

**FINANCIAL AUDIT OF THE
DEPARTMENT OF EDUCATION
STATE OF HAWAII**

Fiscal Year Ended June 30, 2006

**Submitted by
The Auditor
State of Hawaii**



NISHIHAMA & KISHIDA, CPAs, INC.
CERTIFIED PUBLIC ACCOUNTANTS

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March 29, 2007

Ms. Marion Higa
Office of the Auditor
State of Hawaii

Dear Ms. Higa:

This is our report on the financial audit of the Department of Education (DOE), State of Hawaii for the fiscal year ended June 30, 2006. Our audit was performed in accordance with the terms of our contract with the State of Hawaii and with the requirements of the Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and the *Compliance Supplement for Single Audits of State and Local Governments*.

OBJECTIVES OF THE AUDIT

The primary purpose of our audit was to form an opinion on the fairness of the presentation of the DOE's financial statements for the fiscal year ended June 30, 2006, and to comply with the requirements of OMB Circular A-133, which establishes audit requirements for state and local governments that receive federal financial assistance. More specifically, the objectives of the audit were as follows:

1. To provide a basis for an opinion on the fairness of the presentation of the DOE's financial statements.
2. To determine whether expenditures and other disbursements have been made and all revenues and other receipts to which the DOE is entitled have been collected and accounted for in accordance with the laws, rules and regulations, administrative directives, policies and procedures of the State of Hawaii and the federal government.
3. To determine whether the DOE has established sufficient internal controls to properly manage federal financial assistance programs and to comply with the applicable laws, regulations, contracts, and grants.
4. To determine whether the DOE has complied with the laws, regulations, contracts, and grants that may have a material effect on the financial statements and on each major federal financial assistance program.

SCOPE OF THE AUDIT

Our audit was performed in accordance with auditing standards generally accepted in the United States of America as prescribed by the American Institute of Certified Public Accountants; *Government Auditing Standards*, issued by the Comptroller General of the United States; and the provisions of OMB Circular A-133. The scope of our audit included an examination of the transactions and accounting records of the DOE for the fiscal year ended June 30, 2006.

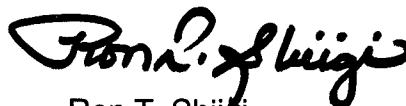
ORGANIZATION OF THE REPORT

This report is presented in six parts as follows:

- Part I - The basic financial statements and related notes of the DOE as of and for the fiscal year ended June 30, 2006, and our opinion on the basic financial statements.
- Part II - Our report on internal control over financial reporting and on compliance and other matters.
- Part III - Our report on compliance with requirements applicable to each major program and on internal control over compliance.
- Part IV - The schedule of findings and questioned costs.
- Part V - Corrective action plan as provided by the Department of Education, State of Hawaii.
- Part VI - The summary schedule of prior audit findings.

We wish to express our sincere appreciation for the excellent cooperation and assistance extended by the officers and staff of the DOE.

Sincerely,



Ron T. Shiigi
Principal

**DEPARTMENT OF EDUCATION
STATE OF HAWAII**

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**DEPARTMENT OF EDUCATION
STATE OF HAWAII**

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PART I
FINANCIAL SECTION



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INDEPENDENT AUDITORS' REPORT

To the Auditor
Office of the Auditor
State of Hawaii

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Department of Education of the State of Hawaii (DOE), as of and for the fiscal year ended June 30, 2006, which collectively comprise the DOE's basic financial statements as listed in the foregoing table of contents. These financial statements are the responsibility of the DOE's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A, the financial statements of the DOE are intended to present the financial position and the changes in financial position, where applicable, of only that portion of the governmental activities, each major fund, and the aggregate remaining fund information of the State of Hawaii that is attributable to the transactions of the DOE. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2006, and the changes in its financial position, where applicable, for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information for the DOE, as of June 30, 2006,

and the respective changes in financial position, where applicable, thereof and the respective budgetary comparison for the general fund for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 20, 2007, on our consideration of the DOE's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the DOE's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
March 20, 2007

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Year Ended June 30, 2006

The following management's discussion and analysis provides an overview of the Department of Education's financial activities for the fiscal year ended June 30, 2006. Readers should also review the basic financial statements and notes to enhance their understanding of the Department's financial performance.

FINANCIAL HIGHLIGHTS

Key government-wide financial highlights for FY2005-06 are as follows:

- General fund revenues were \$1.801 billion. Federal grant, capital project, program reimbursement, and other revenues totaled \$397.7 million.
- Total expenses were \$2.187 billion, of which 90% or \$1.977 billion, was spent for school-level instruction and support services and 8% or \$164.8 million was spent on capital outlays.
- Total assets exceeded liabilities by \$916 million (net assets). Land and depreciated capital assets (land improvements, buildings, building improvements, and equipment) comprise 82% of total assets.
- Net assets increased by \$131 million, primarily due to capital improvement projects (CIP) cash, partly offset by CIP liabilities. This is the first time the Department is accounting for CIP assets and liabilities that were previously administered by DAGS as a result of Act 51, SLH 2004.

OVERVIEW OF THE FINANCIAL STATEMENTS

The financial statements consist of three sections: management's discussion and analysis (this section), basic financial statements and notes, and required supplementary information. These sections are described below.

The basic financial statements include government-wide and fund financial statements, which provide different views of the Department:

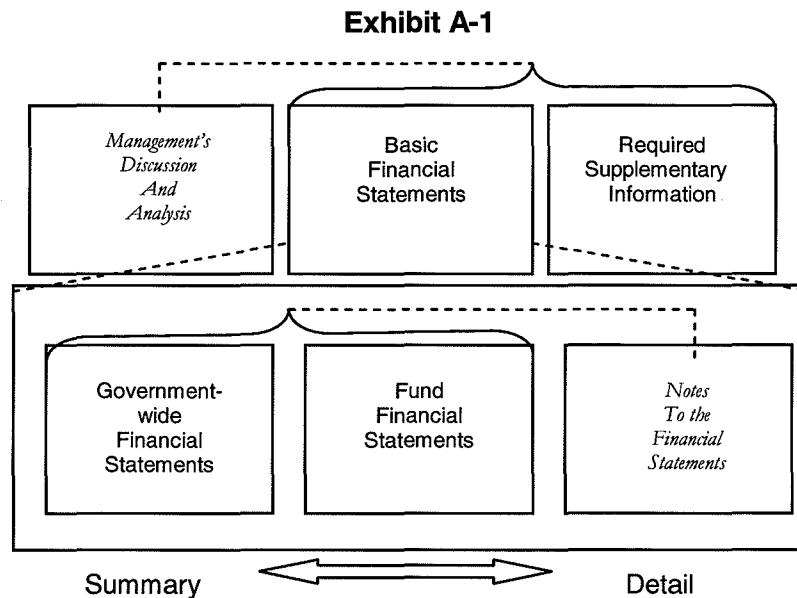
- *Government-wide financial statements* provide both *long-term* and *short-term* information about the Department's *overall* financial position and results of operations. The statements are presented on an accrual basis of accounting and consist of the Statement of Net Assets and the Statement of Activities.
- *Fund financial statements* focus on *individual* parts of the Department and report operations in more detail than the government-wide statements. Governmental funds statements include most of the Department's programs and services such as instruction, support services, operation and maintenance of facilities, student transportation, and extracurricular activities

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

and are presented on a modified accrual basis of accounting. Fiduciary funds statement report on agency funds, which are held in a custodial capacity for students' school activities that take place outside of the formal class period and are not requirements for class work or credit. Certain activities, such as depreciation expense, are included in the government-wide financial statements but not the fund financial statements. These activities are highlighted in the financial statement's *Reconciliation of the Change in Fund Balances of Governmental Funds to the Statement of Activities*.

Notes are included in the financial statements to explain financial statement information and provide more detailed data. The basic financial statements are followed by a section of required supplementary information. This section further explains and supports the information in the financial statements.

Exhibit A-1 shows how the required parts of this annual report are arranged and relate to one another.



State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

GOVERNMENT-WIDE FINANCIAL ANALYSIS

The following discussion highlights management's understanding of the key aspects of the Department's financial activities.

Net Assets. The Department's largest portion of net assets is capital assets (e.g. land, buildings, equipment), which are unavailable for future spending. The Department's unrestricted net assets are available for future use to provide program services. However, in FY2005-06, liabilities exceeded unrestricted assets (cash and receivables).

Exhibit A-2
Government-Wide
Condensed Statement of Net Assets
Fiscal Years 2006 and 2005
(Amounts in millions)

	<u>Governmental Activities</u>	
	<u>2006</u>	<u>2005</u> (Restated)
Assets		
Current	\$ 203.2	\$ 170.0
Non-current (Capital assets, net depreciation)	<u>955.9</u>	<u>807.9</u>
TOTAL ASSETS	\$ <u>1,159.1</u>	\$ <u>977.9</u>
Liabilities		
Current	\$ 180.2	\$ 138.7
Non-current	<u>62.5</u>	<u>54.2</u>
Total Liabilities	<u>242.7</u>	<u>192.9</u>
Net Assets		
Restricted (Capital assets, net depreciation)	955.9	807.9
Unrestricted	<u>(39.5)</u>	<u>(22.9)</u>
Total Net Assets	<u>916.4</u>	<u>785.0</u>
TOTAL LIABILITIES AND NET ASSETS	\$ <u>1,159.1</u>	\$ <u>977.9</u>

Changes in Net Assets. Total net assets increased by \$131 million (see Exhibit A-3). This increase was primarily due to capital improvement projects (CIP) cash, partly offset by CIP liabilities. This is the first time the department is accounting for CIP assets and liabilities that were previously administered by DAGS as a result of Act 51, SLH 2004.

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

Exhibit A-3
Government-Wide
Changes in Net Assets
Fiscal Years 2006 and 2005
(Amounts in millions)

	<u>Governmental Activities</u>	
	<u>2006</u>	<u>2005</u> <u>(Restated)</u>
Revenues		
State appropriations	\$ 1,801.6	\$ 1,544.2
Federal funds	227.2	235.3
Other revenues	<u>170.5</u>	<u>56.7</u>
Total Revenues	<u>2,199.3</u>	<u>1,836.2</u>
Expenses		
School level instruction	1,290.0	1,063.3
Comprehensive student support	435.8	406.7
Instructional support	40.3	44.5
State and complex administration	46.3	40.1
School support	258.5	228.1
School community service	18.5	19.3
Public libraries	28.3	31.3
Capital outlay	63.6	14.7
Other	<u>5.5</u>	<u>7.3</u>
Total Expenses	<u>2,186.8</u>	<u>1,855.3</u>
Excess (Deficiency) Revenues Over Expenses		
Before Transfers	12.5	(19.1)
Transfers	<u>118.9</u>	<u>--</u>
Change in Net Assets	131.4	(19.1)
Beginning Net Assets	785.0	787.4
Prior Period Adjustment	<u>--</u>	<u>16.7</u>
Beginning Net Assets - Restated	<u>785.0</u>	<u>804.1</u>
Ending Net Assets	\$ <u>916.4</u>	\$ <u>785.0</u>

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

EXPLANATION OF MAJOR DEPARTMENTAL PROGRAMS

The State Budget is organized by major program areas. The Department's major programs are:

<u>Program #</u>	<u>Program Title</u>	<u>Program Description</u>
EDN 100	School-Based Budgeting	Instructional services, curriculum programs, at-risk programs, fringe benefits, and debt service
EDN 150	Comprehensive Student Support Services	Special needs assessment, special education services, school-based behavioral health services, and other related services required for a free and appropriate public education, autism services, and professional development
EDN 200	Instructional Support	Curriculum support, assessment, planning, information technology support, and school leadership training
EDN 300	State and Complex Administration	Board of Education, Superintendent, Complex Area Superintendents, budget, communications, civil rights compliance, internal audit, business services, human resources, and information technology
EDN 400	School Support	School food services, utilities, custodial services, repair and maintenance, and student transportation
EDN 407	Hawaii State Public Library System	The Hawaii State Public Library System is included in the Department of Education's combined financial statements since both the Library System and the Department are administratively and legally supervised by the Hawaii State Board of Education
EDN 500	School Community Services	After school care and adult education

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

Exhibit A-4 summarizes the Department's revenue. Revenues are primarily from state general funds (taxpayer monies). Other revenues are from federal grants, special funds to support specific programs such as cafeteria collections for school food services, and donations.

Exhibit A-4

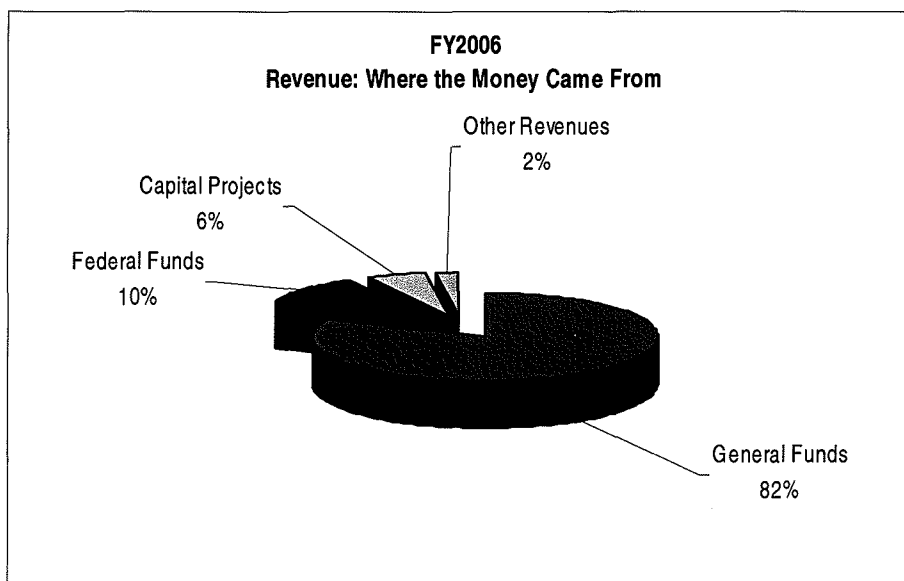
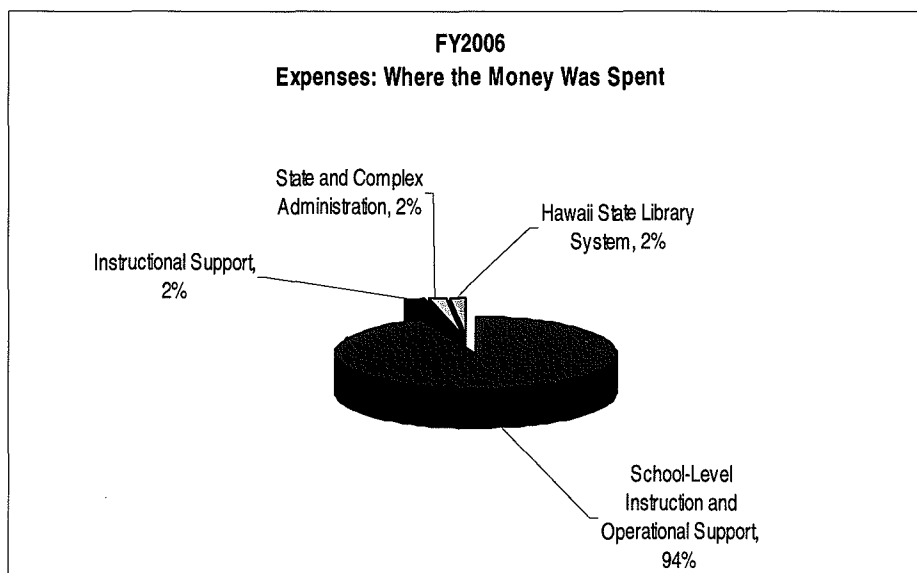


Exhibit A-5 summarizes the Department's expenses. A total of 94% of Department expenditures are for school-level instructional and support programs in EDN 100, 150, 400, and 500, while only 2% are for Complex and District Administration.

Exhibit A-5



State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

GENERAL FUND BUDGETARY HIGHLIGHTS

The Department was appropriated general funds of \$1,832.5 million in FY2005-06. General fund allotments increased due to School Based Budgeting (\$205.2 million), School Support (\$49.1 million), Comprehensive Student Support (\$23.4 million), Instructional Support (\$2.9 million), and State and District Administration (\$3.2 million).

The law permits the Department to "carryover" up to 5% of general fund appropriations from one fiscal year to the next. The Department carried over \$30.6 million in FY2004-05 general fund appropriations for expenditures in FY2005-06. Carryover funds enable schools to make long-range fiscal plans, save for major purchases for which single year funding may not be sufficient, and provide funds to start the next school year, which occurs within weeks of the beginning of the fiscal year.

FIDUCIARY FUNDS

Fiduciary funds or "local school funds" are held for students in a custodial capacity and do not require deposit into the State Treasury. The fund contains monies collected and maintained by schools for students. Examples include yearbook, newspaper fund, student government dues, physical education uniform sales, and excursions. The funds are used for school activities that take place outside formal class periods and are not required for class work or credit.

Fiduciary fund net assets were \$17.7 million in FY2005-06, resulting in a small 2% increase from the prior fiscal year.

CAPITAL ASSET AND DEBT ADMINISTRATION

The Department's capital improvement program strives to provide facilities that are well placed, sufficient in number, flexible, functional, and creatively designed to accommodate population changes, support educational programs, and promote health and safety of students, employees, and the public. The Departments of Accounting and General Services, Land and Natural Resources, and Budget & Finance assist the department with various aspects of capital improvement.

Buildings, building improvements, and land improvements less than \$100,000 are not reported as capital assets. This year's capital improvements included the acceptance of eight-classroom buildings at Leilehua and Waipahu High schools and a new cafeteria at Waipahu Intermediate School. Please refer to Note E for capital asset details.

The Department's long-term debt is managed by the Department of Budget and Finance; however, general fund appropriations for interest payment and debt retirement are included in the Department's budget. Interest payments and debt retired were \$206.1 million in FY2005-06, resulting in more than a 100% increase from the prior fiscal year.

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET

The State's unemployment rate has been at a record low with seasonally adjusted unemployment rate being as low as 2.1% in October 2006. One year ago, Hawaii's seasonally adjusted unemployment rate was 2.8% while the national rate was 4.4%.

Cumulative tax collections for the first five months of FY2006-07 exceeded \$2.1 billion or \$64.1 million more than the corresponding period last year. General excise and use tax collections, which are the largest source of revenue and a good measure of economic growth, increased 10.0% in the same period.

In September 2006, the Council on Revenues estimated that the General Fund tax growth rate would be 6.0% in FY2006-07 and FY2007-08. Actual General Fund tax collections rose by 3.8% in the first five months of FY2006-07 from FY 2005-06. Higher general excise and use tax collections and the substantial rise in corporate income tax collections were the primary factors underlying this strong performance. In November 2006, the Council on Revenues forecasts Hawaii's growth at 6% in 2007 total personal income.

FUTURE EVENTS THAT WILL FINANCIALLY IMPACT THE DEPARTMENT

Act 51, the Reinventing Education Act of 2004, has enabled the Department to significantly reshape Hawaii's public school system. The Act identifies a number of critical goals, with some financially impacting the Department.

The Act strives to address student individual needs by requiring the establishment of a weighted student formula to allocate funds to public schools. In the past, allocations were more focused on schools, rather than students. The Act also requires that school principals expend not less than seventy per cent (70%) of operating funds for the Department of Education, excluding debt service and capital improvement programs. These efforts will be directed towards strengthening the relationship of financial resources to the academic plans of each school, with the overall goal of improving student achievement.

Schools' staffing and expenditures were based on weighted student formula allocations beginning School Year 2006-07. The amount of funds to allocate did not change due to the implementation of the weighted student formula, but the methodology of allocation did change. This student-focused methodology resulted in most schools receiving either more funds or fewer funds than the previous allocation methodology, since the total amount of funds available to allocate remained unchanged. The Department of Education is reviewing other funds for services that are currently expended by Department of Education state and complex area offices to determine if they could be allocated under the weighted student formula.

State of Hawaii
Department of Education
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
Fiscal Year Ended June 30, 2006

The Department of Education is working to make its financial matters more transparent to school-level personnel and the public. This has resulted in the need for more financial reports that are easily understood by non-fiscal personnel, and more easily used for financial management. The Department is investigating the possibility of replacing some of the current financial systems or taking other steps to significantly improve financial reports.

Beginning July 1, 2007, it is anticipated that 258.00 positions for school health aides will be transferred to the Department of Education's budget from the Department of Health's budget. This transfer will result in increased use of support services such as personnel and payroll processing for the additional employees.

In addition to Act 51, the Federal No Child Left Behind Act is an under funded federal mandate. The Department is requesting approximately \$12.5 million dollars in additional general fund resources for each year of the budget biennium 2007-2009 in order to ensure compliance in the next biennium. The amounts are primarily due to non-Title I schools currently in need of improvement or corrective action which may not make Adequate Yearly Progress (AYP) by 2007 and testing development and student assessment. Title I schools are those with the highest concentrations of poverty which are receiving federal fund support to help disadvantaged students meet the same high standards expected of all students. However, the performance goals specified by the Act call for the Department to implement the requirements for all students, not only students in schools eligible for Title I funding. The Act does not provide any funding to implement the requirements for non-Title I schools. Additional resources are needed to provide extended school programs; provide student support services such as English for Second Language Learners (ESLL) and high school reform; and implement the infrastructure required for testing, accountability analyses, and data collection.

CONTACTING THE DEPARTMENT'S FINANCIAL MANAGEMENT

The financial report is designed to provide the public with a general overview of the Department's finances and demonstrate the Department's accountability for the money it receives. If you have questions about this report or need additional financial information, please contact the Office of the Superintendent, Department of Education, P.O. Box 2360, Honolulu, Hawaii 96804.

**Department of Education
State of Hawaii
STATEMENT OF NET ASSETS
June 30, 2006**

ASSETS	<u>Governmental Activities</u>
Cash	\$ 185,215,106
Certificates of deposit	10,764
Receivables	
Due from federal government	16,816,945
Accounts receivable	935,334
Due from other agency	<u>270,824</u>
Total current assets	203,248,973
Property and equipment, net of accumulated depreciation	<u>955,858,816</u>
Total assets	\$ <u>1,159,107,789</u>
LIABILITIES	
Current liabilities	
Vouchers and contracts payable	\$ 55,640,814
Accrued wages and employee benefits	96,877,579
Accrued compensated absences	5,547,580
Current portion of workers' compensation claims	13,738,400
Deferred revenues	2,096,543
Due to State of Hawaii General Fund	5,077,868
Due to others	<u>1,188,675</u>
Total current liabilities	180,167,459
Accrued compensated absences, less current portion	25,932,760
Workers' compensation claims	<u>36,640,766</u>
Total liabilities	<u>242,740,985</u>
NET ASSETS	
Investment in capital assets	955,858,816
Unrestricted	<u>(39,492,012)</u>
Total net assets	\$ <u>916,366,804</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
STATEMENT OF ACTIVITIES
Fiscal Year Ended June 30, 2006**

Functions/Programs	Expenses	Program Revenues		Net Expense and Changes in Net Assets
		Charges for Services	Operating Grants and Contributions	Governmental Activities
Governmental activities:				
School level instruction	\$ 1,290,016,681	\$ 9,044,554	\$ 141,481,706	\$ (1,139,490,421)
Comprehensive student support	435,796,525	--	34,122,229	(401,674,296)
Instructional support	40,308,918	4,792,033	6,569,142	(28,947,743)
State and district administration	46,248,546	840,961	48,522	(45,359,063)
School support	258,520,055	20,496,950	40,410,521	(197,612,584)
School community service	18,440,992	3,398,756	3,036,012	(12,006,224)
Public libraries	28,295,681	2,364,207	1,612,499	(24,318,975)
Capital outlay	63,646,138	--	122,764,824	59,118,686
Other	5,503,181	--	5,606,224	103,043
Total governmental activities	<u>\$ 2,186,776,717</u>	<u>\$ 40,937,461</u>	<u>\$ 355,651,679</u>	<u>(1,790,187,577)</u>
General revenues:				
				State allotted appropriations, net of lapses 1,801,562,149
				Unrestricted investment earnings 1,111,926
				Total general revenues 1,802,674,075
Transfers				118,922,773
Change in net assets				131,409,271
Net assets at June 30, 2005				768,257,782
Prior period adjustment				16,699,751
Net assets restated at July 1, 2005				784,957,533
Net assets at June 30, 2006				<u>\$ 916,366,804</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
BALANCE SHEET - GOVERNMENTAL FUNDS
June 30, 2006**

	General	Federal	Capital Projects	Other	Total
ASSETS					
Cash	\$ 95,268,653	\$ 36,247,486	\$ 17,843,293	\$ 35,855,674	\$ 185,215,106
Certificates of deposit	--	--	--	10,764	10,764
Receivables					
Due from federal government	--	16,816,945	--	--	16,816,945
Accounts receivable	--	--	--	935,334	935,334
Due from other agency	--	--	--	270,824	270,824
Total assets	\$ <u>95,268,653</u>	\$ <u>53,064,431</u>	\$ <u>17,843,293</u>	\$ <u>37,072,596</u>	\$ <u>203,248,973</u>
LIABILITIES AND FUND BALANCES					
LIABILITIES					
Vouchers and contracts payable	\$ 21,887,976	\$ 10,967,310	\$ 21,396,637	\$ 1,388,891	\$ 55,640,814
Accrued wages and employee benefits payable	91,790,190	3,646,350	15,965	1,425,074	96,877,579
Deferred revenues	--	2,096,543	--	--	2,096,543
Due to State of Hawaii General Fund	5,077,868	--	--	--	5,077,868
Due to others	--	1,188,675	--	--	1,188,675
Total liabilities	<u>118,756,034</u>	<u>17,898,878</u>	<u>21,412,602</u>	<u>2,813,965</u>	<u>160,881,479</u>
FUND BALANCES					
Reserved for encumbrances	39,526,173	12,275,800	195,439,956	1,140,617	248,382,546
Reserved for continuing appropriations	29,791,685	--	--	--	29,791,685
Unreserved	<u>(92,805,239)</u>	<u>22,889,753</u>	<u>(199,009,265)</u>	<u>33,118,014</u>	<u>(235,806,737)</u>
Total fund balances (deficit)	<u>(23,487,381)</u>	<u>35,165,553</u>	<u>(3,569,309)</u>	<u>34,258,631</u>	<u>42,367,494</u>
Total liabilities and fund balances	\$ <u>95,268,653</u>	\$ <u>53,064,431</u>	\$ <u>17,843,293</u>	\$ <u>37,072,596</u>	\$ <u>203,248,973</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
RECONCILIATION OF THE GOVERNMENTAL FUND BALANCE
TO THE STATEMENT OF NET ASSETS
June 30, 2006**

Total fund balances - governmental funds		\$ 42,367,494
Amounts reported for governmental activities in the statement of net assets are different because:		
Capital assets used in governmental activities are not financial resources and therefore are not reported in the governmental funds.		
Governmental capital assets	\$ 1,871,891,481	
Less accumulated depreciation	<u>(916,032,665)</u>	955,858,816
Accrued compensated absences liability is not due in the current period and therefore is not reported in the governmental funds.		
		(31,480,340)
Accrued workers' compensation liability is not due in the current period and therefore is not reported in the governmental funds.		
		<u>(50,379,166)</u>
Net assets of governmental activities		\$ <u>916,366,804</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
STATEMENT OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCES
GOVERNMENTAL FUNDS
Fiscal Year Ended June 30, 2006**

	General	Federal	Capital Projects	Other	Total
REVENUES					
State allotments, net	\$ 1,801,562,149	\$ --	\$ --	\$ --	\$ 1,801,562,149
Intergovernmental revenues	--	227,245,090	--	--	227,245,090
Other revenues	--	--	122,764,824	47,691,153	170,455,977
	<u>1,801,562,149</u>	<u>227,245,090</u>	<u>122,764,824</u>	<u>47,691,153</u>	<u>2,199,263,216</u>
EXPENDITURES					
School level instruction	1,104,229,117	130,872,844	--	7,269,246	1,242,371,207
Comprehensive student support	395,861,362	39,935,162	--	--	435,796,524
Instructional support	29,761,436	6,465,338	--	3,853,340	40,080,114
State and district administration	43,559,276	491,866	--	635,910	44,687,052
School support	193,381,236	43,663,441	--	21,693,495	258,738,172
School community service	12,851,683	3,035,562	--	2,550,708	18,437,953
Public libraries	34,138,980	1,576,957	--	3,096,704	38,812,641
Capital outlay	--	--	164,822,203	--	164,822,203
Other	182,819	--	--	5,309,041	5,491,860
	<u>1,813,965,909</u>	<u>226,041,170</u>	<u>164,822,203</u>	<u>44,408,444</u>	<u>2,249,237,726</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES					
	(12,403,760)	1,203,920	(42,057,379)	3,282,709	(49,974,510)
OTHER FINANCING SOURCES					
Transfers in	<u>870,413</u>	<u>--</u>	<u>40,220,066</u>	<u>647,494</u>	<u>41,737,973</u>
NET CHANGE IN FUND BALANCES	(11,533,347)	1,203,920	(1,837,313)	3,930,203	(8,236,537)
FUND BALANCES AT JULY 1, 2005	<u>(11,954,034)</u>	<u>33,961,633</u>	<u>(1,731,996)</u>	<u>30,328,428</u>	<u>50,604,031</u>
FUND BALANCES AT JUNE 30, 2006	\$ <u>(23,487,381)</u>	\$ <u>35,165,553</u>	\$ <u>(3,569,309)</u>	\$ <u>34,258,631</u>	\$ <u>42,367,494</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
RECONCILIATION OF THE CHANGE IN FUND BALANCE
OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES
Fiscal Year Ended June 30, 2006**

Net change in fund balances - total governmental funds		\$ (8,236,537)
Amounts reported for governmental activities in the statement of activities are different because:		
Transfers of construction-in-progress reported in the statement of activities do not provide current resources and therefore are not reported as transfers in governmental funds		77,184,800
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets are depreciated over their estimated useful lives.		
Expenditures for capital assets	\$ 137,900,022	
Loss on disposal of capital assets	(2,167,064)	
Less current fiscal year depreciation	<u>(64,981,808)</u>	70,751,150
Change in long-term compensated absences reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds.		(3,174,044)
Change in workers' compensation liability reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds.		<u>(5,116,098)</u>
Change in net assets of governmental activities		\$ <u>131,409,271</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
STATEMENT OF REVENUES AND EXPENDITURES -
BUDGET AND ACTUAL - GENERAL FUND
Fiscal Year Ended June 30, 2006**

	Original	Final	Actual on Budgetary Basis	Variance Favorable (Unfavorable)
Budgetary fund balance, July 1, 2005	\$ <u>30,780,541</u>	\$ <u>30,780,541</u>	\$ <u>30,780,541</u>	\$ <u>--</u>
Revenues				
State allotments	<u>1,816,986,160</u>	<u>1,827,680,356</u>	<u>1,801,652,401</u>	<u>(26,027,955)</u>
Expenditures				
School level instruction	1,274,985,212	1,268,633,445	1,232,097,437	36,536,008
Comprehensive student support services	320,869,090	323,749,090	310,340,135	13,408,955
Instructional support	27,451,030	22,636,030	22,309,368	326,662
State and district administration	34,969,366	35,146,514	35,360,095	(213,581)
School support	151,604,632	170,458,447	164,766,400	5,692,047
School community service	11,267,940	11,217,940	11,148,718	69,222
Public libraries	<u>26,619,431</u>	<u>26,619,431</u>	<u>26,619,104</u>	<u>327</u>
	<u>1,847,766,701</u>	<u>1,858,460,897</u>	<u>1,802,641,257</u>	<u>55,819,640</u>
EXCESS(DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>(30,780,541)</u>	<u>(30,780,541)</u>	<u>(988,856)</u>	<u>29,791,685</u>
Budgetary fund balance, June 30, 2006	\$ <u>--</u>	\$ <u>--</u>	\$ <u>29,791,685</u>	\$ <u>29,791,685</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
STATEMENT OF REVENUES AND EXPENDITURES -
BUDGET AND ACTUAL - FEDERAL FUND
Fiscal Year Ended June 30, 2006**

	<u>Original</u>	<u>Final</u>	<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
Revenues				
Federal grants	\$ <u>232,020,262</u>	\$ <u>391,926,072</u>	\$ <u>211,346,207</u>	\$ <u>(180,579,865)</u>
Expenditures				
School level instruction	144,301,896	251,869,546	133,850,341	118,019,205
Comprehensive student support services	46,249,630	68,259,510	41,298,507	26,961,003
Instructional support	1,720,000	17,865,490	6,427,751	11,437,739
State and district administration	590,000	2,333,950	236,151	2,097,799
School support	34,533,485	44,111,685	33,950,524	10,161,161
School community service	3,260,007	4,660,680	2,941,953	1,718,727
Public libraries	<u>1,365,244</u>	<u>2,825,211</u>	<u>1,765,930</u>	<u>1,059,281</u>
	<u>232,020,262</u>	<u>391,926,072</u>	<u>220,471,157</u>	<u>171,454,915</u>
EXCESS (DEFICIENCY) REVENUES OVER EXPENDITURES	\$ <u> --</u>	\$ <u> --</u>	\$ <u>(9,124,950)</u>	\$ <u>(9,124,950)</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
STATEMENT OF ASSETS AND LIABILITIES
AGENCY FUNDS
June 30, 2006**

ASSETS

Cash and cash equivalents	\$ <u>17,684,590</u>
Total assets	\$ <u>17,684,590</u>

LIABILITIES

Due to student group and others	\$ <u>17,684,590</u>
Total liabilities	\$ <u>17,684,590</u>

See accompanying notes to the basic financial statements.

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE A - FINANCIAL REPORTING ENTITY

The Department of Education of the State of Hawaii (DOE), administers the statewide system of public schools and public libraries. Additionally, the DOE is responsible for administering state laws regarding regulation of private school operations through a program of inspection and licensing and the professional certification of all teachers for every academic and non-college type of school. Federal grants received to support public school and public library programs are administered by the DOE on a statewide basis.

The DOE is a part of the executive branch of the State of Hawaii (State). The DOE's basic financial statements reflect only its portion of the fund type categories. The State Comptroller maintains the central accounts for all state funds and publishes financial statements for the State annually which includes the DOE's financial activities.

The DOE has considered all potential component units for which it is financially accountable and other organizations for which the nature and significance of their relationship with the DOE are such that exclusion would cause the DOE's financial statements to be misleading or incomplete. The Governmental Accounting Standards Board (GASB) has set forth criteria to be considered in determining financial accountability. The DOE has determined, based on the GASB criteria, that it has no component units.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the DOE have been prepared in conformity with accounting principles generally accepted in the United States of America prescribed by the GASB.

- (1) ***Basis of Presentation*** - The government-wide financial statements report all assets, liabilities, and activities of the DOE as a whole. The fiduciary funds are excluded from the government-wide financial statements because the DOE cannot use those assets to finance its operations.

The financial transactions of the DOE are recorded in individual funds that are reported in the fund financial statements and are described in the following sections. Each fund is considered a separate accounting entity. The operations of each are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues, and expenditures.

The fund financial statements focus on major funds rather than reporting funds by type. Each major fund is reported in separate columns and non-major funds are combined in one column. Major funds are funds which have total assets, liabilities, revenues or expenditures of the fund that are at least ten percent of the same element for all funds of its fund type or at least five percent of the same element for all governmental funds combined.

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

Governmental Fund Types

General Fund - The general fund is the general operating fund of the DOE. It is used to account for all financial activities except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted.

Special Revenue Funds - Special revenue funds are used to account for the proceeds of specific revenue sources (other than expendable trusts) that are legally restricted to expenditures for specified purposes. Special revenue funds include the federal fund which accounts for grants received directly from the federal government.

Capital Projects Fund - The capital projects fund is used to account for financial resources to be used for the acquisition or construction of major capital facilities.

Fiduciary Fund Type

Agency Funds - Agency funds are used to account for assets held by the DOE on behalf of outside parties, including other governments, or on behalf of individuals.

(2) *Measurement Focus and Basis of Accounting*

Government-wide Financial Statements - The economic resources measurement focus and accrual basis of accounting is used for reporting the government-wide financial statements. With this measurement focus, all assets and liabilities associated with the operations of the DOE are included on the statement of net assets. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are recorded at the time liabilities are incurred. Revenue from grants is recognized when all eligibility requirements have been satisfied.

Governmental Funds - All governmental funds are accounted for using a current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized in the accounting period when they become both measurable and available. Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after fiscal year-end to liquidate liabilities existing at the end of the fiscal year. For this purpose, the DOE considers revenues to be available if they are collected within sixty days of the end of the current fiscal year end. Principal revenue sources considered revenues susceptible to accrual include federal grants and charges for services. Expenditures are generally recorded when the related fund liabilities are incurred.

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

Agency Funds - Agency funds are used to account for resources held by the DOE as an agent for individual private organizations or government agencies. Agency funds are custodial in nature (i.e., assets equal liabilities) and do not involve measurement of results of operations.

- (3) **Use of Estimates** - The preparation of basic financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.
- (4) **Capital Assets** - Capital assets include land, improvements to land, buildings, building improvements, vehicles, machinery, equipment, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.

When capital assets are purchased, they are capitalized and depreciated in the government-wide financial statements. Capital assets are recorded as expenditures of the current period in the governmental fund financial statements.

Capital assets are valued at cost where historical records are available and at estimated historical cost where no records exist. Donated capital assets are valued at their estimated fair value on the date received.

Improvements to capital assets that materially add to the value or extend the life of the assets are capitalized. Other repairs and normal maintenance are not capitalized. Major outlays for capital assets and improvements are capitalized as projects are constructed.

The DOE has adopted the following capitalization policy:

Asset Type	Minimum Capitalization Amount	Estimated Useful Life
Land	All	Not applicable
Land improvements	\$ 100,000	15 years
Buildings and improvements	\$ 100,000	30 years
Furniture and equipment	\$ 5,000	7 years
Motor vehicles	\$ 5,000	5 years
Public library materials	All	5 years

Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

- (5) **Deferred Revenues** - Deferred revenues at the fund level and government-wide level arise when the DOE receives resources before it has a legal claim to them. In subsequent periods, when the revenue recognition criteria is met, or when the DOE has a legal claim to the resources, the liability for deferred revenue is removed from the statement of net assets and revenue is recognized. Deferred revenues consist primarily of federal grant funds.
- (6) **Accumulated Vacation** - Employees are credited with vacation at the rate of 96 to 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year-end and is convertible to pay upon termination of employment. Such accumulated vacation has been accrued and reflected in the statement of net assets.
- (7) **Appropriations** - Appropriations represent the authorizations granted by the State Legislature that permit a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year.
- (8) **Program Revenues** - Program revenues derive directly from the programs of the DOE or from parties outside of the DOE and are categorized as charges for services, operating grants and contributions, or capital grants and contributions.
- Charges for services - Charges for services include revenues based on exchange or exchange-like transactions. These revenues arise from charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided. Revenues in this category include fees charged for meals served, educational classes, use of facilities, transportation services, and use of library materials.
- Operating Grants and Contributions - Program-specific operating and capital grants and contributions include revenues arising from mandatory and voluntary non-exchange transactions with other governments, organizations, or individuals that are restricted for use in a particular program. Governmental grants and assistance awards made on the basis of entitlement periods are recorded as intergovernmental receivables and revenues when entitlement occurs. All other federal reimbursement-type grants are recorded as intergovernmental receivables and revenues when the related expenditures or expenses are incurred.
- (9) **Intrafund and Interfund Transactions** - Significant transfers of financial resources between activities included within the same fund are offset within that fund. Transfers of revenues from funds authorized to receive them to funds authorized to expend them have been recorded as operating transfers in the basic financial statements.
- (10) **Risk Management** - The DOE is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if information indicates that it is probable that a liability has been incurred at the date of the basic financial statements and the amount of the loss is reasonably estimable.

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE C - 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 budgetary comparison schedules of the general and special revenue funds 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.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations such as those related to the special revenue funds.

Section 37-41.5 of the Hawaii Revised Statutes allows the DOE to carryover up to five percent each of any appropriation at the end of the fiscal year except for appropriations to fund certain financing agreements. These carryover funds, to the extent not expended or encumbered, lapse at June 30 of the first fiscal year of the next fiscal biennium. As of June 30, 2006, general funds carried over amounted to approximately \$29,800,000.

For purposes of budgeting, the DOE's budgetary fund structure and accounting principles differ from those utilized to present the fund financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP). The DOE's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to (1) the encumbrance of purchase orders and contract obligations, (2) the recognition of certain receivables, and (3) special revenue funds operating grant accruals and deferrals. These differences represent a departure from GAAP.

The following schedule reconciles the budgetary amounts to the amounts presented in accordance with GAAP for the fiscal year ended June 30, 2006.

	<u>General</u>	<u>Federal</u>
Excess (deficiency) of revenues over expenditures and other uses - actual on a budgetary basis	\$ (988,856)	\$ (9,124,950)
Reserved for encumbrances at fiscal year-end	39,526,173	12,275,800
Expenditures for liquidation of prior fiscal year encumbrances	(37,743,645)	(7,598,083)
Net change in unreserved liabilities	(13,197,432)	518,375
Accrual adjustments related to federal reimbursements for program expenditures	--	5,132,778
Unbudgeted transfers in	<u>870,413</u>	<u>--</u>
Excess (deficiency) of revenues over expenditures and other uses - GAAP basis	\$ <u>(11,533,347)</u>	\$ <u>1,203,920</u>

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE D - CASH AND CASH EQUIVALENTS

Substantially all of the DOE's cash and certificates of deposit are held in the State Treasury. The State Director of Finance is responsible for safekeeping of all monies paid into the State Treasury. The State Director of Finance pools and invests any monies in excess of the amounts necessary for meeting specific requirements of the State. The Hawaii Revised Statutes authorize the State Director of Finance to invest in 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.

Information relating to custodial credit risk of cash deposits and interest rate risk, credit risk, custodial risk, and concentration of credit risk of investments in the State Treasury is available on a statewide basis and not for individual departments or agencies.

Custodial credit risk

Cash and deposits with financial institutions are collateralized in accordance with State statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

The DOE also maintains cash in banks which are held separately from cash in the State Treasury. As of June 30, 2006, the carrying amount of total bank deposits was approximately \$5,567,000 and the corresponding bank balances which are represented were approximately \$17,598,000. Of this amount, approximately \$5,440,000 is insured by the Federal Deposit Insurance Corporation and collateralized with securities held by the DOE's agent. The uninsured and uncollateralized balance at June 30, 2006, was approximately \$12,158,000.

Interest rate risk

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

Credit risk

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

Custodial risk

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

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE D - CASH AND CASH EQUIVALENTS (Continued)

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.

NOTE E - CAPITAL ASSETS

The changes in capital assets were as follows:

	Balance June 30, 2005	Transfers	Balance July 1, 2005	Additions	Deductions	Balance June 30, 2006
Governmental activities						
Capital asset, not being depreciated						
Land	\$ 61,246,260	\$ --	\$ 61,246,260	\$ --	\$ --	\$ 61,246,260
Land improvements	5,781,281	--	5,781,281	232,779	--	6,014,060
Construction in progress	--	77,621,998	77,621,998	101,553,452	56,818,378	122,357,072
Total capital assets not being depreciated	67,027,541	77,621,998	144,649,539	101,786,231	56,818,378	189,617,392
Capital assets, being depreciated						
Land improvements	66,065,136	--	66,065,136	10,830,287	--	76,895,423
Building and improvements	1,402,753,044	--	1,402,753,044	61,938,747	786,298	1,463,905,493
Furniture and equipment	65,342,648	--	65,342,648	10,794,471	3,563,025	72,574,094
Public library materials	67,143,377	--	67,143,377	8,931,465	7,175,763	68,899,079
Total capital assets being depreciated	1,601,304,205	--	1,601,304,205	92,494,970	11,525,086	1,682,274,089
Less accumulated depreciation for:						
Land improvements	50,649,490	--	50,649,490	3,518,246	--	54,167,736
Building and improvements	712,616,009	--	712,616,009	48,911,517	213,675	761,313,851
Furniture and equipment	45,931,581	--	45,931,581	6,590,957	1,968,584	50,553,954
Public library materials	51,211,799	--	51,211,799	5,961,088	7,175,763	49,997,124
Total accumulated depreciation	860,408,879	--	860,408,879	64,981,808	9,358,022	916,032,665
Governmental activities, net	\$ 807,922,867	\$ 77,621,998	\$ 885,544,865	\$ 129,299,393	\$ 58,985,442	\$ 955,858,816

On July 1, 2005, the rights, powers, functions, duties and resources of the State Department of Accounting and General Services relating to the capital improvement programs were transferred to the DOE pursuant to Act 51 SLH 2004. As part of the transfer, approximately \$78 million in construction in progress were transferred to the DOE.

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE E - CAPITAL ASSETS (Continued)

Depreciation expense was charged to functions as follows:

	<u>Governmental Activities</u>
School level instruction	\$ 46,712,238
Instructional support	591,818
State and district administration	1,211,268
School support	1,479,622
School community service	51,940
Public libraries	14,928,701
Other	<u>6,221</u>
Total depreciation expense	\$ <u>64,981,808</u>

NOTE F - LONG-TERM LIABILITIES

The change in the long-term liabilities during the fiscal year ended June 30, 2006, was as follows:

	<u>Accrued Compensated Absences</u>	<u>Workers' Compensation Claims</u>
Balance at June 30, 2005	\$ 45,006,048	\$ 45,263,068
Prior period adjustment	<u>(16,699,751)</u>	<u>--</u>
Balance at June 30, 2005, restated	\$ 28,306,297	\$ 45,263,068
Additions	9,999,309	14,926,483
Reductions	<u>(6,825,266)</u>	<u>(9,810,385)</u>
Balance at June 30, 2006	\$ <u>31,480,340</u>	\$ <u>50,379,166</u>
Due within one year	\$ <u>5,547,580</u>	\$ <u>13,738,400</u>

The compensated absences and workers' compensation liabilities have been paid primarily by the general fund in the past.

Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006

NOTE G - FUND BALANCES

Reserved for Encumbrances

Reserved for encumbrances represents the portion of the fund balance that is segregated for expenditure on vendor performance.

Reserved for Continuing Appropriations

Reserved for continuing appropriations represents unencumbered allotment balances that have been released and made available for encumbrance or expenditure and are legally segregated for a specific future use.

Fund Balance Deficit

The general fund and capital project fund had a deficit balance in the unreserved fund balance at June 30, 2006, of \$92,805,239 and \$199,009,265, respectively. The deficits resulted primarily from expenditures being recorded on the accrual basis when incurred, and revenues being recognized only when funds are measurable and available.

NOTE H - CHANGES IN ASSETS AND LIABILITIES OF THE AGENCY FUNDS

The agency funds are purely custodial (assets equal liabilities) and thus do not involve the measurement of results of operations. The changes in assets and liabilities of the agency funds for the fiscal year ended June 30, 2006, were as follows:

	<u>Balance</u> <u>July 1, 2005</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance</u> <u>June 30, 2006</u>
ASSETS				
Cash and other assets held in trust	\$ <u>17,408,260</u>	\$ <u>27,646,485</u>	\$ <u>27,370,155</u>	\$ <u>17,684,590</u>
LIABILITIES				
Due to student groups and others	\$ <u>17,408,260</u>	\$ <u>27,646,485</u>	\$ <u>27,370,155</u>	\$ <u>17,684,590</u>

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE I - LEASE COMMITMENTS

The DOE leases equipment from third party lessors under various operating leases expiring through 2014. Future minimum lease rentals under non-cancelable operating leases with terms of one year or more at June 30, 2006, were as follows:

<u>Fiscal Year Ending June 30,</u>	<u>Amount</u>
2007	\$ 3,264,000
2008	2,567,000
2009	1,774,000
2010	1,035,000
2011	383,000
2012 - 2014	<u>57,000</u>
	<u>\$ 9,080,000</u>

Total rent expense related to the above leases for the fiscal year ended June 30, 2006, amounted to approximately \$3,299,000.

NOTE J - RETIREMENT BENEFITS

Employees' Retirement System

Substantially all eligible employees of the DOE are required by Chapter 88, Hawaii Revised Statutes (HRS), to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained by writing to the ERS at City Financial Tower, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Members of the ERS belong to either a contributory or noncontributory option. Only employees of the DOE hired on or before June 30, 1984 are eligible to participate in the contributory option. Members are required by state statute to contribute 7.8% of their salary to the contributory option and the DOE is required to contribute to both options at an actuarially determined rate. The portion of the contributions related to DOE's general and special revenue funds are recorded as an expenditure of the respective funds in the financial statements. Contributions by the DOE for the fiscal year ended June 30, 2006, 2005, and 2004, were approximately \$148,810,000, \$92,159,000, and \$90,892,000. The contribution rates for the fiscal years ended June 30, 2006, 2005, and 2004, were 13.75%, 9.14%, and 8.87%, respectively.

On July 1, 2006, a new hybrid contributory plan will become effective pursuant to Act 179 SLH 2004. Members in the hybrid plan will be eligible for retirement at age 62 with 5 years of credited service or age 55 and 30 years of credited service. Members will receive a benefit multiplier of 2% for each year of credited service in the hybrid plan. The benefit payment options are similar to the current contributory plan. All members of the

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE J - RETIREMENT BENEFITS (Continued)

noncontributory plan and certain members of the contributory plan will be eligible to join the hybrid plan. Most new employees hired from July 1, 2006 will be required to join the hybrid plan.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State, pursuant to Section 87A of the Hawaii Revised Statutes, provides certain health care and life insurance benefits to retired state employees. Contributions are financed on a pay-as-you-go basis. The DOE's general fund and special revenue fund share of the expense for post-retirement health care and life insurance benefits for the fiscal year ended June 30, 2006, was approximately \$67,115,000 and \$4,206,000, respectively, and is included in the basic financial statements.

Deferred Compensation Plan

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all state employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

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

NOTE K - RISK MANAGEMENT

The DOE is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; and workers' compensation. The State generally is at risk for the first \$250,000 per occurrence of property losses and the first \$4 million with respect to general liability claims. Losses in excess of those retention amounts are insured with commercial insurance carriers. The limit per occurrence for property losses is \$100 million (\$50 million for earthquake, named hurricane and flood) and the annual aggregate for general liability losses per occurrence is \$10 million. The State also has an insurance policy to cover medical malpractice risk in the amount of \$20 million per occurrence with no annual aggregate limit. The State is generally self-insured for automobile claims.

The DOE is self-insured for workers' compensation and automobile claims. The DOE's estimated reserve for losses and loss adjustment costs include the accumulation of estimates for losses and claims reported prior to fiscal year-end, estimates (based on projections of historical developments) of claims incurred but not reported, and estimates of costs for investigating and adjusting all incurred and unadjusted claims. Amounts reported are subject to the impact of future changes in economic and social conditions. The DOE believes that, given the inherent variability in any such estimates, the reserves are within a reasonable and acceptable range of adequacy. Reserves are continually monitored and reviewed, and as

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE K - RISK MANAGEMENT (Continued)

settlements are made and reserves adjusted, the differences are reported in current operations. A liability for a claim is established if information indicates that it is probable that a liability has been incurred at the date of the basic financial statements and the amount of the loss is reasonably estimable.

NOTE L - COMMITMENTS AND CONTINGENCIES

Construction Contracts

The DOE is committed under contracts awarded and orders placed for construction, expenses, supplies, etc. These commitments amounted to approximately \$216,837,000 as of June 30, 2006.

Accumulated Sick Leave

Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service without limit, but can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, a public employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2006, amounted to approximately \$159,208,000.

Litigation

The DOE is a party to various legal proceedings. Although the DOE and its counsel are unable to express opinions as to the outcome of the litigation, it is their opinion that any potential liability arising therefrom will not have a material adverse effect on the financial position of the DOE because any judgments against the DOE are judgments against the State and would be paid by legislative appropriation of the State General Fund and not by the DOE.

NOTE M - FOOD DISTRIBUTION PROGRAM

The DOE receives food commodities from the U.S. Department of Agriculture, Food and Nutrition Service (FNS), under the Federal Food Distribution Program. The DOE School Food Services Branch distributes the food to qualifying schools, charitable organizations, and nonprofit summer camps for children. The total value of the amount of food which the DOE is entitled to receive is determined in part by the number of meals served under the National School Lunch Program. The DOE's allocation balance is reduced as the DOE receive the food commodities. The amount charged to the DOE allocation balance is based upon the FNS's cost to purchase the commodities. The bonus commodities do not reduce the DOE's allocation balance.

**Department of Education
State of Hawaii
NOTES TO THE BASIC FINANCIAL STATEMENTS
June 30, 2006**

NOTE M - FOOD DISTRIBUTION PROGRAM (Continued)

The following is a summary of the value of the food commodities received by the DOE during the fiscal year ended June 30, 2006. The value of the bonus commodities is based upon the estimated costs provided by the FNS in the *Current Commodity File* report dated June 30, 2006.

	<u>Amount</u>
Basic allocation	\$ 2,653,221
Bonus commodities	<u>89,855</u>
	\$ <u>2,743,076</u>

NOTE N - PRIOR PERIOD ADJUSTMENT

Accrued vacation liability as of June 30, 2005, reported on the government-wide financial statements erroneously included balances of earned and unearned leave credit for terminated employees amounting to \$16,699,751. To properly reflect the beginning net assets as of July 1, 2005, an adjustment to correct an overstatement of prior fiscal year expenditures of \$16,699,751 was recorded.

SUPPLEMENTARY INFORMATION

**Department of Education
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Fiscal Year Ended June 30, 2006**

<u>Federal Grantor/Pass-through Grantor and Program Title</u>	<u>Federal CFDA Number</u>	<u>Pass-Through Entity Identifying Number</u>	<u>Federal Expenditures¹</u>	<u>Amount Provided to Subrecipient</u>
U.S. Department of Agriculture				
Food Donation ²	10.550	--	\$ 2,743,076	\$ --
Child Nutrition Cluster:				
School Breakfast Program	10.553	--	7,020,617	338,863
National School Lunch Program	10.555	--	18,945,571	1,020,314
Special Milk Program for Children	10.556	--	6,040	6,040
Summer Food Service Program for Children	10.559	--	754,868	754,868
Child and Adult Care Food Program	10.558	--	4,775,941	4,775,941
State Administrative Expenses for Child Nutrition	10.560	--	<u>569,039</u>	<u>--</u>
Total U.S. Department of Agriculture			<u>34,815,152</u>	<u>6,896,026</u>
U.S. Department of Defense				
National Defense Authorization Act P.L. 102-484	N/A ³	--	4,438,209	--
Troops To Teachers - DOD FY05	N/A ³	--	60,366	--
Troops To Teachers - DOD FY06	N/A ³	--	44,111	--
Passed-through State Department of Defense				
Joint Venture Education Forum	N/A ³	--	<u>2,972,951</u>	<u>--</u>
Total U.S. Department of Defense			<u>7,515,637</u>	<u>--</u>
U.S. Department of Commerce				
Coastal Services Center	11.473	--	<u>22,863</u>	<u>--</u>
Total U.S. Department of Commerce			\$ <u>22,863</u>	\$ <u>--</u>

**Department of Education
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (Continued)
Fiscal Year Ended June 30, 2006**

<u>Federal Grantor/Pass-through Grantor and Program Title</u>	<u>Federal CFDA Number</u>	<u>Pass-Through Entity Identifying Number</u>	<u>Federal Expenditures¹</u>	<u>Amount Provided to Subrecipient</u>
U.S. Department of Interior				
Passed-through State Governor's Office Economic, Social, and Political Development of the Territories	15.875	GR270094	\$ <u>255,554</u>	\$ <u>--</u>
Total U.S. Department of the Interior			<u>255,554</u>	<u>--</u>
U.S. Department of Justice				
Passed-through State Department of Human Services Part E State Challenge Activities	16.549	JE-FX-00146-2002	<u>34,178</u>	<u>--</u>
Total U.S. Department of Justice			<u>34,178</u>	<u>--</u>
U.S. Department of Transportation				
Passed-through State Department of Transportation State and Community Highway Safety	20.600	AL06-02 (13-S-01)	33,384	--
		AL06-02 (10-S-01)	<u>26,963</u>	<u>--</u>
Total U.S. Department of Transportation			<u>60,347</u>	<u>--</u>
Institute of Museum and Library Services				
Grants to States	45.310	--	<u>1,239,736</u>	<u>--</u>
Total Institute of Museum and Library Services			<u>1,239,736</u>	<u>--</u>
National Science Foundation				
Education and Human Resources	47.076	--	875,709	--
Passed-through Maui Economic Development Board Hands-On Science for Maui (Project SEED)	N/A ⁴	ESI-9253304	<u>781</u>	<u>--</u>
Total National Science Foundation			\$ <u>876,490</u>	\$ <u>--</u>

**Department of Education
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (Continued)
Fiscal Year Ended June 30, 2006**

<u>Federal Grantor/Pass-through Grantor and Program Title</u>	<u>Federal CFDA Number</u>	<u>Pass-Through Entity Identifying Number</u>	<u>Federal Expenditures¹</u>	<u>Amount Provided to Subrecipient</u>
U.S. Department of Education				
Adult Education - State Grant Program	84.002	--	\$ 3,120,903	\$ --
Title I Grants to Local Educational Agencies	84.010	--	43,732,364	--
Migrant Education - State Grant Program	84.011	--	783,009	--
Title I Program for Neglected and Delinquent Children	84.013	--	156,024	--
Special Education - Grants to States	84.027	--	32,506,009	--
Impact Aid	84.041	--	46,384,910	--
Safe and Drug-Free School and Community - National Programs	84.184	--	115,663	--
Byrd Honors Scholarships	84.185	--	154,500	--
Safe and Drug-Free Schools and Communities - State Grants	84.186	--	1,499,798	--
Bilingual Education - Professional Development	84.195	--	24,292	--
Education for Homeless Children and Youth	84.196	--	207,649	--
Even Start - State Educational Agencies	84.213	--	956,844	--
Even Start - Migrant Education	84.214	--	429,823	--
Fund for the Improvement of Education	84.215	--	1,473,579	--
Charter Schools	84.282	--	730,572	711,264
Twenty-First Century Community Learning Centers	84.287	--	4,762,042	--
Native Hawaiian Curriculum Development, Teacher Training and Recruitment	84.297	--	17,155	--
State Grants for Innovative Programs	84.298	--	1,342,599	--
Education Technology State Grants	84.318	--	4,381,992	--
Special Education - State Personnel Development	84.323	--	395,437	--
Special Education - Technical Assistance and Dissemination to Improve Services and Results for Children with Disabilities	84.326	--	1,342,707	--
Advanced Placement Program	84.330	--	22,526	--
Comprehensive School Reform Demonstration	84.332	--	1,177,921	--
Transition to Teaching	84.350	--	14,884	--
School Renovation Grants	84.352	--	71,659	--

Department of Education
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (Continued)
Fiscal Year Ended June 30, 2006

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures ¹	Amount Provided to Subrecipient
Reading First State Grants	84.357	--	\$ 3,588,915	\$ --
Native Hawaiian Education	84.362	--	888,989	--
English Language Acquisition Grants	84.365	--	2,432,376	--
Mathematics and Science Partnerships	84.366	--	832,827	--
Improving Teacher Quality State Grants	84.367	--	12,162,656	--
Grants for State Assessments and Related Activities	84.369	--	3,894,128	--
Common Core of Data Survey Project	N/A ³	--	41,441	--
NAEP State Coordinator	N/A ³	--	151,122	--
			<u>169,797,315</u>	<u>--</u>
Passed-through Office of the State Director for Vocational Education				
Vocational Education - Basic Grants to States	84.048	V048A020011	(3,911)	--
		V048A040011	1,911,052	--
		V048A050011	416,888	--
			<u>2,324,029</u>	<u>--</u>
Tech-Prep Education	84.243	V243A020011	<u>150,022</u>	<u>--</u>
Passed-through State Department of Human Services				
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126	MOA-DHHS	66,200	--
Safe and Drug-Free Schools and Communities - State Grants	84.186	S186B020012	<u>123,352</u>	<u>--</u>
			<u>189,552</u>	<u>--</u>
Passed-through Alu Like, Inc.				
Native Hawaiian Vocational Education	84.259	S362A0310013	8,064	--
		VE-04-01	36,916	--
		VE-04-04	49,569	--
		VE-04-05	31,154	--
		VE-05-01	112,454	--
		VE-05-02	31,460	--
		VE-05-04	76,379	--
			<u>\$ 345,996</u>	<u>\$ --</u>

**Department of Education
State of Hawaii
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (Continued)
Fiscal Year Ended June 30, 2006**

Federal Grantor/Pass-through Grantor and Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures ¹	Amount Provided to Subrecipient
Passed-through University of Hawaii				
Gaining Early Awareness and Readiness for Undergraduate Programs	84.334	P334S000195-03A P334S000195-04	\$ 9,255 159,867 <u>169,122</u>	\$ -- -- --
Native Hawaiian Special Education	84.221	CO10147-mod #3 CO10147-mod #4	1,318,490 723,007 <u>2,041,497</u>	-- -- --
Passed-through University of Oregon				
Special Education - Personnel Development to Improve Services and Results for Children with Disabilities	84.325	--	<u>15,506</u>	--
Total U.S. Department of Education			<u>175,033,039</u>	--
U.S. Department of Health and Human Services				
Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	93.938	--	<u>569,819</u>	--
Passed-through State Department of Human Services				
Temporary Assistance for Needy Families	93.558	G050001HTNS	485,994	--
Child Care and Development Block Grant	93.575	G0100HICCD2	<u>306,414</u>	--
Total U.S. Department of Health and Human Services			<u>1,362,227</u>	--
Corporation for National and Community Service				
Passed-through State Department of Labor				
Learn and Serve America - School and Community Based Programs	94.004	03KSPHI001	<u>67,080</u>	--
Total Corporation for National and Community Service			<u>67,080</u>	--
TOTAL FEDERAL GRANT FUND EXPENDITURES			\$ <u>221,282,303</u>	\$ <u>7,607,290</u>

¹ The accompanying schedule of expenditures of federal awards is prepared on the cash basis of accounting.

² Expenditures for the Food Donation Program (CDFA No., 10.550) are based on the value of food commodities received.

³ Not applicable.

⁴ Not available.

PART II

**AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON
COMPLIANCE AND OTHER MATTERS**



NISHIHAMA & KISHIDA, CPAs, INC.
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**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***

To the Auditor
State of Hawaii

We have audited the financial statements of the Department of Education of the State of Hawaii (DOE), as of and for the fiscal year ended June 30, 2006, and have issued our report thereon dated March 20, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the DOE's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the DOE's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 2006-01 to 2006-03.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal

control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 2006-01 to be a material weakness. We also noted other matters involving the internal control over financial reporting, which we have reported to the management of the DOE in a separate letter dated March 20, 2007.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the DOE's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars, 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*.

This report is intended solely for the information and use of management, federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
March 20, 2007

PART III

**AUDITORS' REPORT ON COMPLIANCE
WITH REQUIREMENTS APPLICABLE TO EACH MAJOR
PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE**



NISHIHAMA & KISHIDA, CPAs, INC.
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**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
APPLICABLE TO EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

To the Auditor
State of Hawaii

Compliance

We have audited the compliance of the Department of Education of the State of Hawaii (DOE) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the fiscal year ended June 30, 2006. The DOE's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the DOE's management. Our responsibility is to express an opinion on the DOE's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the DOE's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the DOE's compliance with those requirements.

As described in items 2006-04 to 2006-06 in the accompanying schedule of findings and questioned costs, the DOE did not comply with the following requirements:

CFDA Number	Program Title	Type of Compliance Requirement	Reference Number
84.002	Adult Education - State Grant Program	Allowable Costs	2006-04
84.010	Title I Grants to Local Educational Agencies	Allowable Costs	2006-04
84.011	Migrant Education - State Grant Program	Allowable Costs	2006-04
84.048	Vocational Education - Basic Grants to States	Allowable Costs	2006-04
84.213	Even Start - State Educational Agencies	Allowable Costs, Matching, Eligibility	2006-04, 2006-05, 2006-06
84.287	21 st Century Community Learning Centers	Allowable Costs	2006-04
84.362	Native Hawaiian Education	Allowable Costs	2006-04
84.369	Grants for State Assessments and Related Activities	Allowable Costs	2006-04

Compliance with such requirements is necessary, in our opinion, for the DOE to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, the DOE complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the fiscal year ended June 30, 2006. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items 2006-07 and 2006-08.

Internal Control Over Compliance

The management of the DOE is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the DOE's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the DOE's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 2006-04 to 2006-08.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

This report is intended solely for the information and use of management, federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
March 20, 2007

PART IV
SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
Fiscal Year Ended June 30, 2006

SECTION I - SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued:	Unqualified
Internal control over financial reporting:	
Material weakness(es) identified?	<input checked="" type="checkbox"/> yes <input type="checkbox"/> no
Reportable condition(s) identified not considered to be material weaknesses?	<input checked="" type="checkbox"/> yes <input type="checkbox"/> none reported
Noncompliance material to the financial statements noted?	<input type="checkbox"/> yes <input checked="" type="checkbox"/> no

Federal Awards

Internal control over major program:	
Material weakness(es) identified?	<input type="checkbox"/> yes <input checked="" type="checkbox"/> no
Reportable condition(s) identified not considered to be material weaknesses?	<input checked="" type="checkbox"/> yes <input type="checkbox"/> none reported

Type of auditors' report issued on compliance for major programs:	Qualified
--	-----------

Any audit findings disclosed that are required to be reported in accordance with OMB Circular A-133, Section .510(a)?	<input checked="" type="checkbox"/> yes <input type="checkbox"/> no
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Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
84.002	Adult Education - State Grant Program
84.010	Title I Grants to Local Educational Agencies
84.011	Migrant Education - State Grant Program
84.041	Impact Aid
84.048	Vocational Education - Basic Grants To States
84.213	Even Start - State Educational Agencies
84.287	21 st Century Community Learning Centers
84.362	Native Hawaiian Education
84.369	Grants for State Assessments and Related Activities
none	National Defense Authorization Act

Dollar threshold used to distinguish between Type A and Type B programs:	\$3,000,000
---	-------------

Auditee qualified as a low-risk auditee?	<input type="checkbox"/> yes <input checked="" type="checkbox"/> no
--	---

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

SECTION II - FINANCIAL STATEMENT FINDINGS

Ref

No. Internal Control Findings

2006

- 01 Improve Reporting System for Vacation and Sick Leave

The sick leave balance the DOE reported to the State Comptroller as of June 30, 2006, was approximately \$575 million for the public school system. The balance was comprised of leave credits for 27,221 individuals, which is greater than the actual number of personnel as of September 30, 2006, of 23,383 reported in the State of Hawaii [Budget] *Variance Report for FY2006 and FY2007*. The computerized leave accounting system included over 2,000 terminated employees with vacation leave balances. Because many of these employees were classified as active, the computer system automatically calculated leave credits earned until the employee was either classified as inactive or deleted. Similarly, the computerized leave accounting system included over 7,000 terminated employees with sick leave balances.

The DOE uses a computerized leave accounting system to compile and print accrued compensated absences information for reporting the liability to the State Comptroller and for financial reporting purposes. All leaves taken are transmitted from the TSEA (electronic substitute teacher system) for teachers or recorded in the computerized leave accounting system by the DOE's Payroll Section for all other employees. A manual form is submitted to the Payroll Section for recording leave taken in instances when TSEA is not used.

We were informed that terminated employees may have been classified as inactive in the computerized leave accounting system because the schools did not submit copies of termination documents to the Payroll Section in a timely manner. Although the schools did not submit the termination documents timely to keep the computerized leave information current and accurate, the DOE had available information from other sources to determine the reasonableness of the information generated from the computerized leave accounting system and to detect significant errors that should be adjusted. The DOE did not establish control procedures to review the reported leave information for reasonableness or to make adjustments for detected significant errors.

The official record for compensated absences is the *Employee Leave Record* (Form 7), which is separately maintained electronically or manually by the various schools and offices. The computerized leave accounting system was used as a more efficient alternative to consolidating individual Form 7s for reporting purpose.

The computerized leave accounting system has no effect on actual termination payments or current monitoring of leave balances at the school or office level which is based on the Form 7. Errors in the computerized leave accounting system affected only the financial reporting of liabilities of the DOE and the State of Hawaii.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref

No. **Internal Control Findings (Continued)**

2006

- 01 Improve Reporting System for Vacation and Sick Leave (Continued)

As a result of classifying terminated employees in an active status and including the records of terminated employees when compiling accrued leave balance, the vacation and sick leave balances as of June 30, 2006, were overstated by approximately \$19 million and \$428 million, respectively excluding fringe costs. A prior period adjustment to the financial statements as of June 30, 2006, was made to correct an overstatement of over \$16 million in accrued vacation liability as of June 30, 2005.

Recommendation

The DOE should improve its leave reporting system to ensure accurate and current information. To achieve this, the DOE should reexamine its process of compiling leave information for financial reporting purposes including determination of the best source for timely and accurate data whether it is from the payroll system, personnel system, other existing system or a combination of systems. The DOE should establish and implement procedures to review the leave information and adjust the information to prepare timely reports that are reasonably stated. The DOE should also establish and implement procedures to make adjustments for significant errors detected.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref

No. Internal Control Findings (Continued)

2006

- 02 Improve Compensating Controls for Inadequate Segregation of Duties over Local School Funds

Most, if not all, of a school's cash functions are handled by the school administrative services assistant (SASA) or account clerk. One person receives the cash, prepares the receipts for deposit to the bank, prepares the checks, records the receipts and disbursements, and prepares the bank reconciliation.

No one person should have access to both physical assets and the related accounting records, or to handle all phases of a transaction. Without adequate segregation of duties, funds may be lost, unrecorded or misused.

For many schools, it is not possible to delegate the duties to another person. To compensate for inadequate segregation of duties, the DOE established control procedures that are to be performed by the school principal or designee. The control procedures are enumerated in Exhibit 9-12 of the FMS User Policy and Process Flow Guide (Guide) as well as on the DOE's website.

We reviewed controls for ten schools during our test of the nonappropriated local school funds and noted the following conditions:

- Two schools had inadequate segregation of duties but did not perform all the compensating controls enumerated in the Guide. One school did not perform any of the compensating controls. The other school did not conduct unannounced cash counts of the school petty cash fund.
- One school documented performance of the compensating controls but did not follow up on discrepancies in the bank reconciliations. It appeared that the principal did not adequately perform all the procedures for monitoring bank reconciliations enumerated in Exhibit 9-12 of the Guide.

Exhibit 9-12 of the Guide provides the following compensating controls:

1. Conduct periodic unannounced cash counts of the school petty cash fund.
2. Verify that monthly reconciliations between the bank statement and the school's check register are being performed.
3. Inspect checks outstanding for more than six months ("stale" checks) during the review of the monthly bank reconciliations. These checks should be cancelled.
4. Check if cash receipts are deposited daily. The dates on the Official Receipts Form 239 should be the same as the bank deposit slip date.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref

No. **Internal Control Findings (Continued)**

2006

- 02 Improve Compensating Controls for Inadequate Segregation of Duties over Local School Funds (Continued)

5. The principal or designee will prepare a report of the reviews conducted during the year indicating the areas reviewed, the date of the reviews, discrepancies found and the report should be kept on file for audit purposes.

Recommendation

The school principal or designee should perform all compensating controls enumerated in Exhibit 9-12 of the Guide, including documentation of the procedures performed and the results. In addition, appropriate action should be taken and documented for any discrepancies noted.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref
No. **Internal Control Findings (Continued)**

2006
- 03 Continue to Improve Controls over Workers' Compensation Data

Workers' compensation payment data, estimated and actual, are maintained using the Renaissance (REN) software program and are used for multiple purposes. However, the DOE could not be assured of the completeness and accuracy of wage loss payments during the fiscal year ended June 30, 2006. In addition, reserves on open claims had negative balances as of June 30, 2006.

In prior years, due to software licensing issues and incompatibility with the DOE's payroll system, paid wage loss information was maintained separately from REN which resulted in inefficiencies and inaccuracies in financial reporting. The DOE implemented alternative procedures to improve its workers' compensation information system.

Effective October 1, 2004, the Workers' Compensation office maintained an electronic spreadsheet of claims filed and paid in order to track unpaid claims. Maintaining the spreadsheet was time consuming. We were informed that tracking unpaid claims could not be done using REN because REN did not allow the input of estimated wage loss payments. In August 2005, the DOE upgraded REN which enabled the DOE to record estimated and actual wage loss payments which allowed DOE to track unpaid claims more efficiently. However actual payments recorded in REN were not reconciled to payments recorded in the DOE's payroll system to ensure completeness and accuracy. Reconciliations for each pay date were performed effective August 2006.

We also noted numerous open claims as of June 30, 2006, with negative reserve balances that totaled approximately \$4 million. Although claims opened from prior fiscal years accounted for nearly all the dollar total of negative balances, 45 of the 165 claims with negative balances were opened during the fiscal year ended June 30, 2006. Reserves were not always adjusted when actual payments exceeded the initial reserve amount for the claim or when reserves became at risk of underestimation.

The DOE needs complete and accurate wage loss payments recorded in REN to properly identify unpaid wage loss claims that may result in late payment penalties and to provide historical payments that can be used to evaluate a component of workers compensation liability for financial statement reporting. Reserves on open claims represent estimates of payment amounts to settle claims which should be periodically readjusted and should not have negative balances.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref
No. **Internal Control Findings (Continued)**

2006
- 03 **Continue to Improve Controls over Workers' Compensation Data (Continued)**

Recommendation

The DOE should continue to improve its controls over workers' compensation data maintained in REN by performing the following established procedures:

1. Reconcile the wage loss payments recorded in REN to the payments recorded in the payroll system to ensure completeness and accuracy of both the wage loss data recorded in REN and payments made by the Payroll Section. The Workers Compensation Office and the Payroll Section should investigate discrepancies between their records and make necessary corrections for any recording or payment errors.
2. Periodically re-evaluate and adjust reserve balances, particularly balances that are at risk of becoming negative, to ensure reasonableness of the reserve amount. A report identifying claims at risk and those with negative reserves should be generated periodically to assist in the evaluation.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

SECTION III - FEDERAL AWARD FINDINGS

Ref
No. **Compliance and Internal Control Findings**

Questioned
Costs

2006
- 04 Document Time Spent on Federal Programs

The DOE relied on the schools to maintain certain documentation that support payroll expenditures charged to the federal programs. However, the schools did not provide documentation approved by a responsible official to support that the time charged to various federal programs was for actual time spent on the related federal program. The schools also did not prepare certifications for numerous employees certifying that those employees worked solely on a single federal award. The results of our testing of a sample of the payroll expenditures for various federal programs are summarized in the following table.

Program Title	CFDA No.	No Certification and						
		No Certification		No Time Support		Time Support		Total
		Count	Payroll	Count	Payroll	Count	Payroll	
Payroll Cost								
Adult Education	84.002	3	\$ 18,201	5	\$ 135,986	4	\$ 194,816	\$ 349,003
Title I	84.010	1	10,574	16	426,690	4	123,911	561,175
Migrant Education - State Grant Program	84.011	1	22,836	9	83,892	4	77,636	184,364
Vocational Education	84.048	1	11,738	5	41,418	12	176,143	229,299
Even Start - State Educational Agencies	84.213	--	--	17	456,869	5	119,091	575,960
21st Century Community Learning Centers	84.287	2	17,232	1	65,281	2	20,093	102,606
Native Hawaiian Education	84.362	1	41,264	--	--	--	--	41,264
Grants for State Assessments and Related Activities	84.369	4	326,179	--	--	--	--	326,179
Total		13	\$ 448,024	53	\$ 1,210,136	31	\$ 711,690	\$ 2,369,850

In addition, numerous certifications supporting over \$500,000 in payroll expenditures for various federal programs were prepared over seven or thirteen months after the end of service period stated in the certification.

Attachment B, Paragraph 8.h(1) of the Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, codified in 2 CFR 225 states, "Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit."

Paragraph 8.h(3) adds, "Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification."

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
2006 - 04	Document Time Spent on Federal Programs (Continued)	
	<p>These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee."</p> <p>The schools were unaware of the requirement for periodic certification to support charges for employees who worked solely on a single Federal award or cost objective.</p> <p>As a result of inadequate payroll documentation, \$2,369,850 is considered questioned costs.</p>	\$ <u>2,369,850</u>
	Recommendation	
	<p>The DOE should prepare and maintain payroll documentation in accordance with OMB Circular A-87, including periodic certifications for employees who worked solely on a federal program or cost objective. Certifications should be prepared in a timely manner to ensure that they are readily available to support time charged to federal programs.</p>	

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
2006 - 05	<p>Use Actual Costs to Document Compliance With Cost Sharing Requirement</p> <p>The DOE inappropriately used budgeted amounts to support that it complied with the federal cost sharing requirement for the Even Start - State Educational Agencies program (CFDA No. 84.213). The federal program grant and non-grant cost amounts the DOE claimed it incurred was from the program grant application submitted by each participating school that included a budget of planned expenditures and the related funding sources including in-kind costs such as the value of using DOE facilities.</p> <p>In addition, the DOE was unable to substantiate the value of the in-kind costs claimed for part of its non-grant cost share.</p> <p>20 USC 6381c states in part,</p> <p>“(a) In general - In carrying out an Even Start program under this subpart, a recipient of funds under this subpart shall use those funds to pay the Federal share of the cost of providing intensive family literacy services that involve parents and children, from birth through age 7, in a cooperative effort to help parents become full partners in the education of their children and to assist children in reaching their full potential as learners.</p> <p>(b) Federal share limitation-</p> <p>(1) In general-</p> <p>(A) Federal share- Except as provided in paragraph (2), the Federal share under this subpart may not exceed -</p> <p>(i) 90 percent of the total cost of the program in the first year that the program receives assistance under this subpart or its predecessor authority;</p> <p>(ii) 80 percent in the second year;</p> <p>(iii) 70 percent in the third year;</p> <p>(iv) 60 percent in the fourth year;</p> <p>(v) 50 percent in the fifth, sixth, seventh, and eighth such years; and</p>	

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
2006 - 05	Use Actual Costs to Document Compliance with Cost Sharing Requirement (Continued)	

(vi) 35 percent in any subsequent year

- (B) Remaining cost- The remaining cost of a program assisted under this subpart may be provided in cash or in kind, fairly evaluated, and may be obtained from any source, including other Federal funds under this Act."

Attachment A, Paragraph B.9 of OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, codified in 2 CFR 225 states in part, " 'Cost' means an amount as determined on a cash, accrual, or other basis acceptable to the Federal awarding or cognizant agency...."

34 CFR 76.730 states, "A State and a subgrantee shall keep records that fully show:

- (a) The amount of funds under the grant or subgrant;
- (b) How the State or subgrantee uses the funds;
- (c) The total cost of the project;
- (d) The share of that cost provided from other sources; and
- (e) Other records to facilitate an effective audit."

34 CFR 76.731 states, "A State and a subgrantee shall keep records to show its compliance with program requirements."

34 CFR 80.24(b)(6) states, "Records. Costs and third party in-kind contributions counting towards satisfying a cost sharing or matching requirement must be verifiable from the records of grantees and subgrantee or cost-type contractors. These records must show how the value placed on third party in-kind contributions was derived. To the extent feasible, volunteer services will be supported by the same methods that the organization uses to support the allocability of regular personnel costs."

The DOE did not have procedures to account for actual costs that may be counted as its non-grant cost share. The program administrator believed the schools' program grant application budget was sufficient to demonstrate compliance.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
2006 - 05	Use Actual Costs to Document Compliance with Cost Sharing Requirement (Continued)	
	<p>Activities and related costs may not always happen as planned and therefore budgeted amounts are generally not an acceptable basis for quantifying allowable costs.</p> <p>Without demonstrating the actual amount of non-grant funds expended and demonstrating that the amount was at least equivalent to the amount of computed non-grant cost share as defined in 20 USC 6381c(b)(1)(B), the DOE cannot be assured it is in compliance with the program cost share requirements. Because substantiation of the actual non-grant cost share amount was not available, program grant funds expended during the fiscal year ended June 30, 2006, of \$956,844 is a questioned cost.</p>	\$ <u>956,844</u>
	Recommendation	
	<p>The DOE should establish procedures to monitor and account for actual costs that may be counted towards the non-program-grant cost share requirement of the Even Start Program. The procedures should address documentation supporting the value of in-kind costs using allowable methods.</p> <p>Finally, the DOE should document its demonstration that its actual non-program-grant cost share is at least equivalent to the amount of computed required cost share as defined in 20 USC 6381c(b)(1)(B).</p>	

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
2006 - 06	<p>Perform and Document Eligibility Verification Procedures</p> <p>The DOE did not always verify information used to determine participant eligibility or document its verification for the Even Start - State Educational Agencies program (CFDA No. 84.213). To be eligible to participate in the program, the student enrolled in the DOE generally must be seven years old or younger, the family must be of low income, and the participating adult parent must be of a certain level of education.</p> <p>During our testing of the DOE's program participant eligibility determination procedures, we noted the following:</p> <ul style="list-style-type: none"> • For 25 participants, we were informed that the income level of the participant's family was verified but not documented. One school informed us that the income level was not verified for any participant for that school. • For 17 participants, there was no documentation supporting the participant's education level. Five of the participants were at greater risk for ineligibility because they informed the school they received post secondary level education. It is probable these participants received a secondary school diploma which may exceed the maximum education level allowed if they do not lack sufficient mastery of basic educational skills to function effectively in society. • For six participants, there was no documentation that the schools verified the age of the student enrolled in the DOE. <p>34 CFR 76.730 states, "A State and a subgrantee shall keep records that fully show:</p> <ul style="list-style-type: none"> (a) The amount of funds under the grant or subgrant; (b) How the State or subgrantee uses the funds; (c) The total cost of the project; (d) The share of that cost provided from other sources; and (e) Other records to facilitate an effective audit." <p>34 CFR 76.731 states, "A State and a subgrantee shall keep records to show its compliance with program requirements."</p> 	

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	<u>Questioned Costs</u>
2006 - 06	<p>Perform and Document Eligibility Verification Procedures (Continued)</p> <p>Each school was responsible for developing its own intake, verification, and documentation procedures, if any. Some of the school personnel administering the program were unaware of the need to perform verification procedures or to document information that is critical to support its compliance with program eligibility requirements and to facilitate an effective audit.</p> <p>Without verifying the information in the program participant application that directly affects the participant's eligibility and documentation of the verification, the DOE cannot be assured the information is accurate and the participant is eligible to participate in the program.</p> <p>Recommendation</p> <p>To ensure eligibility of participants for the Even Start - State Educational Agencies program, the DOE should establish standardized forms and procedures to perform and document eligibility verification procedures.</p>	<u>Unknown</u>

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref No.	Compliance and Internal Control Findings (Continued)	Questioned Costs
2006 - 07	Compute Indirect Cost Rate in Accordance with OMB Circular A-87	

The U.S. Department of Education approved DOE's proposed fixed indirect cost rates used to assess over \$2 million in indirect cost charges for the fiscal year ended June 30, 2006. The rates were based on fiscal year 2004 costs as allowed. However, the indirect cost rate for the fiscal year 2006 did not include adjustment for over-recovery of indirect costs related to the use of fixed indirect cost rates for the fiscal year ended June 30, 2004. The amount of over-recovery was \$281,070, \$3,403,985, and \$21,894,816 for the food service unrestricted rate, instruction restricted rate and instruction unrestricted rate, respectively. In the transmittal letter for the proposed indirect cost rates, the DOE informed the U.S. Department of Education that the carryover adjustment was not received and thus not deducted. No further discussion of the omission was made.

Attachment E, Paragraph B.6 of OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, codified in 2 CFR 225 states in part, " 'Fixed rate' means an indirect cost rate which ... the difference between the estimated costs and the actual, allowable costs of the period covered by the rate is carried forward as an adjustment to the rate computation of a subsequent period."

As a result of excluding the over-recovery carryforward adjustment, the unrestricted rate for food service of 5.78%, restricted rate for instruction of 2.04%, and unrestricted rate for instruction of 10.55% were overstated by .33%, .23% and 1.56%, respectively.

\$ --

Recommendation

The DOE should compute proposed indirect cost rates in accordance with OMB Circular A-87. The DOE should also resolve with the U.S. Department of Education the exclusion of rate adjustment for over-recovery of indirect costs related to the use of fixed indirect cost rates during the fiscal year ended June 30, 2004.

Department of Education
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)
Fiscal Year Ended June 30, 2006

Ref		Questioned
<u>No.</u>	Compliance and Internal Control Findings (Continued)	<u>Costs</u>

2006		
- 08	Improve Cash Management Procedures	

At the end of the webpage where the DOE draws down from the U.S. Department of Education, there is an instruction that states, "Please be advised that the amounts you drawdown must be spent within 3 working days after the deposit date. Please obtain prior approval from your program office for exceptions." By submitting a request for fund drawdown, the DOE makes the following certification: "I certify, by processing this payment request and/or re-allocation, that the funds are being expended within three business days of receipt for the purpose and condition of the grant agreement."

The DOE held cash for eight consecutive business days for the Grants for State Assessments and Related Activities program (CFDA No. 84.369).

We were informed that cash was not expended within three business days because of overestimated payroll projections, unexpected delays in processing payments due to vendor errors, or submission of invoices for payment later than anticipated.

\$ --

Recommendation

The DOE should improve its cash management procedures to increase the predictability of disbursements and time draw down of federal funds to comply with the U.S. Department of Education's requirement to expend funds within three working days.

PART V
CORRECTIVE ACTION PLAN
(Provided by the Department of Education, State of Hawaii)



STATE OF HAWAII
DEPARTMENT OF EDUCATION

P.O. BOX 2360
HONOLULU, HAWAII 96804

OFFICE OF THE SUPERINTENDENT

March 28, 2007

Nishihama & Kishida, CPA's, Inc.
Certified Public Accountants
American Savings Bank Tower
1001 Bishop Street, Suite 1700
Honolulu, Hawaii 96813-3696

Ladies and Gentlemen:

We appreciate your assistance in our successful completion of the Single Audit of the State of Hawaii Department of Education within the nine-month timeline in accordance with OMB Circular A-133.

We have reviewed your findings and recommendations and will continue to make further improvements. In accordance with OMB Circular A-133, on the following pages are the **Corrective Action Plan** and **Summary Schedule of Prior Audit Findings** of the State of Hawaii Department of Education for the year ended June 30, 2006.

Very truly yours,

A handwritten signature in cursive script, reading "Patricia Hamamoto".

Patricia Hamamoto
Superintendent

PH:DY

Attachments

**STATE OF HAWAII DEPARTMENT OF EDUCATION
SINGLE AUDIT -- CORRECTIVE ACTION PLAN
Fiscal Year Ended June 30, 2006**

FINANCIAL STATEMENT FINDINGS

2006-01 Improve Reporting System For Vacation and Sick Leave

(Pages 55 to 56)

Corrective Action Plan

The DOE recognizes the issues raised concerning the accuracy of estimated accrued sick and vacation leave liability balances and will work towards resolving this problem. The DOE is attempting to clear the backlog in processing leave accounting reports. During the past year, a computer software vendor was contracted to update the 12-month employee leave reports from 2001 to the present. The contract was originally scheduled to run 3 months but required nearly one year to update one year of transactions. It was more difficult than anticipated to accelerate the update of the leave accounting records. The existing leave accounting system was developed in the 1980s and has not been modified since its inception. Corrections to the 12-month leave reports for 2002 year are presently being finalized.

Updating employee leave records in the DOE is a difficult time-consuming process because of the large number of employees in the Department and the assorted variety of different leave accrual rules which must be followed for different types of employees to comply with different union contract provisions. In most departments, employees simply earn 14 hours of sick and vacation leave each month, which may be prorated based on the actual number of days the employee is on paid status during the month. In the DOE, there are basically 4 categories of employees with different leave accrual rules:

- (1) 10-month certificated employees, or teachers, who are credited with 18 days of sick leave at the beginning of each school year.
- (2) 10-month classified employees, like Educational Assistants, who are credited with 144 hours of sick leave at the beginning of each school year.
- (3) 12-month certificated/classified employees, who earn the normal 14 hours of sick leave and vacation leave each month
- (4) 12-month rainbow teachers and registrars, who earn 21 days of sick leave and 14 days of vacation leave each year

The staff has been unable to assign personnel to focus on the leave accounting backlog because of difficulty in finding employees to accept temporary positions established to clear the backlog. Existing staff must process payroll for the Department's employees, which has grown since the transfer of DAGS employees as part of the Act 51 delinking process.

The DOE is exploring various options, including the possibility of converting the positions to permanent ones to attract and retain qualified individuals to clear the leave accounting backlog, revising the minimum qualifications for the temporary positions to attract a wider pool of applicants in Honolulu's tight labor market, contracting with an external firm to provide temporary staffing assistance, or contracting with an external firm to provide services to clear the leave accounting backlog.

The DOE will reexamine its methodology for estimating the accrued vacation and sick leave liability in light of the present backlog in leave accounting reports. Once the leave status reports include transactions for past years, most of the former employee records should be eliminated from the file. Comparisons with personnel records to determine active employees will be made to derive a more accurate estimate of leave liability.

Contact Person: Mr. Alan Shimono, Accounting Operations Specialist III
Operations Section
Office of Fiscal Services

Anticipated Completion Date: On-going

2006-02 Improve Compensating Controls For Inadequate Segregation of Duties over Local School Funds (Page 57 to 58)

Corrective Action Plan

The Department recognizes the need for improving compensating controls due to inadequate segregation of duties over the Local School funds. Ideally, the department would want additional support staff to segregate financial duties, but given the constraint of funds this is highly improbable. Consequently, the department will continue to require schools to document their internal compensating controls for cash through the Non-Appropriated Local School Funds Administrator's Checklist. This checklist will document the following:

1. Conduct periodic unannounced cash counts of the school petty cash fund;
2. Verify that monthly reconciliations between the bank statement and the school's check register are being performed;
3. Inspect checks outstanding for more than six months (state dated checks); and
4. Check if cash receipts are being deposited daily.

It should be noted that 80% of the sample size of schools tested are performing this function. Although this is not 100%, the Department is pleased that the frequency of performance, as represented by the sample size, is high. Further, the School Support Section of the Office of Financial Services is reviewing recent audit findings with all school level clerical support staff at workshops being conducted from March through April 2007. The Complex Administrative Services Assistants are available to assist Principals in doing the tasks on the Non-Appropriated Funds Local School Fund Administrator's Checklist. Finally, the Department will continue to provide year round training to the support staff as well as continue to provide reminders to the educational officers through our publication "NOTES & NEWS" and memorandums.

Contact Person: Mr. Charles Kagawa, School Business Specialist III
School Support Section
Administrative Services Branch
Office of Fiscal Services

Anticipated Completion Date: Ongoing

Corrective Action Plan

The Workers' Compensation (WC) Unit will continue to address the audit findings and recommendations as follows:

1) From August 2005, the WC Unit provided the Payroll Section with a monthly report showing all authorized but unpaid wage loss payments identified on the REN, for the Payroll Section to reconciliation and resolve. From August 2006, the Payroll Section has been providing the WC Unit with batched and tallied wage loss payment verification data for each pay date for the WC Unit reconciliation with REN data. Also, the WC Unit has reconciled any discrepancies in REN data and has provided the Payroll Section with a spreadsheet of REN payments for each pay date for the Payroll Section to reconcile with their payment data.

The WC Unit will continue to:

- a) Provide a monthly report to the Payroll Section to show all unpaid claims from the REN data for their reconciliation;
- b) Reconcile REN data with Payroll Section batched and tallied wage loss payment verification data for each pay date and provide the Payroll Section with a spreadsheet of REN payment data for the Payroll Section's investigation of discrepancies, reconciliation and correction;
- c) Investigate REN discrepancies between REN and Payroll Section records and make necessary corrections for any recording or payment errors;
- d) Provide the Payroll Section with a reconciliation worksheet with the spreadsheets to identify the specific discrepancies with REN and Payroll Section data and adjusted totals; and
- e) Provide the Payroll Section with semi-annual spreadsheets showing all unpaid claims from the September 2005 when wage loss payments were tracked in the REN for their reconciliation.

2) The WC Unit will continue to aggressively monitor and enforce the Reserve Methodology Procedure, adopted on August 1, 2004, which includes the review of monthly reports showing claims that are at risk of becoming negative, re-evaluate and adjust reserve amounts when cumulative actual payments reach 75% of the reserve balance recorded on REN and/or when changes in the claim necessitate the adjustment. The WC Unit will also generate a monthly report for WC case managers, showing negative reserve balances to assist with the WC case managers' evaluation of reserve amounts.

Contact Person: Ms. Merlene Akau, Personnel Specialist III
Workers' Compensation Unit
Personnel Assistance Branch
Office of Human Resources

Anticipated Completion Date: Ongoing

FEDERAL AWARD FINDINGS

2006-04 Document Time Spent on Federal Programs

(Pages 61 to 62)

Corrective Action Plan:

The Department will establish standards of practice for programs using federal grant awards in the following areas to ensure compliance with OMB Circular A-87:

1. Providing payroll documentation guidance to recipients of federal funds,
2. Providing guidance to federal fund program managers, and
3. Monitoring and reporting of compliance with the use of federal funds for payroll.
4. The standards of practice will be completed and recipients of federal funds will be informed by June 30, 2007.

Contact Person: Robert Campbell, Ph.D., Director
 Program Support and Development
 Office of the Superintendent

Anticipated Completion Date: June 30, 2007

2006-05 Use Actual Costs To Document Compliance With Cost Sharing Requirement

(Pages 63 to 65)

Corrective Action Plan:

NCLB Title I Part B: Subpart 3 – William F. Goodling Even Start Family Literacy Programs

The Special Programs Management Section (SPMS) will work with the Hawaii Even Start sites to develop a procedure for our sites to use for documenting the in-kind match with other funds besides the federal monies they receive from Even Start.

The following timeline will be used to address this finding:

April 12, 2007	Sharing of auditor's findings with the sites
July, 2007	Develop methodology and documentation procedures to value in-kind costs; Develop guidance to comply with federal share limitations as stated in 20 USC 6381c for CFDA No. 84.213.
August, 2007	Finalize procedures Presentation to site managers Implementation of requirement.

Contact Person: Mr. Solomon Kaulukukui, SPM Specialist II, Title I/Migrant Ed.
Special Programs Management Section
School & Community Leadership Branch
Office of Curriculum, Instruction and Student Support

Anticipated Completion Date: August, 2007

Corrective Action Plan:

NCLB Title I Part B: Subpart 3 – William F. Goodling Even Start Family Literacy Programs

The Special Programs Management Section will develop procedures for our sites to use for documenting the eligibility verification of the families that we serve. In particular, these procedures will address the findings of verification of income and age of the participants. The procedures have already been shared with the sites that were monitored on 3/1/07 via email. These procedures will be shared with all the Even Start sites at a meeting scheduled for 4/12/07.

At the beginning of each school year, the Special Programs Management Section has a meeting with all Even Start grantees to review and update program requirements and procedures for this grant. This meeting will take place at the end of August. The Special Programs Management will review each program sites documentation to monitor proper usage of the sites intake/interview verifications and documentation.

Contact Person: Mr. Solomon Kaulukukui, SPM Specialist II, Title I/Migrant Ed.
Special Programs Management Section
School & Community Leadership Branch
Office of Curriculum, Instruction and Student Support

Anticipated Completion Date: August, 2007

Corrective Action Plan:

The Department of Education will ensure that any necessary carryover adjustments are reflected in future indirect cost proposals submitted to the U.S. Department of Education in accordance with OMB Circular A-87.

Contact Person: Ms. Lisa Hankins, Fiscal Specialist III
Accounting Section
Administrative Services Branch
Office of Fiscal Services

Anticipated Completion Date: April, 2007

2006-08 Improve Cash Management Procedures

(Page 69)

Corrective Action Plan:

The Accounting Section exercises oversight for all cash withdrawals made by the accounting staff. Our current procedures require the accountant to analyze, prepare, and submit a worksheet showing current cash requirements for each federal fund grant to his/her supervisors for review to minimize the excess cash balances or cash shortages.

Currently, financial information is obtained from a variety of sources - Financial Management System (FMS) on-line inquiry, FMS reports (DAFR4210 Letter of Credit report), payroll summary report, and casual payroll information from an electronic financial data warehouse. FMS generated reports are provided to the accountants one or two days prior to the withdrawal to aid the accountants in projecting the grant cash requirements. The accountants may also draw additional cash draws based on program manager requests.

Accounting section staff will be reminded to better monitor their cash draw downs and balances to avoid having federal cash on hand more than three working days.

Contact Person: Ms. Lisa Hankins, Fiscal Specialist III
Accounting Section
Administrative Services Branch
Office of Fiscal Services

Anticipated Completion Date: April, 2007

PART VI
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
(Provided by the Department of Education, State of Hawaii)

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
Prior Fiscal Year Ended June 30, 2005

SECTION II - FINANCIAL STATEMENT FINDINGS

2005-01 Improving Compensating Controls For Inadequate Segregation of Duties over Local School Funds

(Pages 54 to 55 of the Prior Year June 30, 2005 Report)

Status -- Partially Accomplished. Corrective action and monitoring is in progress. Please refer to the current year response to Financial Statement Finding No. 2006-02.

2005-02 Strengthen Controls Over Workers' Compensation Data

(Pages 56 to 57 of the Prior Year June 30, 2005 Report)

Status -- Partially Accomplished. Corrective action and monitoring is in progress. Please refer to the current year response to Financial Statement Finding No. 2006-03.

2005-03 Establish Monitoring System for Vacation and Sick Leave Records

(Page 58 of the Prior Year June 30, 2005 Report)

Status -- Partially Accomplished. Corrective action and monitoring is in progress. Please refer to the current year response to Financial Statement Finding No. 2006-01.

SECTION III - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

2005-04 Ensure Accurate Meal Counts are Obtained for the School Lunch and Breakfast Programs

(Page 59 of the Prior Year June 30, 2005 Report)

Status --Corrective action has been taken to the extent that this finding no longer appears in the Federal Award Findings and Questioned Costs.

2005-05 Ensure Annual Verification Procedures are Completed Timely and Accurately

(Page 60 of the Prior Year June 30, 2005 Report)

Status --Corrective action has been taken to the extent that this finding no longer appears in the Federal Award Findings and Questioned Costs.