



Office of the Auditor State of Hawaii

Financial Statements
(With Independent Auditors' Report Thereon)

June 30, 2018

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Financial Statements

June 30, 2018

Table of Contents

	Page
PART I – INTRODUCTION SECTION	
Audit Objectives	1
Scope of Audit	1
Organization of Report	2
PART II – FINANCIAL SECTION	
Independent Auditors’ Report	3
Management’s Discussion and Analysis – Unaudited	6
Basic Financial Statements:	
Statement of Net Position and Governmental Fund Balance Sheet	12
Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance	13
Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) – General Fund	14
Budgetary Reconciliation – General Fund	15
Notes to Basic Financial Statements	16
PART III – INTERNAL CONTROL AND COMPLIANCE SECTION	
Independent Auditors’ Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>	41

PART I

INTRODUCTION SECTION

December 21, 2018

The Auditor
State of Hawaii:

We have completed our audit of the financial statements of the Office of the Auditor, State of Hawaii (the Agency), as of and for the year ended June 30, 2018. We transmit herewith our independent auditors' reports containing our opinions on those financial statements and our report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*.

Audit Objectives

The objectives of the audit were as follows:

1. To provide opinions on the fair presentation of the Agency's financial statements in accordance with accounting principles generally accepted in the United States of America.
2. To consider the Agency's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements.
3. To perform tests of the Agency's compliance with certain provisions of laws, regulations, contracts, and grant agreements, non-compliance with which could have a direct and material effect on the determination of financial statement amounts.

Scope of Audit

We performed an audit of the Agency's financial statements as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

As part of the audit of the Agency's financial statements, we considered the Agency's system of internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements. We also performed tests of the Agency's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

Organization of Report

This report has been organized into three parts as follows:

1. The Introduction Section describes briefly the objectives and scope of our audit and the organization and contents of this report.
2. The Financial Section includes management's discussion and analysis, the Agency's financial statements as of and for the year ended June 30, 2018, related notes, and our independent auditors' report thereon.
3. The Internal Control and Compliance Section contains our independent auditors' report on the Agency's internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*.

* * * * *

We would like to take this opportunity to express our appreciation for the courtesy and assistance extended to us by the personnel of the Office of the Auditor during the course of our engagement. Should you wish to discuss any of the matters contained herein, we will be pleased to meet with you at your convenience.

Very truly yours,

KKDLY LLC

PART II

FINANCIAL SECTION

Independent Auditors' Report

The Auditor
State of Hawaii:

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities and the general fund of the Office of the Auditor, State of Hawaii (the Agency), as of and for the year ended June 30, 2018, and the related notes to financial statements, which collectively comprise the Agency's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the general fund of the Agency as of June 30, 2018, and the respective changes in financial position and the budgetary comparison for the general fund for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

Change in Accounting Principles

As discussed in Note 2 to the financial statements, the Agency adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, and GASB Statement No. 85, *Omnibus 2017*, effective July 1, 2017. Our opinions are not modified with respect to these matters.

Relationship to the State of Hawaii

As discussed in Note 1 to the financial statements, the financial statements of the Agency are intended to present the financial position, the changes in financial position, and budgetary comparison of only that portion of the governmental activities and the general fund of the State of Hawaii that is attributable to the transactions of the Agency. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2018, and the changes in its financial position and budgetary comparison for the year then ended, in accordance with accounting principles generally accepted in the United States of America. Our opinions are not modified with respect to this matter.

Other Matter

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 21, 2018, on our consideration of the Agency's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Agency's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Agency's internal control over financial reporting and compliance.

KKDL Y LLC

Honolulu, Hawaii
December 21, 2018

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Management's Discussion and Analysis - Unaudited

June 30, 2018

This Management's Discussion and Analysis provides an overview of the financial activities of the Office of the Auditor, State of Hawaii (the Agency), for the fiscal year ended June 30, 2018. Readers should consider the information presented here in conjunction with the financial statements and notes thereto, which follow this section.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Agency's financial statements. The Agency's basic financial statements are comprised of three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to basic financial statements. These components are described as follows:

Government-Wide Financial Statements

The government-wide financial statements are designed to provide readers with a broad overview of the Agency's finances in a manner similar to private-sector companies.

The Statement of Net Position presents information on all of the Agency's assets and liabilities, with the difference between the two reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the Agency is improving or deteriorating.

The Statement of Activities presents information showing how the Agency's net position changed during the fiscal year. This statement shows the extent to which the Agency's activities depend on state appropriations for support.

The Statement of Net Position can be found in the Statement of Net Position and Governmental Fund Balance Sheet on page 12 of this report, and the Statement of Activities can be found in the Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance on page 13 of this report.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Agency maintains a single governmental fund, its general fund.

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

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Management's Discussion and Analysis - Unaudited

June 30, 2018

Because the focus of governmental funds is narrower than that of government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities of the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Agency's near-term financing decisions.

The governmental fund financial statements can be found in the Statement of Net Position and Governmental Fund Balance Sheet on page 12 of this report, and in the Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance on page 13 of this report.

Both the Statement of Net Position and Governmental Fund Balance Sheet, and the Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The governmental fund financial statements are followed by the Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) – General Fund, which compares the general fund's original and final budget and actual amounts prepared on a budgetary basis. The Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) – General Fund can be found on page 14 of this report. A reconciliation between the general fund revenues and expenditures prepared on a GAAP basis compared to the general fund revenues and expenditures prepared for budgetary purposes can be found on page 15 of this report.

Notes to Basic Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the governmental-wide and fund financial statements. The notes to the basic financial statements can be found on pages 16 through 40 of this report.

Change in Accounting Principles

Effective July 1, 2017, the Agency adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* (Statement No. 75). This statement addresses accounting and financial reporting for other postemployment benefits (OPEB) that are provided to the employees of state and local governmental employers through OPEB plans administered through trusts or equivalent arrangements meeting certain criteria. This statement also establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures.

Simultaneously with the adoption of Statement No. 75, the State adopted the provisions of GASB Statement No. 85, *Omnibus 2017* (Statement No. 85). The objective of this statement is to address practice issues that have been identified during the implementation and application of certain GASB statements.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Management's Discussion and Analysis - Unaudited

June 30, 2018

The adoption of Statement Nos. 75 and 85 had no significant effect on the Agency's financial statements as it is the State's policy to allocate a portion of the OPEB liability, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB only to component units and proprietary funds that are reported separately in stand-alone financial statements or in the State's Comprehensive Annual Financial Report.

Condensed Financial Information

The following are summaries from the Agency's government-wide financial statements as of and for the years ended June 30, 2018 and 2017.

**Table 1
Condensed Statements of Net Position**

	<u>2018</u>	<u>2017</u>
Assets:		
Current assets	\$ 10,558,759	\$ 8,994,330
Capital assets, net	<u>26,323</u>	<u>37,889</u>
Total assets	<u>10,585,082</u>	<u>9,032,219</u>
Liabilities:		
Current liabilities	245,600	401,535
Long-term liability - compensated absences	<u>315,370</u>	<u>305,588</u>
Total liabilities	<u>560,970</u>	<u>707,123</u>
Net position:		
Invested in capital assets	26,323	37,889
Unrestricted	<u>9,997,789</u>	<u>8,287,207</u>
Total net position	<u>\$ 10,024,112</u>	<u>\$ 8,325,096</u>

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Management's Discussion and Analysis - Unaudited

June 30, 2018

**Table 2
Condensed Statements of Activities**

	Governmental Activities	
	2018	2017
Revenues:		
State allotted appropriations, net	\$ 6,279,746	\$ 5,128,352
Reimbursements	2,879,296	3,003,502
Other	1,336,926	1,052,371
Total revenues	<u>10,495,968</u>	<u>9,184,225</u>
Expenses:		
Current:		
Contractual services	5,228,857	5,301,404
Personal services	3,388,153	3,050,911
Other	135,459	132,494
Capital outlays:		
Equipment and furniture	44,483	36,061
Total expenses	<u>8,796,952</u>	<u>8,520,870</u>
Change in net position	1,699,016	663,355
Beginning Net Position	<u>8,325,096</u>	<u>7,661,741</u>
Ending Net Position	<u>\$ 10,024,112</u>	<u>\$ 8,325,096</u>

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Management's Discussion and Analysis - Unaudited

June 30, 2018

Government-Wide Financial Analysis

Overall Financial Position

The assets of the Agency exceeded its liabilities by \$10,024,112 and \$8,325,096 as of June 30, 2018 and 2017, respectively. The Agency's government-wide net position increased by \$1,699,016 or 20.4% during the year ended June 30, 2018. Substantially all of the Agency's net position at June 30, 2018 and 2017 was unrestricted and may be used to meet the Agency's ongoing operations.

Results of Operations

State allotted appropriations, net totaled \$6,279,746, which represents an increase of \$1,151,394 or 22.5% over the prior fiscal year. The increase was due to an increase in amounts appropriated for the audits of the Honolulu Authority for Rapid Transportation and the Department of Land and Natural Resources, State of Hawaii, aggregating to \$1,100,000.

Total expenses amounted to \$8,796,952, an increase of \$276,082 or 3.2% over the prior fiscal year. This was primarily attributable to an increase in personal services expense of \$337,242 or 11.1% due to pay increases in the current fiscal year.

Governmental Fund – General Fund Financial Analysis

The focus of the Agency's governmental fund, which is its general fund, is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in evaluating the Agency's financing requirements. In particular, unreserved fund balances may serve as a useful measure of the Agency's net resources available for spending next year.

At the end of the fiscal year, the Agency's general fund reported a fund balance of \$10,313,159, an increase of \$1,720,364 or 20.0% from the prior fiscal year. \$6,950,891 of the fund balance was assigned, \$165,798 of the fund balance was committed, and \$3,196,470 of the fund balance was unassigned.

General Fund Budgetary Highlights

The Agency's general fund budget for the year ended June 30, 2018 remained the same from the original to the final budget.

Actual contractual services on a budgetary basis were less than the budgeted amount by \$400,416 or 5.2%. The difference was primarily attributable to the cost of consultant contracts actually incurred during the year.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Management's Discussion and Analysis - Unaudited

June 30, 2018

Actual personal services on a budgetary basis were less than the budgeted amount by \$597,758 or 21.7%. The difference was primarily attributable to vacant staff positions.

Capital Assets and Long-Term Liability

At June 30, 2018, the Agency had capital assets, net of accumulated depreciation, of \$26,323. There was a decrease in capital assets of \$11,566 or 30.5% from the prior fiscal year, which was attributable to depreciation expense for the year ended June 30, 2018. Further details can be found in Note 7 to the basic financial statements.

At June 30, 2018, the Agency's only long-term liability was for employees' compensated absences, which amounted to \$315,370, an increase of \$9,782 or 3.2% from the prior fiscal year. Further details can be found in Note 8 to the basic financial statements.

Currently Known Facts and Conditions

The 2018 State Legislature provided the Agency a flat budget for fiscal year 2018-2019. No other events or factors that may impact future periods are anticipated at this time.

Request for Information

Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Auditor, Office of the Auditor, State of Hawaii, 465 South King Street, Room 500, Honolulu, Hawaii, 96813.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Statement of Net Position and Governmental Fund Balance Sheet

June 30, 2018

	General Fund	Adjustments (Note 3)	Statement of Net Position
Assets:			
Cash and cash equivalents	\$ 10,402,434	\$ -	\$ 10,402,434
Reimbursements receivable from State of Hawaii departments and agencies	47,500	-	47,500
Interest receivable	108,825	-	108,825
Capital assets, net	-	26,323	26,323
	\$ 10,558,759	26,323	10,585,082
 Liabilities:			
Vouchers and contracts payable	\$ 58,686	-	58,686
Accrued wages and employee benefits payable	184,914	-	184,914
Due to State of Hawaii	2,000	-	2,000
Long-term liability - compensated absences:			
Due within one year	-	91,933	91,933
Due after one year	-	223,437	223,437
	245,600	315,370	560,970
 Fund Balance/Net Position:			
Fund balance:			
Assigned	6,950,891	(6,950,891)	-
Committed	165,798	(165,798)	-
Unassigned	3,196,470	(3,196,470)	-
	10,313,159	(10,313,159)	-
Total fund balance	10,313,159	(10,313,159)	-
Total liabilities and fund balance	\$ 10,558,759		
 Net position:			
Invested in capital assets		26,323	26,323
Unrestricted		9,997,789	9,997,789
		\$ 10,024,112	\$ 10,024,112
Total net position		\$ 10,024,112	\$ 10,024,112

See accompanying notes to basic financial statements.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Statement of Activities and Governmental Fund Revenues, Expenditures, and
Changes in Fund Balance

Year Ended June 30, 2018

	General Fund	Adjustments (Note 4)	Statement of Activities
Revenues:			
State allotted appropriations, net	\$ 6,279,746	\$ -	\$ 6,279,746
Reimbursements	2,879,296	-	2,879,296
State-provided payroll fringe benefits	1,165,881	-	1,165,881
Interest	171,045	-	171,045
Total revenues	<u>10,495,968</u>	<u>-</u>	<u>10,495,968</u>
Expenditures/Expenses:			
Current:			
Contractual services	5,228,857	-	5,228,857
Personal services	3,378,371	9,782	3,388,153
Dues and subscriptions	44,485	-	44,485
Equipment rental and maintenance	22,635	-	22,635
Travel and subsistence, out-of-state	21,510	-	21,510
Telephone	14,649	-	14,649
Depreciation	-	11,566	11,566
Training	10,163	-	10,163
Office supplies and postage	5,778	-	5,778
Travel and subsistence, in-state	984	-	984
Other	3,689	-	3,689
Capital outlays:			
Equipment and furniture	44,483	-	44,483
Total expenditures/expenses	<u>8,775,604</u>	<u>21,348</u>	<u>8,796,952</u>
	<u>1,720,364</u>	<u>(21,348)</u>	<u>1,699,016</u>
Net change in fund balance	1,720,364	(1,720,364)	-
Change in net position	-	1,699,016	1,699,016
Fund Balance/Net Position:			
Beginning of the year	8,592,795	(267,699)	8,325,096
End of the year	<u>\$ 10,313,159</u>	<u>\$ (289,047)</u>	<u>\$ 10,024,112</u>

See accompanying notes to basic financial statements.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Statement of Revenues and Expenditures - Budget and Actual (Budgetary Basis) - General Fund

Year Ended June 30, 2018

	<u>Original and Final Budget</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Positive (Negative)</u>
Budgetary Balance at July 1, 2017	\$ 3,760,158	\$ 3,760,158	\$ -
Revenues:			
State appropriations	7,179,762	6,309,780	(869,982)
Reimbursements	(260,158)	2,896,331	3,156,489
Interest	-	171,045	171,045
Total revenues	<u>6,919,604</u>	<u>9,377,156</u>	<u>2,457,552</u>
Expenditures:			
Current:			
Contractual services	7,744,916	7,344,500	400,416
Personal services	2,753,562	2,155,804	597,758
Office supplies and postage	47,500	49,754	(2,254)
Travel and subsistence, out-of-state	42,000	25,593	16,407
Equipment rental and maintenance	20,000	21,971	(1,971)
Training	13,200	11,122	2,078
Printing	5,000	-	5,000
Travel and subsistence, in-state	4,800	984	3,816
Other	2,500	3,064	(564)
Capital outlays:			
Equipment, furniture, and books	46,284	21,381	24,903
Total expenditures	<u>10,679,762</u>	<u>9,634,173</u>	<u>1,045,589</u>
Budgetary Balance at June 30, 2018	<u>\$ -</u>	<u>\$ 3,503,141</u>	<u>\$ 3,503,141</u>

See accompanying notes to basic financial statements.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Budgetary Reconciliation - General Fund

Year Ended June 30, 2018

Revenues:

Actual revenues on a budgetary basis, net of current year lapsed appropriation	\$ 9,377,156
Differences between budgetary basis and GAAP basis:	
Prior year lapsed appropriations	(30,034)
On-behalf fringe benefits	1,165,881
Current year reimbursements receivable from State of Hawaii departments and agencies	47,500
Prior year reimbursement receivable from State of Hawaii departments and agencies	<u>(64,535)</u>
Total revenues reported in the Statement of Governmental Fund Revenues, Expenditures, and Changes in Fund Balance	<u><u>\$ 10,495,968</u></u>

Expenditures:

Actual expenditures on a budgetary basis	\$ 9,634,173
Differences between budgetary basis and GAAP basis:	
Current year reserved for encumbrances	(6,614,891)
Expenditures for liquidation of prior fiscal year encumbrances	4,596,568
Payment of prior year expenditures	(194,498)
Expenditures paid with future appropriations	188,371
On-behalf fringe benefits	<u>1,165,881</u>
Total expenditures reported in the Statement of Governmental Fund Revenues, Expenditures, and Changes in Fund Balance	<u><u>\$ 8,775,604</u></u>

See accompanying notes to basic financial statements.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

1. Financial Reporting Entity

The Office of the Auditor (the Agency) is a governmental unit of the State of Hawaii (the State) Legislative Branch and conducts post-audits of the transactions, accounts, programs and performance of all departments, offices, and agencies of the State and its political subdivisions.

The State Comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually, which includes the Agency's financial activities. The Agency utilizes office space in a State building and, accordingly, no expenditure is recorded for such space.

The accompanying financial statements present only the activities of the Agency and are not intended to present fairly the financial position of the governmental activities and the general fund of the State, and the respective changes in financial position and budgetary comparison for the year then ended in conformity with accounting principles generally accepted in the United States of America (GAAP).

2. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of the Agency have been prepared in conformity with GAAP. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial accounting principles.

The government-wide financial statements report all assets, liabilities, net position, and activities of the Agency as a whole. They include all funds of the reporting entity except for fiduciary funds.

Net position is restricted when constraints placed on it are either externally imposed or imposed by constitutional provisions or enabling legislation. Internally imposed designations of resources are not presented as restricted net position. When both restricted and unrestricted resources are available for use, it is generally the Agency's policy to use restricted resources first, then unrestricted resources as they are needed.

Fund financial statements are organized on the basis of funds, each of which is considered to be a separate accounting entity. The operations of each accounting fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues and expenditures. The Agency uses fund accounting to report on its financial position and results of operations. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Governmental Funds Types

The Agency has only one governmental fund, which is the general fund, and no proprietary fund operations.

The general fund is used to account for all of the Agency's financial resources. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted for.

Measurement Focus and Basis of Accounting

Government-wide financial statements - Government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are recorded at the time liabilities are incurred or economic assets used. Revenues, expenses, gains, losses, assets, and liabilities resulting from exchange and exchange-like transactions are recognized when the exchange takes place.

In addition, amounts paid to acquire capital assets are capitalized as assets in the government-wide financial statements rather than reported as an expenditure. Amounts paid to reduce long-term indebtedness of the reporting government are reported as a reduction of the related liability, rather than as an expenditure.

Governmental fund financial statements - Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recorded when susceptible to accrual, i.e., both measurable and available, usually when the appropriations are allotted. Expenditures are generally recognized when the related liability is incurred, except for accumulated unpaid vacation, which is recognized as expenditures when payable from expendable available resources.

Amounts expended to acquire capital assets are recorded as expenditures in the fiscal year that resources were expended, rather than as fund assets. Expenditures related to compensated absences are recorded only when payment is due.

Encumbrances are recorded obligations in the form of purchase orders or contracts. The Agency records encumbrances at the time purchase orders or contracts are awarded and executed. Encumbrances outstanding at fiscal year-end do not constitute expenditures or liabilities.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Governmental entities with a single governmental program are allowed to present combined government-wide and fund financial statements. Thus, the basic financial statements of the Agency are composed of the following:

- Statement of Net Position and Governmental Fund Balance Sheet
- Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance
- Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) – General Fund
- Budgetary Reconciliation – General Fund
- Notes to Basic Financial Statements

Appropriations

Appropriations represent the authorizations granted by the State Legislature that permit a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year, with the exception of the State appropriations made to the Audit Revolving Fund, which do not lapse.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash in bank and amounts held in State Treasury as discussed in Note 6. The State's investments held in the State Treasury are reported at fair value within the fair value hierarchy established by GAAP.

Fair Value Measurements

The Agency measures the fair value of assets and liabilities as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants at the measurement date. The fair value hierarchy distinguishes between independent observable inputs and unobservable inputs used to measure fair value, as follows:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 - Inputs other than quoted market prices included in Level 1 that are observable for an asset or liability, either directly or indirectly.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Level 3 - Unobservable inputs for an asset or liability reflecting the reporting entity's own assumptions. Level 3 inputs are used to measure fair value to the extent that observable Level 1 or 2 inputs are not available.

Reimbursement Receivables

The Agency pays for the audit fees incurred by departments, offices, agencies and political subdivisions of the State of Hawaii and are reimbursed by them based on a predetermined percentage of the audit fees. All receivables are reported net of estimated uncollectible amounts.

Capital Assets

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

Government-wide Financial Statements

The Agency records the acquisition of capital assets, costing \$5,000 or more, which only includes furniture and equipment. Depreciation of furniture and equipment is computed using the straight-line method over 7 years.

Maintenance and repairs are charged to operations when incurred. Betterments and major improvements which significantly increase values, change capacities, or extend useful lives are capitalized. Upon sale or retirement of capital assets, the cost and the related accumulated depreciation, as applicable, are removed from the respective accounts, and any resulting gain or loss is recognized in the Statement of Activities.

Fund Financial Statements

Capital assets used in governmental fund operations are accounted for as capital expenditures of the governmental fund upon acquisition.

Compensated Absences

Employees are permitted to accumulate earned but unused vacation and sick leave benefits. There is no liability for unpaid accumulated sick leave since sick leave is not convertible to pay upon termination of employment.

In the government-wide financial statements, vacation pay is accrued when the obligation is incurred. The fund financial statements report an accrued vacation liability only when vacation pay is due and payable in the current period.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Fund Balances

In the governmental fund financial statements, fund balances are classified using a hierarchy based on the extent to which the Agency is bound to follow constraints on the specific purposes for which amounts in the funds may be spent.

Fund balances are classified as follows:

Nonspendable - Nonspendable fund balance includes amounts that cannot be spent because they are either not in spendable form or they are legally or contractually required to be maintained intact.

Restricted - Restricted fund balances are restricted to specific purposes which are usually imposed by external parties such as grantors, contributors, or laws or regulations of other governments.

Committed - Committed fund balances are amounts that can only be used for specific purposes pursuant to formal action of the State Legislature.

Assigned - Assigned fund balance includes amounts that are constrained by the State's intent to be used for specific purposes, but are neither restricted nor committed. The State Legislature authorizes the amounts to specific purposes through the budgetary process. Assigned amounts within the general fund include non-liquidated encumbrances at year end that are carried forward to the next fiscal year.

Unassigned - Unassigned fund balance is the residual classification for the general fund. This classification represents fund balance that has not been assigned to other funds, and that has not been restricted or assigned to specific purposes within the general fund.

The Agency has only assigned, committed, and unassigned fund balances.

Risk Management

The Agency is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; workers' compensation; and acts of terrorism. A liability for insurance-related losses is established if information indicates that it is probable that a loss has been incurred and the amount of the loss is reasonably estimable.

Deferred Compensation Plan

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all state employees, permits employees to

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

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

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Change in Accounting Principles

Effective July 1, 2017, the Agency adopted the provisions of GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* (Statement No. 75). This statement addresses accounting and financial reporting for other postemployment benefits (OPEB) that are provided to the employees of state and local governmental employers through OPEB plans administered through trusts or equivalent arrangements meeting certain criteria. This statement also establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures.

Statement No. 75 replaces the requirements of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multi-Employer Plans*.

Simultaneously with the adoption of Statement No. 75, the Agency adopted the provisions of GASB Statement No. 85, *Omnibus 2017* (Statement No. 85). The objective of this statement is to address practice issues that have been identified during the implementation and application of certain GASB statements.

The adoption of Statement Nos. 75 and 85 had no significant effect on the Agency's financial statements as it is the State's policy to allocate a portion of the OPEB liability, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB only to component units and proprietary funds that are reported separately in stand-alone financial statements or in the State's Comprehensive Annual Financial Report (CAFR).

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Recently Issued Accounting Pronouncements

GASB Statement No. 83

The GASB issued Statement No. 83, *Certain Asset Retirement Obligations*. This statement provides financial statement users with information about asset retirement obligations that were not addressed in GASB standards by establishing uniform accounting and financial reporting requirements for these obligations. The requirements of this statement are effective for reporting periods beginning after June 15, 2018. The Agency is currently evaluating the impact that this statement will have on its financial statements.

GASB Statement No. 87

The GASB issued Statement No. 87, *Leases*. The objective of this statement is to improve accounting and financial reporting for leases by governments. This statement requires recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the provisions of the contract. The requirements of this statement are effective for reporting periods beginning after December 15, 2019. The Agency is currently evaluating the impact that this statement will have on its financial statements.

3. Explanation of Differences Between the Governmental Fund Balance Sheet and Statement of Net Position

The "total fund balance" reported in the Agency's Governmental Fund Balance Sheet of \$10,313,159 differs from the "net position" of governmental activities of \$10,024,112 reported in the Statement of Net Position. This difference primarily results from the long-term economic focus of the Statement of Net Position and the current financial resources focus of the Governmental Fund Balance Sheet.

Capital Assets

When equipment and furniture that are to be used in governmental activities are purchased, the costs of those activities are reported as expenditures in governmental funds. However, the Statement of Net Position includes those capital assets among the assets of the Agency as a whole. Capital assets, net of accumulated depreciation, amounted to \$26,323 at June 30, 2018.

Long-Term Liability

Long-term liability applicable to the Agency's governmental activities is not due and payable in the current period and accordingly is not reported as fund liability. The liability for compensated

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

absences (both current and long-term) is reported in the Statement of Net Position. The balance of compensated absences payable at June 30, 2018, was \$315,370.

4. Explanation of Differences Between the Governmental Fund Operating Statement and the Statement of Activities

The "net change in fund balance" reported in the Agency's Statement of Governmental Fund Revenues, Expenditures, and Changes in Fund Balance of \$1,720,364 differs from the "change in net position" for governmental activities of \$1,699,016 reported in the Statement of Activities. The difference primarily results from the long-term economic focus of the Statement of Activities and the current financial resources focus of the Statement of Governmental Fund Revenues, Expenditures, and Changes in Fund Balance.

Capital Assets

When capital assets that are to be used in governmental activities are purchased, the resources expended for those assets are reported as expenditures in the governmental fund. However, in the Statement of Activities, the costs of those assets are allocated over their estimated useful lives and reported as depreciation expense. As a result, fund balance decreases by the amount of financial resources expended, whereas, net position decreased by the amount of depreciation expense charged for the fiscal year. There was a net decrease in capital assets of \$11,566 during the year ended June 30, 2018 due to current year depreciation expense.

Long-Term Liability

Some expenses reported in the Statement of Activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental fund. For the Agency, this difference is due to a net adjustment resulting from an increase in compensated absences of \$9,782.

5. Budgeting and Budgetary Control

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues and budgeted expenditures in the Statement of Revenues and Expenditures – Budget and Actual (Budgetary Basis) – General Fund are derived primarily from acts of the State Legislature and from other authorizations contained in other specific appropriation acts in various Session Laws of Hawaii.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations. The Audit Revolving Fund is allowed to carry over unused funds to the subsequent fiscal year.

For purposes of budgeting, the Agency's budgetary fund structure and accounting principles differ from those utilized to present the general fund financial statements in conformity with GAAP. The Agency's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to the encumbrance of purchase orders and contract obligations. These differences represent departures from GAAP. The differences between the budgetary amounts and the amounts presented in accordance with GAAP for the fiscal year ended June 30, 2018, are further explained in the Budgetary Reconciliation - General Fund.

6. Cash and Cash Equivalents

Cash and cash equivalents at June 30, 2018, consisted of cash in bank and amounts held in State Treasury at June 30, 2018:

Cash in bank	\$ 2,000
Amounts held in State Treasury	<u>10,400,434</u>
Total cash and cash equivalents	<u><u>\$ 10,402,434</u></u>

Amounts Held in State Treasury

The Director of Finance is responsible for the safekeeping of all monies paid into the State Treasury. The Director of Finance pools and invests any monies of the State, which in the Director of Finance's judgment, are in excess of the amounts necessary for meeting the specific requirements of the State. Investment earnings are allocated to the pool participants based upon their equity interest in the pooled monies. Legally authorized investments include obligations of or guaranteed by the U.S. government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

At June 30, 2018, amounts held in State Treasury by the Agency totaled \$10,400,434. The amounts held in State Treasury reported in the accompanying Statement of Net Position and Governmental Fund Balance Sheet reflects the Agency's relative position in the State's investment pool based upon the average monthly investment balance of each participant in the investment pool.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Information relating to the cash and investments in State Treasury is determined on a statewide basis and not for individual departments or agencies. Information regarding the carrying amount and corresponding bank balances of the investment pool and collateralization of the investment pool balances is included in the State's CAFR.

Cash and Cash Equivalents

The State maintains bank accounts for various purposes at locations throughout the State and the nation. Bank deposits for the State Treasury are under the custody of the Director of Finance. Cash and cash equivalents consist of cash, time certificates of deposit, and money market accounts. Cash and cash equivalents also include repurchase agreements and U.S. government securities with original maturities of three months or less.

Investments

The State holds investments both for its own benefit and as an agent for other parties. Further, the State pools all excess funds into an investment pool that is administered by the Department of Budget and Finance, State of Hawaii (B&F). The pool's investment options are limited to investments listed in the Hawaii Revised Statutes (HRS).

At the end of each year, B&F allocates the investment pool amount to each of the participants. The allocation is based on the average monthly investment balance of each participant in the investment pool.

The Hawaii Employer-Union Health Benefits Trust Fund (the EUTF) maintains a separate investment pool. The EUTF board is responsible for safekeeping these monies and has appointed an investment committee responsible for investing EUTF assets in compliance with HRS Sections 87A-24(2) and 88-119. Money is invested in accordance with the EUTF's investment policy.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

The following table presents the fair value of the State's investments by level of input at June 30, 2017 (amounts expressed in thousands):

	Reported Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Primary government:				
Investments by fair value level:				
U.S. government securities	\$ 2,307,970	\$ 552,527	\$ 1,755,443	\$ -
Mutual funds	37,127	37,127	-	-
	<u>2,345,097</u>	<u>\$ 589,654</u>	<u>\$ 1,755,443</u>	<u>\$ -</u>
Investments measured at amortized cost:				
Certificates of deposit	<u>1,242,753</u>			
Total investments	<u>\$ 3,587,850</u>			
Fiduciary funds:				
Investments by fair value level:				
Equity securities	\$ 413,652	\$ 413,652	\$ -	\$ -
U.S. government securities	306,888	47,645	259,243	-
Mutual funds	132,899	132,899	-	-
Derivatives	(148)	-	(148)	-
	<u>853,291</u>	<u>\$ 594,196</u>	<u>\$ 259,095</u>	<u>\$ -</u>
Investments at net asset value (NAV):				
Commingled funds:				
Domestic equity	358,322			
International equity	377,205			
Domestic core fixed income	224,097			
Domestic inflation-linked fixed income	52,061			
Alternative investments	<u>74,919</u>			
Total investments at fair value	1,939,895			
Investments measured at amortized cost:				
Certificates of deposit	<u>107,164</u>			
Total investments	<u>\$ 2,047,059</u>			
Invested securities lending collateral at NAV:				
Money market fund	<u>\$ 27,061</u>			

Information relating to the fair value of investments in the State's investment pool at June 30, 2018 will be included in the State's CAFR when issued.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Cash and Cash Equivalents, Certificates of Deposit, and Repurchase Agreements

The State considers all cash and investments with original maturities of three months or less to be cash equivalents. The carrying amounts for cash equivalents, certificates of deposit, and repurchase agreements are measured at amortized cost.

Debt Securities, Equity Securities, Mutual Funds, Commingled Funds and Alternative Investments, and Money Market Funds

The following methods and assumptions were used by the State in estimating the fair value of its financial instruments:

Debt securities – Debt securities held by the State consist of U.S. government obligations including U.S. Treasury bills and U.S. Treasury notes and bonds. The fair value of these investments are based on quoted prices in active markets or other observable inputs, including pricing matrices. These investments are categorized in either Level 1 or 2 of the fair value hierarchy.

Equity securities – Equity securities held by the State are valued at the closing price reported on the active market on which the individual securities are traded. These investments are categorized in Level 1 of the fair value hierarchy.

Mutual funds – The mutual funds held by the State are open-ended mutual funds that are registered with the Securities Exchange Commission (SEC). The fair value of these mutual funds are valued at the daily closing price as reported by the fund. These funds are required to publish their daily NAV and to transact at that price. These investments are categorized in Level 1 of the fair value hierarchy.

Commingled funds and alternative investments – Investments in commingled funds and alternative investments are valued at the NAV of units of the investment vehicles. The NAV is based on the fair value of the underlying assets held by the fund less its liabilities. The State has no unfunded commitments with regard to these commingled funds and alternative investments.

Money market funds – Investments in money market funds are valued at the NAV of the custodian bank liquid asset portfolio. NAV is based on the fair value of the underlying assets held by the fund less its liabilities.

The preceding measurements described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. The market volatility of equity-based investments is expected to substantially impact the value of such investments at any given time. It is likely that the State's investments have fluctuated since June 30, 2017.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

The following table presents the investments included in the State's investment pool by maturity period at June 30, 2017 (amounts in thousands):

	Reported Value	Maturity (in years)		
		Less than 1	1-5	>5
Primary government:				
Certificates of deposit	\$ 1,242,753	\$ 1,187,710	\$ 55,043	\$ -
U.S. government securities	2,307,970	704,940	1,603,030	-
	<u>3,550,723</u>	<u>\$ 1,892,650</u>	<u>\$ 1,658,073</u>	<u>\$ -</u>
Mutual funds	37,127			
Total investments	<u>\$ 3,587,850</u>			
Fiduciary funds:				
Certificates of deposit	\$ 107,164	\$ 102,418	\$ 4,746	\$ -
U.S. government securities	306,888	60,788	246,100	-
Derivatives	(148)	-	(148)	-
	<u>413,904</u>	<u>\$ 163,206</u>	<u>\$ 250,698</u>	<u>\$ -</u>
Equity securities	413,652			
Mutual funds	132,899			
Commingled funds	1,011,685			
Alternative investments	74,919			
Total investments	<u>\$ 2,047,059</u>			

Information relating to the State's investment pool by maturity period at June 30, 2018 will be included in the State's CAFR when issued.

Interest Rate Risk

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

Credit Risk

The State's general investment policy limits investments in state and U.S. treasury securities, time certificates of deposit, U.S. government or agency obligations, repurchase agreements, commercial paper, banker's acceptances, and money market funds maintaining a Triple-A rating.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Custodial Risk

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

Concentration of Credit Risk

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

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. The State's asset allocation and investment policy allows for active and passive investments in international securities. The foreign currency risk exposure to the State arises from the international equity investment holdings, including commingled funds, common stocks, and exchange traded funds.

7. Capital Assets

The changes in capital assets during the year ended June 30, 2018 was as follows:

	Balance July 1, 2017	Additions	Deductions	Balance June 30, 2018
Governmental activities:				
Equipment and furniture	\$ 117,514	\$ -	\$ -	\$ 117,514
Less accumulated depreciation	(79,625)	(11,566)	-	(91,191)
Capital assets, net	<u>\$ 37,889</u>	<u>\$ (11,566)</u>	<u>\$ -</u>	<u>\$ 26,323</u>

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

8. Long-Term Liability

The only long-term liability for governmental activities is for compensated absences. Long-term liability activity during the year ended June 30, 2018 was as follows:

Balance at June 30, 2017	\$ 305,588
Additions	193,439
Reductions	<u>(183,657)</u>
Balance at June 30, 2018	<u>\$ 315,370</u>
Due within one year	<u><u>\$ 91,933</u></u>

The compensated absences liability has been paid primarily by the general fund in the past.

9. Non-Imposed Employee Fringe Benefits

Payroll fringe benefit costs of the Agency's employees funded by state appropriations (general fund) are assumed by the State and are not charged to the Agency's operating funds. These costs, totaling \$1,165,881 for the year ended June 30, 2018, have been reported as revenues and expenditures of the Agency's general fund.

10. Retirement Benefits

Pension Plan

Plan Description

Generally, all full-time employees of the State and counties, which includes the Agency, are required to be members of the Employees' Retirement System of the State of Hawaii (the ERS), a cost-sharing multiple-employer defined benefit pension plan that administers the State's pension benefits program. Benefits, eligibility, and contribution requirements are governed by HRS Chapter 88 and can be amended through legislation.

Benefits Provided

The ERS Pension Trust is comprised of three pension classes for membership purposes and considered to be a single plan for accounting purposes since all assets of the ERS may legally be used to pay the benefits of any of the ERS members or beneficiaries. The ERS provides retirement, disability, and death benefits with three membership classes known as the

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

noncontributory, contributory, and hybrid retirement classes. The three classes provide a monthly retirement allowance equal to the benefit multiplier (generally 1.25% or 2%) multiplied by the average final compensation multiplied by years of credited service. Average final compensation for members hired prior to July 1, 2012 is an average of the highest salaries during any three years of credited service, excluding any salary paid in lieu of vacation for members hired January 1, 1971 or later and the average of the highest salaries during any five years of credited service including any salary paid in lieu of vacation for members hired prior to January 1, 1971. For members hired after June 30, 2012, average final compensation is an average of the highest salaries during any five years of credited service excluding any salary paid in lieu of vacation.

Each retiree's original retirement allowance is increased on each July 1 beginning the calendar year after retirement. Retirees first hired as members prior to July 1, 2012 receive a 2.5% increase each year of their original retirement allowance without a ceiling. Retirees first hired as members after June 30, 2012 receive a 1.5% increase each year of their original retirement allowance without a ceiling. The annual increase is not compounded.

The following summarizes the provisions relevant to the largest employee groups of the respective membership class. Retirement benefits for certain groups, such as police officers, firefighters, some investigators, sewer workers, judges, and elected officials, vary from general employees.

Noncontributory Class

Retirement Benefits

General employees' retirement benefits are determined as 1.25% of average final compensation multiplied by the years of credited service. Employees with ten years of credited service are eligible to retire at age 62. Employees with 30 years of credited service are eligible to retire at age 55.

Disability Benefits

Members are eligible for service-related disability benefits regardless of length of service and receive a lifetime pension of 35% of their average final compensation. Ten years of credited service is required for ordinary disability. Ordinary disability benefits are determined in the same manner as retirement benefits but are payable immediately, without an actuarial reduction, and at a minimum of 12.5% of average final compensation.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Death Benefits

For service-connected deaths, the surviving spouse/reciprocal beneficiary receives a monthly benefit of 30% of the average final compensation until remarriage or re-entry into a new reciprocal beneficiary relationship. Additional benefits are payable to surviving dependent children up to age 18. If there is no spouse/reciprocal beneficiary or dependent children, no benefit is payable.

Ordinary death benefits are available to employees who were active at the time of death with at least ten years of credited service. The surviving spouse/reciprocal beneficiary (until remarriage/re-entry into a new reciprocal beneficiary relationship) and dependent children (up to age 18) receive a benefit equal to a percentage of member's accrued maximum allowance unreduced for age or, if the member was eligible for retirement at the time of death, the surviving spouse/reciprocal beneficiary receives 100% joint and survivor lifetime pension and the dependent children receive a percentage of the member's accrued maximum allowance unreduced for age.

Contributory Class for Members Hired Prior to July 1, 2012

Retirement Benefits

General employees' retirement benefits are determined as 2% of average final compensation multiplied by the years of credited service. General employees with five years of credited service are eligible to retire at age 55.

Police officers and firefighters' retirement benefits are determined using the benefit multiplier of 2.5% for qualified service, up to a maximum of 80% of average final compensation. Police officers and firefighters with five years of credited service are eligible to retire at age 55. Police officers and firefighters with 25 years of credited service are eligible to retire at any age, provided the last five years is service credited in these occupations.

Disability Benefits

Members are eligible for service-related disability benefits regardless of length of service and receive a one-time payment of the member's contributions and accrued interest plus a lifetime pension of 50% of their average final compensation. Ten years of credited service is required for ordinary disability. Ordinary disability benefits are determined as 1.75% of average final compensation multiplied by the years of credited service but are payable immediately, without an actuarial reduction, and at a minimum of 30% of average final compensation.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Death Benefits

For service-connected deaths, the surviving spouse/reciprocal beneficiary receives a lump sum payment of the member's contributions and accrued interest plus a monthly benefit of 50% of the average final compensation until remarriage or re-entry into a new reciprocal beneficiary relationship. If there is no surviving spouse/reciprocal beneficiary, surviving children (up to age 18) or dependent parents are eligible for the monthly benefit. If there is no spouse/reciprocal beneficiary or dependent children/parents, the ordinary death benefit is payable to the designated beneficiary.

Ordinary death benefits are available to employees who were active at time of death with at least one year of service. Ordinary death benefits consist of a lump sum payment of the member's contributions and accrued interest plus a percentage of the salary earned in the 12 months preceding death, or 50% joint and survivor lifetime pension if the member was not eligible for retirement at the time of death but was credited with at least ten years of service and designated one beneficiary, or 100% joint and survivor lifetime pension if the member was eligible for retirement at the time of death and designated one beneficiary.

Contributory Class for Members Hired After June 30, 2012

Retirement Benefits

General employees' retirement benefits are determined as 1.75% of average final compensation multiplied by the years of credited service. General employees with ten years of credited service are eligible to retire at age 60.

Police officers and firefighters' retirement benefits are determined using the benefit multiplier of 2.25% for qualified service, up to a maximum of 80% of average final compensation. Police officers and firefighters with ten years of credited service are eligible to retire at age 60. Police officers and firefighters with 25 years of credited service are eligible to retire at any age, provided the last five years is service credited in these occupations.

Disability and Death Benefits

Members are eligible for service-related disability benefits regardless of length of service and receive a lifetime pension of 50% of their average final compensation plus refund of contributions and accrued interest. Ten years of credited service is required for ordinary disability. Ordinary disability benefits are 1.75% of average final compensation for each year of service for police officers and firefighters and are payable immediately, without an actuarial reduction, at a minimum of 30% of average final compensation.

Death benefits for contributory members hired after June 30, 2012 are generally the same as those for contributory members hired June 30, 2012 and prior.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Hybrid Class for Members Hired Prior to July 1, 2012

Retirement Benefits

General employees' retirement benefits are determined as 2% of average final compensation multiplied by the years of credited service. General employees with five years of credited service are eligible to retire at age 62. General employees with 30 years of credited service are eligible to retire at age 55.

Disability Benefits

Members are eligible for service-related disability benefits regardless of length of service and receive a lifetime pension of 35% of their average final compensation plus refund of their contributions and accrued interest. Ten years of credited service is required for ordinary disability. Ordinary disability benefits are determined in the same manner as retirement benefits but are payable immediately, without an actuarial reduction, and at a minimum of 25% of average final compensation.

Death Benefits

For service-connected deaths, the designated surviving spouse/reciprocal beneficiary receives a lump sum payment of the member's contributions and accrued interest plus a monthly benefit of 50% of the average final compensation until remarriage or re-entry into a new reciprocal beneficiary relationship. If there is no surviving spouse/reciprocal beneficiary, surviving dependent children (up to age 18) or dependent parents are eligible for the monthly benefit. If there is no spouse/reciprocal beneficiary or dependent children/parents, the ordinary death benefit is payable to the designated beneficiary.

Ordinary death benefits are available to employees who were active at time of death with at least five years of service. Ordinary death benefits consist of a lump sum payment of the member's contributions and accrued interest plus a percentage multiplied by 150%, or 50% joint and survivor lifetime pension if the member was not eligible for retirement at the time of death but was credited with at least ten years of service and designated one beneficiary, or 100% joint and survivor lifetime pension if the member was eligible for retirement at the time of death and designated one beneficiary.

Hybrid Class for Members Hired After June 30, 2012

Retirement Benefits

General employees' retirement benefits are determined as 1.75% of average final compensation multiplied by the years of credited service. General employees with ten years of credited service are eligible to retire at age 65. Employees with 30 years of credited service are eligible to retire at

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

age 60. Sewer workers, water safety officers, and emergency medical technicians may retire with 25 years of credited service at age 55.

Disability and Death Benefits

Provisions for disability and death benefits generally remain the same except for ordinary death benefits. Ordinary death benefits are available to employees who were active at time of death with at least ten years of service. Ordinary death benefits consist of a lump sum payment of the member's contributions and accrued interest, or 50% joint and survivor lifetime pension if the member was not eligible for retirement at the time of death but was credited with at least ten years of service and designated one beneficiary, or 100% joint and survivor lifetime pension if the member was eligible for retirement at the time of death and designated one beneficiary.

Contributions

Contributions are established by HRS Chapter 88 and may be amended through legislation. The employer rate is set by statute based on the recommendations of the ERS actuary resulting from an experience study conducted every five years. Since July 1, 2005, the employer contribution rate is a fixed percentage of compensation, including the normal cost plus amounts required to pay for the unfunded actuarial accrued liabilities. The contribution rates for fiscal year 2018 were 28.0% for police officers and firefighters and 18.0% for all other employees. Pension contributions paid by the State on behalf of the Agency for the year ended June 30, 2018 were approximately \$400,000.

On May 18, 2017, the Governor signed into law Act 17 SLH 2017. Per Act 17, future employer contributions from the State and counties are expected to increase pursuant to a phased-in contribution rate increase beginning July 1, 2017. The rate for police and firefighters increases to 31.0% on July 1, 2018; 36.0% on July 1, 2019; and 41.0% on July 1, 2020, and the rate for all other employees increases to 19.0% on July 1, 2018; 22.0% on July 1, 2019; and 24.0% on July 1, 2020.

The employer is required to make all contributions for noncontributory members. Contributory members hired prior to July 1, 2012 are required to contribute 7.8% of their salary, except for police officers and firefighters who are required to contribute 12.2% of their salary. Contributory members hired after June 30, 2012 are required to contribute 9.8% of their salary, except for police officers and firefighters who are required to contribute 14.2% of their salary. Hybrid members hired prior to July 1, 2012 are required to contribute 6.0% of their salary. Hybrid members hired after June 30, 2012 are required to contribute 8.0% of their salary.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Pension Liability, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pension

Measurement of the actuarial valuation of the pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to pension is made for the State as a whole and is not separately computed for the individual state departments and agencies such as the Agency. The State allocates the pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to pension only to component units and proprietary funds that are reported separately in stand-alone financial statements or in the State's CAFR. Accordingly, the Agency's proportionate share of the State's pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to pension is not reported in the accompanying financial statements.

Additional disclosures and required supplementary information stipulated by Statement Nos. 68 and 71 pertaining to the State's net pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to pension can be found in the State's CAFR. The State's CAFR can be obtained at the Department of Accounting and General Services' website: <http://hawaii.gov/dags/rpts>.

Postemployment Health Care and Life Insurance Benefits

Plan Description

The State provides certain health care and life insurance benefits to all qualified employees. Pursuant to Act 88, SLH 2001, the State contributes to the EUTF, an agent multiple-employer defined benefit plan that replaced the Hawaii Public Employees Health Fund effective July 1, 2003. The EUTF was established to provide a single delivery system of health benefits for state and county workers, retirees, and their dependents.

For employees hired before July 1, 1996, the State pays the entire base monthly contribution for employees retiring with ten or more years of credited service, and 50% of the base monthly contribution for employees retiring with fewer than ten years of credited service. A retiree can elect a family plan to cover dependents.

For employees hired after June 30, 1996, but before July 1, 2001, and who retire with fewer than ten years of service, the State makes no contributions. For those retiring with at least ten years but fewer than 15 years of service, the State pays 50% of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75% of the base monthly contribution. For employees retiring with at least 25 years of service, the State pays 100% of the base monthly contribution. Retirees in this category can elect a family plan to cover dependents.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

For employees hired on or after July 1, 2001, and who retire with fewer than ten years of service, the State makes no contributions. For those retiring with at least ten years but fewer than 15 years of service, the State pays 50% of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75% of the base monthly contribution. For employees retiring with at least 25 years of service, the State pays 100% of the base monthly contribution. Only single plan coverage is provided for retirees in this category. Retirees can elect family coverage, but must pay the difference.

Members Covered by Benefit Terms

At July 1, 2017, the State's plan members covered by the benefit terms consisted of the following:

Inactive plan members or beneficiaries currently receiving benefits	35,374
Inactive plan members entitled to but not yet receiving benefits	8,124
Active plan members	<u>50,101</u>
Total plan members	<u><u>93,599</u></u>

Contributions

Contributions are governed by HRS Chapter 87A and may be amended through legislation. Contributions to the EUTF paid by the State on behalf of the Agency was approximately \$200,000 for the fiscal year ended June 30, 2018.

OPEB Liabilities, OPEB Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to OPEB

Measurement of the actuarial valuation of the OPEB liability, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB is made for the State as a whole and is not separately computed for the individual state departments and agencies such as the Agency. The State allocates the OPEB liability, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB only to component units and proprietary funds that are reported separately in stand-alone financial statements or in the State's CAFR. Accordingly, the Agency's proportionate share of the State's OPEB liability, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB are not reported in the accompanying financial statements.

Additional disclosures and required supplementary information stipulated by Statement Nos. 75 and 85 pertaining to the State's net OPEB liability, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB can be found in the State's CAFR.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

11. Risk Management

The Agency records a liability for risk financing and insurance related losses if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State, which includes the Agency, retains various risks and insures certain excess layers with commercial insurance companies. The excess layers insured with commercial insurance companies are consistent with the prior fiscal year. Settled claims have not exceeded the coverage provided by commercial insurance companies in any of the past ten fiscal years. A summary of the State's underwriting risks is as follows:

Property Insurance

The State has an insurance policy with a variety of insurers in a variety of layers for property coverage. The deductible for coverage is 3% of loss subject to a \$1,000,000 per occurrence minimum. This policy includes windstorm, earthquake, flood damage, terrorism, and boiler and machinery coverage. The limit of loss per occurrence is \$200,000,000, except for terrorism, which is \$50,000,000 per occurrence and a \$10,000 deductible.

Crime Insurance

The State also has a crime insurance policy for various types of coverages with a limit of loss of \$10,000,000 per occurrence with a \$500,000 deductible per occurrence, except for claims expense coverage, which has a \$100,000 limit per occurrence and a \$1,000 deductible. Losses under the deductible amount are paid by the Risk Management Office of the Department of Accounting and General Services and losses not covered by insurance are paid from legislative appropriations of the State's general fund.

General Liability (Including Torts)

Liability claims up to \$10,000 and automobile claims up to \$15,000 are handled by the Risk Management Office. All other claims are handled by the Department of the Attorney General. The State has personal injury and property damage liability, including automobile and public errors and omissions, insurance policy in force with a \$4,000,000 self-insured retention per occurrence. The annual aggregate per occurrence is \$9,000,000 and for crime loss, \$10,000,000 with no aggregate limit. Losses under the deductible amount or over the aggregate limit are paid from legislative appropriations of the State's general fund.

Cyber Liability Insurance

The State is insured for various types of cyber-related activities with a loss limit of \$50,000,000 with a deductible of \$500,000 per occurrence. This policy includes (with sub-limits) system failure business interruption, dependent business interruption, dependent business interruption system failure and Payment Card Industry – Data Security Standard coverage.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Self-Insured Risks

The State generally self-insures its automobile no-fault and workers' compensation losses. Automobile losses up to \$15,000 are administered by the Risk Management Office. The State administers its workers' compensation losses.

Reserve for Losses and Loss Adjustment Costs

A liability for workers' compensation and general liability claims is established if information indicates that a loss has been incurred as of June 30, 2018, and the amount of the loss can be reasonably estimated. The liability also includes an estimate for amounts incurred but not reported. The estimated losses are paid from legislative appropriations of the State's general fund. The Agency's portion of the State's workers' compensation expense for the year ended June 30, 2018 was approximately \$25,000.

12. Commitments and Contingencies

Encumbrances

Encumbrances totaled approximately \$6,951,000 as of June 30, 2018.

Accumulated Sick Leave

Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service without limit. Sick leave can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2018 amounted to approximately \$757,000.

Litigation

From time to time, the Agency is named as a defendant in various legal proceedings. It has been the State's historical practice that certain types of judgments and settlements against an agency of the State are paid from the State's general fund through an appropriation bill which is submitted annually by the Department of the Attorney General to the State Legislature.

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2018

Lease Commitments

The Agency leased office equipment under noncancelable operating leases expiring in October 2022. Total equipment rental expenditures for the fiscal year ended June 30, 2018 amounted to approximately \$23,000. Future lease commitments for the operating leases are approximated as follows:

Fiscal Year Ending June 30,	
2019	\$ 14,600
2020	14,600
2021	14,600
2022	14,600
2023	<u>3,700</u>
	<u><u>\$ 62,100</u></u>

13. Subsequent Events

The Agency has evaluated subsequent events through December 21, 2018, the date the financial statements were available to be issued, and determined that there are no other matters to disclose.

PART III

INTERNAL CONTROL AND COMPLIANCE SECTION

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

The Auditor
State of Hawaii:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of the governmental activities and the general fund of the Office of the Auditor, State of Hawaii (the Agency), as of and for the year ended June 30, 2018, and the related notes to financial statements, which collectively comprise the Agency's basic financial statements, and have issued our report thereon dated December 21, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Agency's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Agency's internal control. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Agency's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KKDL LLC

Honolulu, Hawaii
December 21, 2018