CAYMAN ISLANDS

REPORT OF

THE AUDITOR GENERAL

on the

Financial Statements of the

Government of the Cayman Islands

for the Six-Month Period Ended 30 June 2003

CAYMAN ISLANDS AUDIT OFFICE

Report of the Auditor General

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REPORT OF THE AUDITOR GENERAL

PART I

FINANCIAL STATEMENTS OF THE CAYMAN ISLANDS GOVERNMENT FOR THE PERIOD ENDED 30 JUNE 2003

STATUTORY BASIS FOR THE AUDITOR GENERAL'S REPORT

1.01 In accordance with the provisions of Section 43(1)(b) of the Public Finance and Audit Law (1997 Revision), this Report is submitted to the Presiding Officer of the Legislative Assembly of the Cayman Islands. This Report contains my examination and certification of the financial statements of the Government of the Cayman Islands for the six-month period ended 30 June 2003 as required by the Public Finance and Audit Law. As far as possible, this Report has been agreed with the appropriate Government authorities to be a fair summary of relevant facts. This Report, together with the financial statements of Government, is required to be considered by the Public Accounts Committee of the Legislative Assembly in accordance with Standing Orders. After deliberation by the Public Accounts Committee, this Report, the certified financial statements and the Committee's own report are required to be laid before the Legislative Assembly and submitted to the Secretary of State in accordance with Section 43(2) of the Public Finance and Audit Law (1997 Revision).

Financial Management Initiative; Change in the Format and Timing of the Accounts

1.02 The Financial Management Initiative in conjunction with the reporting requirements of the new Public Management and Finance Law (2003 Revision) has mandated a major change in the accounting procedures and accounting systems of Government. The six-month period to 30 June 2003 has seen a transition from accounting for Government as a single organisation to accounting for Ministries and Portfolios as separate entities (multiple organisations). This change also entailed setting up of the accounting system to prepare for accrual accounting and output-based reporting.

1.03 The Portfolio of Finance and Economics has been the driving force in this massive changeover exercise and have faced numerous obstacles, challenges and delays in the process, not the least of which was a steep learning curve. I commend the Accountant General and her staff for the tremendous effort put in to prepare the 2003 half-year financial statements.

1.04 In regards to the timing of the accounts, the first draft financial statements for the six-month period ended 30 June 2003 was submitted to the Audit Office on 4 November 2003. These financial statements were incomplete due to some schedules not being included and the accounts receivables and accounts payables not reversed out for cash purposes.

1.05 As much as we were able to, we worked with the first draft hoping to achieve the statutory deadline of 31 January 2004. However, the second draft was not received until March 2004, almost four and a half months later. This draft also required substantial and material changes to it. For example, there was the omission of the Statement of Assets and Liabilities, incorrect presentation in overseas medical provision of $13.5 million and the inclusion of the incorrect budget figures.

1.06 On 5 April 2004 we submitted these further changes to the Treasury Department and on 11 June we received the third draft which was supposed to address the numerous significant changes we highlighted. We received a fourth draft on 28 July and eventually were able to hold a closing meeting with Treasury on 9 August to discuss our approach to having the accounts certified. On 11th October 2004 we received the last set of amended pages from Treasury and we were able to certify immediately afterwards.

1.07 These delays had a serious adverse effect on our time budget and staff productivity and as at the end of May 2004 we spent approximately 750 hours (costing $50,000) in additional audit time. In the future, with tighter statutory deadlines, a similar situation will create some difficulty in our Office's ability to achieve our output requirements and adherence to Public Management & Finance Law (2003 Revision) obligations. Additionally, we will have to charge full recovery cost which will be passed on to Treasury when we spend unanticipated additional time in auditing various incomplete or under prepared draft accounts or sections thereof.

1.08 In a recent meeting with the Public Accounts Committee (PAC), the delay in finalizing the accounts was a point of great concern for the Chairman. PAC has challenged us to certify the accounts within a more reasonable timeframe (or where it is mandated by Law) in order for their members to be in a position to deliberate on accounts in a timely manner. However, I must point out the obvious - my Office cannot certify financial statements until a proper statement has been presented for audit.

Year-End Change and 1st Six-Month Fiscal Period

1.09 The Public Management and Finance Law, 2001 (PMFL), S84(3)(b) states "*the financial year immediately prior to the year ending 30 June 2004 shall be for a period of six months ending 30 June 2003*". This was necessary to initiate the move to the 30 June year-end. The Government's financial performance and position under the modified cash basis is therefore being reported for only six months to 30 June 2003 (also referred to as 2003(H)).

1.10 It should be noted that the 2002 (12-month) information provided for Receipts and Expenditures would therefore not be comparable in absolute terms with current period (6-month) information.

New Financial Statements Format

1.11 The financial statements have taken on a new streamlined look in accordance with the PMFL. Much of the detailed or repeated information has been removed. Statements of Responsibility and Accounting Policies have been introduced as well as a financial statement note showing Operating Expenditure by Function in accordance with Organisation for Economic Co-operation & Development (OECD) guidelines.

1.12 Loan proceeds, which was previously shown in the Statement of Receipts and Payments is also now shown as a Balance Sheet Inflow. Borrowings of $136.8 million from the Note Issue in April 2003 are further discussed at **paragraph 1.96**. On the Statement of Operating Receipts and Payments, Investment Income is now shown as a separate category under Operating Receipts. Operating Expenditure, which was previously disclosed by the various *Heads* (Police, Prison etc) is now reported by the *expenditure category* (or sub head categories – personal emoluments etc., which was previously shown as a summary appendix). In 2003(H) there has also been the introduction of three new categories of expenditure as follows:

- Outputs Purchased from Statutory Authorities, Government Companies & Non Governmental Suppliers;
- Transfer Payments; and
- Other Executive Expenses.

1.13 In 2002 (and prior), these were amalgamated under the single heading of Grants, Contributions and Subsidies which was $55 million (22%) out of $252 million of total recurrent expenditure. These new categories provide much clearer distinction and more precise information for users of the accounts.

1.14 *Outputs Purchased* refers to payments to a statutory authority, government company or non-governmental output supplier to provide a specific service to the Governor in Cabinet.

1.15 *Transfer Payments* are benefits or similar payments for which no output or consideration are provided and include such items as financial assistance and ex-gratia benefit payments to seamen and ex-servicemen.

1.16 *Other Executive Expenses* are expenses incurred by the core government other than entity expenses. These include expenses incurred by the Governor in Cabinet, in purchasing outputs from ministries, portfolios, the Office of the Complaints Commissioner, the Audit Office and other suppliers but does not include expenses incurred by the core government as trustee for another person.

1.17 *Statutory Expenditure* relating to pension expenses ($5.9 million) is still on the face of the Statement of Operating Receipts and Payments as is the interest portion ($2.5 million) of Borrowings (Public Debt and Self Financing Loans).

1.18 The capital element of Borrowing i.e. receipts ($136.8 million) and repayments ($120.6 million) is shown on the Statement of Balance Sheet Receipts and Payments. The Borrowing Inflow of $136.8 million was due to the Government's Bond Issue in April 2003 and is further discussed at **Paragraph 1.96** of this report. Capital acquisitions ($3.8 million) and equity injections ($5.9 million) are now shown as outflows under Asset Activity also on this Statement.

AUDIT OPINION ON THE COMBINED FINANCIAL STATEMENTS

1.19 Based on section 42 of the Public Finance and Audit Law, the Accountant General is to transmit to the Auditor General the following:

- A statement of assets and liabilities of the Government;
- An annual statement of the receipts and payments.

1.20 My audit opinion, on the Statement of Assets and Liabilities, Statement of Operating Receipts and Payments and the Statements of Operating and Balance Sheet Receipts and Payments of the Cayman Islands Government for the six-month period ended 30 June 2003 is reproduced at **Appendix A** of this report. As described in the following paragraphs, I have qualified my opinion on the 2003(H) combined financial statements.

The qualification issues comprise:

I. Statement of Operating Receipts and Payments

- **Unappropriated Expenditure:** Excess expenditure totalled $18,016,195 for various output groups (see **paragraph 1.54**). Of this amount, $13,500,000 relates to the overseas medical provision (see **paragraph 1.82**).
- **Deferred Expenditure:** Deferred and unpaid expenditures of approximately $4,112,013 for recurrent items and $5,579,138 for the statutory Past Service Pensions Liability (PSPL) have not been reflected in either the Statement of Operating Receipts and Payments or the Combined Statement of Assets and Liabilities (see **paragraph 1.131**).

II. Combined Statement of Assets and Liabilities

- **Overseas medical advances:** As in past years, I disagree with the accounting policy for overseas medical advances. Payments totalling $19,281,659 for overseas medical treatment have not been recognised as expenditure. These payments have been classified as recoverable advances and have been included as assets in the Combined Statement of Assets and Liabilities. Amounts accumulated as advances are brought to account infrequently, and are often accompanied by conversion of individual debts to long term loans. However, very few of these "loans" are ever paid off and the vast majority are more than ten years old. The effect of this accounting policy, which has been followed for many years, is to defer recognition of expenditure to future periods. In my opinion, overseas medical advances should be expensed and brought to account in the year of payment. It was my Office's opinion in previous years that most, if not all of these advances will prove to be irrecoverable. After reviewing the situation for 2003(H), I have come to the same conclusion. In 2003(H), the government has undertaken to make a provision for the write off of $13,500,000 of these medical advances leaving a residual balance of $5,781,659. While the write off of a majority of the account is laudable, I believe that the remaining balance is mostly irrecoverable and I have qualified accordingly.

- **Immigration deposit liability:** We have not been able to verify the accuracy of the immigration deposit liability balance of $6,389,343. In 1991 and 1995 an amount of $2,210,362 was transferred from the immigration repatriation deposit account to the General Revenue of Government. The authority cited for these transactions was section 24(4) of the Public Finance and Audit Law (1997 Revision), which permits deposits unclaimed for five years to be treated as revenue. I have concluded that the transfer of these funds to Government revenue was fundamentally incorrect and that the deposit liability is understated, but I have not been able to quantify the extent of the understatement and its impact on the Combined Statement of Assets and Liabilities. An indicative range of the magnitude of understated liabilities is $1,200,000 to $1,700,000. I have also attempted to corroborate the immigration deposit balance of $6,389,343 in the deposit liability account but have been unsuccessful due to the lack of supporting evidence and reconciliations. The Immigration Department however, is in the process of validating this figure. Without the validation information from Immigration, I am not able to conclude on the accuracy of the immigration deposit liability balance of $6,389,343.

III. Matter of Emphasis

Affordable Housing: I have also included in my audit opinion, a matter of emphasis paragraph relating to $4,538,959 shown as an advance recoverable regarding the Affordable Housing project (see **paragraph 1.85**). This is covered more fully in a separate report to be issued in due course to the Legislative Assembly.

FINANCIAL HIGHLIGHTS FOR FISCAL 2003(H)

COMBINED FUNDS

1.21 The change in the reporting structure of the government's accounts has resulted in financial data being analysed into more useful information (summarised in **Table 1**).

1.22 With only half-year data and the presentation of financial information in 2003(H), it may not be as straightforward to compare to the previous year (12 months to December 2002) to determine the financial performance of the government.

1.23 Receipts and payments continue to be organised into nine separate Funds, namely:

Operating Funds	*Reserve Funds*
General Revenue	General Reserve
Capital Development	Housing Guarantee Reserve
Infrastructure Development	Student Loan Reserve
Environmental Protection	National Disaster
Roads Development	

1.24 For 2003(H), total recurrent receipts were $185.6 million, funds receipts were $3.5 million and total operating expenditure was $150 million. A major part of government's revenue (financial institutions' license fees) is collected in the early part of the calendar year. This coupled with only a half-year's expenses results in a desirable position of an operating surplus of $39.1 million. In 2002 there was a much smaller surplus of $3.5 million.

1.25 Certain expenditures such as capital acquisitions of $3.8 million, capital development of $6.7 million and equity injection of $5.9 million have now been reclassified as Balance Sheet Outflows. If we consider these amounts, deferred expenditure of $4.1 million and the unpaid $5.6 million of Past Service Pensions Liability (PSPL) for the period, altogether totalling $26.1 million in terms of how they were reflected in 2002 then the surplus for 2003(H) would 'decrease' to $13.0 million. Again, this surplus may seem high compared to 2002 due to the greater influx of revenues in the first half of the 2003 calendar year (i.e. January to June).

1.26 The closing cash balance of $60 million should be understood from the point of view that $20 million is the remnant of the bond issue proceeds (debt) and $15 million relates to deposits (accounts payable) held on behalf of third parties (Immigration, Customs, etc). This would effectively 'decrease' the government's own-generated accumulated cash surplus to $25 million. Of this amount, $18 million (72%) is the accumulated balances on the various Funds (EPF, CDF, etc). The activity of the General Revenue Fund has added $7 million to the government cash coffers during the six months to 30 June 2003.

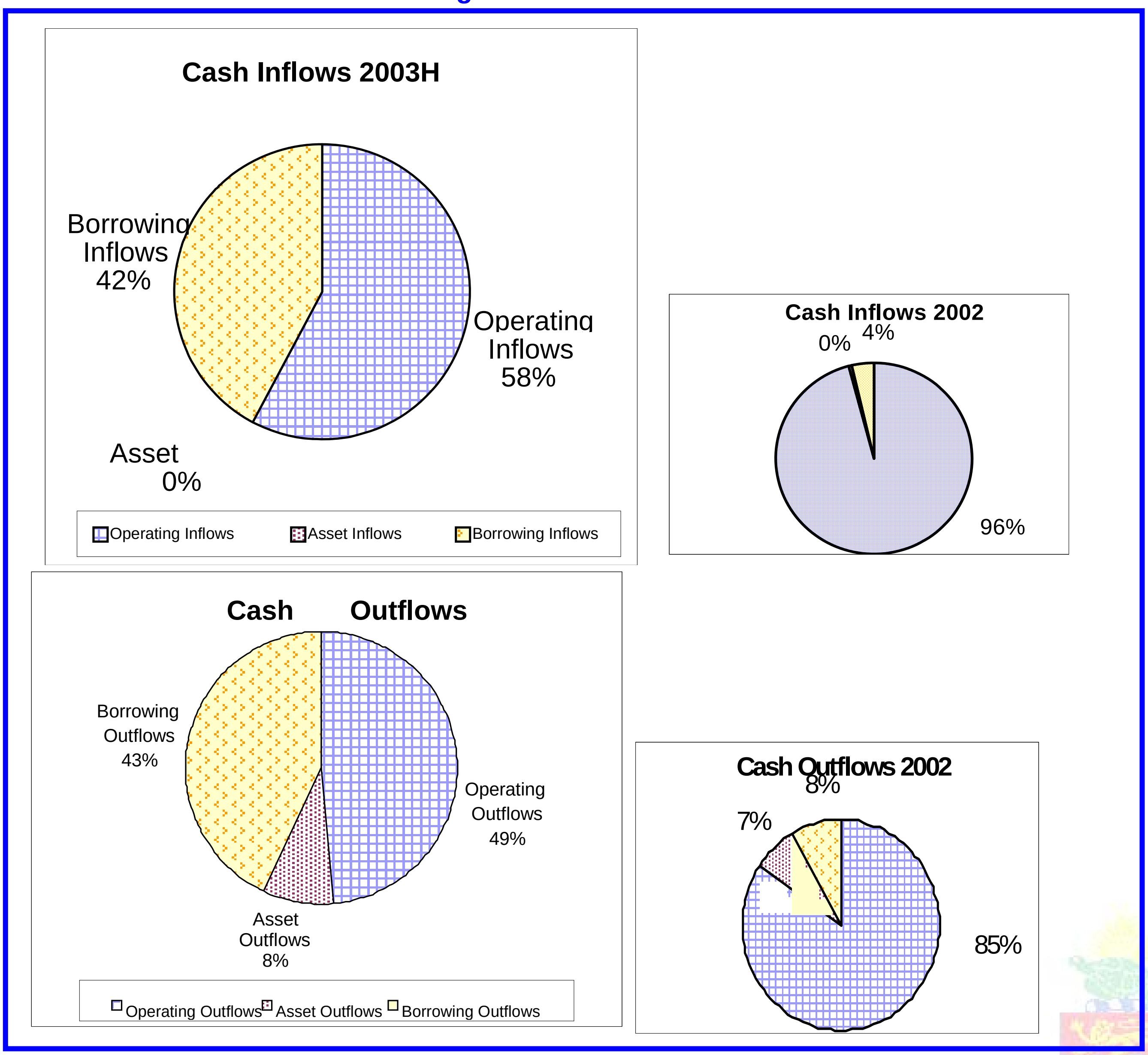
1.27 It should also be noted that there was $71 million of receivables outstanding at the end of June 2003. Of this amount, $43 million related to revenue debtors (see **paragraph 1.116**) and $28 million related to advances (see **paragraph 1.76**) of which government has made a provision to write off $13.5 million of uncollectible overseas medical advances.

Table 1: Summary of Receipts and Payments

	Revised Estimate 2003(H) ($m)	6 Month Actual 2003(H) ($m)	12 Month Actual 2002 ($m)	Increase/ (Decrease) %
OPERATING ACTIVITY				
Recurrent Receipts	188.778	185.560	305.364	(39)
Fund Receipts	3.097	3.510	8.915	(61)
Total Operating Revenue	**191.875**	**189.070**	**314.279**	**(40)**
Recurrent Expenditure	(127.574)	(141.519)	(247.014)	(43)
Statutory Expenditure	(9.628)	(8.480)	(27.348)	(69)
Total Operating Expenditure	**(137.202)**	**(149.999)**	**(274.362)**	**(45)**
OPERATING SURPLUS	**54.673**	**39.071**	**39.917**	**(2)**
ASSET ACTIVITY				
Inflows	**4.351**	**7.144**	**1.213**	**489**
Capital Acquisitions	(1.596)	(3.844)	(3.064)	25
Capital Development	(7.359)	(6.734)	(14.786)	(54)
Equity Injections	(7.099)	(5.926)	(4.328)	37
Advances and Loans	(8.024)	(0.213)	(1.910)	(89)
Total Outflows	**(24.078)**	**(16.717)**	**(24.088)**	**(31)**
NET ASSET INFLOW/(OUTFLOW)	**(19.727)**	**(9.573)**	**(22.875)**	**(58)**
SURPLUS BEFORE BORROWING	**34.946**	**29.498**	**17.042**	**73**
BORROWING ACTIVITY				
New Borrowing Inflow	136.829	136.817	10.866	1,159
Deposits and Self Financing Loan Receipts	22.072	1.242	1.151	8
Total Inflows	**158.901**	**138.059**	**12.017**	**1,049**
Borrowing Repayments	(108.471)	(119.958)	(21.326)	462
Deposits and Self Financing Loans	(20.283)	(0.656)	(5.303)	(88)
Total Outflows	**(128.754)**	**(120.614)**	**(26.629)**	**353**
NET BORROWING INFLOW	**30.147**	**17.445**	**(14.612)**	**(219)**
SURPLUS FOR THE YEAR	**65.093**	**46.943**	**2.430**	**1,832**
CASH AND CASH EQUIVALENTS				
Beginning of Year		12.959	10.529	23
End of Year		**59.902**	**12.959**	362
Less Restricted Cash				
General Reserve		27.182	5.837	
Other Funds and Reserves		18.449	15.153	
GENERAL REVENUE FUND BALANCE		**14.271**	**(8.031)**	

1.28 The analysis in **Figure 1** shows that while borrowing inflows increased to 42% during the six months to 30 June 2003, corresponding outflows increased to 43% for borrowing repayments. This occurred as the majority of the proceeds of government's Bond Issue were used to repay existing loans, thereby consolidating government's direct borrowings. It should be noted that self financing loans (i.e. external loans serviced by statutory authorities) were not included in the repayment from the bond proceeds.

Figure 1: Cash Flows



Total Recurrent Receipts - $185,560,514

1.29 Recurrent revenues for the period are shown **Table 2**. Revenue for the six-month period to 30 June 2003 equalled 61% of revenues reported for the preceding twelve-month period. While this may seem favourable, it must be noted that the majority of Government's revenue is usually collected during the first half of the calendar year (i.e. January to June). Almost 88% of all revenues for both years are derived from Fees, Duty and Licenses.

Table 2: Summary of Revenue

Category	2003(H) (6 months) ($)	%	2002 (12 months) ($)	%
Fees	66,498,232	36	100,586,736	33
Duty	56,059,323	30	109,338,118	36
Licenses	41,198,908	22	52,792,750	17
Charges	14,344,026	8	24,114,996	8
Sales	2,350,014	1	4,529,814	1
Other	5,110,011	3	14,001,175	5
Total	***185,560,514***	***100***	***305,363,589***	***100***

Operating Expenditure - $149,999,341

1.30 **Table 3** shows a summary of actual expenses with 2002 full year comparatives as shown in the Statement of Operating Receipts and Payments.

Table 3: Summary of Operating Expenditure

Description	2003(H) ($)	%	2002 ($)	%
Recurrent Expenditure:				
Personnel Emoluments	57,057,253	38	129,276,027	47
Outputs from SAs, GC & NGS	27,931,311	19	39,419,145	14
Other Operating & Maintenance	18,022,107	12	35,399,087	13
Overseas Medical Provision	13,500,000	9	-	-
Other	5,367,307	4	8,677,217	3
Transfer Payments	5,237,062	3	11,448,104	4
Other Executive Expenses	4,035,476	3	1,077,228	1
Utilities	3,968,936	2	7,946,352	3
Supplies and Materials	3,498,004	2	9,279,368	3
Insurance	2,901,531	2	4,491,237	2
Total Recurrent	141,518,987	94	247,013,765	90
Statutory Expenditure:				
Pensions Contributions	5,903,169	4	12,654,738	4
Interest on Borrowings	2,529,346	2	4,491,467	2
Past Service Pensions' Liability	47,839	0	10,202,292	4
Total Statutory	8,480,354	6	27,348,497	10
Total Operating Expenditure	**149,999,341**	**100**	**274,362,262**	**100**

1.31 Salary related items including statutory pension contributions to the Public Service Pensions Board have traditionally accounted for approximately half of government's expenses (2003(H): 42%; 2002: 51%). Pensions payments for PSPL was $10,202,292 in 2002 compared to the recorded $47,839 for 2003(H) due to omission of $5.6 million from the 2003(H) budget.

1.32 Outputs from statutory authority, government company or non-governmental output supplier (SAs, GC and NGS) is the second highest (2003(H): 19%; 2002: 14%) expenditure item and relates mainly to subsidies. The subsidy to the HSA ($13.8 million) is half of this amount. Other operating and maintenance expenditure is made up of a host of accounts. Two items, advertising and professional fees, account for approximately $7 million or 39% of this total.

1.33 Since 1993, the Auditor General's report has drawn attention to the irrecoverability of overseas medical advances and the audit opinion has been qualified on this issue since 1995. For 2003(H), Government has decided to make an overseas medical provision of $13.5 million as a non-cash item that increases expenses. This is further discussed in at **paragraph 1.82**.

1.34 **Table 4** summarises actual operating expenses as shown in the categories of the Appropriation Law.

Table 4: Expenditure by Appropriation Headings

Entity	2003(H) Actual** ($)	%	2003(H) Budget* ($)	%	(Under)/ Over Spent
Ministry of Education, HR&C	18,936,237	13	19,962,169	13	(1,025,932)
Ministry of Planning, CW&IT	18,171,232	12	19,493,445	13	(1,322,213)
Ministry of Tourism, ED&C	16,811,368	11	19,887,728	13	(3,076,360)
Portfolio of Internal & External Affairs	13,686,052	9	14,024,449	9	(338,397)
Overseas Medical Provision	13,500,000	9	-	-	13,500,000
Health Services Authority	12,922,594	9	12,875,306	8	47,288
Ministry of Community Servs, WAY&S	9,829,220	7	13,755,104	9	(3,925,884)
Portfolio of Finance & Economics	9,691,261	6	10,371,276	7	(680,015)
Non Government Output Suppliers	6,784,452	5	6,853,339	5	(68,887)
Transfer Payments	5,215,279	3	5,681,300	4	(466,021)
Ministry of Health, DA&A	4,952,139	3	6,055,709	4	(1,103,570)
Other Executive Expenses	4,720,389	3	5,464,472	4	(744,083)
Monetary Authority	4,250,000	3	4,250,000	3	-
Financing Expenses	2,592,667	2	4,640,800	3	(2,048,133)
Portfolio of Legal Affairs	2,021,567	1	1,997,090	1	24,477
Judicial Administration	1,329,782	1	1,364,542	1	(34,760)
Audit Office	534,857	0	546,895	0	(12,038)
Other Authorities	4,050,245	3	3,789,111	3	261,134
Totals	**149,999,341**	**100**	**151,012,735**	**100**	**(1,013,394)**

Notes:

** The Budget figures used differ from the Appropriation Laws in that they take into account the reductions stipulated in the Supplementary Annual Plan & Estimates.*
***There are no comparatives for 2002 as information was neither maintained nor disclosed by these headings.*

1.35 The Ministry of Education, Human Resources and Culture utilised the largest portion (13%) of total actual expenses with $18.9 million. The Ministry of Planning and the Ministry of Tourism were in 2nd and 3rd place respectively.

1.36 For 2003(H) the total operating expenditure was also categorised in accordance with Government Finance Statistics OECD Classification (Note 1 to financials) based on ***function***. This is illustrated in **Figure 2** and detailed in **Table 5**.

Figure 2: Expenditure by Function

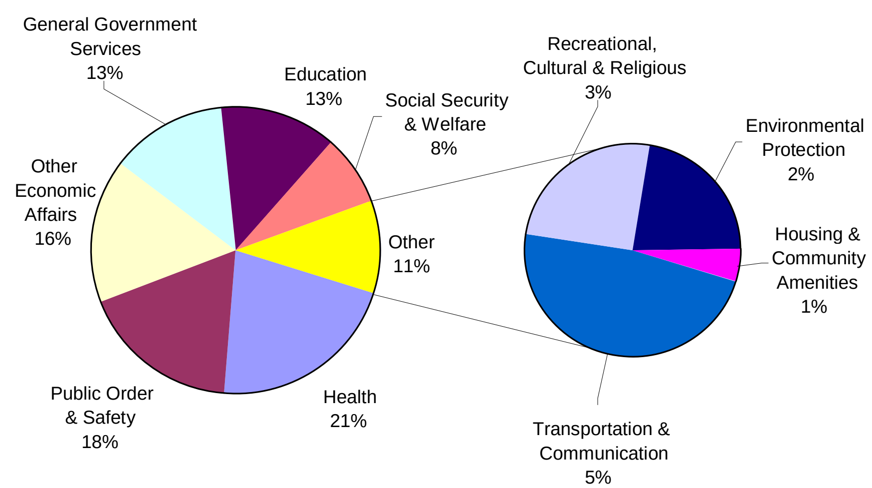


Table 5: Expenditure by Function

Function	2003 (Half) Actual $	%
Health	31,565,480	21
Public Order and Safety	26,585,541	18
Other Economic Affairs	24,959,974	16
General Government Services	19,791,404	13
Education	19,703,419	13
Social Security and Welfare	12,139,835	8

Transportation and Communication	7,195,304	5
Recreational, Cultural and Religious	3,887,249	3
Environmental Protection	3,401,725	2
Housing and Community Amenities	769,410	1
Total	***149,999,341***	***100***

Note that there are also no comparatives for 2002 as information was neither maintained nor disclosed by function.

1.37 Overall, the Health sector accounted for 21% of total government's expenditure with $31.6 million of which $13.5 million (43%) is the provision for the uncollectible overseas medical expenses. Public order and safety is second, accounting for $26.6 million or 18%, with Other Economic Affairs as the third highest at 16% of total expenditure. Education and General Government Services were the next highest at 13% respectively.

1.38 The table below compares Cayman to other selected countries in terms of proportion to spending.

	Mil CI$		Mil Euro		Mil Euro		Mil DKK		Mil Euro		Mil Euro		Mil GBP	
	Cayman		**Austria**		**Belgium**		**Denmark**		**Finland**		**Ireland**		**UK**	
	2004	%	2002	%	2002	%	2002	%	2002	%	2002	%	2002	%
General public services	49.644	16	16,826	15	25,813	20	116,111	15	8,512	12	4,584	11	43,513	11
Defence	-	0	1,911	2	3,225	3	22,065	3	2,024	3	865	2	26,048	6
Public order and safety	45.924	15	3,094	3	4,109	3	13,594	2	1,968	3	1,881	4	21,468	5
Economic affairs	63.812	21	11,273	10	12,027	9	50,134	7	6,968	10	6,461	15	24,585	6
Environment protection	6.040	2	734	1	1,933	1	..		466	1	..	0	5,808	1
Housing & community amenities	0.632	0	1,786	1	881	1	11,959	1	670	1	2,672	6	5,282	1
Health	41.121	14	14,559	13	17,299	13	76,414	10	8,846	13	8,235	19	66,745	16
Recreation, culture and religion	11.215	4	2,297	2	3,126	2	22,542	3	1,703	2	696	2	5,347	1
Education	43.295	14	12,543	11	16,603	13	113,387	15	9,172	13	5,585	13	52,074	13
Social protection	41.967	14	47,070	42	46,265	35	333,176	44	29,751	42	12,090	28	163,874	40
Total Expenditure	303.650	100	112,093	99	131,281	101	759,382	99	70,080	100	43,069	100	414,744	101

1.39 The largest item of $32.2 million is Economic Affairs and includes $9 million of tourism related expenses and $5 million of financial services expenses. Cayman is highly geared towards these two fields which could explain the disparity with the other six countries listed. If these two expenditure items were removed this will bring the percentage to approximately 8% of total country expenditure which is sufficiently close to the other countries.

1.40 The second largest amount expended was in Health and includes the $13.5 million overseas medical provision. If this was excluded, the percentage of overall spending will decrease to 13%, which is in line with Austria, Belgium and Finland and is below Ireland (19%) and the UK (16%).

1.41 Public order and safety is the third largest expenditure item for the Cayman Islands with $26.6 million or 18% of the total. This seems abnormally higher than the rest of the countries listed, with the highest after Cayman being the UK with only 5% of their total spending attributed to this service. This is an area that more attention should be given to, to determine how efficiently government funds are being utilised.

1.42 General public services and Education are the fourth and fifth highest expenditure categories and seem to be in sync with the six other countries listed for comparison purposes.

APPROPRIATION (JANUARY TO JUNE 2003) LAW, 2002 ISSUES

Change in Presentation of the Appropriation Law

1.43 Clearly it can be seen that the Appropriation Law has taken on a very different way of providing information on government's spending. This is the Public Management and Finance Law in operation. S24(2)(a) states, *"the annual plan and estimates shall specify the output groups, transfer payment categories, other executive expenses, equity investments, capital withdrawals, capital expenditure on executive assets, disposals of executive assets, loans and legislative measures that the Governor in Cabinet intends to pursue during the budget year"*.

1.44 In previous years the appropriations were shown by Heads, i.e. the various departments in government, in accordance with the Public Finance and Audit Law (1997 Revision). Section 6(3) states, that *"the estimates of expenditure shall – (a) classify expenditure under heads and subheads with the ambit of each head described;"*.

1.45 However, S6(2) says, *"Subject to subsection (3), the estimates of revenue and expenditure shall be in such form as the Financial Secretary may, from time to time, direct"*.

1.46 This was used as the justification for deviating from the normal presentation to that specified in the new PMF Law.

Spending Commenced Before Appropriation Law Effected (s20 PFAL)

1.47 The Appropriation Law (Law 48 of 2002) was assented to by the Governor on 18th March 2003 and gazetted on 7th April 2003. However, spending for the 2003(H) period had already commenced before the Law came into effect. In other words, until 7th April 2003, spending was not authorised as required by S20(1) of the Public Finance and Audit law (1997 Revision) which states that, "*Upon coming into operation of an Appropriation Law, the Financial Secretary shall authorise the Accountant General by general warrant under his hand to pay from revenue such sums as may be required to meet expenditure in accordance with that law*".

1.48 The Audit Office brought this to the attention of the Treasury Department and the Budget Management Unit (BMU) in early February 2003. After some urgency with the Legal Department the Appropriation Bill came into Law.

1.49 This is a particular peculiar incident and we do not foresee that there will be a recurrence.

Error of $228,613 in the Appropriation Law

1.50 Paragraph 2 of the Law states that, "*the Financial Secretary of the Islands may pay a sum not exceeding $146,060,097…*". During our check of the sum total of all the output groups disclosed in the Law, it was discovered that this amount actually totalled $146,288,710 resulting in an understatement error of $228,613.

1.51 We sought confirmation of this error from the BMU and the Financial Secretary's Offices and it was indeed confirmed as an error by the latter.

1.52 The Audit Office had raised on a few occasions the issue that we would like to see subtotals and grand totals provided in the Appropriation Law. It was for ease of reference and a check on arithmetical accuracy that this was requested. In the January – June 2003 Appropriation Law we saw it being beneficial to the Legislators and other relevant persons to have subtotals for each Ministry, Portfolio and other categories of Outputs such as:

- Statutory Authorities and Government Companies
- Non Governmental Output Suppliers
- Transfer Payments
- Financing Expenses
- Other Executive Expenses
- Equity Investments
- Capital Acquisition

- Capital Development and
- Loans.

In this format the total output cost for any Ministry or Portfolio or other output category can be easily determined. The grand total of these would then be reflected in summary (without error) in the opening paragraphs of the Law.

Completeness of Supplementary Budgeted Information

1.53 The Supplementary Appropriation Law that was assented to by the Acting Governor in August 2003 only approved increases to the original Appropriation Law, and the Supplementary Annual Plan & Estimates (AP&E) reflected decreases to the original Law. This resulted in some confusion as to which figure should be used for the final budgeted amounts in the financial statements. We were of the opinion that all budget documents approved by the Legislative Assembly should be taken into consideration to determine the final budgeted amounts to be disclosed in the financial statements. Treasury sought Legal opinion on this which ruled that the Appropriation and Supplementary Appropriation Laws would be the documents as prescribed by the PFAL. The Audit Office does not agree with this ruling because the legislators also approved the Supplementary AP&E documents.

Unappropriated Expenditure – $18,016,195

1.54 The Statement of Unappropriated Expenditure to the financials discloses all output groups that have exceeded their appropriated expenditure amounts. In previous years this would be akin to the excess and unauthorised expenditures which we usually qualified the audit opinion on as this represented unappropriated (unapproved) expenditure.

1.55 Of the $18 million of unappropriated expenditure, $13.5 million relates to the overseas medical provision (see paragraph **1.82**).

1.56 Even though there have been excesses on the approved appropriated amounts for certain output groups, overall the respective entities may not have surpassed their budgets by material amounts. The entities that have, on an overall basis, exceeded their appropriated amounts are presented in **Table 6**.

Table 6: Expenditure Over Budget

Entity	$
Portfolio of Legal Affairs	24,477
C. I. Development Bank	56,156
Civil Aviation Authority	96,126
Ministry of Health	47,288
Tourism Attractions Board	15,150
Total	**239,197**

1.57 Globally, the appropriated (approved budgeted) grand total of all output groups and categories including statutory expenditures, capital acquisition, capital development, equity injection and loans made for 2003(H) was $172.4 million. Actual expenditure was $166.7 million (see **Table 7**). This meant that there was an overall underspend of $5.7 million. This cannot be easily determined from the financials because most expenses are disclosed by nature such as personal emoluments, travel, etc. rather than output categories. Outputs purchased from Statutory Authorities, Government Companies & Non Governmental Output Suppliers, Transfer Payments, Other Executive Expenses, Capital Development, Capital Acquisition, Equity Injections and Loans Made are shown as their respective output categories as per the Appropriation Law.

Table 7: Actual Expenditure

Description	$
Total Recurrent expenditure (incl $13.5 million overseas medical provision)	141,518,987
Total Statutory expenditure	8,480,354
Capital Development	6,733,850
Capital Acquisition	3,844,278
Equity Injections	5,925,821
Loans Made	213,434
Total	***166,716,724***

Disclose Statutory Expenses ($13.8 million) in Appropriation Law

1.58 Total statutory expenses for the six months to June 2003 were budgeted at $13.8 million as follows in **Table 8**.

Table 8: Statutory Expenses

Item	$
Pension Expenses	9,163,315
Borrowing Repayments – interest portion	4,575,800
Statutory Salary	52,550
Total	**13,791,665**

1.59 We recognise that statutory expenditures are approved elsewhere by various laws however, we feel that the total should be disclosed within the Appropriation Law to provide legislators with a complete view of all anticipated expenditures.

1.60 It should be noted that Past Service Pensions Liability of $5.6 million was omitted from the budget process and the value of statutory expenditure should have been closer to $19.4 million. This is the complete picture which we would like legislators to be aware of.

IRIS MULTI-ORG

1.61 In order to prepare for accrual and output accounting and decentralisation of performance responsibility, government's Integrated Resource Information System (IRIS) was upgraded from single organisation accounting (Single-Org) to multi-organisation accounting (Multi-Org). This enabled Ministries and Portfolios to be set up as separate entities for budgeting and accounting purposes.

Changeover from Single-Org to Multi-Org

1.62 There was phased cut-over of government entities (Ministries, Portfolios, Audit Office and Judicial Department) from Single-Org to Multi-Org between 20 January 2003 and 01 May 2003. Balances were transferred from the Single-Org trial balance via spreadsheets mapping to the new account codes. The resulting journals were then uploaded to the Multi-Org system using facilitating software.

1.63 This transfer of data provided an unnecessarily complex audit trail making it difficult and time-consuming to verify on an overall basis. A review of the revenue and expenditure accounts revealed that material balances were properly transferred.

Allocation to Outputs

1.64 Allocating costs to various outputs became necessary for the June 2003 half year-end because the Appropriation (January to June 2003) Law, 2002 was presented by Output Group Number, Output Group Name and the Appropriation amount. The change in the format of the Law to output groups from expenditure heads and subheads meant that these expenditures would now have to be tracked using a different cost allocation system.

1.65 With the Appropriation Law being passed in this new format after the year began, it would have required the cost allocation systems to be up and running at the beginning of the year in order to track the expenditures to outputs appropriately so they could be measured against the amounts appropriated in the Law.

1.66 Output accounting entails allocation of expenditures to related outputs denoted by a nine-digit category code in IRIS. While some expenses can be directly coded to a specific output, many are indirect costs such as some payroll expenses and need to be allocated out to several outputs based on some type of cost driver. These indirect expenses are allocated by a spreadsheet-assisted manual process called "Mass Allocation". For the 2003(H) year all indirect costs are being allocated on the basis of timesheet data. A new government wide time recording system (TRS) was to be used by all Ministries/Portfolios and departments to help allocate these indirect costs.

1.67 The time recording system was ready for use at the beginning of January 2003, but many Ministries & Portfolios were not trained and ready to implement TRS on the 1^{st} of January.

1.68 Our review of output costs consisted of whether the cost allocation systems were producing reliable information (i.e. the data is complete, accurate & authorised). A significant portion of this review dealt with the TRS system since it is an integral component of the overall cost allocation system. In performing our work we obtained the TRS database and a TRS status report of timesheet information entered in and authorised. We also obtained the TRS extraction spreadsheets and the mass allocation journal entries. We also performed a TRS application control review and reviewed the general controls of the environment in which the TRS operated.

Output Findings

1.69 We found that the TRS system processed authorised data completely and accurately. However, it also showed that as at 3 September 2003 only 65% of the time records were transferred to IRIS. The remaining 35% of the time records were not transferred to IRIS because they were not authorised and released by supervisors. Without having the 35% of the data to help allocate the indirect costs we were unable to determine if 65% of the time recorded was representative of the overall time and therefore the reliability of the output costing numbers are suspect.

1.70 The major challenge to TRS is the systems development process and systems maintenance. There is no clear ownership of the system and there is no user steering committee guiding its development. The Computer Services Department originally developed the TRS for their own use. Treasury and the IRIS management Office implemented TRS on government's network to provide a tool for output costing.

1.71 Some Ministries did not use TRS for output costing and had developed their own systems (i.e. using excel spreadsheets) or were able to code a significant portion of their payroll costs to a specific output. For those Ministries we attempted to review their alternative cost allocation systems and make an assessment of them. Further work will be done in 2003-04 as some cost allocation systems were not well established for the 2003(H) year.

1.72 For the 2003/04 year a more sophisticated set of cost allocation routines will be built into IRIS. This will allow indirect costs to be allocated using alternative allocation methods in the costing spreadsheet, such as timesheet data, floor area, number of computers, etc.

1.73 A review of the mass allocation entries revealed that this process did not affect individual account balances.

Conclusion

1.74 Our review has revealed that we cannot rely on the actual figures stated in the Statement of Unappropriated Expenditure due to the unreliability of the cost allocation system. The Audit Opinion is qualified on this point (refer to audit opinion at Appendix A).

1.75 The TRS requires an owner and the formal involvement of users to ensure it will meet the needs of output costing for the Ministries & Portfolios.

ADVANCE ACCOUNTS – $14,746,088

1.76 The Accountant General under the general or specific authority of the Financial Secretary, or as prescribed in the Public Finance and Audit Law may grant loans and advances. Once granted a control account must be set up to record the total sum provided for each category of loan or advance, the amounts issued, the repayment received, and the balance outstanding.

1.77 For the six month period ended 30 June 2003 the balance in the Advances account decreased by $6,923,987 (32%) over the prior year ending balance after taking into consideration the write off of overseas medical advances of $13.5 million.

1.78 A summary of advance account balances along with the 2002 comparative figures is shown in **Table 9** below. Comments on the major components of advances are provided.

Table 9: Summary of Advance Accounts

Category	2003(H)	2002	Difference
Cash Loss	600	600	0
Deferred Expenditure	2,629,411	474,891	2,154,520
Affordable Housing	4,538,959	657,197	3,881,762
Health Services	194,466	260,732	(66,266)
Official Travel	309,610	458,850	(149,240)
Dishonored Cheques	406,250	208,910	197,340
CIG. & Other Agencies	124,540	(262,161)	386,701
Loans to Non-Civil Servants	90,000	9,390	80,610
Loans to Civil Servants	0	47,268	(47,268)
Overseas Medical Advances	19,281,659	19,258,456	23,203
Miscellaneous	330,614	310,590	20,024
Unallocated Stores	339,979	245,352	94,627
Overseas medical provision	(13,500,000)	-	(13,500,000)
Grand Total	**14,746,088**	**21,670,075**	**(6,923,987)**

Overseas Medical Advances -- $19,281,659

Transfer of responsibilities to Treasury's Debt Collection Unit

1.79 During 2002, the Health Services Department's (HSD) operations were handed over to the newly established Health Services Authority (HSA). The HSD abdicated itself from the responsibility of collection of overseas medical advances, as they claim this is not an asset of the Authority but that of the government. The HSD now acts simply as the facilitator for overseas referrals. Over a period of several months, the HSD gradually transferred the records and the responsibility for billing, recording and collecting overseas accounts to the Treasury's Debt Collector. This process was eventually completed in March 2003.

Promissory Notes

1.80 The 1995, 1998 and 2002 Auditor General's Reports raised the issue that promissory notes signed by the patients were not binding and possibly not enforceable. This was because the amount owed by the patient was not stated since, at the time of signing, the patient had not yet been treated and the liability was therefore unknown. At present, the patient signs a promissory note before their visit to Baptist Hospital. When the bill is received, the patient or person who is assuming liability for the debt must sign another promissory note, which states the exact amount of the liability. However, this procedure has been implemented in only a few cases and many patients have not responded to the request. Based on discussions with the Treasury's Debt Collector, this still presents a risk and the debtors may be able to successfully challenge the enforceability of these promissory notes.

Collateral

1.81 One of the measures adopted by the HSD to recover debts is to have them secured with collateral. Financial assessments are performed and the patient's financial status determined. Where possible, patients are required to provide security for their debts. This is usually in the form of life insurance policies, fixed deposits promissory notes and land. In the case of land, the patient and a representative of Health Services would sign a charge, which is then registered with the Lands and Survey Department.

Provision to Write off Overseas Medical Advances

1.82 The Cayman Islands Government 2003 financial statement includes a provision for overseas medical advances of $13.5 million. This represents amounts that were previously advanced by Government to cover the medical cost of persons who received medical attention outside of the Islands and are now deemed to be unrecoverable from these individuals.

1.83 The provision of $13.5 million has been presented in the Statement of Operating Receipts and Payments as a recurrent expenditure, and reduced from the total advances amount. The impact of this, is an increase in expenditures and an increase in asset inflows. Disclosure of this amount is also included in the notes to the financial statements, stating that approval has been sought from the Finance Committee to write this amount off. Approval was subsequently obtained on 29 June 2004.

1.84 The Cayman Islands Government financial statements are prepared on the cash basis, therefore items presented in the asset and borrowing activity section of the statement of receipts and payments represent cash inflows and outflows made during the financial period, with the net balance sheet activity amount being the surplus or deficit resulting from netting the cash inflows and outflows.

The $13.5 million for the provision for overseas medical was also included in the statement of operating receipts and payments as at June 30th 2003. This inclusion increased the total recurrent expenditure for the period to $141.5 million and reduced the operating surplus to $39.1 million.

Considering that amounts advanced for overseas medical advances were not recognised as expenditure when originally advanced, it is reasonable for the provision amount to be currently reflected in the operating statement, hence correctly reducing the operating surplus.

Affordable Housing -- $4,538,959

1.85 The Affordable Housing Initiative, under the responsibility of the Minister for Community Services, Youth, Sports & Gender Affairs is supposed to address concerns that a large percentage of Caymanians were not in a financial position to acquire housing through the traditional commercial route. The first phase of the project consists of 200 units situated at four sites on Grand Cayman. It should be noted that we are in the process of doing a value-for-money review of this project in 2004 which will soon be submitted to the Legislative Assembly.

1.86 The Ministry anticipates the cost of the first phase of the project to be $US14.5 million and is in the process of securing financing from Scotiabank in the form of a bond issue, which is to be guaranteed by the Cayman Islands Government.

1.87 During the six month period ended June 30th 2003, the total cost incurred on the project had increased from $657,197 to $4,538,959. As financing had not yet been secured, it was necessary for Government to provide additional advances to cover these expenditures. As at September 2003, expenditures incurred and covered by government through advances had risen to $8.5 million.

1.88 The intended repayment of these funds to Government upon the securing of financing is the premise under which this advance account has been established. The responsibility of securing financing and effecting the repayment to Government rests with the National Housing and Community Development Trust, which was legally established in September 2003. This is to be a registered charitable company limited by guarantee, with the Governor being the sole member, with its own Articles and Memorandum of Association.

1.89 Although the Trust existed as a legal entity prior to the issuance of this report, negotiations to secure funding for the project and the repayment of the advances to government have not been finalised. In this light, and given the material nature of the transactions involved, I have included a “matter of emphasis” paragraph in my audit opinion to inform the readers of the accounts of this significant issue.

Deferred Expenditure -- $2,629,411

1.90 The increase of $2,154,520 (454%) in deferred expenditures is attributable to an increase in salary advances and the inclusion of an insurance reimbursable amount which was not featured in the prior year balance.

1.91 The Risk Management Unit within the Portfolio of Finance is responsible for the insurance coverage for the whole of Government and made payments for various categories of coverage during the period ending June 30th 2003. With the decentralisation of the Government, Ministries are required to repay the risk management unit for any payments made on their behalf for coverage. The insurance reimbursable account represents amounts still owed to the Risk Management Unit as at June 2003 by a number of departments for their insurance coverage payments.

1.92 During the period ended June 30th 2003 the balance in the salary advances account increased by $649 thousand when compared to the balance at December 31 2002. This increase is attributable to an amount posted by the Ministry of Education in June 2003 of approximately $604 thousand. This amount represents advances paid to teachers for the summer vacation. Due to the change in fiscal year-end, the amount seems significantly higher for 2003 as compared to 2002. This is because the June year-end takes into account the summer advances which is more significant than the December advances.

1.93 A review of the Ministry of Education's advance account for the months immediately following the year-end showed that the advances were reversed as they were recognised as salary and expensed for the respective period.

Official Travel -- $309,610

1.94 Official travel advances decreased by $149,240 (33%) from the 2002 balance of $458,850. These advances are supposed to be accounted for by the respective departments within seven days of an officer's return from overseas travel. From 2002 onwards, it was noted that the Treasury Department sent letters to the various departments that have been tardy in accounting for their respective balances; these measures have been aided by the efforts of the respective CFOs to reduce this balance.

Dishonoured Cheques -- $406,250

1.95 This balance representing statute barred cheques increased by $197,340 from December 2002 to June 2003. Our examination of this account showed that $177,792 of the total balance relates to one customer. This customer had a balance at December 2002 of $13,850 which increased by $163,942 to June 2003. It is not clear why measures were not put in place to stop the receipt of cheque payments from this customer as sufficient grounds existed to suggest that they would not be honoured.

STATEMENT OF BORROWINGS

Government Issue of 5.3% Notes due April 8, 2018

1.96 The balance on borrowings at the end of June 2003 was $149,794,537 (31 December 2002 - $133,048,481). On April 8, 2003, the Government authorised the issue and sale of 5.3% Notes of aggregate principal US$163.2 million (CI$136 million) under section 4(1) of the Cayman Islands Government Securities Law, 2002 (formerly Cayman Islands Registered Stock Law). The proceeds of this issue were used to pay off loans comprising the public debt in the amount of CI$114 million and the balance was taken to the General Reserve.

1.97 The Notes, in denominations of US$200,000, were issued to various entities (see **Table 10** below) and have a final maturity date of 8 April 2018. Principal repayments of US$5.44 million and interest at 5.3% per annum of the reducing balance are due every 6 months commencing 8 October 2003.

Table 10: ORIGINAL ISSUE OF NOTES

Note Holder	Holding (US$)
Pacific Life Insurance Company i.n.o. Mac & Co.	43,200,000
The Lincoln National Life Insurance Company	35,000,000
First Penn-Pacific Life Insurance Company i.n.o. Cudd & Co.	5,000,000
Hartford Life Insurance Company	25,000,000
Hartford Casualty Insurance Company	10,000,000
AllState Life Insurance Company	25,000,000
Bank of Butterfield International (Cayman) Ltd	20,000,000
TOTAL NOTE ISSUE	**163,200,000**

1.98 The Bank of New York was appointed Fiscal Agent (Registrar) under s11A of the Law, for a one-time acceptance fee of US$5,000 and an annual fee of US$5,000 plus reasonable out-of-pocket expenses. RBS Securities Corporation and Bank of Butterfield were appointed agent and advisor respectively.

1.99 The Note Issue is the first step to consolidating and more effectively managing the government's public debt. The interest rate of 5.3% is fixed. This allows the Government to predict its debt servicing costs with certainty. It also protects them from future hikes in interest rates above 5.3%.

1.100 Of the $119 million in public debt brought forward at 30 June 2003, $5 million was repaid from General Revenue and $114 million was repaid from the proceeds of the Note Issue. A net surplus of CI$22 million of note proceeds was realised after repayment of public debt balances. Self Financing Loans (loans serviced by Statutory Authorities) remain outstanding to be repaid as per original loan agreements.

1.101 Section 14(3)(c) of the Public Management and Finance Law 2001 (2003 Revision) states that debt servicing costs (principal repayments, interest and other relevant expenses) for any financial year from 1 July 2004 should not exceed 10% of revenue. Debt servicing costs for the periods 2000 to 2003 are shown in **Table 11**.

Table 11: Debt Servicing Costs as a Percentage of Revenue

	2003(H) $	2002 $	2001 $	2000 $
Loan Balances				
Public Debt	136,000,000	119,151,440	129,534,374	92,494,367
Self Financing Loan	11,630,963	12,958,896	13,950,103	15,354,098
Total Loan Balance	147,630,963	132,110,336	143,484,477	107,848,465
Debt Servicing Costs (Principal and Interest)				
Public Debt	14,251,800	25,153,443	18,691,222	18,958,337
Self Financing Loans	929,000	1,912,792	2,030,029	2,363,070
Total Debt Serving Costs	15,180,800	27,066,235	20,721,251	21,321,407
Recurrent Revenue	185,560,514	307,727,428	282,582,915	273,188,505
10% of Recurrent Revenue	18,560,514	30,772,743	28,258,292	27,318,851
Debt Servicing Costs as a Percentage of Revenue	**8.2%**	**8.8%**	**7.3%**	**7.8%**

INVESTMENTS IN UNDERTAKINGS

1.102 Investments in undertakings changed from $49.3 million in 2002 to $56.7 million at June 2003 (15% increase) and represents government's equity interests in statutory authorities and government companies.

Inconsistency of Accounting Treatment

1.103 The government's financial statements to June 2003 show equity investments of $2,000,000 in Cayman Airways and $2,984,254 for the Health Services Authority. The accounting treatment of these items was called into question, as some of these items are subsidies for operating expenditures. In the case of Cayman Airways, the entire amount is a subsidy, and the subsidy for the Health Services Authority is $1,316,518.

1.104 Private entities typically finance short-term expenses through short-term financing as opposed to additional equity investment. Private owners are loathe to invest equity capital to fund short-term losses because such investing activities are very risky in nature. However, government does not have the luxury of refusing to finance short-term losses because such refusal can threaten the going concern of the entity. Even if the entity chose bank debt to finance its operational shortfall, the burden of these debts eventually falls on government. Therefore, since government cannot escape providing subsidies for these entities' short-term operations and government is the owner, these may form capital contributions.

1.105 The recipient of these subsidies should treat the funds as contributions from owners. The alternative treatment is to treat the subsidy as revenue in the income statement. Though the net balance sheet effect of either method is nil, the revenue method will give rise to the need for a consolidation adjustment as the balance sheets and income statements will not automatically eliminate the inter-company transactions.

1.106 The method of disclosure used by the recipient entity should be consistent with that used by government. Government should instruct the recipient as to the purpose and intent of the subsidy/contribution for accounting purposes.

1.107 As stated earlier, the net effect on owner's equity is nil. The difference in the method only causes differences in the components of equity. If the contributions are passed through the income statement of the entity, the losses would be mitigated by the size of the subsidy, which means the overall retained losses would be less than if the contributions are credited directly to owners' contributions.

1.108 The downside of crediting grants directly to owners' contribution in the books of the investee, is that the amount of annual government 'assistance' is not clear. The problem is compounded where the government also contributes capital to the entity for fixed asset investments.

1.109 It is important to have adequate note disclosure to the financial statements to make distinctions between contributions received from government for the purpose of meeting revenue shortfalls, as opposed to financing received for business expansion or asset replacement.

Completeness of Note 7 Disclosure

1.110 The inconsistency in accounting treatment for equity investments brings into question the completeness of that schedule. We urged that Treasury undertake to agree the investment balances with each recipient entity and verify the completeness of the balances. This is especially important with the onset of accrual accounting and consolidation of financial information required for the 2004-05 financial year and beyond.

STATEMENT OF CONTINGENT LIABILITIES

1.111 The contingent liabilities for the government amounted to $212,047,645 for the six-month period ended 30 June 2003 (2002: $215,629,883). The largest portion of these contingent liabilities, 83%, relates to actuarial deficiencies for the three government-sponsored pension plans. The projected liability outlined in **Table 12** is derived from the actuarial valuation on 01 January 2002, accepted by the Public Service Pensions Board on 19 July 2002.

Table 12: Past Service Liability

Pension Plan	Actuarial deficiencies ($)
Public Service	164,649,000
Parliamentarian	11,503,000
Judiciary	190,000
Total	**176,342,000**

1.112 Three percent of the contingent liabilities of the government relates to blanket guarantees of between 10% and 35% of the upper layer of loans made by participating banks under the Government Home Mortgage Guarantee Scheme. The management of the Scheme is examined at **paragraph 1.179** of this report.

1.113 The remaining 14% of the contingent liabilities relates to guarantees given by government to various banks for amounts borrowed by statutory authorities.

ARREARS OF REVENUE

1.114 Government reports on a cash basis and only revenue ***received*** is reported in the annual financial statements. Accounts receivable can easily be overlooked or forgotten with the resulting loss to public revenue. This is one of the main weaknesses of the cash basis of financial reporting.

1.115 Of particular significance is the inability of Government to collect the amounts that it is owed for services that it has provided to the public. Between December 2002 and June 2003 receivables increased by $14.14 million. **Table 13** below compares the amounts owed in 2003 half year and 2002.

Table 13: Break down of Debtors ($ millions)

Detail	2003 (H)	2002
Revenue Debtors	$43.02	$28.31
Advances	$19.46	$ 19.60
Loan Debtors	$7.12	$7.55
Total	**$69.60**	**$55.46**

1.116 The revenue debtor balance examined in further detail in **Table 14** shows how the growing amount of uncollected revenue was distributed along the Ministries and Portfolios.

Table 14: Ministry/Portfolio Debtor Balances

Revenue Type:	Finance & Economics	Health Services DA & A	Planning, CW & IT	Tourism ED &C	Education, HR & C	Legal Affairs	Judicial	Internal & External	Community Sport	Total
Duty	501,325									501,325

Charges	98,848			240,483						339,331
Licenses	1,658,047									1,658,047
Sales	8,750	128,636	30,498	4,800				15,170		187,854
Fees	29,945,854	27,222	5,250,478		554,503	19,901		1,494,945		37,292,903
Fines/rent/interest/misc	19,596		1,390		83,372		214,443			318,801
Services	725,847		319,370	30,680						1,075,897
Interest Receipts from Statutory Authorities	579,809									579,809
Investment Income	500,000								225,000	725,000
Environmental Protection Fund	342,752									342,752
Total Revenue Debtors	**34,380,828**	**155,858**	**5,601,736**	**275,963**	**637,875**	**19,901**	**214,443**	**1,510,115**	**225,000**	**43,021,719**

1.117 The table above shows that of the total $43 million of receivables, Portfolio of Finance is responsible for $34.4 million or 80%. Of the Portfolio's revenue, fees account for approximately $30 million. The second highest receivable balance of $5.6 million is owed to the Ministry of Planning.

Portfolio of Finance – Revenue Debtors

1.118 The table below shows the outstanding amounts for the Portfolio of Finance analyzed by department and revenue type.

Table 15: Debtor Balances – Portfolio of Finance

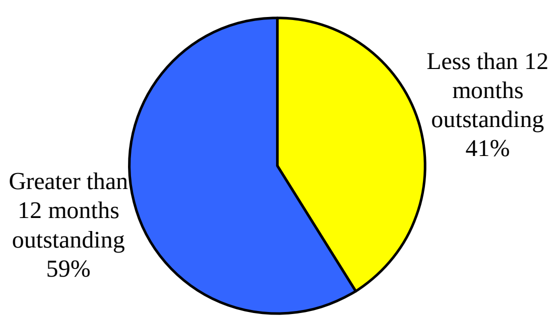
Revenue Type:	General Registry	Customs	Treasury	Shipping Registry	Monetary Authority	TOTAL
Duty		501,325				501,325
Charges		5,998			92,850	98,848

Licenses				16,567	1,641,480	1,658,047
Sales				8,750		8,750
Fees	29,157,262	1,750	426,973	359,868		29,945,853
Services		725,847				725,847
Interest Revenue			4,676			4,676
Interest Receipts from Stat. Auth.			579,809			579,809
Investment Income			500,000			500,000
Miscellaneous				14,920		14,920
Environmental Protection Fund			342,752			342,752
Total Revenue Debtors	**29,157,262**	**1,234,920**	**1,854,210**	**400,105**	**1,734,330**	**34,380,827**

General Registry – $29,157,262

1.119 General Registry's fees of $29.2 million accounts for 85% of the arrears of revenue for the Portfolio of Finance or 67% of the total government's revenue debtors. Moreover, the department's submission to the Accountant General shows that $17.2 million was in arrears for over 12 months. Graphically illustrated below, 59% of General Registry's accounts receivable have been uncollectible for over a year.

Figure 3: General Registry - Receivables over 12 months



Financial Reporting System Limitations

1.120 Discussions with the Financial and Administrative Officer at General Registry indicated that there were some limitations with the financial reporting system. These include:

- The inability to generate the retroactive balances of receivables at a particular historic date.
- The inability to provide an ageing of receivables.
- Reports in the previous system not being carried over to the current system.
- Manually having to go through over 75,000 records to determine which companies are in arrears.

No Provision for Bad Debts

1.121 General Registry does not usually provide for doubtful debts or write off such debt. When companies that have been struck off apply for reinstatement, total fees in arrears have to be paid prior to reinstatement. As such there is no provision for bad debts.

1.122 In the transition to accrual accounting and based on International Public Sector Accounting Standards, accounts receivable must be stated at net realizable value, i.e. net collectible. An ageing of accounts receivable is helpful in determining net receivables because it identifies probability of collection based on the length of time revenue remains uncollected. It answers the question of how much of the $29.2 million is in arrears and how much is realistically collectible. The Audit Office does not think that the full sum is collectible and as such the inclusion of the gross amount without reasonable estimation of the doubtful or bad accounts will be misleading to the readers of the financial statements when prepared under full accrual basis.

Loss of Revenue and Growing Accounts Receivable

1.123 General Registry's financial system generates bills at 1st January for the entire calendar year although the financial year is only for a period of the 6 months ended 30 June 2003. Based on reports generated by the Computer Services Department, the General Registry raised approximately $40 million in revenues for 2003, while only $28.2 million was collected. This adds $11.8 million to prior years' uncollected balance of $17.4 million, totalling $29.2 million as cumulative uncollected amounts. This is a very material amount of revenue that may never be collected.

1.124 Over recent years the Government has implemented revenue enhancement measures aimed at raising new revenue. Notwithstanding these efforts to raise funds, the delay in revenue collection and the non-collection of revenue must also be addressed in order to minimize material revenue losses. To levy increased fees and taxes will have little benefit if these funds are not collected. Delays or absence of revenue collection erode the probable future economic benefit derived from the cash asset earned. The longer the balances remain uncollected, the less likely collection will be realized. In essence, the government (in the case of General Registry) has potentially provided over $11.8 million dollars of free service to the companies and individuals in the 2003(H) financial year. This impacts significantly on the General Reserves of the country. Even striking the names of delinquent companies off the records may not sufficiently aid in the collection process, especially in cases where the company may not intend to continue operations in the Cayman Islands.

1.125 Companies Law (2003 revision), sections 175, and 187 through 189, allow the Registrar General discretion to strike off companies for not paying their annual fees. However, section 178 allows companies the option of reinstatement that recognizes them as having never been struck from the register if application is made before ten years.

1.126 The government cannot be financially successful if it continues to allow the loss of significant revenues. With output auditing, Chief Officers will be held accountable for all areas of their entity's operations including meeting budgetary targets. Should the present modus operandi and system weaknesses continue to pervade the public sector, the financial and operational results will be significantly impaired.

1.127 I urge the government to adopt much more aggressive debt collection schemes. At June 2003, $43 million had not been collected for services provided across the entire public service. This amount does not take into consideration the amount that is outstanding as a result of loans and advances which were discussed previously.

The Effect of Overstated Accounts Receivable on the Accrual Financial Statements

1.128 The amounts owed to the government are not reflected in the balance sheet as accounts receivable as at 30 June 2003. However, this will change as the entire public sector converts to accrual accounting effective 1 July 2004.

1.129 Accounts receivable is defined as amounts due from customers for services and goods provided in the normal course of business. Therefore accounts receivable is shown as a current asset, which means that the amount due has high liquidity or can be converted into cash easily within the current operating cycle. Unfortunately, as it relates to the $43 million owed to government, it is misleading to believe that this amount is fully collectible.

1.130 Including this entire amount in the balance sheet not only overstates assets, but directly impacts on the working capital and current ratios. Working capital measures how much in liquid assets, an entity has available to build its business. In general, entities that have a lot of working capital will be more successful since they can expand and improve their operations. Current ratios measure the entity's ability to meet short-term debt obligations. Essentially, the inclusion of this amount in the financial statements misguides the user of the financial statement as to the true financial position of the government to meet its debts and improve on its operations.

UNPAID EXPENDITURES

1.131 Under the cash basis of accounts, the stake holders may not be fully cognizant of the effect of having unpaid or deferred expenditure at the end of the financial year. It is thought that cash receipts and cash payments are only recognized or accounted for when received or paid.

1.132 However, a fundamental concept of the cash basis of accounting is that there must be no postponement of payments for any reason and I have qualified my audit opinion on this matter for some years now, taking into consideration the material sums involved.

1.133 Deferred and unpaid expenditures at June 2003 of approximately $4,112,013 have not been reflected in either the Statement of Operating Receipts and Payments or the Combined Statement of Assets and Liabilities as a result of the postponement of payments.

1.134 Another unpaid expenditure was the government's Past Service Pensions Liability of $5,579,138. For the half-year to June 2003 no amount was budgeted and therefore paid over to the Public Service Pensions Board with respect to this commitment. Again this understates the expenditure and the resulting operating surplus which impairs the readers of the accounts.

1.135 As the government changes to accrual accounting and each Ministry and Portfolio will be responsible for producing individual financial statements, it is important to present the financial performance and position fairly in all material respects.

1.136 Complete and accurate information about accounts payable (deferred expenditure) is important because it is a key element in determining operating performance and solvency (the ability to meet obligations as they occur). Solvency will be critical for all entities since there will be more decentralised costs for which they will be responsible. Management must be able to place reasonable reliance on these key performance indicators in decision-making, in order to secure optimal organisational performance.

DEPOSIT LIABILITY - $15,087,537

1.137 Deposit accounts represent liabilities for cash received from third parties and deposited in government's bank account and which are not classified as revenue. Deposit accounts increased by $1,117,869 or 8% over the 2002 balance of $13,969,668. The change in this account can be attributed to the net effect of the cumulative increases in the Customs and the Miscellaneous deposit balances and the decrease in the Hurricane Michelle balance by $982,993. The summary of balances with 2002 comparatives is shown in **Table 16**.

Table 16: Comparative Summary of Deposit Accounts

Department	2003(H)	2002	Change ($)
Customs Department	1,587,269	670,111	917,158
Education Department	624,197	614,780	9,417
Health Services Department	257,398	254,800	2,598
Hurricane Michelle	761	983,754	(982,993)
Immigration Department	6,389,343	6,665,588	(276,245)
Miscellaneous	1,887,700	69,409	1,818,291
Philatelic Bureau	12,999	52,619	(39,620)
Prison Department	121,854	114,365	7,489
Registrar of Companies	2,678,348	2,670,295	8,053
Social Services Department	98,556	93,631	4,925
Special Funds	0	10,066	(10,066)
Road Development Fund	94,532	94,532	0
U.S. Treasury – 1994	1,263,504	1,604,643	(341,139)
UNDP – Projects	71,075	71,075	0.00
Grand Total	**$15,087,536**	**$13,969,668**	**1,117,868**

Immigration Security Deposit -$6,389,343

1.138 Immigration security deposit represents monies held on behalf of employers for the repatriation of employees under work permits in the Islands and represents 42% of the government's deposit liability. An amendment to the Law in October 2000 replaced this fee with a non-refundable repatriation fee. The issues with regards to this account balance have resulted in the audit opinion being qualified and have been discussed in detail in previous audit reports. These are summarized below:

- There has been no reconciliation between the Immigration's IMS System and the Government's system for several years.
- There is no list of the debtors to whom the balance on the account of $6,389,343 is owed.
- There were unauthorized transfers of $2.2 million from the liability account to General Reserve in 1991 and 1995, thus resulting in an understatement of the deposit liability.
- There was agreement that these funds are not the government's and should be separated and will be maintained as a Trust Fund.

1.139 In early September 2004 the Public Accounts Committee met and discussed these recurring issues with the officials from the Immigration Department and the following came to the fore:

- The Chief Financial Officer of the Portfolio of Internal & External Affairs was committed to working diligently with the reconciliation process to ensure success before the end of the year;

- The Deputy Financial Secretary noted that the account was not growing and was down to almost $5 million at June 2004;

- The previous Chief Immigration Officer suggested that a policy decision should be made to refund the deposits to the employers and allow them to pay the non-refundable $200.00 per employee. In this way the deposit liability balance will be reduced to a much more manageable level. *Note that this was only a suggestion and has not yet been explored.*

1.140 Based on the discussions with the PAC and the Immigration officials, I am hopeful that the long outstanding recurring problems associated with the Immigration security deposit will be resolved in the near future.

Customs Deposits -- $1,587,269

1.141 Customs deposits increased by $917,158 (137%) from the 2002 balance of $670,111. There have always been three areas of particular concern for our Office, which are noted briefly below as they have been discussed in more detail in previous audit reports:

- Differences between balances stated in IRIS (Treasury) and CTSS (Customs)
- Lack of timely reconciliation of traders' accounts and
- Lack of timely confirmation of trader balances.

1.142 When the Public Accounts Committee met in early September 2004 these issues were raised with the Customs Department. The Collector assured the Committee that these problems have now been rectified as at the end of August 2004. He stated that the accounts (CTSS and IRIS) are now in agreement and that the traders accounts all agree with the respective traders.

1.143 The Committee was also concerned about the capacity and cost of the computer system and software to be able to handle information processing and manipulation for reporting purposes. The Collector informed the Committee that he is making good progress with the in-house system which will be more cost effective for the government.

1.144 The Audit Office is pleased with the progress that the Collector and his Department has made with these recurring issues. We will review these deposits in future years to ensure that the problems have been resolved.

Hurricane Michelle Insurance Claim-- $761

1.145 The funds in this account are proceeds received from insurance companies for damages sustained during Hurricane Michelle. The balance decreased during the year by 99%. This decrease is the net effect of two receipts ($500,000 and $908,792) received from Cayman General Insurance Co. Ltd as claims reimbursement and payouts totaling $2.39 million to entities damaged during the hurricane.

Miscellaneous Deposits -- $1,887,700

1.146 Miscellaneous deposits increased during the six-month period ended June 2003 by $1,818,291. This increase is mainly attributable to the inclusion of pension funds payables deposits of $722,855 and a balance for transfer journals of $522,935 not included in the prior year balance.

Registrar of Companies -- $2,678,348

1.147 The balance on the Registrar of Companies deposit which increased by $8,053 is comprised of defunct companies' balances and deposits held for on-line companies' registration. Concerns relating to the management of these deposits have been discussed extensively in prior audit reports.

US Treasury 1994 - $1,263,504

1.148 This category of deposits relates to funds received from the US Treasury through the Mutual Legal Assistance Treaty (MLAT). Under the terms of the treaty, the Cayman Islands Government receives funds for assisting the United States Government in combating illegal activities. The balance on the MLAT account for 2003(H) is $1,263,504 disclosed in Note 2 of the government's financial statements as US Treasury –1994 deposit. Movements on the account are summarised in **Table 17**. These amounts are held in the Cayman Islands Government's general bank accounts. Treasury has indicated that these will be treated as trust accounts and will be transferred to separate bank accounts for the upcoming financial year.

Table 17: Movement on the MLAT account

Description	($)
Opening Balance	1,604,643
Payments	(433,280)
Receipts	92,141
Total	**1,263,504**

1.149 There were two payments from the MLAT accounts in 2003(H), the largest of which was $433,146 paid to the United States Government in March 2003 under the provision of the treaty and approved by the Executive Council.

1.150 My office was unable to verify the completeness of the funds presented herein. This subject area (including criminal assets confiscation) has been the focus of a special audit by my Office and the final report is due to be issued to the Legislative Assembly shortly.

CAPITAL DEVELOPMENT FUND

1.151 Capital expenditures for the six months to 30 June 2003 were $6.7 million ($14.5 million to December 2002). **Table 18** shows the breakdown of the projects on which this amount was spent[1]: The following paragraphs discuss the key issues noted.

Table 18: Capital Expenditure by Project

Project	Amount
Construction of the Quincentennial Square	229,385
Purchase of lands: new and ongoing purchases	741,758
Other projects	1,513,851
Roads and Drainage	1,593,361
Roads Settlement of Gazetted Claims	2,655,495
Total	**6,733,850**

Compensation Payments in Excess of Valuations

1.152 In connection with a claim arising from the Crewe Road Bypass, the Highway Authority paid $433,043 more to a claimant than amounts valued by Lands and Survey. The payment was for block 14 D 297 Rem 1. Lands and Survey valued the 2.41 acres at $6.50 per square foot but the Highway Authority paid $12 per square foot, qualifying the payment by designating a portion of the payment ($6.00 per square foot) as an "ex gratia" payment. Lands and Survey department recommended that the Assessment Committee be utilised to settle this matter but as far as we can establish, the matter never went before the Committee.

1.153 It concerns us that ex-gratia payments would be made and the Assessment Committee not used, as this reduces the transparency of the transaction. In our 2002 Report we did a special review on Road Compensation Payments from 1999 to 2001 and commented on the underutilization and bypass of the Assessment Committee at that time. It appears similar practices are continuing within the Department.

[1] Note: no comparatives are shown because Capital Development information was reported in different categories in 2002.

1.154 The use of ex-gratia payments tend to reduce the perception that the compensation payments are awarded in an open, fair and equitable manner. We recommend that the road compensation payments be awarded in an open, fair and equitable manner and that the matter be approved by the Assessment Committee when the payment is more than the Lands and Survey recommendation. Without such review, it appears that Government may have paid more than they should have. In our opinion, using ex-gratia payments undermines Government's negotiating powers by establishing a precedent of paying significantly more than parcels' valuations.

Contingency Warrant Issued for Non-Urgent Expenditure

1.155 In May 2003 the Highway Authority paid US$275,000 (CI$229,625) as a deposit for the acquisition of Furtherland Farms (block 62 A Parcels 4, 5 and 6 and block 66A parcels 1, 37 and 39). The total cost of the property is US$1,100,000 (CI$918,500) and is being paid over four years.

1.156 Under the Public Finance and Audit Law Section 20, the use of contingency warrants is limited to exceptional circumstances and urgent needs "*…..which cannot be deferred without detriment to the public interest*". I have not been able to establish the urgency of this purchase that resulted in the need to issue a contingency warrant. This is not the first instance that I have had cause to report on the misuse of contingency warrants. It must be noted that the use of contingency warrants temporarily subverts the parliamentary process of authorizing Government expenditure as such expenditures do not receive the Legislative Assembly's scrutiny until after-the-fact.

Lack of Specific Project for Land Acquisition

1.157 Also in connection with the acquisition of Furtherland Farms, at report date, the Audit Office could not ascertain what specific project necessitated this purchase. We requested this information from the Ministry of Planning, Communication, District Administration and Information Technology but have not received a response.

Road Project Design and Implementation

1.158 As part of the Crewe Road Bypass project, modifications were gazetted under Boundary Plan 407. Under this Boundary Plan, the estimated total landtake pertinent to the project was 7.95 acres. There was a revision to the design and a subsequent Boundary plan was gazetted with the estimated landtake marked down to 4.57 acres.

The implication of this type of action is that government was exposed to the risk of paying for land that they did not require since the revision rendered the original estimated landtake superfluous. Alternatively, it implies that the revision may have been fit into a less than optimal design since the government was obliged to accept less land than it needed for the project. Either way the process of road design must be such that the best possible design is forwarded and approved prior to gazetting, ensuring that any private property expropriated by the Highway Authority was absolutely necessary.

Audit Opinion

1.159 The Fund's accounts for 2003(H) received an unqualified audit opinion.

ENVIRONMENTAL PROTECTION FUND

1.160 The Environmental Protection Fund (EPF) was established in December 1997 pursuant to section 30 of the Public Finance and Audit Law (1997 Revision). The purpose of the Fund is to ensure that environmental protection fees are *segregated from other government revenues*. Revenue is derived from charges levied against departing air and cruise ship passengers under the Travel (Departure Tax and EPF) Law (1999 Revision). Disbursements from the Fund may only be made in accordance with resolutions made by Finance Committee for the purpose of *defraying expenditure incurred in protecting and preserving the environment.*

Key Points

1.161 Revenue collected in 2003(H), amounted to $2,789,625 (2002: $4,538,707). There were no expenditures or transfers in 2003. There was a transfer of $250,000 to the Capital Development Fund as a contribution in 2002. In my opinion such a general transfer without a specific environment project is in violation of the Law. This supports our concerns that there is no evidence that the Fund is being used for the purpose for which it was originally created.

1.162 In May 2003, the Internal Audit Unit (IAU) issued a report on an audit conducted on the EPF for 2002. Their findings are detailed in a management letter issued to the Fund Accountant.

1.163 **Previous years' issues** which still need to be addressed are:

- Amending the law to make provision for an interest or penalty element on overdue balances;
- EPF transactions should be recorded in a separate Fund rather than as a deposit account with the General Revenue Fund;
- Revenue should be recorded using the AR module of IRIS rather than Excel spreadsheets to enable more efficient management of receivable balances;
- Revision of Law to clarify when cruise ship passengers should be charged the fee. Cruise ships were being charged on *departure*, whereas the interpretation of the Law by Legal Department meant on *arrival*.
- The 2000 IAU's Report stated that the "definition for 'Yearly' and 'Seasonal' requires review as revenue may be lost as a result of ships arranging to call during a period not classified as seasonal".

Audit Opinion

1.164 The Fund's 2003(H) accounts received an unqualified audit opinion.

INFRASTRUCTURE DEVELOPMENT FUND

1.165 The Infrastructure Development Fund (IDF) was created by the Development and Planning (Amendment) Law 1997, for the purpose of providing funds for development of roads and other infrastructure in the Islands. For 2003(H) the IDF received $391,764 (2002: $3,060,873). The Fund receives revenue from two sources: Infrastructure Fees collected by Planning Department and Stamp Duty from land transfers collected by Lands & Survey department.

1.166 Stamp Duties are charged on the conveyance or transfers of immovable property at rates of 7.5% and 9% of the value of the consideration, depending on the registration sections, block and parcel of the property. For transfers where the rate of 9% is applicable, 1.5% of the consideration is applied to the Infrastructure Development Fund and 7.5% to Stamp Duties. For other transfers (i.e. areas where the rate is 7.5%) no Infrastructure Fees are charged. Effective from June 2001 Infrastructure Fees were levied on building permits for industrial and commercial buildings, hotels, strata lots, apartments and houses exceeding 4,000 square feet at a fixed dollar rate ranging from $0.50 to $2.50 per square foot.

1.167 A concession was granted by Cabinet effective 14 November 2001 and now continues until 11 January 2004 that reduces Stamp Duties from 9% and 7.5% to 5% on all transfers, and the 1.5% Infrastructure Fees to zero. The concession also reduced the infrastructure rates used by Planning by 50%. IDF fees collected during the period January to June 2003 were $0 (2002: $17,366) by the Lands & Survey Department and $384,937 (2002: $3,077,034) from the Planning Department.

1.168 Reduction in fees from Lands and Survey is as a result of IDF fees from Stamp Duties being zeroed as part of Government concession plans. The comparative variance for fees collected by the Planning Department is attributable to the following factors – the prior year balance represents transactions for 12 months whereas the current period is for 6 months; and in the prior year collections for one of the most significant projects, The Ritz Carlton, was $1.5 million, whereas in the current period only $211,000 was collected.

Audit Opinion

1.169 The Fund's accounts for 2003(H) received an unqualified audit opinion.

ROADS DEVELOPMENT FUND

1.170 The Roads Development Fund (RDF) was proposed for consideration through Private Member's Motion 4/98 on 11 March 1998. This fund was intended to keep monies separate from general revenues and the capital development fund for the sole purpose of developing roads.

1.171 The fund receives monies from duty collected by the Customs Department. For the half-year ended June 2003 the amount collected and the balance in this account was $328,175 (2002: $1,315,389). The prior year balance was zero as all the funds were transferred to the Capital Development Fund.

Audit Opinion

1.172 The Fund's accounts for 2003(H) received an unqualified audit opinion.

NATIONAL DISASTER FUND

1.173 The National Disaster Fund (NDF) was established in April 1999 by Finance Committee in accordance with section 30 of the Public Finance and Audit Law (1997 Revision). Its purpose is to assist in dealing with and recovering from the events of a national disaster. The fund started at $400,000 with a transfer from General Revenue and each year after, with the approval of Finance Committee, an additional $400,000 was transferred. The Fund balance at June 2003 was $2,110,476 inclusive of interest.

1.174 The earnings from interest or dividends on investment of Fund monies must be retained for the purpose of the Fund, and not form part of General Revenue. For the half year ended 30th June 2003 total interest received was $11,473 (2002: $28,229). This Fund has its own separate bank account and all monies are placed on fixed deposit with principal and interest being rolled over on maturity.

Audit Opinion

1.175 The Fund's accounts for 2003(H) received an unqualified audit opinion.

STUDENT LOAN RESERVE FUND

1.176 The Student Loan Reserve Fund (SLRF) was established in December 1999 to support the Government's guarantee of 100% on student loans administered by the Cayman Islands Development Bank (formerly Agricultural and Industrial Development Board). These loans are disbursed by selected commercial banks. The fund started at $100,000 with a transfer from General Revenue in 1999 and a further $100,000 is paid into the Fund in December of each year. The transfer was made in June of this year as a result of the change in the governments' financial year end. No claims have been made to the Fund since then. The Fund's balance as at June 2003 was $527,752 inclusive of interest (2002: $424,883).

1.177 The earnings from interest on investment of Fund monies have been retained for the purpose of the Fund as required. For the half year ended June 2003, total interest received of $2,869 (2001: $7,060) was reflected in the financial statements. This Fund has its own separate bank account and all monies are placed on fixed deposit with principal and interest being rolled over on maturity.

Audit Opinion

1.178 The Fund's accounts for 2003(H) received an unqualified audit opinion.

HOUSING GUARANTEE RESERVE FUND

1.179 The Housing Guarantee Reserve Fund (HGRF) was created in 1994 to make good any default which may arise from the Government guarantees provided under the Low Income Housing Scheme. The guarantees cover between 10 and 35% of the upper layer of loans and once this layer is repaid, the guarantee is extinguished. The Government's overall possible exposure is $14.6 million. The annual Reserve provision must be adjusted at the end of each year to equate to 15% of the aggregate liability outstanding against the actual guarantees.

1.180 The Portfolio of Finance previously administered the Fund and in February 2002, this responsibility was passed to the Cayman Islands Development Bank (CIDB).

1.181 The Government's guarantees totalled $5,350,000. The Fund's calculated balance at year-end was $802,500 ($5,350,000 x 15%). However, the balance in the Fund at year-end was $1,201,738 after payouts to the banks for defaulting borrowers of $108,826. This effectively caused an overprovision in the Fund of $399,238. Treasury has recognized the overprovision calculation by the Audit Office but has elected to leave as is and make the necessary adjustment to the Fund at a later date.

1.182 The Fund balance is kept in separate bank accounts and is comprised of two fixed deposits however no separate accounting records are maintained. Even though there is limited number of transactions for the Fund it is necessary that adequate financial records be maintained.

1.183 The government's contingent liability is set at approximately 35% of the mortgage total under the scheme representing its potential exposure. In previous years our review of the defaulters revealed that banks were including foreclosure costs in their claims. This resulted in demands that were in excess of the 35% guarantee on the defaulting loans and the government was honouring these claims. The Legal Department reviewed the contracts between the banks and the government under the scheme with a view to determining if their liability is limited to 35% of the loans given (and until that upper layer is repaid). It was noted from this review that the agreements "not only expressly excludes foreclosure costs as being part of the government's liability but expressly provides that such costs may be recovered from the mortgagors (the borrowers). However where the Bank is unable to recover the enforcement costs from the Borrower and/or out of the proceeds of sale then it may not look to the government for repayment of those costs out of the guarantee". Following from this review the Cayman Islands Development Bank (CIDB) has discontinued the practice of making payouts in excess of the government's liability on defaulted loans.

1.184 The total payout by the government to the participating banks for defaults under the scheme since 2000 totals $457,115 and is detailed in **TABLE 19**.

TABLE 19: LOANS IN DEFAULT

Year	Total Default Paid Out ($)	Number of Defaulters
2000	75,559	3
2001	112,813	3
2002	244,342	5
2003(H)	24,401	1
	457,115	**12**

1.185 There is little evidence that efforts have been made to recover these amounts. Government ought to take a much more vigorous approach in attempting to recover the amounts owing by the defaulters. The Debt Recovery Unit could assist with collection. Insofar as pursuing the recourse to recover government's monies paid out under the demand notices, the CIDB has discussed this with the Legal Department. It was their view that although there was an implied liability, it was highly unlikely that the debt would be repaid if the borrowers were unable to pay in the first instance. Notwithstanding this, the CIDB has agreed to pursue Audit's recommendation to discuss this matter with the Treasury's Debt Recovery Unit.

Audit Opinion

1.186 The Fund's accounts for 2003(H) received an unqualified audit opinion.

Report of the Auditor General

PART II

Audits of Statutory Authorities and Other Public Bodies

2.01 The table below highlights the status of the various Statutory Authorities' audits my Office conducts.

Table 20: Status of Financial Statement Audits of Statutory Authorities

Entity	Year-ended	Audit Completed/ Date Signed Off	Tabled in LA	Note
Cayman Islands Development Bank	10 mths to 31 Dec 2002	(S) 31 October 2003.	Yes	
Cayman Islands Development Bank	6 mths to 30 June 2003	(S) 16 February 2004	No	A
Cayman Islands Stock Exchange	31 December 2002	(S) September 2003	Yes	B
Cayman Islands Stock Exchange	30 June 2003	(S) 16 February 2004	No	A
Civil Aviation Authority	31 December 2000	(S) 19 June 2002	No	A
Civil Aviation Authority	31 December 2001	(S) 09 December 2002	No	A
Civil Aviation Authority	31 December 2002	Substantially completed	N/A	B
Civil Aviation Authority	30 June 2003	Substantially completed	N/A	B
Community College	31 December 2002	Substantially completed	N/A	B
Health Services Authority	30 June 2003	In progress	N/A	B
Information and Communications Technology Authority	30 June 2003 (13 month audit)	In progress	N/A	B
Monetary Authority	30 June 2003	(S) 30 October 2003	No	A
National Drug Council	30 June 2002	(S) 15 January 2003	No	A
National Drug Council	30 June 2003	(S) 9 June 2004	No	A
Port Authority	31 December 2001	(S) 9 January 2003	No	A
Port Authority	31 December 2002	(S) 16 March 2004	No	A
Public Service Pensions Fund	31 December 1999	(S) 14 March 2003	No	A

Entity	Year-ended	Audit Completed/ Date Signed Off	Tabled in LA	Note
Public Service Pensions Fund	31 December 2000	(S) 21 July 2004	No	A
Public Service Pensions Fund	31 December 2001	In progress	N/A	B
Tourism Attraction Board	31 December 1998	(S) 31 July 2002	No	A
Tourism Attraction Board	31 December 1999	(S) 31 July 2002	No	A
Tourism Attraction Board	31 December 2000	(S) 18 February 2003	No	A
Tourism Attraction Board	31 December 2001	(S) 02 September 2003	No	A
Tourism Attraction Board	31 December 2002	(S) 27 February 2004	No	A
Water Authority	31 December 1999	(S) 14 March 2001	No	A
Water Authority	31 December 2000	(S) 3 September 2001	No	A
Water Authority	31 December 2001	(S) 31 July 2002	No	A
Water Authority	31 December 2002	(S) 18 June 2003	No	A
Water Authority	30 June 2003	(S) 21 January 2004	No	A

NOTES:	
A:	Audit completed and audit opinion issued but statements not tabled in the Legislative Assembly.
B:	Draft financial statements received and audit is underway.
C:	Appointment of auditors not yet finalised
(S):	Date audited financial statements were signed by the AG.
N/A	Not applicable, as not audit completed.

Cayman Islands Development Bank

2.02 The Agricultural and Industrial Development Board (AIDB) and the Housing Development Corporation (HDC) merged in 2002 to form a new entity. Effective 1 March 2002, the AIDB and the HDC were dissolved and all the assets and liabilities and powers and functions were transferred to the Cayman Islands Development Bank (CIDB) by virtue of the Cayman Islands Development Bank Law (2001). The financial statements for the 10-month period to 31 December 2002 were certified on 31 October 2003.

2.03 The CIDB changed its fiscal year end from 31 December to 30 June to bring the Bank's financial year–end in line with the Public Management and Finance Law (Revision 2003) as it relates to the Entire Public Sector. The financial statements for the six-month period ended 30 June 2003 were certified on 16 February 2004. I have no further report to make on these accounts.

CAYMAN ISLANDS STOCK EXCHANGE LTD

2.04 The financial statements of the Cayman Islands Stock Exchange (CSX) are audited by a private sector auditor appointed by the Stock Exchange Authority with the approval of the Financial Secretary. Under sections 14(7) and (8) of the Cayman Islands Stock Exchange Company Law, the Auditor General is also required to provide an opinion on the financial statements.

2.05 For the 31 December 2002 financial year-end, there were no contentious issues and the accounts were certified in September 2003.

2.06 The CSX has opted, based on the advice of the FMI Adviser and to fall in line with the Public Management and Finance Law (2003 Revison) to prepare accounts for the 18 months to June 2004, thus not producing accounts to 31 December 2003.

CIVIL AVIATION AUTHORITY (CAA)

2.07 The audits of the Civil Aviation Authority's financial statements for the year ended 31 December 2002 and for the six months ended 30 June 2003 were completed during 2003. However the audit opinions were not issued because of clarification relating to Past Service Pensions Liability (PSPL) from the Public Service Pensions Board (PSPB). In previous years the audit opinions included a matter of emphasis paragraph relating to PSPL which were not included in the financial statements.

2.08 On 19 December 2003 the Public Service Pensions Board informed the CAA they would not be required to reflect any amount relating to the unfunded Past Service Pensions Liability on CAA's financial statements for 2002 going forward until further directive from the Government. CAA's management made the necessary changes to the financial statements based on the directive received from the PSPB. Subsequently the CAA was informed that letter of 19 December 2003 was incorrect. The statements had to be changed once more and we hope to certify these soon.

COMMUNITY COLLEGE OF THE CAYMAN ISLANDS

2.09 The audit of the College's financial statements for the year ended 31 December 2002 was substantially completed during the first quarter of 2004. These statements will be certified soon.

CAYMAN ISLANDS MONETARY AUTHORITY

2.10 The Cayman Islands Monetary Authority (CIMA) amended their Law to be consistent with the June year-end as stated in the Public Management and Finance Law (2001). As such the 2003 accounts were prepared for six months from January to June 2003.

2.11 CIMA's financial statements for the six-month period ended 30 June 2003 were certified on 30 October 2003. An unqualified audit opinion was issued. The non-accrual of Past Service Pensions Liability (PSPL) which gave rise to a '*matter of emphasis*' paragraph in the audit opinion for the year ended 31 December 2001 had been dropped due to the Director of Pensions indicating that the Unfunded Past Service Liability should remain a liability of the Entire Public Sector (EPS).

2.12 My Office had extensive correspondence and discussions with the Board and the Financial Secretary (also the Chairman of the Public Service Pensions Board) to attempt to resolve the matter of who the PSPL belonged to (EPS or the Authority). The Financial Secretary noted that the individual Authorities would in fact be responsible for their respective PSPLs as they were established as an economic entity whereby they would be responsible for all their obligations. As such, the PSPL for CIMA will need to be accrued for or I will have to re-instate the '*matter of emphasis*' paragraph in the audit opinion for the year ended 30 June 2004.

2.13 I have no further report to make on this account.

HEALTH SERVICES AUTHORITY

2.14 The Health Services Authority (HSA) is a new audit for the Audit Office for the year ending 30 June 2003. The HSA was established by *The Health Services Authority Law, 2002* and began operations on 1 July 2002. The HSA is to provide health care services and facilities in the Cayman Islands in accordance with the National Strategic Plan for Health prepared by Government. The HSA is to promote the health and wellness of the patients of those facilities, provide public health programmes, and provide health care for employees of the Government, indigent persons and such others as may be agreed upon with the Minister of Health. In conjunction with the financial statement audit we have also prepared a report called the ***HSA Viability Report***, of which a summary is found in **Part III** of this report.

2.15 The Board of the HSA reports to the Legislative Assembly through the Minister of Health Services, Agriculture, Aviation and Works.

2.16 The audit of the Health Services Authority for both the opening balance sheet as at 1 July 2002 and for the year ended 30 June 2003 has been delayed substantially due to lack of information and unresolved issues. Recently, we communicated a deadline date of 18 June 2004 to the HSA as a cut-off to provide us with the remaining information that has been requested. If we have not received any information by that date it will be assumed that there is not sufficient audit evidence to support those line items and therefore we will have to qualify our audit opinion on the financial statements.

2.17 There was not a proper accounting system in place prior to the commencement of the operations of the HSA to measure accrual information and prepare accrual financial statements. Therefore, there is an information vacuum concerning typical balance sheet items like inventory and fixed assets. Even though there was a system in place for measuring accounts receivable information in prior years, our past audits revealed that this system was also very weak and unreliable. A significant amount of work was done in an attempt to prepare reasonable opening balance sheet numbers, which has caused the delay of the auditing of the financial statements.

2.18 As a result of this delay, the HSA has not complied with section 28 of the HSA Law. Section 28 requires the HSA to prepare financial statements within two months (August 2003) of the end of the financial year and submit to the Auditor General for auditing, and the Auditor General is to provide a written report on such statements within two months (October 2003) of the receipt of the financial statements. Section 28 also requires an annual report to be presented to the Governor in Council by the Minister no later than 4 months (October 2003) after the end of the financial year and this report is to be presented to the Legislative Assembly no later than four months and two weeks after the end of the financial year or the first sitting day thereafter by the Minister.

2.19 In our opinion, there is a serious accountability issue arising as a result of this significant delay in preparing accurate financial statements, submitting them to the Governor in Council and presenting them to the Legislative Assembly. Public funds have been entrusted to the Authority to provide health care services and facilities to the people of the Cayman Islands. Reports need to be provided to the Governor in Council and the Legislative Assembly in a timely manner to ensure that the accountability cycle is maintained and public debate can occur in regards to the adequacy of its operations.

Recommendation

2.20 The Authority should establish proper financial systems to enable it to prepare accurate accrual financial statements in accordance with International Financial Reporting Standards. The financial statements should be prepared, submitted to the Governor in Council, and laid in the Legislative Assembly in accordance with *The Health Service Authority Law, 2002.*

INFORMATION & COMMUNICATIONS TECHNOLOGY AUTHORITY

2.21 The Information & Communications Technology Authority (ICTA) is a new audit for the Audit Office for the year ending 30 June 2003. The ICTA was established on 6 May 2002 by *The Information & Communications Technology Authority Law, 2002.* The ICTA received initial funding on 12 July 2002, appointed its first staff in August of 2002 and thereafter progressively started assuming responsibility for the regulation and licensing of telecommunications, broadcasting, and all forms of radio which includes ship, aircraft, mobile and amateur radio. The ICTA conducts the administration and management of the *.ky* domain, and also has a number of responsibilities under *The Electronic Transactions Law 2000*.

2.22 The Board of the ICTA reports to the Legislative Assembly through the Minister of Planning, Communications, District Administration and Information Technology.

2.23 The ICTA Law indicates that the financial year of the Authority is to end on 31st December or such other date as the Board resolves. In February 2003 we held a meeting with the Managing Director of the Authority to determine whether financial statements would be prepared for us to audit in accordance with Section 20 of The ICTA Law. We were provided with a partial set of financial statements at this meeting. On the 3 June 2003 we wrote to the Chair of the Authority outlining some options available to the Authority in preparing a complete set of financial statements and the implications of each option. A letter was received back from the Authority on the 23 June 2003 indicating that the Board passed a formal resolution (11 June 2003) amending their first financial year to 30 June 2003.

2.24 During the initial start up period and during the first year of operations significant issues regarding the appropriate method of funding the operations of the Authority and how to account for this funding needed to be resolved by Government and the Authority. Due to these factors, the audit of the 30 June 2003 financial statements has been significantly delayed.

2.25 As a result of this delay the Authority has not complied with Section 21 of the ICTA Law because it has not submitted to the Governor in Council a report within 6 months of the revised year end (i.e. December 2003) on it activities and transactions during the previous financial year along with audited accounts. These reports are then to be laid on the Table of the Legislative Assembly by the Minister not later than 3 months (i.e. March 2004) following their submission to the Governor in Council.

2.26 Although the Authority has complied with Government's internal financial reporting requirements, it has been unable to give sufficient priority to the preparation of the financial statements required by the ICTA Law due to other work pressures during the first year of operations. In our opinion, this raises a serious accountability issue because public funds have been entrusted to the Authority to regulate the information and communications industry. Reports need to be provided to the Governor in Council and the Legislative Assembly in a timely manner to ensure that the accountability cycle is maintained and public debate can occur in regards to the adequacy of the Authority's operations. The Authority has indicated to us that in the future it should be able to meet the deadlines as stated in the ICTA Law.

Recommendation

2.27 The Authority should prepare adequate accrual financial statements in accordance with International Financial Reporting Standards. The financial statements should be prepared, submitted to the Governor in Council, and laid in the Legislative Assembly within the time frame specified under the ICTA Law.

NATIONAL DRUG COUNCIL

2.28 The National Drug Council's financial statements for the year ended 30 June 2003 were certified on 9 June 2004. An unqualified audit opinion was issued. However, the 30 June 2003 financial statements and audit thereof were delayed significantly. Every effort must be made to prepare the financial statements accurately and in a timely manner in order for them to be used as an effective accountability tool. The audit was also delayed as a result of Audit Office priorities changing due to loss of personnel.

2.29 Under Section 24 of the *National Drug Council Law (2003 Revision)*, the National Drug Council (Council) is to submit within six months (December) after the end of each financial year a report on the operation of the Council and a copy of audited financial statements to the Minister of Health Services, Agriculture, Aviation and Works. The Minister is to lay these reports on the Table of the Legislative Assembly not later than 30 June following the end of the financial year to which they relate.

2.30 The Council's 30 June 2002 financial statements were certified on 15 January 2003. However, these financial statements have not been tabled in the Legislative Assembly as of 30 June 2003. The 30 June 2003 annual report and financial statements also have not been tabled within the required timelines. As a result the Council has not complied with Section 24 of the *National Drug Council Law (2003 Revision)*.

2.31 I anticipated the annual report along with the financial statements would be tabled in the Legislative Assembly soon after the audit opinion was issued. It is important that the annual reports and financial statements are tabled on a regular basis to ensure proper accountability of the Council's operations.

Recommendation

2.32 The financial statements should be prepared, submitted to the Minister, and tabled in the Legislative Assembly in accordance with the Law.

2.33 There were no other significant items to report for the National Drug Council for the year ending 30 June 2003.

PORT AUTHORITY OF THE CAYMAN ISLANDS

2.34 The Port Authority of the Cayman Islands (the "Port Authority") is a statutory body established on 15 September 1976 under the *Port Authority Law*. The Port Authority is principally engaged in the management and control of all ports; the general supervision of territorial waters and of vessels and wrecks located therein; and the loading and unloading of vessels.

2.35 The audit of the Port Authority financial statements are carried out on my behalf by a recognised accounting firm. They have carried out their audit work in accordance with International Standards on Auditing.

2.36 The 31 December 2002 audited financial statements were signed off on 16 March 2004. An unqualified audit opinion was issued. The 31 December 2003 audit has been completed and the financial statements were sent to the Board for approval on 30 June 2004. At this time the Board has not approved the financial statements.

2.37 During the 2003 audit two legislative matters came to our attention:

Report on activities not being prepared

2.38 Under subsection 4(10) of *The Port Authority Law (1999 Revision)*, the Authority is to prepare, within one month of the receipt of Auditor's Report on its financial accounts, a report on its activities during the period and submit this report along with the Auditor's Report to be published as soon as practicable as a supplement to the Gazette.

2.39 The Authority has not prepared any reports on its activities and has only submitted in the past the Auditor's Report and relating financial statements to be published in the Gazette. The financial statements for the years ending 31 December 2001 & 2002 have not yet been published in the Gazette. We issued our Auditor's Report on these financial statements 9 January 2003 and 16 March 2004 respectively. I anticipated the annual report along with the financial statements for that year and my Auditor's Report would be tabled in the Legislative Assembly soon after the audit opinion was issued. It is important that the annual report on its operations is prepared and financial statements are tabled in a timely manner to ensure proper accountability of the Authority's operations. Management has indicated to us that reports on its activities are prepared and submitted to the Board regularly, but have not been gazetted.

2.40 As a result, in our opinion, the Authority has not complied with subsection 4(10) of *The Port Authority Law (1999 Revision).*

Recommendation

2.41 The Authority should prepare an annual report on its activities and submit this along with the financial statements and Auditor's Report to be published in the Gazette in accordance with subsection 4(10) of the Port Authority Law.

Board meetings not held regularly & board minutes not signed off

2.42 Board meetings were not held regularly throughout 2003 as The Port Authority Law requires. Under sub-section 3(4) "*The Authority shall meet at least once in every month and at such other times as meetings may be convened by the Chairman*". In 2003, the Board met only five times, and held one special meeting.

2.43 It is important for a Board to meet regularly to ensure appropriate governance is maintained over the organisation. Without regular Board meetings it is hard to hold management accountable for carrying out the directions of the Board, or let alone for management to know what directions the Board wants them to carry out.

2.44 It has also come to our attention that the Board minutes for the Authority are not signed off once approved by the Board. It is important to sign off the Board minutes to certify that they are a true and accurate account of the proceedings that occurred during the Board meeting. We also reported this issue for the 2002 year-end financial statements to management.

Recommendation:

2.45 The Chairman should convene a Board meeting at least once a month in accordance with the Port Authority Law.

2.46 The Chairman and Secretary of the Board should sign off the minutes once they are approved by the Board, indicating that these are a true and accurate account of the proceedings.

Future value for money audit

2.47 During 2004-05 year we plan to carry out a value for money audit on the tendering and construction of the George Town and West Bay cruise ship terminal projects. It is important that contracts are awarded in an open, fair and equitable manner through the tendering process so that value for money is achieved.

PUBLIC SERVICE PENSIONS BOARD (PSPB)

31 December 2000

2.48 The first draft financial statements for 2000 were submitted to our Office for audit on 29 October 2002. However due to the absence of key senior accounting personnel we were unable to commence the audit until 1st December 2003 – thirteen (13) months after.

2.49 Due to our internal planning issues, a second draft set of financials was received on 5 January 2004 with supporting schedules and full fieldwork was underway. We were able to conclude the majority of the audit and had our internal review completed in the first week of February. During the months of March, April and May there were contentious issues for the Board to resolve and provide to us to be able to have the accounts certified.

2.50 The financial statements were certified on 21 July 2004.

31 December 2001

2.51 The Board has been put on a very tight deadline by the Chairman to have the backlog of accounts updated to 31 December 2003 before the end of 2004. The Audit Office has re-affirmed that we would ensure, as much as we are able to, that those rigorous deadlines are met. The Board submitted the 31 December 2001 to 2003 financial statements for audit at the end of July 2004. The audits are underway with staff from various managers involved to be able to complete them as soon as possible.

TOURISM ATTRACTION BOARD[2]

2.52 The financial statements for the year ended 31 December 2002 were certified on 27 February 2004. In our audit opinion we had a scope limitation relating to revenues at Pedro St. James, the Pirates Week Festival and the Queen Elizabeth II Botanic Park.

2.53 At the date of compiling this report, the financial statements for the years ended 31 December 1998, 1999, 2000, 2001 and 2002 have yet to be tabled in the Legislative Assembly. This delay is of particular concern to me.

WATER AUTHORITY

2.54 The Water Authority is a statutory body that was established on 1 January 1990 under the Water Authority Law. The Water Authority is principally engaged in

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[2] The Board has statutory responsibility for the operation and management of Pedro St James, Queen Elizabeth II Botanic Park, Pirates Week Festival and Hell.

the management of water supply and sanitation affairs of the Cayman Islands including the provision of public water supplies, sewerage systems and the management, development and protection of water resources.

2.55 The fiscal period for the Water Authority was changed to 30 June in 2003 to correspond to the change in fiscal period of the Government of the Cayman Islands.

2.56 The Water Authority's financial statements for the six-months ended 30 June 2003 were certified on 21 January 2004. An unqualified audit opinion was issued.

Report on activities not being prepared

2.57 Under Section 18 of the *Water Authority Law (1996 Revision)*, the Authority is to within one month of its receipt of the Auditor General's Report, prepare a report on its activities during the period and together with the audited accounts they shall be laid on the table of the Legislative Assembly.

2.58 The Annual Report, Auditor General's Report and the audited accounts have not been tabled for the 1999 to 2003 year ends. As a result the Water Authority has not complied with Section 18 of the *Water Authority Law (1996 Revision)*. It is important that the annual reports and financial statements are tabled on a regular basis to ensure proper accountability of the Authority's operations.

Year End	Auditor General's Report issued	Tabling Deadline
31 Dec 1999	14 March 2001	14 April 2001
31 Dec 2000	3 September 2001	3 October 2001
31 Dec 2001	31 July 2002	30 August 2002
31 Dec 2002	18 June 2003	18 July 2003
30 June 2003	21 January 2004	21 February 2004

Recommendation:

2.59 The Annual Report, the Auditor General's Report and audited accounts should be prepared, submitted to the Minister, and tabled in the Legislative Assembly in accordance with the Law.

NON – PUBLIC FUNDS

2.60 This section of the report is submitted pursuant to section 47(2) of the Public Finance and Audit Law (1997 Revision) and deals specifically with the Auditor General's certification of non-public funds. For avoidance of doubt, these Funds represent monies under the control and management of Government officials. The Funds are segregated and are not available to be appropriated and spent by the Cayman Islands Government.

COURT FUNDS OFFICE

2.61 Audit work on the 1998, 1999 and 2000 financial statements was substantially completed. The Treasury Department submitted financial statements for the years ended 31 December 1998, 1999, 2000 and 2001 during December 2002. Audit work on the 1998 financial statements was substantially completed at the end of December 2000. However we did not obtain the completed general ledger records and some duplicate receipts for 1998 relating to Cayman Brac. It is anticipated that the audits for the year's 1998 to 2001 will be completed by the end of the first quarter of 2003-2004.

REPORT OF THE AUDITOR GENERAL – 2003 HALF

PART III

VALUE FOR MONEY REPORTS

PRISON DEPARTMENT

INTRODUCTION

3.01 The Prison Department (HMP Northward) is responsible for the confinement of persons convicted of crimes committed in the Cayman Islands and sentenced to terms of incarceration. It also caters to prisoners on remand, those adjudicated to be mentally unsafe, persons awaiting deportation, and others who are not convicted but need to be detained. The most important strategic goal of the prison is to protect the Caymanian society by providing for the safe, humane and secure confinement of prisoners. The Prison department develops correctional programs that seek a balanced application of the concepts of punishment, deterrence and incapacitation with opportunities to prepare the offender for successful reintegration into society.

Overview of the Prison Department

3.02 The Prison department has two residential facilities. The male facility at Northward has a stated capacity for 214 inmates, and the female facility at Fairbanks has a stated capacity for 32. Prior to the riots in September 1999 the Northward facility housed approximately 300 male and female prisoners.

3.03 Control of the Prison after the 2 days riot was not fully re-established for a further 50 days and over the two years subsequent to the riots the Prison department faced significant challenges. A detailed departmental report was sent to the management of the Prison. I last reported on the Prison in my 1996 Auditor General's Report. It seemed that a significant factor contributing to the 1999 riot was overcrowding at the Prison. I decided to examine the adequacy of the Prison infrastructure. I also decided to carryout an audit of the financial management and operations of the Prison.

3.04 Since the date of the audit, December 2001, some changes have been made at the Prison. An administrative manager has been employed and the prisoners' savings account, previously overdrawn and included in a departmental report, was corrected. This point has been deleted from the report. It is possible that management may have already dealt with some other matters that are included in this report. We commend management for taking the necessary action in those cases.

AUDIT FINDINGS

Related Party Transactions

3.05 A wide array of overseas purchases was made from a Miami based company operating from a private residence. The Stores Controller (SC) at HMP Northward was a principal of this company. From 30 August 2000 (two days after formation) to February 2002 approximately USD $38,000 was sold to the Prison. The company filed for voluntary dissolution in March 2002.

3.06 The Royal Cayman Islands Police confirmed that:

- The Stores Controller was a principal of the company,
- The company was operating out of a private residence, and
- The date of formation was 28 August 2000.

3.07 We further observed that the SC of HMP Northward travelled to Miami on the 24 August 2000 on a ticket purchased from Prison funds. The Director said that although the SC was on personal business, the SC made a purchase valuing US$500 from the company, thus he felt that the purchase of the ticket was reasonable under the circumstances. This purchase on 30 August 2000 occurred only two days after formation of this company.

3.08 Whilst the timing of the travel and the initial purchase from the company may seem coincidental, there exists the possibility that the SC used publicly funded travel to arrange the establishment of a personal and private business, which later became a supplier to HMP.

3.09 Purchases from the company for the year 2000 were US$2,964.60 and purchases for 2001 totalled US$23,418.81. As at 12 February 2002 the Prison has already been billed US$11,678.12, which represents approximately 50% of the purchases made in 2001. We reviewed all purchases made from the company during the year 2001. We found that the company appeared to have issued 28 invoices. Of this amount, 17 were to the Prison Department. This represents approximately 61% of the range of invoices. This led us to conclude the Prison Department is one of the company's major customers. Our general conclusion is that increasing reliance is being placed on the company as a supplier to HMP Northward.

3.10 While the purchases are of small amounts over approximately two years, we have obtained credible evidence that a larger purchasing scheme was in the making to include other government departments. The general plan was to purchase items in bulk and to store them in containers on HMP property.

3.11 General Orders Chapter 9 Sections 6(c) and (d) are relevant to the type of activity described in the preceding paragraphs. In particular, Section 6(c) quite clearly states that an officer may not at any time engage in any activity, which might place him or give the appearance of placing him in a position to use his official appointment for his private benefit.

PURCHASE OF INDUSTRIAL WASHING MACHINES

3.12 The Prison lost its laundry facilities during the riot in September 1999. As an interim measure the Public Works Department (PWD) purchased twelve domestic washers and dryers for the Prison. As a longer-term solution to this problem, three industrial washing machines and two industrial dryers costing $66,460 were purchased in November 1999. As at the end of March 2002, twenty-eight months subsequent to purchase, these were not installed and operational. The cost of repairs to the building to house the laundry facilities and installation of the equipment is estimated at $62,000. The Prison department commented that although requests were made in two previous year budgets, funds were only made available in the 2002 budget for this project to be completed.

3.13 There was no evidence that bids or quotes were obtained for the supply of the equipment. Additionally the invoice from the overseas supplier appeared to be generic. The Audit Office reproduced a similar invoice from Microsoft Excel. This seems to indicate that the invoice may not be a true original.

3.14 We were unable to determine whether the equipment was acquired at the lowest possible price, with consideration given to quality, performance and the warranty period. However, the Prison Department has confirmed that the warranty on the machines has expired.

The terms of the purchase arrangement are unknown, and we cannot determine whether the supplier should have installed the equipment.

Management Controls over Purchasing

3.15 Management controls over the purchasing system are weak, and in particular there is lack of segregation of duties. The Stores Controller orders, receives, records and issues goods. In many cases goods are received without purchase orders being prepared.

3.16 In addition there was no evidence seen that competitive quotes were obtained before purchases were made either locally or overseas.

Infrastructure Needs

3.17 Prison Infrastructure and the resulting overcrowding was a significant contributing factor to the 1999 riot. Significant improvements were made since then. In particular a two storey visitors' block has been built through the initiative of Prison Officers, prisoners and contributions from members of the community.

3.18 Prison management provided us with other examples of initiative and community support in infrastructure development:

- The former training room was converted largely through recycled materials into a central stores area.
- The canteen was moved into a customised container.
- The education classrooms, including a computer room were developed over the former medical centre.
- The prison was zoned with fences made of recycled material so that all wings are now enclosed with their own discrete perimeter.
- A customised container was converted into the medical treatment room.
- The burnt out auto body shop was extended and refurbished into a Reception Building and prisoner's property store.
- An additional 3 cells have been reclaimed on B wing. In addition a staff toilet has been provided.
- The former medical and dental surgeries facility has been converted into two six bedded dormitories with their own shower and lavatory facilities.
- The burnt out dormitory on A-wing has been refurbished, and equipped with donated gym equipment.
- The exercise yard on the end of A-wing has been converted into a secure yard.
- The internal area between C wing and the sports field has been converted into a market garden area.
- A hut has been acquired and installed to protect the garbage compactor.
- Former staff bungalows have been turned into the Caribbean Training Centre, which successfully opened in May 2001.

- The maintenance facility was moved to the stores area.
- With money from the Foreign Commonwealth Office, cameras and electronic locks have been installed in various locations throughout the prison.
- The former gate office has been extended and equipped to provide a communications room.
- Upgraded the security of the cellblocks, particularly the windows in D wing and the security grill on B.
- Former Director's residential bungalow has been refurbished as a Headquarters enabling the administrative Department to move out of the prison in to the former Headquarters.
- Work is in progress to convert the former prisoners dining hall into a central laundry, expanded tailors shop and wash up for the kitchen.
- One of the former staff bungalows has been converted into a hostel for long-term minimum-security prisoners.
- Concrete trolley ways to the wings from the kitchen are being constructed.
- An extension on B wing to provide association and dining facilities is in progress.
- Visitors' waiting room and an area to sell prison produce are in progress.
- At Fairbanks a well-equipped classroom has been established.

3.19 Notwithstanding the progress made since the 1999 riots, we noted that prisoners are still being held at the police lock ups. This highlights that there are still additional infrastructure needs.

Inmates at Northward for Immigration Matters

3.20 Inmates held at Northward for immigration matters contribute to overcrowding at this facility. In December 2001, auditors noted that the Prison population stood at 211 based on the manual records maintained. It was further observed that three additional inmates were brought in by the RCIP, which took the population to 214 inmates, which is the stated capacity of the Prison. A check of the manual records maintained revealed that two of these new inmates were brought in for a period of 14 days each. The reasons for incarceration was overstaying and working without a work permit, respectively.

3.21 Based on records maintained at the Prison twenty persons were sent to Northward for crimes relating to work permit offences and overstaying during the period January 2000 to November 2001. Incarceration periods for these offences ranged from 14 days to five months. This highlights the need for short term holding facilities. A careful assessment should be conducted to determine the future needs of the Prison facilities in the Cayman Islands.

SUCCESSION MANAGEMENT

3.22 In a report entitled, "***Report on The Inspection of Northward and Fairbanks Prison on Grand Cayman, 25 – 30 March 2001***" written by Her Majesty's Chief Inspector of Prisons, Sir David Ramsbotham, the issue of succession management was raised.

3.23 The Cayman Islands Audit Office received a copy of this report after we had issued our departmental report to the Prison. However we noted that there are some similar and even more robust recommendations made by HM Chief Inspector of Prisons. Particularly the report recommended that:

- *"A competition should be held for accelerated promotion to Assistant Director and Director for non-United Kingdom staff. Successful candidates should undertake an intensive training programme at home and abroad to develop the required skills and competencies. Part of such a training programme should include a secondment to the Prison Inspectorate."*
- *"Senior managers should introduce effective systems across the establishment to control prisoners and an urgent programme of staff training should be embarked upon that concentrates on the day to day tasks that face all staff…"*

3.24 Sixteen of the twenty UK Prison Officers employed in early 2000 to take up positions at HM Northward to enhance security after the September 1999 riot left after the expiry of their two-year contract. We noted at the time that local prison officers had not been employed and trained to take up the vacant positions left by these experienced officers. Instead a lower grade of auxiliary officers has been hired.

3.25 Discussion with several UK officers revealed that they were recruited to implement UK Prison Standards and to provide training for staff that would ensure the smooth and efficient operation of the Prison after their departure.

3.26 Succession management should apply to all staff but is most relevant to the senior management of the Prison. There is an expectation that senior management of HMP will be Caymanians in the not too distant future. This vision may be delayed or impaired should plans for succession management not be effectively implemented. We suggest that management carry out an analysis of the human resources needs of the prison to decide whether current staff progression schemes are adequate to implement the recommendations by HM Chief Inspector of Prisons to enable Caymanians to fill directorship and other senior roles competently.

Human Resource Benefits

Pensions for Seconded United Kingdom Officers

3.27 Superannuation for some twenty seconded UK Prison Officers has not been paid over to the UK Prison Service as at January 2002. Additionally, those UK Prison Officers who have served 20 years or more are entitled to a double pension contribution for each year served in excess of the twenty.

3.28 As of 28 February 2002, HMP Northward, neither the Personnel department nor the London Office was able to quantify the amount of this liability. It is probable that a substantial bill will be presented to Government. HMP is attempting to get information from the UK Authorities. This liability needs to be quantified and included in Government's accrual based financial statements 1 July 2004, if the amount is still outstanding as at that date.

Officers receiving Contracted Officer Supplement and Cayman Islands Government paid UK Pension

3.29 During the review of the personal emoluments we noted that UK officers on secondment were entitled to both Contracted Officers Supplement (C.O.S.) and UK pension from the Cayman Islands Government. The C.O.S. is a 15% monthly cash payment in lieu of pensions, which is not available to pension entitled employees. Additionally the Public Service Pension Law 2000, section 3 states that:

> *"An employee who is entitled to a contracted officer's supplement shall not be entitled to the coverage of the Plan and the administrator shall exempt such an employee from the coverage of the plan."*

3.30 Personnel Management Services Department cited that C.O.S. and pensions were given to the seconded officers (as advertised in the UK) because:

(i) The post 1999 riot conditions at the prison were unacceptable, and

(ii) To avert any potential delays caused by recruiting from a highly trade unionised UK Prison Service.

Payment of Housing Allowance

3.31 During 2001 one hundred and one Prison Officers received housing allowance, whereas thirty-four Officers did not receive this allowance. Included in those receiving the allowance are six officers also receiving Contracted Officers Supplement (C.O.S.), and ninety-one pension-entitled officers. Housing allowance of approximately $171,000 was paid to pension entitled and contracted officers in 2001. We were unable to determine those Prison Officers that were eligible for the payment of housing allowance because there was no housing allowance policy in place to guide who should receive it or not.

3.32 Concerning housing allowance, General Orders Chapter 10, section 2 states:

"The following groups of public officers are entitled to rent subsidy as stated:

(1) A Caymanian Officer who is compulsorily transferred within the Islands to an Island not being the officer's Island of domicile;

(2) *Police and prison officers to the extent provided in the law."*

3.33 Whereas the Police Regulations (1996 Revision), section 14 contains provision for payment of housing allowance, per our corroboration with the Personnel Department, there appears to be no such provision in the Prison Laws.

3.34 The Audit Office recommends that the management of the Prison should determine whether the payment of housing allowance to Prison officers is covered under the current laws and regulations. In addition we recommend that the criteria for entitlement be assessed for adequacy and fairness, since all officers at the time of audit were not receiving housing allowance.

INMATE SECURITY CLASSIFICATION AND THE WORK PARTY SYSTEM

3.35 The Prison Rules (1999 Revision), section allows for a standard system of categorisation of inmates entering H M Prison Northward. We were provided with documentation about the security categories of A, B, C, D or U. Table 1 lists the definition of the security categories.

Table 1: Categorisation of Prisoners

Security Category	Definition
A	Prisoners whose escape would be highly dangerous to the public, police or security of the State regardless how unlikely that escape might be and for whom the aim must be to make the escape impossible.
B	Prisoners for whom the very highest security conditions are not necessary but for whom escape must be made very difficult.
C	Prisoners who do not have the resources to make a determined escape attempt and can be trusted to work outside the institution under supervision.
D	Prisoners who can be reasonably trusted in open conditions without supervision.
U	All prisoners on remand awaiting trial, or convicted awaiting sentence, and those prisoners who have not been assessed by the internal classification board, as unclassified and, apart from potential Category A prisoners, will be treated as category B.

3.36 Generally all prisoners are classified as Category U upon arrival. However they may be down graded or up graded depending on the likelihood and means of escape. According to documents provided to us, an internal classification board is to meet regularly to decide on changes to categorisations of prisoners. Only category C and D inmates can be employed outside the perimeter of the Prison. Prison staff must supervise category C inmates when outside the establishment. Category D inmates can work unsupervised by prison staff.

3.37 This directly affects the work party system. Inmates with higher security categories (A and B) would most likely be assigned to a work party that is working on the inside of the prison, while categories C and D can work outside of the perimeter of the prison.

Labour Board Function

3.38 It would seem that the internal classification board referred to in Table 1 is the Labour Board of HMP Northward. The Prison guidelines which were provided to us regarding the treatment of inmates recommends the review of every prisoner's category at least once every three months, seeking opinions from a range of staff dealing with the prisoner. The Prison Labour Board is comprised of an assistant director, a security representative, and a representative of each of the prison wings.

3.39 Auditor General's staff attended a Labour Board meeting held on 6 December 2001, and noted the following:

(i) A prisoner's security level was reduced to Category C allowing him to work outside of the gated prison perimeter. However the inmate already had access to the outside of the prison while still classified as a Category B (prisoners for whom the very highest security conditions are not necessary but for whom escape must be made very difficult).

(ii) There were several other grants of lower security categories in order to facilitate construction and other jobs on the outside of the gated prison perimeter.

Labour Board Guidelines

3.40 We requested the criteria used for varying of inmate security levels, given the potential risk of escape and consequential effect on society, but these were not provided. There appears to be no clear policy on what criteria determines either work party size or guard to prisoner ratio. Neither does there appear to be any available guidelines for this area of prison operation.

3.41 To ensure that security, the interest of society, and inmates' needs are at optimal levels, there must be a well-designed and enforceable documented operational procedure covering inmate security within a work party that is followed.

Grade S Prisoners

3.42 Grade S Prisoners are inmates who can work in the community on a pre-release program. The program is meant to provide re-integration into society for inmates who are approaching the end of their sentence.

3.43 From our discussions with HMP personnel the criteria to determine whether an inmate is eligible to work in the community and the method of employer to inmate assignment were not clear. We noted that there is insufficient information on the duration of employment and payment terms. The lack of criteria and structure to this process may give the perception of unfair treatment to prisoners, thus possibly retarding the rehabilitation process.

3.44 Our discussions with the personnel in charge of the inmate pre-release labour program do not satisfy us that the systems to monitor compliance with terms of employment are adequate. There appears to be no structured method of assessing inmate performance at an employer before they are released into society. Similarly there is no system to accurately account for funds received by HMP Northward.

Unpaid Expenditure in 2000 and 2001 has understated the cost of Prison Operations

3.45 Unpaid expenditures at the years ended 31 December 2000 and 2001 amounted to $217,977 and $196,997 respectively. When these amounts are factored into the total expenditures for those years the following results are evident: over expenditures are $564,906 or 9.15 % for 2000 and $489,957 or 7.34% for 2001.

3.46 Over the five-year period 1997 to 2001, the government has spent approximately $28.5 million on the cost of maintaining HM Prison. This is shown in **Table 2**. This cost does not include statutory expenditure, medical costs and depreciation charge for capital assets. In addition to the above, undetermined and unpaid UK superannuation expenses are due to increase both the 2000 and 2001 unpaid expenditure.

Table 2: Cost of Prison Operations 1997 - 2001

Year	Actual Expenditure $	Approved Expenditure $	(Under)/Over Spent $
1997	4,544,070	4,574,444	(30,374)
1998	4,816,452	4,745,942	70,510
1999	5,193,490	5,377,252	(183,762)
2000	6,740,792	6,175,886	564,906
2001	7,164,846	6,674,889	489,957
Total	28,459,650	27,548,413	911,237

Note: the 2000 and 2001 figures include the unpaid amounts noted above.

3.47 We were unable to establish the exact reasons for the unpaid expenditures. However, it is possible that this was due to no funds being available in the department's budget. In addition, the Treasury department usually closes off the general ledger early in December each year, which results in invoices not being paid.

3.48 The carrying over of unpaid bills to another year understates the true operating cost of the Prison. It is difficult to justify increased resources if these are understated in the first place.

2001 REVENUE ENHANCEMENT MEASURES

BACKGROUND

4.01 In September 2001, the Auditor General prepared a special report on '*The State of Public Finances*' relating to the financial position of the Cayman Islands Government as at 31 December 2000. At that time, the Government was facing a deepening cash crisis and unpaid expenditures exceeded $22 million. One of the primary reasons for this unanticipated financial position was the substantial shortfall in revenues that reached only $280.7 million against a budget of $314.2 million. The shortfall in revenues of approximately $33.5 million was mainly due to a slowdown in economic activity during 2000 when compared with 1995 to 1999.

4.02 In the 2001 Budget the government announced twenty-one revenue enhancement measures to earn increased revenues of $19.9 million. The government usually announces new/enhancement revenue measures to meet any shortfall, which has contributed to the divergence between what the country collects and what it spends on public services. Total revenues for 2001 reached only $287.5 million against a budget of $317.5 million, giving rise to a shortfall in revenues of $30 million. The government was able to keep a tight rein on expenditures that amounted to $310 million against a budget of $334.2 million. This reduction in actual expenditures of $24.2 million compared to budget coupled with loan income of $30 million was what enabled the government to end fiscal 2001 with a surplus.

4.03 We decided to review the reasonableness of the estimated amounts for the revenue enhancement measures given the substantial shortfall in revenues in 2000 and again in 2001.

DETAILS OF FINDINGS

REVENUE MEASURES - Overstated by approximately $1.7 million

4.04 Twenty-one new/enhancement revenue measures totalling $19,882,725 (see **Table 1)** were announced during the 2001 budget address.

Table 1: Estimated Revenues from 2001 New/Enhancement Revenue Measures[3]

	REVENUE MEASURE	CI$
1	Financial Services Fees[4]	1,845,037
2	Professional Licensing Fees	65,000
3	Vehicle Licensing Unit Fees	629,942
4	Environmental Health Fees	215,886
5	Spear-Gun Licenses	11,667
6	Law School Fees	13,400
7	Postal Fees	864,063
8	Customs Warehouse Fee & Package Tax[5]	1,629,450
9	M.R.C.U. Fees	56,951
10	Stamp Duty on Debit Transactions	1,166,667
11	Some Bakery Products (excluding bread)	5,250,000
12	Water	318,750
13	Ornamental Plants	375,000
14	Some Foodstuff	1,200,000
15	Personal Watercraft for Pleasure or Sports	262,500
16	Timeshare Fee	700,000

[3] The Cayman Islands Government - Budget Address 2001 delivered by the Honourable Financial Secretary, G.A. McCarthy, O.B.E., J.P.

[4] This amount includes $900,084 of General Registry Fees

[5] Comprised of Warehousage $1,086,300 and Package Tax $543,150.

17	Infrastructure Fee	641,666
18	Health Insurance Fund	4,300,000
19	Land holding Companies – Stamp Duty	70,000
20	Hotel/Condo/Guest House Room Tax	79,875
21	Various Administrative Fees	186,871
	TOTAL	**19,882,725**

4.05 In several instances, the calculations of the additional revenues were based on the new fees rather than the incremental fee increases. In other cases, the numbers used in the calculation seemed too optimistic. The impact of the timing of revenue earnings in some departments was excluded from the revenue measures calculation. Upon recalculation, it was determined that the total revenue measures were overstated by approximately $1,684,861. The largest errors noted were in the financial service fees ($670,833) and postal box fees ($611,839).

- The major problem in the calculations for financial service fees was the use of the increased fee for calculating the revenue enhancement rather than the incremental rates.
- In compiling the expected revenue enhancements for the various departments the Budget and Management Unit (BMU) excluded the important variable of the specific pattern of revenue generation during the year. This was most evident with postal box fees where most of the postal box rental fees are paid between January and April each year, but the new fee structure was implemented in the latter part of April 2001. Additional fees could not be earned in this case as BMU had predicted.
- During the review, the most critical deficiency that served to undermine the revenue projections was the unavailability of supporting evidence for the underlying numbers used in the estimates. This is a significant problem, as in too many instances we were told that the numbers used in these enhancement measures were "estimates".

4.06 This was raised with officials at the BMU and they said that the errors were due in part to, the tight deadline in which they had to prepare the revenue enhancement measures.

ENABLING LEGISLATION

4.07 The introduction of the revenue enhancement measures was mainly to alleviate the foreseen revenue shortfall in 2001. The BMU and the Financial Advisory Committee compiled the majority of the measures and from all indications, the relevant governmental departments made limited contributions to the process.

4.08 Some of the revenue measures were for the entire twelve months, some for nine months and others for seven months. Government intended to collect $4.3 million from the Health Insurance Fund and Room Tax for the full twelve months, nine months collection on import duty ($9 million), and seven months collection on the other items ($6.5 million). However, there were delays in the implementation of several of the fees. The June, July and August 2001 gazettes brought most of the new and increased fees into law. This was approximately three months and in some cases six months late, as many calculations were based on the government collecting the new fees for seven, nine and twelve months into the new year. The government had considerable losses in these areas.

4.09 In particular it was noted that one law was not passed at all during 2001, one was passed but not implemented and two others were enacted closer to the year-end. The revenue loss (using the BMU's revenue enhancement projections) was approximately $974,833. In the paragraph below we describe the revenue loss in relation to these four laws.

4.10 We were unable to precisely determine the reason(s) why the law relating to Laboratory Services was not passed during 2001. The estimated revenue loss was $14,945.

4.11 In the case of timeshare fees, there was industry outcry against this new revenue measure and it was not implemented. Estimated revenue loss was $700,000.

4.12 The collections of the Vehicle Disposal Fee, of $250 per car were originally expected to begin in June 2001, but the requisite law was not enacted until September 2001, and the Government lost four months of revenue within the year. This revenue loss was estimated at $251,333.

4.13 The government had proposed the implementation of several Training Services Fees for food handlers, beauty salons and swimming pool operators. These were gazetted as late as 3 December 2001. Estimated loss was $8,555.

REVENUE SHORTFALL - $30 MILLION

4.14 Revenues earned during 2001 totalled $287.5[6] million, which represented 90.6% of the budgeted amount, indicating an improvement over 2000 where 89.3% of budgeted revenues were earned. In the 2002 budget document the revenue shortfall noted in 2001 of $30 million was attributed mainly to the slow growth of the United States economy and the terrorist attacks of 11 September 2001. These factors exerted a negative impact on growth, primarily through effects on the tourism and construction industries.

4.15 Government did not collect an estimated $2.7 million of revenues from the revenue enhancement measures ($19.9 million) because of incorrect calculations, the non-passage as well as delays in the passing of legislation in a timely manner. The estimated loss due to incorrect calculations was $1.7 million and that due to delays and non-passage of laws was $975,000

4.16 Those revenue areas showing the largest shortfall in revenues from budget were analyzed in more detail. These are outlined in Table 2. These revenues fall under Treasury Department, Customs, Lands and Survey and Post Office, General Registry and the Infrastructure Development Fund.

Table 2: Actual vs. Budgeted Revenues

Account	Original Estimate	Revenue Enhancement	Total Expected	2001 Actual	Excess/ (Shortfall)
	$	$	$	$	$
Debit Transaction	-	1,166,667	1,166,667	97,979	(1,068,688)
Other Import Duty	62,000,000	7,406,250	69,406,250	55,575,783	(13,830,467)
Warehousage	148,000	1,086,300	1,234,300	265,707	(968,593)
Package Tax	135,700	543,150	678,850	202,267	(476,583)
Other Stamp Duty	7,665,000	700,000	8,365,000	5,816,123	(2,548,877)
Other Co. Fees	38,894,000	900,084	39,794,084	37,265,472	(2,528,612)
Infrastructure Fees	2,250,000	641,666	2,891,666	1,599,029	(1,292,637)
Total	**111,092,700**	**12,444,117**	**123,536,817**	**100,822,360**	**(22,714,457)**

[6] Cayman Islands Government 2001 Audited Financial Statements page 5

4.17 As shown in Table 2, these revenue areas had a total shortfall of $22.7 million, whereas the overall government experienced a shortfall of $30 million, indicating that the below expectation performance in these areas had the most negative impact on the governments ability to meet its revenue targets.

HOW WERE BUDGETED FIGURES DETERMINED & WHAT WERE THE MAIN REASONS FOR REVENUE SHORTFALLS?

4.18 We looked at some of the areas in Table 2 in more detail and noted the following:

a. Treasury Department - Debit Transaction Fees

4.19 The Debit Transaction Fees Legislation was issued under the Stamp Duty Law in June 2001. The fee was a new measure implemented by the government, which represents a charge of 10 cents on every debit transaction, estimated to be 20,000,000 in 2001, with $1,166,667 as budgeted revenue for seven months in 2001. The Finance Department explained that the expected number of annual transactions was estimated after consultation with the banking industry. It seems that the number of debit transactions used in the calculation was overstated since only $97,979 was actually collected.

4.20 Government did not establish an administrative framework for the collection of this new fee, and the Finance department indicated that this would be corrected. No checks are carried out on the completeness and correctness of the monthly debit transactions and the resulting remittances by the banks. In addition, no framework was established to ensure that all banks in operation on the Islands that have customers who make debit transactions make these remittances. Since the required remittances are not being made, the government is not in a position to determine the number of debit transactions that are done either monthly or annually, in the Islands.

4.21 As a result of collecting only $97,979 in fees of the estimated $1,166,667 in 2001, the government in its 2002 budget revised the number of expected annual transactions downward to 5,000,000 with expected revenue of $500,000. The less than expected fees may not be only as a result of smaller number of transactions, but also a case of non-payment of the fees by some banks to the government.

b. Customs Department - Other Import Duty

4.22 Other import duty encompasses everything that is imported into the Islands except motor vehicles, gasoline/diesel, alcoholic beverages and tobacco products that have their own customs tariff codes. The revenue measure with the most impact in this area related to a charge of 20% duty on some bakery products (excluding bread). The BMU in conjunction with the Statistics Department estimated that this 20% duty would apply to imports valued at $35,000,000.

4.23 The contracting of the economy severely affected the importation of goods, on which this income category is solely based. A comparison of the imports into the Islands for January to September 2001 with a similar period for 2000 showed a decline of approximately 10%, decreasing from $411.7 million to $371.2 million.[7]

4.24 The reduction in imports is largely attributed to the decline in the tourism and the construction industries, the most significant contributors to this income source. The tourism industry saw a 6% decline in air visitor arrivals in 2001, moving from 354,087 in 2000 to 334,071 in 2001[8]. Air arrivals are the backbone of the tourism industry, and due to the multiplier effect many areas have experienced declines in earnings. Cruise ship arrivals however, have experienced an 18% increase in 2001 moving from 1,030,857 to 1,214,757[9].

c. Customs Warehousage and Package Tax

4.25 Warehousage and Package tax figures were based on the actual for 2000, and projected to the year 2001. For those items that represented reintroduction of duties, the estimates were based on the declaration of import forms. The Customs Department took samples of these for one quarter and projected the numbers for the entire year. We were unable to verify whether the numbers used were reasonable, as the required documents were not provided.

d. Lands & Survey and Post Office

4.26 Revenue under these departments showed a shortfall of $2.5 million. The analysis of the other stamp duty category of revenue showed an original budget of

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[7] Economic Report (January-September 2002) by the Economic Research Unit, page iii

[8] International Tourism Arrivals, Air and Sea - Department of Tourism

[9] Refer to footnote # 6 on page 84.

$7,665,000. Income is derived from two sources, stamp duty from the Lands and Survey department ($6,500,000) and revenue stamps for the post office ($1,165,000). The greater part of income in this account is derived from the 1% government charge on all legally registered mortgages. The Lands and Survey department pointed out that the majority of the income earned is related to the legal documents being drafted, which is a general indication of the ongoing commercial activity within the economy. The fall off of the actual fees in relation to the budget is due to the relative decline in the real estate market.

4.27 The amount of $700,000 in timeshare fees (revenue measure) was not earned, as the law although passed, was never implemented. This is a serious issue which needs to be addressed.

e. General Registry - Other company fees

4.28 The four accounts of the General Registry that were affected by the enhancement measures were other company fees: non-resident, resident, foreign and exempt. Net shortfall in revenues was approximately $2.5 million. The $900,084 incremental revenue was evenly distributed amongst the four categories.

4.29 We were unable to obtain an explanation from the General Registry for the increase in estimated revenues in 2001 by $3.9 million (estimated revenues $38.9 million) when compared to the 2000 actual revenues of $35.04 million. Revenue enhancement of $900,084 further increased the expected amount compared to 2001 actual. Total estimated revenues of $39.8 million ($38.9 plus $0.9 million) would seem to have been an unjustified revenue expectation especially when the resulting under-performance of $2.5 million is considered.

4.30 The department provided documentation that clearly showed incremental revenues from increased fees for the entire 2001 amounting to $375,000. The BMU however included an amount of $900,084 as incremental revenues, an increase of $525,084.

f. Infrastructure Development Fund Fees

4.31 The Infrastructure Development Fund was created by the Development and Planning (Amendment) Law, 1997, for the purpose of providing funds for the development of roads and other infrastructure in the Islands.

4.32 The Fund receives revenue from two sources: Infrastructure Fees (collected by Planning Department) and 1.5% Stamp Duty from land sales in the 9% Stamp Duty range (collected by Lands & Survey). Infrastructure Fees are levied on building permits for industrial and commercial buildings, hotels, strata lots, apartments and houses exceeding 4,000 square feet, depending on the location.

4.33 Fees budgeted in this area was $2,250,000, with an additional $641,666 in revenue enhancement, bringing the total budgeted to $ 2,891,666. Total revenues realised in this area for 2001 were $1,599,029 a shortfall in revenue of $1,292,637.

4.34 The real estate industry as mentioned before experienced a marked decline during 2001 and this adversely affected this category of income.

Sensitivity Analysis

4.35 The 2001 budget address gave brief details of the revenue measures and the areas to be affected. There were no details of how the various amounts were calculated and whether the necessary administrative processes, in the case of new fees, were being put in place to collect these amounts. The assumptions made in calculating the revenue enhancement and the risks relating to these were also not disclosed.

4.36 It is suggested that all assumptions relating to revenue measures should be disclosed explicitly. In future, a sensitivity analysis should be compiled showing the impact key economic assumptions would have on the budget. The budget document should include information on the economic outlook for the Islands, including the assumptions regarding economic growth and the risks underlying the fiscal plan that the Government is proposing.

4.37 The September 2001 Report on "The State of Public Finances" noted that economic information is fairly weak. Only very limited information in support of GDP assessment is available. In the opinion of the Audit Office, GDP data are not considered to be particularly reliable due to a lack of statistical data provided to Government. This situation continued into 2001.

Unable to Quantify Revenue Earned

4.38 We were unable to determine the portion of the $19.9 million of revenue enhancement that was actually collected and were therefore unable to comment on the effectiveness of these measures. In any event, $2.6 million could not be collected due to incorrect calculations and non-passage of necessary pieces of legislation. The amount of $1.1 million relating to debit transaction fees, $0.4 million of vehicle disposal fees and 0.3 of health insurance fund was also not collected. Thus, $4.4 million or 22% in value of expected incremental revenues was not realised.

4.39 The necessary administrative procedures and internal financial controls should be put in place to ensure that such information is available in future. This will assist in setting more realistic revenue estimates in future years.

Response from the Budget and Management Unit (BMU)

"The BMU does not dispute the fact that errors were made or that the projections did not live up to expectations, and the underlying problems relate to the process and approach that has historically been used to establish and forecast new revenue measures. This problem has been recognised by the Portfolio of Finance and Economics, and was identified through the diagnosis phase of F.M.I. and is being tackled through F.M.I. implementation.

- ***Process***

The process problem results from the methodology employed in compiling the old expenditure driven budget. It resulted in revenue and or loan strategies being deployed at the end of the process, and sometimes very close to budget day. This not only resulted in limited analysis but also having to use the relatively poor information that was available at the time and not having time to carry out in depth research.

The 2003 (half) year budget was compiled using a different process (as specified in the PMFL 2001) with a strategic phase, which set allocations on predicted revenues. The budget was revenue driven not expenditure driven. The strategic process allowed more time for greater financial and economic analysis resulting in revenue forecasts being more extensively reviewed and compiled.

- ***Approach***

The Auditor General is aware that the BMU have been concerned about weaknesses in forecasting government revenue. These concerns have been highlighted over recent budgets when it has become clear that their current revenue forecasting capabilities are relatively rudimentary. Most forecasting has historically been based on straight-line extrapolations of recent trends – which may or may not be reflective of future trends – and no use made of more sophisticated and accurate approaches, such as the use of econometric models. Staff of the Foreign and Commonwealth Office highlighted these deficiencies in the 2002 report on the revenue and economic forecasting capabilities.

To improve the methodology and capability in this area, the Portfolio of Finance proposed, and EXCO approved, the establishment of a new Unit within the Portfolio of Finance and Economics (funds requested in the 2003/4 Budget). The Unit will be dedicated to developing more sophisticated revenue forecasting models and to the collection (or co-ordination of the collection) of executive revenue, including improving collection rates."

CAYMAN PROTECTOR REPAIRS - $383,306

Background

5.01 The Cayman Protector (the Protector) is a 48-foot aluminium custom built motor vessel gifted to the Cayman Islands Government (the Government) from the British Government in 1994. This vessel was manufactured specifically for law enforcement activities in the Cayman Islands and is considered the "flagship" of the Drug Task Force (DTF) Marine section. The Protector has been used extensively in search and rescue, marine enforcement and drug seizure operations.

5.02 The Protector was dry-docked and out of active operation for approximately 24 months from September 2000 due to engine failure and structural problems. However several months before being dry-docked, the use of this vessel was limited to inshore patrols. Offshore patrols or search and rescue operations could not be undertaken because of the poor condition of the engines.

5.03 The Protector serves as the sole coast guard vessel for the Cayman Islands. It is also used as the main interceptor for drug trafficking, search and rescue operations and marine policing. The former Commissioner of Police commented that the long absence of this vessel from Cayman waters has not gone unnoticed by drug traffickers.

5.04 Two new engines were installed and all repairs were finally completed at the end of August 2002. Total cost to have this vessel fully operational was approximately CI$383,306. Testing of the vessel was carried out during July and August 2002 to ensure seaworthiness and active duty recommenced.

5.05 We decided to review the circumstances leading up to and resulting in the long period of dry-docking of this important vessel. The review covered the period March 1999 to August 2002 and most of the information was gathered through inquiries with senior staff members of the DTF. In many cases, we were unable to corroborate this information with any documentation or any other form of evidence. We therefore relied on management's representation in these instances.

FINDINGS

Significant delay in repairing the Protector

5.06 The British Military Advisory and Training Team (BMATT) carried out a "health check" on the Protector in March 1999. They identified several defects in the vessel and recommended that these be dealt with as soon as possible. The government paid a deposit of $45,000 in December 1999 towards two replacement engines. The replacement of the two engines and the required structural repairs were not accomplished during 1999, due mainly to financial constraints and heavy workload involved. The DTF stated that a request was made for the additional funds to be included in the 2000 budget, but this was not approved. The Budget and Management Unit (BMU) commented that they were unable to trace a request for purchase of the engines in the original 2000 budget documents. The BMU also stated that it was their understanding that the remaining funds would come from the 2000 boat maintenance vote.

5.07 Funds for capital items should not be included under recurrent expenditure and the BMU should not allow a prepayment of $45,000 under this arrangement. BMU should have advised the Police department of the requirement for purchases of a capital nature to be budgeted for under capital acquisitions.

5.08 The vessel in its state at that time was unable to patrol Cayman waters adequately, and presented security risks. It appears from the various correspondences between the Commissioner of Police and Portfolio of Finance that the urgent need for the two replacement engines was not given high priority by the Finance Branch.

5.09 The fact that the BMU sought the Legislative Assembly's approval of funds of a capital nature but included as recurrent expenditure is somewhat difficult to understand. Capital expenditures should not be included in recurrent expenditure requests. This misleads Parliament. If this request was properly made under capital acquisitions Parliament would have been made aware of the importance of this particular request. The scrutiny and decision-making role of Parliament was therefore circumvented in this instance. The two engines may have arrived one year earlier and the damage to the hull observed much sooner.

Delay in approval of Funds

5.10 A request for funds to complete the purchase of the two engines was made in mid September 2000, but the amount of $147,758 only approved in late November

2000, some two and a half months later. The first deposit was made in December 1999 and this additional amount, which was approved after the vessel became inoperational, implied that no urgency was placed on the request for funds.

5.11 In previous years we have commented on the improper use of Contingency Warrants. The PFAL (1999 Revision) states that the Financial Secretary may authorise the use of Contingency Warrants where he is satisfied that, *"due to exceptional circumstances, an urgent need has arisen for payment to meet expenditure, for which no provision or insufficient provision is shown in the approved estimate, and which cannot be deferred without detriment to the public interest"*.

5.12 This was one of the times in my opinion that a contingency warrant could have been legitimately used, but was not done.

5.13 This payment was funded from the Drug Asset Sharing account. Funds in this account relate to amounts received from the US Treasury through the Mutual Legal Assistance Treaty. Under this treaty the Cayman Islands Government receives funds for assisting the United States and other Governments in combating illegal activities. Funds in this account can be used for fighting illegal activities.

5.14 The balance in this Fund was $2.8 million and $2.2 million as at 31 December 2000 and 2001 respectively. It is difficult to understand why funds were not taken from this account much sooner when it was known that there were engine and structural problems with this vessel. In hindsight if a decision was taken at the appropriate time this problem may have been avoided.

Substantial structural work required

5.15 After the arrival of the two engines in January 2001 the two old engines were removed and the vessel's interior hull inspected. The Principal Marine Surveyor noted that corrosion existed within the inner portions of the hull.

5.16 The marine surveyors concluded that "*if there had been a planned maintenance scheme in place, from the time that the vessel was acquired, then in all probability the corrosion and pitting would have been less extensive, as the water and waste would not have accumulated and the pitting noticed earlier*".

5.17 The DTF Marine section commented that the additional work was much longer than anticipated due to the time it took to find suitable suppliers and to order the necessary parts. In addition the funds required for these purchases were not always available and in most cases was overdue. The welding work that was carried out initially was scrapped since it was not properly done. The contractor arranged for a specialist welding company to send a representative to inspect and re-weld joints, where necessary. As work progressed within the inner hull, further corrosion and wasting was revealed.

5.18 There was no contract arrangement for the repairs work carried out to the Protector costing in excess of $200,000 (excluding cost of engines). Financial and Stores Regulations FSR 8.4.1 requires expenditures in excess of $100,000 to be considered by the Central Tenders Committee (CTC). We were unable to determine whether the total price paid was reasonable or if government's interest was adequately protected.

Cost of the repairs

5.19 In November 2000, it was estimated that the cost of the engines plus installation would be $192,758 of which $45,000 was already prepaid. At that point, the severity of the corrosion was not known, since this could only be determined after the vessel was dry-docked and the engines removed.

5.20 The final cost to have the vessel operational was $383,306. The DTF commented that with proper upkeep and maintenance, this vessel should continue in service for another ten to twelve years. It was their opinion that although the time taken to complete the repairs was very long and the cost very high, it was still better to have the repairs carried out on the Island.

5.21 One other option would have been to obtain another boat altogether, with better capabilities in terms of size, speed and reliability. This option was never considered since the DTF was unaware that these repairs would have turned out to be so costly.

No Marine Base Station

5.22 One of the objectives of the Police Department since 1997 was to commence building a Marine Base Station. H.E. the Governor in his 1997 Throne Speech, stated that one of the Royal Cayman Islands Police's key objectives was to commence construction of a combined Marine Base Station and Drugs Task Force Office. To date, this Base Station has not been built. This project was recorded as non-achievements in both the 1998 and 1999 Annual Budgets but there has been no mention of this project in the Annual Budgets since then. The DTF commented that regular discussions of this subject continued between themselves, the Commissioner of Police, Public Works Department and the Department of Environment.

5.23 We noted that the Civil Aviation Authority transferred 7.6 acres of land to the Police during August 1999. This site was proposed for the new marine base.

5.24 The Cayman Islands Yacht Club has allowed the DTF Marine to use their premises over the years for housing their vessels. Unauthorised persons can access these vessels, as the area is not secured by DTF personnel and there is no privacy to conduct covert operations. This location is also inappropriate to carry out routine maintenance. In the words of DTF staff "*until a secure base or funding for some other form of security measure is implemented, the matter of security will be left to continued good luck*".

5.25 The building of a base station seems to be taking the same course of events that affected the vessel itself. That is, until such time that the vessel is no longer allowed to moor at the Cayman Islands Yacht Club, Government may not consider building a Base Station.

Storage of Spare Parts

5.26 A 20-foot container on loan from a local business firm is used to store essential spares for the Protector and seized outboard engines. This container, which is located next to the office accommodation, is unsuitable for this purpose, since it is not properly ventilated and it has a leaking roof. There is a build up of moisture as a result, which can damage the parts stored there.

5.27 The owner of the container has been calling the DTF for it to be returned. However, despite these repeated requests from the owner, the DTF is unable to do so since there is no alternative storage facility.

Criteria for use of the Protector

5.28 DTF commented that they are called upon to perform tasks that far exceed what the vessel can reasonably achieve without detrimental effects to its longer-term performance. Of particular significance is the towing of much larger vessels that may be in distress that places great strain on the engines. Whenever there is an emergency in Cayman territorial waters, the Protector is called upon to provide the necessary services. There are no clear guidelines regarding what type of work the vessel can perform and this has led to unrealistic expectations. In addition there is no substitute vessel to assist the Protector and this may also affect the maintenance schedule when the workload is heavy. The maintenance log reports on the Protector were not well organised and were confusing to the unfamiliar reader.

Minimal service fees earned

5.29 Fees earned from marine and salvage rescue operations (generally towing of vessels) during the period 1995 to 2001 totalled $24,681.

5.30 The fees for marine rescue and salvage are being charged under The Wreck and Salvage Law (cap.187), 1996 Revision. Per Section 22 of this Law, "*a reasonable amount of salvage, together with all expenses properly incurred in the performance of such services"* may be charged. We suggest that this area be looked at to determine exactly what fees may be charged in relation to the cost of undertaking such operations. The necessary administrative processes should also be set up so that reasonable fees can be charged and accounted for.

5.31 The DTF stated that the issue of towing of vessels is currently under review.

CONCLUSION

5.32 It was evident that the lack of a proper maintenance facility was a significant contributing factor to the extended period of dry-docking of the Cayman Protector. The other major factor was inadequate and untimely funding from Government to affect such maintenance. The problem of major corrosion could not be detected until the engines were removed. Prior inspections of the vessel with the engines still on, did not fully reveal the severity of the corrosion.

5.33 The Cayman Protector was overused as a vessel, as it was the only one of its size and capability in the DTF fleet. It appears that the funding for the upkeep and maintenance of the Cayman Protector was not a high priority for the Government. This is cause for concern taking into consideration the value of this asset and it's importance to the security of these Islands.

LOCAL VESSEL FEES

BACKGROUND

6.01 The local vessel fee is payable by owners of vessels over 18 feet and all jet skis. This fee came into effect on 1 July 1997 and replaced the small boat tax previously administered by the Treasury Department. The Port Authority collects this fee on behalf of the Treasury Department. Effective 1 January 2002 local vessel fees were increased and a boat license fee of $35 introduced.

The 1997 Auditor General's Report

6.02 We last reported on this area in my 1997 Report and the main points highlighted were:

- Approximately $250,000 per annum could be collected from boat and jet ski owners if the scheme was properly implemented.
- The Port Authority does not investigate non-payment of fees due to inadequate records and lack of specific authority under the law.
- A licensing scheme previously under consideration by the Port Authority was not implemented.

6.03 The Audit Office recommendations included:

- The Ministry of Tourism, Environment, Development and Commerce should examine policy options for the efficient and effective collection of local vessel fees and decide if a full licensing system is appropriate and cost effective.
- Consideration should be given to strengthening the law and give specific authority to follow up outstanding fees.

The Public Accounts Committee (PAC) recommendations

6.04 The PAC made two specific recommendations in the first quarter of 1999 based on my 1997 Report:

- The Port Authority should consider providing a registration and safety service to justify payment of the local vessel fees.

- The Portfolio of Finance should review fees for vessels over 50 feet to determine whether these crafts are already registered with the Shipping Registry and pay fees.

FOLLOW UP WORK

6.05 The Audit Office carried out a follow up review of local vessel fees, which covered the period January 1998 to December 2001. In my opinion, minimal progress has been made in this area from an operational and administrative point of view. This is disappointing, not only in relation to revenue loss but also from the perspective of safety of crafts at sea.

Findings

6.06 Revenue collected during 2001 was approximately $82,000. However, the results of a Physical Count of Crafts on all three Islands, carried out in 2001, indicated Local Vessel Fees revenue should be approximately $300,000 per annum.

6.07 It is estimated that Government has lost revenues in the region of $800,000 over the four-year period 1998 to 2001. This amount was computed using the estimated revenues of $300,000 for the years 1998 to 2001 less actual fees collected of $332,637.

6.08 Changes were not effected to the law to address penalties for non-payment of fees, authorisation for the Port Authority to pursue such persons or the setting up of a small craft registry with the ability to inspect and license small crafts within the Islands.

6.09 Since 1997 the Port Authority along with the Shipping Registry considered implementing a vessel registration system similar to that in use for vehicle registration. At that time it was intended that vessel owners would be issued with a registration colour sticker, which can be attached or painted onto the vessel. It was considered that this would facilitate effective monitoring of the registration system so that the relevant authorities would be able to determine whether or not payment has been made for the current year. This system is not yet in place.

6.10 The public needs to be aware that local vessel fees are not just another revenue enhancement measure but that it is a very vital service for the residents of these islands. One very important role of the registration and identification of local crafts would be in the area of search and rescue operations especially in adverse weather conditions. Also, in those cases where violations are committed, whether of an environmental nature or in cases of danger to tourists, the identification of the particular craft would prove very useful.

Recommendations

6.11 Based on our follow up review, it was evident that the present system of administration and collection over local vessel fees are inadequate and in need of change. Our suggestion is to pass legislation to address the weaknesses identified. Such a change should bring financial and environmental benefits, easy identification of crafts in search and rescue operations as well as those involved in illegal activities.

6.12 The community should see tangible evidence of the benefits to be derived from the licensing of crafts in these Islands. One suggestion at the PAC meeting in 1999 was the improvement of facilities for boats, and this may have some merit. In addition, all licensed crafts should be suitably identified by license numbers and entered in the Register of crafts to be maintained by the Port Authority.

HEALTH SERVICES AUTHORITY VIABILITY REPORT

TERMS OF REFERENCE

7.01 In January 2002 we wrote to the Permanent Secretary of the Ministry of Health indicating our concerns in how well prepared the Health Services Department was in order to become an Authority by 1 July 2002. Numerous problems were encountered in a previous attempt in 1992 to establish a Health Services Authority that still seemed to exist.

7.02 The Health Services Authority (HSA) did begin operations as an authority on 1 July 2002. Therefore, we decided to prepare a report on the viability of the HSA due to the quick time frame that was required to get it operational and because this was the second attempt to establish an HSA. The previous attempt undertaken in 1992 quickly ended in 1993 as the HSA was dissolved and reverted back to a department under the Ministry of Health.

7.03 We are not certain what the exact reason for dissolution was. However, from the Auditor General's Report of 1994 we note that there were accounting problems that led to several points of qualification for the audit opinion for the year ended 31st December 1992. One of the reasons acknowledged for the many accounting problems was the state of unreadiness of the Department to convert from a cash-based to an accrual-based system. Also leading to audit delays was the legal requirement to disclose income and expenditure statements for all the health care facilities and separately identifiable programmes and activities of the Authority in their annual financial statements.

7.04 Unfortunately there are no other reports available that comment on the establishment and dissolution of that earlier Authority. Such reports would have been useful in the challenges faced in establishing the current HSA. The current HSA was established in 2002 with a view to ensuring better management by disentangling the operations from the rest of Government. Our viability report was written with the intention of complementing the strategies identified by the Authority's Board and to try and identify any potential pitfalls that it may encounter. We outlined what we deemed were critical factors for success, which are discussed below in summary. The full report was issued to the HSA management.

FACTORS FOR SUCCESS

7.05 In summary, for the Health Services Authority to improve its chances for viability and success, it needs to:

- Establish clear and measurable objectives,
- Develop a business and information technology strategy,
- Ensure a proper legislative framework exists to support operations,
- Ensure adequate resources are obtained to sustain operations, and
- Develop an effective reporting environment.

7.06 These conceptual ideas are further elaborated on below. Our list of factors is by no means an exclusive list or a rigid paradigm to be pursued, but what we consider as desirable dimensions that the HSA Board can use in setting the direction of its operations.

Establishing Clear and Measurable Objectives

7.07 A well-managed organisation will set clear and measurable objectives and establish a framework within which the organisation can operate. The Board's role is to approve and monitor the vision, mission and strategy of the organisation.

7.08 Risk assessment is a vital part of the strategy formulation process. The Board should identify both internal and external risks that the organisation faces, which could undermine the achievement of its stated objectives. The Board then needs to manage these risks to an acceptable level.

7.09 A Planning Committee was formed to initiate the necessary actions for establishing the HSA. The following reasons were cited by the Planning Committee for the re-establishment of an Authority:

- To ensure the sustainability of a health care delivery system that the community has come to expect.
- To relieve government of the burden of the high recurrent operating health care cost.

- To provide flexibility for the Health Services to keep pace with needed development.
- To allow the service to operate as a business.
- To allow for economic growth.
- To separate providers from regulators and payers.
- To de-politicise the management of the service.

7.10 The list implies that the Authority has defined their objectives. However, the objectives did not have tangible performance targets against which they could be measured.

Develop a Business and Information Technology Strategy

7.11 We are aware that the Authority's Board is in the process of developing a business and information technology strategy. We also encourage the Board to continuously challenge the operations of the Authority and adapt its business and information technology strategy to the changing health care environment. The Audit Office has not had the opportunity to review the newly implemented Cerner System and therefore cannot comment on how Cerner fits into the overall IT strategy of the Authority.

7.12 One of the stated objectives of the HSA Law is: "To allow the service to operate as a business". Section 17 of the Law outlines the principles to be followed to accommodate this objective. These principles involve ensuring revenues exceed expenditures, a positive net worth position, and maintenance of optimum cash.

7.13 When developing an effective business strategy, the Board and management should assess the organisation's capability to meet its objectives. The Board needs to ask:

- Do we have the right people, skills, tools and resources? People need to have the necessary knowledge, skills and tools to support the achievement of the organisations objectives.
- Is there adequate information for decision making and to perform the required tasks?

7.14 In order for the Business Strategy to succeed it is important that top management, that is the Board of the Authority, assume a lead role in both formulating the strategy and overseeing its implementation. Proper mechanisms should be established to ensure the success of the strategy is monitored and controlled. From our review of the Board meeting minutes, we note that there is a lot of dialogue geared at formulating a business strategy.

Ensure a Proper Legislative Framework Exists to Support Operations

7.15 Currently, a legislative framework has been put in place to establish and define the powers of the Authority along with its operational boundaries. It is important that a legislative framework supports the operations of the Authority. As the Authority's operations evolve, there will need to be an efficient and effective channel in which legislative amendments can be put forward to the Legislative Assembly, if needed.

7.16 At present, the main laws pertinent to the HSA are the Health Services Authority Law 2002, the Health Insurance Law 1997, and the Health Services Fees Law. The Health Services Authority Law governs the operations of the HSA. The main sections of this law covers:

- Establishment
- Capital Borrowing and Powers
- Reserve Fund
- Board of Directors
- Responsible Financial Management
- Application of Funds and Budgeting
- Reports and Audit
- Regulations and Rules
- Pension
- Fees

7.17 As noted above the HSA Law addresses the main areas that need to be properly managed, especially finances, and places restriction on the amount of discretion that can be exercised by management and the Board.

7.18 It is essential that the legislative framework supports the various functions of the Authority. The best avenue for ensuring the HSA is supported by a proper legislative environment is through the Ministry of Health. The Permanent Secretary is a board member of the Authority and should therefore function as the link between the Authority and the Legislators.

Ensure Adequate Resources Are Obtained to Sustain Operations

7.19 Determining how to resource itself is one of the most challenging areas for the Authority. As mentioned earlier, the Authority needs to identify its core business and its support functions. What makes this a challenging task is the need to balance the social benefits of delivering health services to the population with the cost of providing these services.

7.20 Based on our financial analysis, the Authority is currently not financially viable without direct subsidies from Government and exclusive referrals of civil servants and indigents for medical services. The Ministry of Health and the Authority have many complex issues to resolve and will have to work closely together to ensure the future success of the Authority. We envisage that the Authority will continue to be heavily dependent on the Government in the foreseeable future.

7.21 To date, a comprehensive costing of services has never been performed. Such an exercise is vital to ensure proper revenue management. It will help set appropriate fee levels and also provide information as to which services provided by HSA are cost-effective and can be used to determine the feasibility of outsourcing some services. We stress however, that the decision for providing services be taken with due consideration to non-cost factors since some services are needed for life-saving emergencies.

Develop an Effective Reporting Environment

7.22 It is generally accepted that the previous reporting systems of the Health Services Department were deficient for proper control of activities. The deficiency of the reporting system was due to many factors. Among the shortcomings were the cash-based reporting standards used, an unstructured management reporting system, no record of assets and liabilities, a weak internal control environment and an unsuitable computerised information system. As an Authority, many of these previous weaknesses will have to be overcome in order for the HSA to be successful.

7.23 The HSA needs to develop an effective reporting environment that requires accurate and credible performance reports. These performance reports should report against the organisation's goals and objectives.

ACKNOWLEDGEMENTS

I wish to express my sincere thanks to my dedicated team for their efforts over the past year. I also wish to record my appreciation and thanks to Controlling Officers and their staffs and the Accountant General and her team for their co-operation.

Dan Duguay
Auditor General

Grand Cayman
30 October 2004

CAYMAN ISLANDS

To the Presiding Officer of the Legislative Assembly of the Cayman Islands

CERTIFICATE OF THE AUDITOR GENERAL

As required by Section 43(1) of the Public Finance and Audit Law (1997 Revision), I certify that I have examined the modified cash financial statements of the Cayman Islands Government for the six month period ended 30 June 2003 as set out on pages 6 to 27. These statements have been prepared in accordance with the provisions of Section 42 of the Law.

Respective Responsibilities of Controlling Officers, the Accountant General and the Auditor General.

Under Section 13(2) of the Law, Controlling Officers are responsible and accountable for all expenditure from any head or subhead which they control, and for all public moneys and public property in respect of the Government Department, office or service for which they are responsible.

Under Section 17(1) of the Law, the Accountant General is responsible for the compilation and supervision of the financial statements of Government; the management of accounting operations and procedures; and for ensuring that all regulations, directions or instructions made or given under the Law in respect of the safe custody of public moneys and its accounting are complied with.

Under section 43(1) of the Law, it is my responsibility to examine and audit these financial statements and to form an independent opinion, based on my audit, on these statements and to report my opinion.

Basis of Opinion

I conducted the audit in accordance with International Organisation of Supreme Audit Institutions (INTOSAI) auditing standards. An audit includes an examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the judgements made in the preparation of the financial statements, and whether accounting policies are appropriate and are consistently applied. I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements.

Audit Qualification Matters

I: Unappropriated Expenditure

In the Statement of Unappropriated Expenditure $18,016,195 was incurred in excess of the Appropriation and Supplementary Laws (January to June 2003), 2002 for various output groups. Of this amount, $13,500,000 relates to the overseas medical provision (see III below). In addition, we cannot rely on the actual figures stated in the Statement of Unappropriated Expenditure due to unreliability of the cost allocation system.

II: Deferred Expenditure

The financial statements of the Cayman Islands Government are prepared under the cash basis of accounting. All cash inflows and cash outflows are accounted for in the year of receipt or payment. A fundamental concept of the cash basis of accounting is that there must be no postponement of payments for any reason.

Recurrent: Deferred and unpaid expenditures at 30 June 2003 amounting to approximately $4,112,013 have not been reflected in either the Statement of Operating Receipts and Payments or the Combined Statement of Assets and Liabilities.

Statutory: Government's Past Service Pensions Liability for fiscal 2002 was $10,202,292. For the half-year to June 2003 no amount was budgeted for nor paid over to the Public Service Pensions Board with respect to this substantial commitment. The Pensions Board has determined that $5,579,138 inclusive of interest, was due and payable for the period January to June 2003.

III: Disagreement With Accounting Policy – Overseas Medical Advances

Payments totalling $19,281,659 made between 1992 and June 2003 for overseas medical treatment have not been recognised as expenditure. These payments have been classified as recoverable advances and have been included as assets in the Combined Statement of Assets and Liabilities. Amounts accumulated as advances are brought to account infrequently, and are often accompanied by conversion of individual debts to long term loans. The effect of this accounting policy, which has been followed for many years, is to defer recognition of expenditure to future periods. In my opinion, overseas medical advances should be expensed and brought to account in the year of payment. It was my opinion in previous years that most, if not all of these advances will prove to be irrecoverable. In 2003(H), the government has undertaken to make a provision for the write off of $13,500,000 of these medical advances leaving a residual balance of $5,781,659.

During 2003(H) overseas medical advances increased by $23,203. In my opinion, expenditure on the Statement of Operating Receipts and Payments is understated by this amount, and the reported surplus of $39,070,737 is overstated by a similar amount. The accumulated surplus of the General Revenue Fund reported in the Combined Statement of

Assets and Liabilities is overstated by $5,781,659, the net amount of the overseas medical advances after the $13,500,000 provision.

IV: Uncertainty Over the Accuracy of the Immigration Deposit Liability Balance

In 1991 and 1995 an amount of $2,210,362 was transferred from the immigration repatriation deposit account to the General Revenue of Government. The authority cited for these transactions was section 24(4) of the Public Finance and Audit Law (1997 Revision), which permits deposits unclaimed for five years to be treated as revenue. I have concluded that the transfer of these funds to Government revenue was fundamentally incorrect and that the deposit liability is understated, but I have been unable to quantify the extent of the understatement and its impact on the Combined Statement of Assets and Liabilities. An indicative range of the magnitude of understated liabilities is $1,200,000 to $1,700,000.

I have also attempted to corroborate the immigration deposit balance of $6,389,343 in the deposit liability account but have been unsuccessful due to the lack of supporting evidence and reconciliations. The Immigration Department however, is in the process of validating this figure. As such I am not able to conclude on the accuracy of the immigration deposit liability balance of $6,389,343.

Opinion

Combined Statement of Operating Receipts and Payments

Except for the unappropriated expenditure of $18,016,195, the sums expended have been applied for the purposes authorised by the Legislative Assembly. However, we cannot rely on the actual figures stated in the Statement of Unappropriated Expenditure due to unreliability of the cost allocation system.

Although the Statement of Operating Receipts and Payments properly presents all transactions processed during the six month period ended 30 June 2003, in my opinion, the postponement of payments amounting to $4,112,013 due to suppliers, $5,579,138 due to the Public Service Pensions Board and the classification of $23,203 of overseas medical expenses as recoverable advances constitute a failure to comply with generally accepted principles and practices of cash accounting.

In my opinion payments recorded against the General Revenue Fund are understated by $9,714,354 and the surplus for the year is overstated by a similar amount.

Combined Statement of Assets and Liabilities

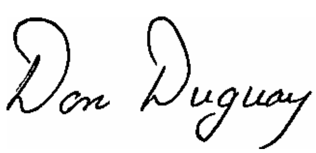
In view of:

- Accumulated overseas medical advances amounting to $5,781,659 which have not been recognised as expenditure but have been classified as assets;
- The understatement of immigration security deposits of between $1,200,000 and $1,700,000;
- The uncertainty in the accuracy of the immigration deposit liability balance of $6,389,343
- Deferred and unpaid expenditures amounting to approximately $4,112,013; and
- The non-payment of the Past Service Pensions Liability of $5,579,138 due to the Public Service Pensions Board

in my opinion the Combined Statement of Assets and Liabilities does not properly present the financial position of the Cayman Islands Government as at 30 June 2003. In my opinion, the accumulated surplus on the General Revenue Fund is overstated by between $16,672,810 and $17,172,810.

Matters of Emphasis

Without further qualifying my opinion, I draw attention to Loans and Advances as at 30 June 2003. There is an amount of $4,538,959 in respect of advances for the Affordable Housing Initiative. The authority for these advances is section 21 of the Public Finance and Audit Law (1997 Revision). Based on my examination and the explanations of management, I am satisfied that the accounting treatment is, in principle, appropriate. However there is an element of subsidy within the Initiative but it is not possible to determine with any degree of certainty the extent of Government's financial liability. No amounts have been expensed to the Statement of Operating Receipts and Payments to recognise this liability.



Dan Duguay
Auditor General

Grand Cayman
30 June 2004