increase in pre-payments from the Counties which are held by the EUTF.

Exhibit 2-3

Cumulative pre-payments held by the EUTF



Source: Office of the County Auditor data from reports of the EUTF

As shown in Exhibit 2-3, the cumulative pre-payments of the City & County of Honolulu, County of Hawaii, and County of Kauai increased substantially between FY 2010 and FY 2013. The increases were attributable to pre-payments being sent to the EUTF and likewise being exposed to the higher investment returns of the EUTF. And, while approximately $60 million was appropriated to its OPEB Fund during that same time frame, because those funds were never sent to the EUTF the County of Maui missed out on the higher investment returns enjoyed by the City & County of Honolulu, County of Hawaii, and County of Kauai.

FINDING 2

The Treasury holds questionable investments

The Treasury holds securities issued by the Federal Agricultural Mortgage Corporation and Federal Farm Credit Bank. Specifically, at the conclusion of FY 2013 and FY 2014, the Treasury held approximately $46 million and $47 million, respectively, of securities issued by the Federal Agricultural Mortgage Corporation. Additionally, at the conclusion of FY 2011, FY 2012, FY 2013, and FY 2014, the Treasury held over $8 million, $11 million, $68 million, and $38 million, respectively, of securities issued by the Federal Farm Credit Bank. During the course of the audit, the Treasury was unable to readily produce documentation confirming that the County is authorized to invest in these specific securities. Additionally, the Treasury does not have a written process to review the appropriateness of investments prior to their purchase.

HRS Section 46-50 and the County's Investment Policy lists the types of short term investments that may be made by the County. Securities issued by the Federal Agricultural Mortgage Corporation and the Federal Farm Credit Bank are not specifically listed in HRS Section 46-50 or the County's Investment Policy.

We recommend the Treasury obtain clarification from legal counsel that investments made in the Federal Agricultural Mortgage Corporation and Federal Farm Credit Corporation are authorized by HRS Section 46-50. Additionally, the Treasury should create procedures to address situations where the descriptions of potential investments or issuers do not readily agree with the plain meaning of the law. This type of procedure should be in place and followed prior to the purchase of questionable securities.

FINDING 3

The County's investment portfolio was overconcentrated in a single business sector

At the conclusion of FY 2012, FY 2013, and FY 2014, on average over 92 percent of the County's investment portfolio, or $250 million, was in the securities of a single business sector: the mortgage industry. While not prohibited by law or the County's Investment Policy, overconcentration in a single business sector could expose taxpayer funds to increased and unnecessary risks.

We recommend the County's Investment Policy be reviewed to consider portfolio diversification best practices issued by the GFOA. If best practices relating to overconcentration of investments in a single business sector are not feasible, management should incorporate that decision and any related rationale into the County's Investment Policy.

FINDING 4

The delegation of multiple critical tasks to a single staff accountant exposes the Treasury to uncertainty; further review by management is warranted

During the course of our audit, we observed multiple critical tasks are assigned to an Accountant III. In addition to being responsible for the management of over $375[5] million of the County's cash and investments, the Accountant III is also responsible for the creation, maintenance, and day-to-day operation of very complex cash flow and investment spreadsheets which are used to ensure that the County has enough cash on hand to fund continued operations.

Since 2003 when this particular position was developed and approved, the Treasury's investment activity has increased by over 200 percent, from a balance of $95 million in FY 2003 to an average of $288 million invested between FY 2011 and FY 2014. While this audit was not specifically focused on personnel management practices, the sheer magnitude of the tasks assigned to this Accountant III warrants further review.

We recommend management ensure that adequate oversight and support is provided to the Treasury to avoid disruptions to its operations.

[5] The average balance of equity pooled in cash and investments from FY 2011 through FY 2014, as presented in the Comprehensive Annual Financial Report of the County of Maui.

FINDING 5

Certain cash handling activities of the Treasury lack adequate segregation

During the course of our audit, we also observed a lack of segregation of duties over cash receipts for Sewer Exception Payments ("SEP"). Specifically, the Accountant II is assigned to generate customer bills, receive payment from customers, enter payment into the County's cashiering system, deposit payments with banks, enter payment into the County's accounting system, and reconcile accounting system cash receipt reports to validated bank deposit slips. The Treasury's written policy over cash receipts has not been updated since December 2006.

SEPs are payments in which standard sewer billing calculations are not used because the water service or sewer system of the customer is not typical. Examples of entities that may have SEP billing include hotels and condominiums, resort areas, schools, and businesses. Currently approximately 90 SEP accounts are billed every other month, with payments ranging anywhere from $9 to $140,000.

The processing of SEPs were performed by the Treasury prior to the tenure of any of the current Treasury staff, so it is unknown what exactly caused the process to be assigned to a sole staff accountant in the Treasury. However, there should be segregation of duties to ensure that an employee who generates bills and receives cash from customers is not the same employee who enters those transactions into the County's accounting system and reconciles banks deposits.

We recommend the cash handling activities of the Treasury be reviewed by management to ensure the written policies and procedures adequately address any potential weaknesses in internal controls. We also recommend management develop and implement appropriate mitigating controls to address the segregation of duties related to SEPs. Adequate internal controls are important because they: 1) protect employees against inappropriate accusation or charges of mishandling funds; and 2) minimize the potential for loss of revenue to the County.

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Response to Management's Comments

Management disagreed with three of the audit findings and recommendations. Management's comments characterized one of our findings as "reckless" and "irresponsible." This is unfortunate and we disagree with Management's characterization and conclusion.

We thoroughly analyzed and reviewed Management's claims against the body of evidence the Office of the County Auditor obtained during the course of the audit. (A listing of the evidence gathering techniques and analysis used to meet our audit objectives can be reviewed in the Scope and Methodology section of this report.)

After careful review, we concluded that substantive changes to our report are not warranted. It is our opinion that we obtained sufficient and appropriate evidence to provide a reasonable basis for our findings and recommendations. Therefore, we stand by all of our findings and recommendations.

Our response below addresses the areas we believe require clarification on some of Management's comments. The absence of a response from the Office of the County Auditor to Management's remaining comments does not reflect an opinion by the Office of the County Auditor towards the merits or accuracy of Management's comments.

Relating to Finding 1

Fiscal Responsibility (The EUTF was not deemed insolvent)

In its comments, Management included the following excerpt from the Introductory Section of the County's Comprehensive Annual Financial Report for FY 2010: "certain information became available from AON Consulting that concluded that *the State of Hawaii Employer Union Trust Fund (EUTF) was deemed insolvent* [emphasis added] for GAAP accounting purposes." This statement is not true and rooted within the misquote of a representative from AON Consulting, the EUTF's actuary.

According to EUTF meeting minutes, the representative from AON Consulting actually stated that if EUTF Trustees did not increase premiums, the probability of insolvency of the EUTF would increase substantially. While this statement must be taken quite seriously, it should not be interpreted to mean the EUTF was in fact insolvent. The consultant continued by saying that if the Trustees were to adopt premium increases, it would protect the EUTF from insolvency. As a result of receiving this guidance, the EUTF Trustees increased premiums between June 2010 and January 2011, addressing the consultant's concerns. It is important to note that the corrective actions of the EUTF Trustees took place in the first half of FY 2011, well over a year before our finding that the pre-payments should have been sent to the EUTF at the start of FY 2013.

Further, if the EUTF was indeed deemed insolvent for GAAP accounting purposes, the opinion letters of the two separate Certified Public Accounting firms that audited the financial statements of the EUTF between FY 2010 and FY 2013 would have contained some mention of insolvency. They did not.

Given the corrective actions of the EUTF Trustees and the clean opinions issued by two separate Certified Public Accounting firms, we feel that Management's concern is a non-issue to our finding.

Interest Earnings Loss of $21M

Management claims that this figure is not substantiated and fails to consider other necessary adjustments. Management further claims that the Office of the County Auditor should consult or obtain further clarification from the EUTF or from independent investment advisors prior to making a statement of such magnitude, i.e. $21 million loss in interest earnings.

We are fully aware of the magnitude of this finding, which is why we exercised a high degree of due professional care and diligence in making this conclusion. Our calculations utilized established future value, investment return, and compounding interest principles. Further, the assumptions used for these calculations were determined through the review of the public reports and public meeting minutes of the EUTF and its consultants, and through interviews conducted with both public and private finance and accounting professionals with specific knowledge of the subject matter. To verify those assumptions and statements for reasonableness, the Office of the County Auditor recalculated key assumptions from alternative sources, ran parallel calculations using alternative methods, and obtained corroboration of verbal statements across multiple sources.

More significant than our finding that an opportunity of earning $21 million dollars was missed is the importance of our recommendation that funds appropriated to the County's OPEB Fund should be sent to the EUTF at the beginning of the fiscal year. This recommendation seeks to ensure that similar opportunities are not missed in the future. Unfortunately, Management's comments fail to address this important recommendation.

We stand by our finding and recommendation.

Investment Rate of Return Assumptions

Management questioned the rates of returns used in our report. Specifically, Management was unable to verify the EUTF's investment returns of 9.4 percent and 15.3 percent per year during FY 2013 and FY 2014, respectively. Similarly, Management refutes our use of the EUTF's 3-year average investment return of 10 percent per year and characterizes it as "optimistic."

Again, we charge that these investment return assumptions were obtained and reviewed for reasonableness in a similar manner discussed in the previous section. The table that Management included in its comments actually provides all the required information to recalculate the 15 percent investment return that the EUTF was able to experience during FY 2014 and the EUTF's 3-year average investment return of 10 percent per year.

Moreover, these investment returns were recently verified in a presentation made by the State Director of Budget and Finance at the Council's Budget and Finance Committee meeting of March 30, 2015. The EUTF is an agency under the State Department of Budget and Finance. In his presentation, the State Director specifically mentions the EUTF's 9.4 percent and 15.3 percent investment returns in FY 2013 and FY 2014, respectively, as well as the EUTF's 3-year average investment return of 10 percent per year.

Given the above, we stand by our investment return assumptions.

Relating to Finding 2

Questionable Investments

Management states that it disagrees with our finding that investments made in the Federal Agricultural Mortgage Corporation and the Federal Farm Credit Bank are not in compliance with HRS Section 46-50, the section of State law which governs investment of County money.

Unfortunately, we feel that Management may have missed our point: It is not clear whether the County's investment in these securities is in fact authorized by HRS Section 46-50 and as such, Management should obtain clarification from its legal counsel. While a degree of operational flexibility should be afforded to the department, the interpretation of law should be deferred to the chief legal advisors and legal representatives of the County of Maui, i.e., the Department of the Corporation Counsel.

Management also did not address our second point that procedures must be put into practice to prevent similar situations from happening in the future. Again, some flexibility may be beneficial to the Department of Finance, but the interpretation of law should be left to the Department of the Corporation Counsel.

Management also stated that its goal is to approach the State Legislature to amend HRS Section 46-50 to allow the Counties to invest in the above-mentioned securities. While this course of action would provide clarification on future investments, we note that it has no bearing on our finding that those current investments may not be in compliance with HRS Section 46-50.

We stand by our finding and recommendation.

Finally, we made technical, non-substantive revisions to our final report where appropriate for consistency and clarity. A copy of Management's comments is attached as Attachment 1.

Lance T. Taguchi
County Auditor

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Examination of the Treasury Function of the Department of Finance

Report No. 14-01, April 2015

The Office of the County Auditor is tasked with promoting economy, efficiency, and improved service in the transaction of public business in the legislative and executive branches of the County. Copies of this audit report can be obtained by contacting the Office of the County Auditor.