FINANCIAL AUDIT OF THE
OFFICE OF THE AUDITOR
STATE OF HAWAII

Fiscal Year Ended June 30, 2012

N&K CPAs, Inc.
ACCOUNTANTS|CONSULTANTS

AMERICAN SAVINGS BANK TOWER | 1001 BISHOP STREET, SUITE 1700 | HONOLULU, HAWAII 96813-3696
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OFFICE OF THE AUDITOR
STATE OF HAWAII

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PART I

FINANCIAL SECTION

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INDEPENDENT AUDITORS' REPORT

To the State Auditor
Office of the Auditor
State of Hawaii

We have audited the accompanying financial statements of the governmental activities and the general fund of the Office of the Auditor of the State of Hawaii (Agency), as of and for the fiscal year ended June 30, 2012, which collectively comprise the Agency's basic financial statements as listed in the foregoing table of contents. These basic financial statements are the responsibility of the Agency's management. Our responsibility is to express opinions 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 basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic 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 opinions.

As discussed in Note A, the financial statements of the Agency are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and the general fund of the State of Hawaii that is attributable to the transactions of the Agency. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2012, and the changes in its financial position 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 and the general fund for the Agency, as of June 30, 2012, and the respective changes in financial position, thereof, and the 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 July 1, 2013, on our consideration of the Agency's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is 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 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.

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

N&K CPAs, Inc.

Honolulu, Hawaii
July 1, 2013

The following management's discussion and analysis provides an overview of the financial activities of the Office of the Auditor, State of Hawaii, for the fiscal year ended June 30, 2012. Readers should also review the basic financial statements and accompanying footnotes to enhance their understanding of the office's financial performance.

Introduction to Basic Financial Statements

The basic financial statements of the office includes: (1) the *Statement of Net Assets and Governmental Fund Balance Sheet* which summarizes assets, liabilities, and fund balances and presents an overall picture of the financial position of the office; (2) the *Statement of Activities and Governmental Fund Revenues, Expenditures and Changes in Fund Balance* which summarizes the financial results of operations for the fiscal year; (3) the *Budgetary Comparison Schedule - General Fund* which compares the actual resources and expenditures against the budget amounts; (4) the *Budgetary Reconciliation - General Fund* which explains differences between the budgetary amounts and the amounts presented in accordance with generally accepted accounting principles; and 5) notes to the basic financial statements.

Analytical Overview

Differences between revenues and expenditures reported on the budgetary basis, which is used operationally, and those reported in the accompanying basic financial statements in accordance with generally accepted accounting principles (GAAP) are mainly due to the different methods used to recognize resource use. For budgeting purposes, revenues are recognized when cash is received and expenditures are recognized when cash disbursements are made or funds are encumbered. In the accompanying basic financial statements presented in accordance with GAAP, revenues are recognized when they become available and measurable and expenditures are recognized as incurred.

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

Analysis of Net Assets

Net assets are a useful indicator of a government's financial position. The office's total assets exceeded liabilities by $6,676,558, an increase of $329,968, or 5.2 percent, during the fiscal year ended June 30, 2012. This increase is due to a $240,211 current fiscal year increase in unexpended cash, a $39,651 decrease in contracts payable, a $28,975 decrease in accrued wages, and a $28,178 decrease in compensated absences.

The following table was derived from the statement of net assets.

Table 1
Condensed Summary of Net Assets

	2012	2011
Assets:		
Current assets	$ 7,099,386	$ 6,859,175
Capital assets	30,988	38,035
Total assets	7,130,374	6,897,210
Liabilities:		
Current liabilities and other liabilities	243,799	334,264
Long-term liabilities	210,017	216,356
Total liabilities	453,816	550,620
Net assets:		
Invested in capital assets	30,988	38,035
Unrestricted	6,645,570	6,308,555
Total net assets	$ 6,676,558	$ 6,346,590

Total assets were $7,130,374 at June 30, 2012. Total assets were comprised of cash and cash equivalents ($7,099,386 or 99.6 percent) and capital assets net of accumulated depreciation ($30,988 or 0.4 percent).

The cash balance mainly represents unexpended appropriated funds held in the state treasury. The cash balance as of June 30, 2012, includes $2,550,828 of funds available to the office's Audit Revolving Fund to conduct annual financial audits of the Comprehensive Annual Financial Report (CAFR) of the State of Hawaii and a majority of the executive departments and attached agencies for fiscal year 2012. Capital assets reflect the cost of furniture and equipment acquired by the office, less accumulated depreciation.

Total liabilities were $453,816 at June 30, 2012, and comprised primarily of contracts payable ($110,833 or 24.4 percent), accrued wages and employee benefits ($49,890 or 11.0 percent), and total compensated absences ($291,093 or 64.1 percent). Compensated absences due after one year ($210,017) are classified as long-term. The decrease in total liabilities of $96,804, or 17.6 percent, as compared to prior fiscal year is partly due to a current fiscal year decrease in the contracts payable balance of $39,651, or 26.3 percent.

A portion of the office's net assets ($30,988 or 0.5 percent) is restricted for investment in capital assets; while the remaining balance of unrestricted net assets ($6,645,570 or 99.5 percent) may be used to meet the office's ongoing obligations.

Changes in Net Assets

The office's net assets increased by $329,968, or 5.2 percent, during the fiscal year ended June 30, 2012. Resources in the amount of $4,796,814 came from state appropriations, net of lapsed appropriations ($417,863). Gross appropriations of $5,214,677 include $2,513,849 for the office's regular operations; $150,000 for special studies and other legislative requests; and $2,550,828 to conduct various financial audits of the State and its agencies, as previously described. The total state appropriations of $5,922,011 for the fiscal year ended June 30, 2011, included $2,408,013 for the office's regular operations; $150,000 for special studies and other legislative requests; $813,170 for regular operations of the State Ethics Commission; and $2,550,828 to conduct various financial audits of the State and its agencies. The current fiscal year appropriation for the office's regular operations reflects a 4.4 percent increase from the previous fiscal year.

Payroll fringe benefit costs of the office's employees funded by state appropriations, such as pension accumulation, retiree health insurance, employee health fund, social security, and Medicare benefits, are assumed by the State and are not charged to the office's operating funds. These costs, totaling $709,123 for the fiscal year ended June 30, 2012, have been reported as revenues and expenditures of the office's general fund appropriation. Total payroll fringe benefit costs for the fiscal year ended June 30, 2011, were $695,782.

Current fiscal year expenditures increased by $415,573, or 5.4 percent, due to increases in personal services and contractual services. Expenditures for personal services ($2,603,617) and contractual services ($5,276,684) accounted for 97.2 percent of the total expenditures for fiscal year ended June 30, 2012. Expenditures for personal services increased by $21,087, or 0.8 percent. The expenditures for contractual services, acquired for financial statement and federal audits, other financial audits, certain management audits, special studies, legal services, and others, increased by $320,719, or 6.5 percent.

For fiscal year 2011, the Department of Accounting and General Services interpreted Act 1, Session Laws of Hawai‘i, 2010, as appropriating the operating funds for the State Ethics Commission to the Office of the Auditor, as opposed to being previously appropriated directly to the State Ethics Commission. As such, expenditures by the State Ethics Commission are reflected as transfers out in the amount of $810,170 in 2011.

Table 2
Condensed Summary of Revenue, Expenses, and Changes in the Net Assets

	2012	2011
Changes in Net Assets		
General revenues:		
State appropriations, net of lapsed amount	$ 4,796,814	$ 5,554,691
State-provided payroll fringe benefits	709,123	695,782
Interest	29,665	228,789
Reimbursements	2,899,512	2,475,689
Total general revenues	8,435,114	8,954,951
Expenditures/expense:		
Current		
Personal services	2,603,617	2,582,530
Contractual services	5,276,684	4,955,965
Depreciation	7,047	5,396
Equipment rental and maintenance	26,533	22,771
Office supplies and postage	6,935	3,274
Other expenses	106,662	102,258
Capital outlays		
Equipment and furniture	77,668	17,379
Total expenditures/expenses	8,105,146	7,689,573
Other financing sources (uses)		
Transfers out	--	(810,170)
Change in net assets	329,968	455,208
Beginning net assets	6,346,590	5,891,382
Ending net assets	$ 6,676,558	$ 6,346,590

Budgetary Information

The following discussion provides an analysis of the revenues and expenditures of the Office as presented on a budgetary basis.

For the fiscal year ended June 30, 2012, the total state appropriation level ($5,214,677) decreased by $707,334, or 11.9 percent.

For the fiscal year ended June 30, 2012, actual expenditures for personal services and contractual services were under budget by $208,006 and $1,313,894 respectively.

Table 3 provides a condensed general fund budgetary comparison schedule for the fiscal years ended June 30, 2012 and 2011.

Table 3
Condensed Budgetary Comparison Schedule - General Fund

	2012		2011	
	Final Budget	Actual on Budgetary Basis	Final Budget	Actual on Budgetary Basis
Budgetary balance at July 1	$ 1,098,109	$ 1,098,109	$ 894,846	$ 894,846
Resources (inflows)				
State appropriations	5,214,677	5,214,677	5,922,011	5,922,011
Reimbursements	2,351,064	2,899,512	2,854,226	2,475,689
Net investment gain	--	29,665	--	228,789
Amounts available	8,663,850	9,241,963	9,671,183	9,521,335
Personal services	2,168,850	1,960,844	2,063,013	1,893,049
Contractual services	6,344,916	5,031,022	6,644,916	5,239,115
Office supplies and postage	45,500	62,324	36,028	2,944
Travel and subsistence, in-state	4,800	4,591	13,857	6,199
Equipment rental and maintenance	20,000	25,848	13,996	22,782
Training/out-of-state travel and subsistence	54,000	26,235	58,489	49,575
Printing	7,000	5,130	12,009	5,155
Other	2,000	2,403	--	--
Capital outlays				
Equipment and furniture	16,784	77,689	15,705	32,859
Total charges to appropriations	8,663,850	7,196,086	8,858,013	7,251,678
Other financing sources (uses)				
Transfers out	--	--	(813,170)	(810,170)
Lapsed appropriations	--	415,296	--	361,378
Budgetary balance at June 30	$ --	$ 1,630,581	$ --	$ 1,098,109

Capital Asset and Debt Administration

During the current fiscal year, the office did not purchase any equipment requiring capitalization.

Capital Assets

At June 30, 2012, the office had $30,988 in capital assets, net of accumulated depreciation of $54,754. Depreciation charges totaled $7,047. There was no debt financing on capital assets.

Table 4
Capital Assets, Net of Depreciation

	2012		2011	
Cost of equipment	$	85,742	$	85,742
Less accumulated depreciation		54,754		47,707
	$	30,988	$	38,035

Long-Term Debt Obligations

At June 30, 2012, the office had $291,093 in long-term debt outstanding. The only long-term liability is for compensated absences representing employees' vested annual vacation leave. The compensated absences liability decreased 8.8 percent from the June 30, 2011 balance of $319,271. This decrease is due primarily to a decrease in accrued vacation hours during the current fiscal year.

Office of the Auditor
State of Hawaii
STATEMENT OF NET ASSETS AND
GOVERNMENTAL FUND BALANCE SHEET
June 30, 2012

	General Fund	Adjustments (Note C)	Statement of Net Assets
ASSETS			
Cash and cash equivalents	$ 7,099,386	$ --	$ 7,099,386
Capital assets			
Equipment and furniture		85,742	85,742
Less accumulated depreciation	--	(54,754)	(54,754)
Total assets	$ 7,099,386	30,988	7,130,374
LIABILITIES			
Contracts payable	$ 110,833	--	110,833
Accrued wages and employee benefits payable	49,890	--	49,890
Due to State of Hawaii	2,000	--	2,000
Compensated absences			
Due within one year	--	81,076	81,076
Due after one year	--	210,017	210,017
Total liabilities	162,723	291,093	453,816
FUND BALANCE/NET ASSETS			
Fund balance			
Assigned	5,462,652	(5,462,652)	--
Unassigned	1,474,011	(1,474,011)	--
Total fund balance	6,936,663	(6,936,663)	--
Total liabilities and fund balance	$ 7,099,386		
Net assets			
Invested in capital assets		30,988	30,988
Unrestricted		6,645,570	6,645,570
Total net assets		$ 6,676,558	$ 6,676,558

See accompanying notes to the basic financial statements.

Office of the Auditor
State of Hawaii
STATEMENT OF ACTIVITIES AND GOVERNMENTAL FUND REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCE
Fiscal Year Ended June 30, 2012

	General Fund	Adjustments (Note D)	Statement of Activities
General revenues			
State appropriations, net of lapsed amount of $417,863	$ 4,796,814	$ --	$ 4,796,814
State-provided payroll fringe benefits	709,123	--	709,123
Net investment gain	29,665	--	29,665
Reimbursements	2,899,512	--	2,899,512
Total general revenues	8,435,114	--	8,435,114
Expenditures/expenses			
Audit services			
Current			
Personal services	2,631,795	(28,178)	2,603,617
Contractual services	5,276,684	--	5,276,684
Depreciation	--	7,047	7,047
Dues and subscriptions	50,180	--	50,180
Equipment rental and maintenance	26,533	--	26,533
Office supplies and postage	6,935	--	6,935
Printing	5,130	--	5,130
Telephone	16,130	--	16,130
Training	9,647	--	9,647
Travel and subsistence, in-state	4,614	--	4,614
Travel and subsistence, out-of-state	19,958	--	19,958
Other	1,003	--	1,003
Capital outlays			
Equipment and furniture	77,668	--	77,668
Total expenditures/expenses	8,126,277	(21,131)	8,105,146
Excess of revenues over expenditures	308,837	21,131	--
Net change in fund balance	308,837	(308,837)	--
Change in net assets		329,968	329,968
Fund balances/net assets			
Beginning of the fiscal year	6,627,826	(281,236)	6,346,590
End of the fiscal year	$ 6,936,663	$ (260,105)	$ 6,676,558

See accompanying notes to the basic financial statements.

Office of the Auditor
State of Hawaii
BUDGETARY COMPARISON SCHEDULE - GENERAL FUND
Fiscal Year Ended June 30, 2012

	Final	Actual on Budgetary Basis	Variance
Budgetary balance at July 1, 2011	$ 1,098,109	$ 1,098,109	$ --
Resources (inflows)			
State appropriations	5,214,677	5,214,677	--
Reimbursements	2,351,064	2,899,512	(548,448)
Net investment gain	--	29,665	(29,665)
Amounts available	8,663,850	9,241,963	(578,113)
Charges to appropriations (outflows)			
Current			
Personal services	2,168,850	1,960,844	208,006
Contractual services	6,344,916	5,031,022	1,313,894
Equipment rental and maintenance	20,000	25,848	(5,848)
Office supplies and postage	45,500	62,324	(16,824)
Printing	7,000	5,130	1,870
Training	12,000	6,356	5,644
Travel and subsistence, in-state	4,800	4,591	209
Travel and subsistence, out-of-state	42,000	19,879	22,121
Other	2,000	2,403	(403)
Capital outlays			
Equipment and furniture	16,784	77,689	(60,905)
Total charges to appropriations	8,663,850	7,196,086	1,467,764
Lapsed appropriations	--	415,296	(415,296)
Budgetary balance at June 30, 2012	$ --	$ 1,630,581	$ (1,630,581)

See accompanying notes to the basic financial statements.

Office of the Auditor
State of Hawaii
BUDGETARY RECONCILIATON - GENERAL FUND
Fiscal Year Ended June 30, 2012

Sources/inflows of resources		
Actual amounts (budgetary basis) available	$	9,241,963
Differences between budgetary basis and GAAP basis		
Lapsed appropriations		(417,863)
On-behalf fringe benefits		709,123
Audit Revolving Fund beginning balance		(1,098,109)
Total revenues per governmental fund financial statement	$	8,435,114
Uses/outflows of resources		
Actual amounts (budgetary basis) charged to appropriations	$	7,196,086
Differences between budgetary basis and GAAP basis		
Reserved for encumbrances		(5,462,652)
Payment of prior year expenditures		5,642,873
Expenditures paid with future appropriations		40,847
On-behalf fringe benefits		709,123
Total expenditures per governmental fund financial statement	$	8,126,277

See accompanying notes to the basic financial statements.

NOTE A - FINANCIAL REPORTING ENTITY

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

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

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

(1) ***Basis of Presentation*** - The financial statements of the Agency have been prepared in conformity with accounting principles generally accepted in the United States of America prescribed by the Governmental Accounting Standards Board (GASB).

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

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

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

Governmental Fund Types

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

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

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

(2) ***Measurement Focus and Basis of Accounting***

Government-wide Financial Statements

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

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

Fund Financial Statements

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

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

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

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

- Statement of Net Assets and Governmental Fund Balance Sheet
- Statement of Activities and Governmental Fund Revenues, Expenditures and Changes in Fund Balance
- Budgetary Comparison Schedule - General Fund

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

- Budgetary Reconciliation - General Fund
- Notes to the Basic Financial Statements

(3) ***Use of Estimates*** - The preparation of 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) ***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, with the exception of the State appropriations made to the Audit Revolving Fund, which do not lapse.

(5) ***Compensated Absences*** - Employees are permitted to accumulate earned but unused vacation and sick leave benefits. There is no liability for unpaid accumulated sick leave since sick leave is not convertible to pay upon termination of employment. All vacation pay is accrued when incurred and is reported in the statement of net assets.

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

Government-wide Financial Statements

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

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

Fund Financial Statements

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

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Fund balances are classified as follows:

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

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

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

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

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

The Agency has only assigned and unassigned fund balances.

(8) ***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 Agency's basic financial statements.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

(9) ***Risk Management*** - The Agency is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; 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.

NOTE C - EXPLANATION OF DIFFERENCES BETWEEN THE GOVERNMENTAL FUND BALANCE SHEET AND STATEMENT OF NET ASSETS

"Total fund balance" of the Agency's general fund of $6,936,663 differs from the "net assets" of governmental activities of $6,676,558 reported in the statement of net assets. This difference primarily results from the long-term economic focus of the statement of net assets and the current financial resources focus of the governmental fund balance sheet.

(1) Capital-related items. When furniture and equipment that are to be used in governmental activities are purchased, the costs of those activities are reported as expenditures in governmental funds. However, the statement of net assets includes those capital assets among the assets of the Agency as a whole.

	Amount
Cost of equipment	$ 85,742
Less accumulated depreciation	54,754
	$ 30,988

(2) Long-term liabilities. Long-term liabilities applicable to the Agency's governmental activities are not due and payable in the current period and accordingly are not reported as fund liabilities. All liabilities (both current and long-term) are reported in the statement of net assets. The balance of compensated absences payable at June 30, 2012, was $291,093.

NOTE D - EXPLANATION OF DIFFERENCES BETWEEN THE GOVERNMENTAL FUND OPERATING STATEMENT AND THE STATEMENT OF ACTIVITIES

The "net change in fund balance" for the governmental fund of $308,837 differs from the "change in net assets" for governmental activities of $329,968 reported in the statement of activities. The differences arise primarily from the long-term economic focus of the statement of activities and the current financial resources focus of the governmental funds.

NOTE D - EXPLANATION OF DIFFERENCES BETWEEN THE GOVERNMENTAL FUND OPERATING STATEMENT AND THE STATEMENT OF ACTIVITIES (Continued)

(1) Capital-related items. When capital assets that are to be used in governmental activities are purchased, the resources expended for those assets are reported as expenditures in the governmental fund. However, in the statement of activities, the costs of those assets are allocated over their estimated useful lives and reported as depreciation expense. As a result, fund balance decreases by the amount of financial resources expended, whereas, net assets decreased by the amount of depreciation expense charged for the fiscal year. As of June 30, 2012, the Agency had $30,988 invested in capital assets. There was a net decrease of $7,047 from the end of the prior fiscal year. During the fiscal year, there were no capital outlays that met the requirements to be capitalized.

(2) Long-term liability transactions. Some expenses reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental fund. For the Agency, this difference is due to a net adjustment resulting from a net change in compensated absences of $(28,178).

NOTE E - 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 Schedule - General Fund are derived primarily from acts of the State Legislature and from other authorizations contained in other specific appropriation acts in various Session Laws of Hawaii.

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

For purposes of budgeting, the Agency's budgetary fund structure and accounting principles differ from those utilized to present the general fund financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP). The Agency's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to the encumbrance of purchase orders and contract obligations. These differences represent departures from GAAP. The differences between the budgetary amounts and the amounts presented in accordance with GAAP for the fiscal year ended June 30, 2012, are further explained in the Budgetary Reconciliation - General Fund.

NOTE F - CASH AND CASH EQUIVALENTS

Substantially all of the Agency's cash is 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 interest rate risk, credit risk, custodial credit risk, and concentration of credit risk is available on a statewide basis and not for individual departments or agencies. Cash and deposits with financial institutions are collateralized in accordance with State statutes.

The Agency was informed by the State Department of Accounting and General Services that State agencies participating in the State Treasury Investment Pool that the State's investments in auction rate securities had a recovery of value for the fiscal year ended June 30, 2012 and that each participating State agency would be allocated a portion of the recovery to offset prior fiscal year's impairment loss. The Agency's allocated recovery for the fiscal year ended June 30, 2012, totaled $14,211.

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 Credit Risk

For an investment, custodial credit 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. The State also requires the institutions to set aside in safekeeping, certain types of securities to collateralize repurchase agreements. The State monitors the market value of these securities and obtains additional collateral when appropriate.

NOTE F - CASH AND CASH EQUIVALENTS (Continued)

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.

Cash in Bank

The Agency also maintains cash in banks which are held separately from cash in the State Treasury. As of June 30, 2012, the carrying amount of total bank balance was approximately $1,300, which is insured by the Federal Deposit Insurance Corporation.

NOTE G - CAPITAL ASSETS

The changes in capital assets were as follows:

	Balance July 1, 2011	Additions	Deductions	Balance June 30, 2012
Governmental activities:				
Equipment and furniture at cost	$ 85,742	$ --	$ --	$ 85,742
Less accumulated depreciation	47,707	7,047	--	54,754
Governmental activities capital assets, net	$ 38,035	$ (7,047)	$ --	$ 30,988

NOTE H - LONG-TERM LIABILITIES

The only long-term liability for governmental activities is for compensated absences. Long-term liability activity during the fiscal year ended June 30, 2012, was as follows:

	Amount
Balance at July 1, 2011	$ 319,271
Additions	180,329
Reductions	(208,507)
Balance at June 30, 2012	$ 291,093

The amount of governmental activities compensated absences liability due within one year is $81,076. The compensated absences liability has been paid primarily by the general fund in the past.

NOTE I - NON-IMPOSED EMPLOYEE FRINGE BENEFITS

Payroll fringe benefit costs of the Agency's employees funded by state appropriations (general fund) are assumed by the State and are not charged to the Agency's operating funds. These costs, totaling approximately $709,000 for the fiscal year ended June 30, 2012, have been reported as revenues and expenditures of the Agency's general fund.

NOTE J - RETIREMENT BENEFITS

Employees' Retirement System

All eligible employees of the Agency 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.

Prior to June 30, 1984, the plan consisted of only a contributory plan. In 1984, legislation was enacted to add a new noncontributory plan for members of the ERS who are also covered under Social Security. Police officers, firefighters, judges, elected officials, and persons employed in positions not covered by Social Security are precluded from the noncontributory plan. The noncontributory plan provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory plan or to elect the new noncontributory plan and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory plans, respectively.

Both plans provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date is based on the three highest paid years of service excluding the vacation payment.

On July 1, 2006, a new hybrid contributory plan became effective pursuant to Act 179, SLH of 2004. Members in the hybrid plan are eligible for retirement at age 62 with 5 years of credited service or age 55 and 30 years of credited service. Members receive a benefit multiplier of 2% for each year of credited service in the hybrid plan. All members of the noncontributory plan and certain members of the contributory plan are eligible to join the new hybrid plan. Most of the new employees hired from July 1, 2006, are required to join the hybrid plan.

NOTE J - RETIREMENT BENEFITS (Continued)

Most covered employees of the contributory option are required to contribute 7.8% of their salary. Police officers, firefighters, investigators of the departments of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2% of their salary. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Effective July 1, 2005, employer contribution rates are a fixed percentage of compensation, including the normal cost plus amounts required to pay for the unfunded actuarial accrued liability.

Pension benefit contributions by the State on behalf of the Agency for the fiscal years ended June 30, 2012, 2011, and 2010, were approximately $293,000, $381,000, and $311,000, respectively, at the rate of 15.00% each year.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State of Hawaii Employer-Union Health Benefits Trust Fund (EUTF), an agent multiple-employer plan provides certain health care (medical, prescription, vision and dental) and life insurance benefits for retired State employees. Act 88 established the EUTF during the 2001 legislative session and is codified in HRS 87A. Contributions are based on negotiated collective bargaining agreements and are limited by State statute to the actual cost of benefit coverage. The Agency's share of the expense for post-retirement health care and life insurance benefits for the fiscal year ended June 30, 2012, was approximately $155,000.

For employees hired before July 1, 1996, the State pays 100% of the monthly health care premium for employees retiring with 10 or more years of credited service, and 50% of the monthly premium for employees retiring with fewer than 10 years of credited service.

For employees hired after June 30, 1996 but before July 1, 2001, and who retire with less than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75% of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100% of the base monthly contribution. Retirees in this category can elect a family plan to cover dependents.

For employees hired on or after July 1, 2001, and who retire with less than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75% of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100% of the base monthly contribution. Only single plan coverage is provided for retirees in this category. Retirees can elect family coverage but must pay the difference.

NOTE J - RETIREMENT BENEFITS (Continued)

The State is required to contribute the annual required contribution (ARC) of the employer, an amount that is actuarially determined. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

Measurement of the actuarial valuation and the ARC are made for the State as a whole and are not separately computed for the individual state departments and agencies. The State has only computed the allocation of the other postemployment benefit (OPEB) costs to component units and proprietary funds that are reported separately in the State's Comprehensive Annual Financial Report (CAFR). Therefore, the OPEB costs for the Agency were not available and are not included in the financial statements. The State's CAFR includes the note disclosures and required supplementary information on the State's OPEB plans.

The EUTF issues a stand-alone financial report that includes financial statements and required supplementary information, which may be obtained at the following address: State of Hawaii Employer-Union Health Benefits Trust Fund, 201 Merchant Street, Suite 1520, Honolulu, Hawaii 96813.

NOTE K - RISK MANAGEMENT

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

Property Insurance

The State has an insurance policy with a variety of insurers in a variety of layers for property coverage. The deductible for coverage is 3% of loss subject to a $1 million per occurrence minimum. This policy includes windstorm, earthquake, flood damage, terrorism and boiler and machinery coverage. The limit of loss per occurrence is $225 million, except for flood and earthquake, which individually is $225 million aggregate loss and terrorism, which is $50 million per occurrence and a $25,000 deductible.

The State also has a crime insurance policy for various types of coverages with a limit of loss of $10 million per occurrence with a $500,000 deductible per occurrence, except for claims expense coverage which has a $100,000 per occurrence and a $1,000 deductible. Losses not covered by insurance are paid from legislative appropriations of the State's General Fund.

NOTE K - RISK MANAGEMENT (Continued)

General Liability (including torts)

Claims under $10,000 are handled by the risk management office of the Department of Accounting and General Services. All other claims are handled by the Department of the Attorney General. The State has personal injury and property damage liability, including automobile and public errors and omissions, insurance policy in force with a $4 million self-insured retention per occurrence. The annual aggregate per occurrence is $15 million, and for crime loss, $10 million with no aggregate limit.

Losses under the deductible amount or over the aggregate limit are paid from legislative appropriations of the State's General Fund.

Self-Insured Risks

The State generally self-insures its automobile no-fault and workers' compensation losses. Automobile losses are administered by third-party administrators. The State administers its workers' compensation losses. The State records a liability for risk financing and insurance-related losses, including incurred but not reported, if it is determined that a loss has been incurred and the amount can be reasonably estimated.

At June 30, 2012, the State recorded an estimated loss for workers' compensation, automobile and general liability claims as long-term debt as the losses will not be liquidated with currently expendable available financial resources. The estimated losses will be paid from legislative appropriations of the State's General Fund. The Agency's portion of the State's workers' compensation expense for the fiscal year ended June 30, 2012, was approximately $24,000.

NOTE L - COMMITMENTS AND CONTINGENCIES

Encumbrances

Encumbrances totaled approximately $5,463,000 as of June 30, 2012.

Accumulated Sick Leave

Employees earn sick leave credits at the rate of 14 hours for each month of service without limit. Sick leave can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2012, amounted to approximately $905,000.

NOTE L - COMMITMENTS AND CONTINGENCIES (Continued)

Litigation

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

Lease Commitments

The Agency leases office equipment under noncancelable operating leases expiring in March 2017. Total equipment rental expenditures for the fiscal year ended June 30, 2012 amounted to approximately $18,000. Future lease commitments for the operating leases are approximated as follows:

Fiscal Year Ending June 30,	Amount
2013	$ 12,600
2014	12,600
2015	12,600
2016	12,600
2017	9,400
Total	$ 59,800

PART II

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

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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 State Auditor
Office of the Auditor
State of Hawaii

We have audited the financial statements of the governmental activities and the general fund of the Office of the Auditor of the State of Hawaii (Agency) as of and for the fiscal year ended June 30, 2012, and have issued our report thereon dated July 1, 2013. 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 Agency's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Agency's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Agency's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Agency'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 the management of the Agency, and is not intended to be and should not be used by anyone other than this specified party.

N&K CPAs, Inc.

Honolulu, Hawaii
July 1, 2013