# Memorandum

**To:** Keali'I S. Lopez, Director, Department of Commerce and Consumer Affairs

**From:** Tonya Moffitt, Partner

**Date:** May 2, 2014

**Re:** Analysis of Specific Capital Fund Expenditures for Olelo

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**Executive Summary:**

Oceanic Time Warner Cable LLC (OTWC) previously Time Warner Entertainment Company, L.P.'s (TWE) will be referred to as Oceanic in this document. Oceanic provided payments to Olelo Community Media (Olelo) for PEG access equipment and facilities. There have been allegations that Olelo misappropriated some of the funds that it received from Oceanic.

Merina & Company, LLP (MCO) completed an onsite analysis at Olelo's Headquarters on May 20-23, 2013, to determine if Olelo misappropriated its facilities and equipment funds. MCO was provided a copy of an Expert Report by Mr. Thomas T. Ueno, CPA dated November 17, 2011. Mr. Ueno's expert opinion included specific details on Olelo's facilities and equipment funds that were being questioned for the period 2006-2010. The two areas that MCO specifically looked at were the capitalized expenses and leasing operations at Olelo.

One of Mr. Ueno's arguments is that Olelo misappropriated capital funds to purchase equipment that was expensed rather than capitalized as a fixed asset. The definitions of PEG equipment and facilities in D&O 154, 310, and 346 is broad and does not exclude expenses that have not been capitalized as a fixed asset. MCOs perspective is if the capital funds were used for PEG equipment they would be allowable even if they were expensed and not capitalized (i.e. reported as a fixed asset).Therefore, these expenses that Mr. Ueno alleged were misappropriated is based solely on the fact that they were expensed instead of capitalized.

Another of Mr. Ueno's arguments is that Olelo leased out part of the building space at its Mapunapuna location to tenants and used capital funds to pay for shared space capital expenditures and/or fixed assets. The definitions of PEG equipment and facilities in D&O 346 is broad and includes any PEG activity; it does not explicitly exclude "Not Sole Use" (i.e. shared space in the building). Olelo uses the rental income to offset PEG operating costs for PEG activity therefore the not sole use assets are used for PEG activity. These expenses that Mr. Ueno alleged were misappropriated because they were not sole use; were not misappropriated since rent was used for PEG activity.

The definition of Access Facilities and Equipment, under which the PEG's were operating under, is broadly defined in D&O's 154, 310, and 346 and contract with Olelo. Therefore, it appears the PEG equipment and facilities reported by Olelo and alleged misappropriations, were used appropriately. It does not appear that Olelo misappropriated PEG equipment and facilities. Our recommendation is that the PEG equipment and facilities should be redefined to avoid such confusion going forward.

**Applicable Decision and Orders (D&O):**

D&O 154 issued January 27, 1993: "TWE shall provide the Director or his designee capital funds for facilities and equipment for public, education and governmental use on an annual basis…"

D&O 310 issued January 22, 2004: "approval of a mutually agreed to payment schedule for capital funds for PEG access equipment and facilities. TWE and Olelo indicated they had reached an agreement that stipulates capital fund payments by TWE to Olelo in the amount of EIGHT HUNDRED TWENTY-THREE THOUSAND AND NO/100 DOLLARS ($823,000) per year for the duration of TWE's current cable television franchise for the island of Oahu."

D&O 346 issued January 14, 2010: Definitions "'Access Facilities and Equipment' or 'PEG Access Facilities and Equipment' means (a) Channel capacity designated for PEG use; and (b) PEG access facilities, including but not limited to real property and equipment related to the use of such Channel capacity or any PEG activity." "'Facility' or 'Facilities' include real property, antenna, poles, supporting structures, wires, cables, conduits, amplifiers, instruments, appliances, fixtures, fiber, and other personal property used by a cable operator in providing service to its Subscribers." "'Capital Fund Payment' means capital contributions made by TWE to the PEG Access Organization, the Director, or the Director's designee, to the extent permitted under the Communication Act, for PEG Access Facilities and Equipment." "'Access Operating Fee' or 'AOF' means the annualized fee paid by TWE to the Director or Director's designee for PEG or other purposes specified by the Director."

D&O 355 issued September 21, 2012: Time Warner Entertainment Company, L.P.'s (TWE) requested to assign/transfer its Hawaii cable franchises for the Island of Oahu to Oceanic Time Warner Cable LLC (OTWC). The Department of Commerce and Consumer Affairs (Department) granted TWE's request.

**Analysis:**

Merina & Company, LLP (MCO) completed an onsite analysis at Olelo's Headquarters on May 20-23, 2013, to determine if Olelo misappropriated its facilities and equipment funds. Our onsite analysis included interview's with Olelo's personnel, observations onsite, review of the purchase and sale agreement, current and prior lease documents, prior year audited financial statements, invoices, and capital asset information. We obtained support to substantiate interviewees statements including examination of pertinent agreements, lease documents, financial statements, capital asset detail, and expense detail. We also did independent research as a part of our analysis.

MCO was provided a copy of an Expert Report by Mr. Thomas T. Ueno, CPA dated November 17, 2011. Mr. Ueno's expert opinion included specific detail on Olelo's facilities and equipment funds that were being questioned for the period 2006-2010; therefore, Mr. Ueno's report will be referenced below.

**Capitalized Expenses:**

In Mr. Ueno report he stated "equipment and facilities are customarily considered fixed assets (property, plant, and equipment). Capitalized expenditures are expenditures creating future benefit… Practically speaking capital expenditures are an exchange of assets for assets or liabilities, that is, cash for capital or fixed assets (property, plant and equipment); they are not expenses. It could also include an asset for a liability (such as a loan)."

The definitions from D&O 154, 310, and 346 do not state that the capital funds can only be used for fixed assets. Capitalization policies are adopted and set by each individual entity (i.e. Olelo). Intermediate Accounting defines "Most expenditures below and established arbitrary minimum amount are expensed rather than capitalized. Many enterprises have adopted the rule that expenditures below, $100 or $500, should always be expensed[1]."

Per Olelo's audited financial statements for the year ended December 31, 2010 its capitalization policy stated, "property and equipment acquisitions of $500 or more and an estimated useful life over one year are capitalized... Expenditures for maintenance, repairs, and minor renewals are charged to expense; expenditures for betterment are capitalized." Therefore Olelo did not capitalize (i.e. report as a fixed asset) property or equipment that was less than $500 and had a useful life of less than one year or was used for maintenance or repairs.

Mr. Ueno report continues that "Olelo misappropriated its facilities and equipment funds to pay for non-capital expenditures. Capitalized expenditures are expenditures with exchange assets such as cash and/or liabilities for fixed assets (property, plant and equipment)... Olelo included expenditures under $500, which is not in accordance with its capitalization policy."

One of Mr. Ueno's argument in the report is that Olelo misappropriated capital funds to purchase equipment that was under $500. One example of the alleged misappropriation of capital funds was to purchase external file storage that are needed for editing and saving programming used on Olelo's channels. These individual external file storage are approximately $70 each, which is below Olelo's capitalization policy of $500, therefore Olelo expensed them instead of capitalizing them. On September 14, 2010, Olelo purchased 97 external file storage for a total of $6,686. Based on the definitions in D&O's 154, 310, and 346 this is an appropriate use of the capital funds because it was used for PEG access equipment.

Mr. Ueno's report noted that $410,298 was expensed for the period 2006-2010 and therefore misappropriated because it was not capitalized as a fixed asset. Although these items did not qualify as fixed assets based on the capitalization policy Olelo established, these funds were spent on PEG access equipment and facilities. Based on the definitions of PEG access equipment and facilities from D&O's 154, 310, and 346 the $410,298 was not misappropriated solely on the fact that it was expensed instead of capitalized (i.e. reported as a fixed asset).

**Leasing Operations:**

Olelo's headquarters are at its Mapunapuna facility, they own the building and lease out a portion of the building and roof to various entities. Mr. Ueno's report argues that "Olelo also included expenditures related to leasing building space to others, which is not related to PEG Access." Mr. Ueno explains that Olelo used capital funds for "Non-PEG Access Services costs paid for by Oceanic... such as the 'Front Parking Lot' which benefit both Olelo's PEG access operations and its rental operations." Mr. Ueno identified expenditures that he considered to be "Not Sole Use" (i.e. shared space in the building).

[1] Intermediate Accounting, by Kieso, Weygandt, Warfield, Tenth Edition page 518

Below is a list of the items Mr. Ueno identified as Not Sole Use assets and their respective cost:

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|---|---|---|
| Outdoor Sprinkler System Work (replacing sprinkler heads with pop-ups in interior planter and back lot) | $ | 1,452 |
| Landscape – Entrance (install landscape in entrance of building) | | 3,448 |
| Miscellaneous Building Improvements (electrical circuit upgrades, compressor replacement, air fan, sprinkler and smoke detectors upgrade, and elevator key stitch) | | 29,916 |
| A/C 14 Replacement (air conditioning for Playback) | | 31,365 |
| Landscape Renovations (redo all landscaping) | | 51,812 |
| A/C 13 Replacement (air conditioning for 2nd floor tech area and edit bays in media center) | | 92,217 |
| Front Parking lot (added 20 visitor parking spaces for visitors) | | 403,834 |
| Total Not Sole Use per Ueno's Exhibit 1 | $ | 614,044 |

It is appropriate and common accounting practice for nonprofits like Olelo to capitalize expenditures that meet their definition of fixed assets including Not Sole Use. These Not Sole Use assets belong to Olelo and do not belong to the renters. The majority of these Not Sole Use assets would need to be installed whether or not Olelo had renters; for example the miscellaneous building improvements included adding sprinkler and smoke detector upgrades and an elevator key switch.

In addition, the rental income received form leasing out a portion of the Mapunapuna facility is used to cover operating PEG activity. Under the definition of PEG access facilities from D&O 346 it includes but not limited to real property and equipment related to the use of such Channel capacity or any PEG activity. Olelo uses the rental income to offset PEG operating costs for PEG activity therefore the not sole use assets are used for PEG activity.

MCO concludes that based on the definitions in D&O's 154, 310 and 346 of PEG equipment and facilities, Olelo did not misappropriate the funds.

**Findings:**

The capital funds that were used for PEG equipment should be allowable even if they were expensed and not capitalized (i.e. reported as a fixed asset). In addition, it is a common accounting practice to capitalize not-sole use assets for non-profits. It appears that the PEG equipment and facilities that were reported by Olelo and alleged misappropriations analyzed above, could fall under the contract with Olelo. It does not appear that Olelo misappropriated PEG equipment and facilities.

Mr. Ueno addressed some areas that should be looked at in the future; there are ambiguous areas under the contract with Olelo.

**Recommendations:**

The issue is that the definition in D&O's 154, 310, and 346 and the contract with Olelo is broad and not specific. Mr. Ueno has made a valid point that a portion of the Not Sole Use expenditures could be apportioned between PEG and non-PEG equipment and facilities. For instance, the building and landscaping expenditures which relate to common areas (i.e. repairs to the elevator and front parking lot) could be apportioned between PEG and non-PEG. Mr. Ueno argued that Not Sole Use assets should be apportioned at 47%. Olelo would probably argue that Not Sole Use assets should not be apportioned because they own the building and it is a PEG asset.

MCO agrees, the Not Sole Use assets could be apportioned anywhere between zero and 47%; however, without a comprehensive definition of PEG equipment and facilities, it is unclear to what degree the Not Sole Use assets should have been apportioned, if at all. Therefore, we recommend the Not Sole Use leasing operations be addressed as it could be apportioned in some way going forward. In the future to avoid confusion about what qualifies as PEG equipment and facilities, the new definition should address expensed vs. capitalized, Not Sole Use facilities and equipment, intangible assets, and software upgrades.