

**FINANCIAL AUDIT OF
OFFICE OF THE AUDITOR
STATE OF HAWAII**

**FOR THE
FISCAL YEAR ENDED JUNE 30, 2014
(With Independent Auditors' Reports)**

**OFFICE OF THE AUDITOR
STATE OF HAWAII**

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INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENTS

To the State Auditor
Office of the Auditor
State of Hawaii

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities and the general fund of the Office of the Auditor of the State of Hawaii (Agency) as of and for the year ended June 30, 2014, and the related notes to the financial statements, which comprise the Agency's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the general fund of the Agency as of June 30, 2014 and the respective changes in financial position thereof and the respective budgetary comparison for the general fund for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1, 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 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, 2014 and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 7 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 Standard Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated October 5, 2015, on our consideration of the Agency'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 the 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* in considering the Agency's internal control over financial reporting and compliance.

Choo, Osuda & Lu, CPAs, Inc.

Honolulu, Hawaii
October 5, 2015

**OFFICE OF THE AUDITOR
STATE OF HAWAII
MANAGEMENT'S DISCUSSION AND ANALYSIS
FISCAL YEAR ENDED JUNE 30, 2014**

This Management's Discussion and Analysis provides an overview of the financial activities of the Office of the Auditor of the State of Hawaii ("Agency") for the fiscal year ended June 30, 2014. Readers should consider the information presented here in conjunction with the basic financial statements as a whole.

Overview of the Basic Financial Statements

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

Government-Wide Financial Statements

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

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

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

The Statement of Net Position, and the Statement of Activities can be found in the Statement of Net Position and Governmental Fund Balance Sheet, and in the Statement of Activities and Governmental Fund Revenues, Expenditures and Changes in Fund Balance, respectively, which immediately follow this discussion and analysis.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Agency's funds are comprised solely of governmental funds.

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

Because the focus of governmental funds is narrower than that of government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities of the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Agency's near-term financing decisions. Both the Statement of Net Position and Governmental Fund Balance Sheet, and the Statement of Activities and Governmental Fund Revenues, Expenditures and Changes in Fund Balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
MANAGEMENT'S DISCUSSION AND ANALYSIS - continued
FISCAL YEAR ENDED JUNE 30, 2014**

The Agency maintains a single governmental fund, its General Fund.

The basic governmental fund financial statements can be found in the Statement of Net Position and Governmental Fund Balance Sheet, and in the Statement of Activities and Governmental Fund Revenues, Expenditures and Changes in Fund Balance, respectively, which immediately follow this discussion and analysis.

Notes to the Basic Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the governmental-wide and fund financial statements. The notes can be found immediately following the basic financial statements.

Condensed Financial Information

The following are summaries from the Agency's government-wide financial statements as of and for the fiscal years ended June 30, 2014 and 2013.

**Table 1
Condensed Summary of Net Position**

	<u>2014</u>	<u>2013</u>
Assets:		
Current assets	\$ 7,393,945	\$ 7,141,949
Capital assets	<u>68,347</u>	<u>32,055</u>
Total assets	<u>\$ 7,462,292</u>	<u>\$ 7,174,004</u>
Liabilities:		
Current liabilities and other liabilities	\$ 313,572	\$ 283,620
Long-term liabilities	<u>212,655</u>	<u>197,751</u>
Total liabilities	<u>526,227</u>	<u>481,371</u>
Net position:		
Invested in capital assets	68,347	32,055
Unrestricted	<u>6,867,718</u>	<u>6,660,578</u>
Total net position	<u>\$ 6,936,065</u>	<u>\$ 6,692,633</u>

**OFFICE OF THE AUDITOR
STATE OF HAWAII
MANAGEMENT'S DISCUSSION AND ANALYSIS - continued
FISCAL YEAR ENDED JUNE 30, 2014**

**Table 2
Condensed Summary of Revenues, Expenses, and Changes in Net Position**

	Governmental Activities	
	2014	2013
General revenues		
State appropriations, net of lapsed amounts	\$ 5,022,182	\$ 4,580,214
State-provided payroll fringe benefits	898,671	731,441
Interest	21,205	49,571
Reimbursements	2,678,165	2,883,571
Total general revenues	<u>8,620,223</u>	<u>8,244,797</u>
Expenses		
Current		
Personal services	3,127,865	2,667,146
Contractual services	5,110,722	5,421,496
Depreciation	14,255	13,298
Dues and subscriptions	29,205	29,023
Equipment rental and maintenance	16,543	18,817
Office supplies and postage	7,422	9,789
Printing	3,313	8,664
Telephone	16,443	15,193
Training	7,003	(275)
Travel and subsistence, in-state	4,402	1,022
Travel and subsistence, out-of-state	25,493	37,158
Other	2,309	4,483
Capital outlays		
Equipment and furniture	11,816	2,908
Total expenses	<u>8,376,791</u>	<u>8,228,722</u>
Change in net position	243,432	16,075
Beginning net position	<u>6,692,633</u>	<u>6,676,558</u>
Ending net position	<u>\$ 6,936,065</u>	<u>\$ 6,692,633</u>

**OFFICE OF THE AUDITOR
STATE OF HAWAII
MANAGEMENT'S DISCUSSION AND ANALYSIS - continued
FISCAL YEAR ENDED JUNE 30, 2014**

Analysis of Overall Financial Position and Results of Operations

Overall Financial Position

Assets of the Agency exceeded its liabilities by \$6,936,065 as of June 30, 2014.

The surplus in total government-wide net position increased by \$243,432, or 3.64 percent over the prior fiscal year.

Results of Operations

State appropriations, net of lapsed amounts, totaled \$5,022,182, an increase of \$441,968 or 9.65 percent over the prior fiscal year. The increase was due to the decrease in amounts lapsed.

State-provided payroll fringe benefits, totaled \$898,671, an increase of \$167,230 or 22.86 percent over the prior fiscal year. The increase was due to increased personal service expense over the prior fiscal year.

Total expenses amounted to \$8,376,791, an increase of \$148,069 or 1.80 percent over the prior fiscal year. Items contributing to the increase included an increase in personal services and the related fringe benefits.

Analysis of Agency's Individual Funds

Governmental Funds

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

At the end of the fiscal year, the Agency's governmental fund (general fund) reported an ending fund balance of \$7,202,145, an increase of \$249,202 or 3.58 percent from the prior fiscal year. The entire fund balance was unassigned or assigned.

General Fund Budget

The fiscal year budget for the Agency's General Fund remained the same from the original to the final budget.

Actual personal services on a budgetary basis were less than the budgeted amount by \$190,572 or 8.13 percent. The difference was primarily attributable to vacant staff positions.

Contractual services on a budgetary basis were less than the budgeted amount by \$1,425,074 or 21.94 percent. The difference was primarily attributable to decreases in consultant contracts.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
MANAGEMENT'S DISCUSSION AND ANALYSIS - continued
FISCAL YEAR ENDED JUNE 30, 2014**

Capital Assets and Long-Term Debt

At June 30, 2014, the Agency had capital assets, net of accumulated depreciation, of \$68,347. There was an increase in capital assets (additions, deductions, and depreciation) of \$36,292 or 113.22 percent from the prior fiscal year. Further details can be found in Note 7 to the basic financial statements.

At June 30, 2014, the Agency had long-term liabilities of \$212,655, consisting of the liabilities for employees' compensated absences due after one year. There was an increase of \$14,904 or 7.54 percent from the prior fiscal year. Further details can be found in Note 8 to the basic financial statements.

Currently Known Facts and Conditions

The 2014 State Legislature provided the Agency a flat budget for fiscal year 2014-2015. No other events or factors that may impact future periods are anticipated at this time.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
STATEMENT OF NET POSITION AND GOVERNMENTAL FUND BALANCE SHEET
JUNE 30, 2014**

	<u>General Fund</u>	<u>Adjustments (Note 3)</u>	<u>Statement of Net Position</u>
ASSETS			
Cash and cash equivalents	\$ 7,393,945	\$ -	\$ 7,393,945
Capital assets			
Depreciable, net of accumulated depreciation of \$82,307	<u>-</u>	<u>68,347</u>	<u>68,347</u>
Total assets	<u>\$ 7,393,945</u>	<u>\$ 68,347</u>	<u>\$ 7,462,292</u>
LIABILITIES			
Contracts payable	\$ 15,600	\$ -	\$ 15,600
Accrued wages and employee benefits payable	174,200	-	174,200
Due to State of Hawaii	2,000	-	2,000
Compensated absences			
Due within one year	-	121,772	121,772
Due after one year	-	212,655	212,655
Total liabilities	<u>191,800</u>	<u>334,427</u>	<u>526,227</u>
FUND BALANCE/NET POSITION			
Fund balance			
Assigned	5,115,391	(5,115,391)	-
Unassigned	<u>2,086,754</u>	<u>(2,086,754)</u>	<u>-</u>
Total fund balance	<u>7,202,145</u>	<u>(7,202,145)</u>	<u>-</u>
Total liabilities and fund balance	<u>\$ 7,393,945</u>		
Net position			
Invested in capital assets		68,347	68,347
Unrestricted		<u>6,867,718</u>	<u>6,867,718</u>
Total net position		<u>\$ 6,936,065</u>	<u>\$ 6,936,065</u>

See accompanying notes.

**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, 2014**

	<u>General Fund</u>	<u>Adjustments (Note 4)</u>	<u>Statement of Activities</u>
General revenues			
State appropriations, net of lapsed amount of \$577,795	\$ 5,022,182	\$ -	\$ 5,022,182
State-provided payroll fringe benefits	898,671	-	898,671
Net investment gain	21,205	-	21,205
Reimbursements	2,678,165	-	2,678,165
Total general revenues	<u>8,620,223</u>	<u>-</u>	<u>8,620,223</u>
Expenditures/expenses			
Audit services			
Current			
Personal services	3,085,803	42,062	3,127,865
Contractual services	5,110,722	-	5,110,722
Depreciation	-	14,255	14,255
Dues and subscriptions	29,205	-	29,205
Equipment rental and maintenance	16,543	-	16,543
Office supplies and postage	7,422	-	7,422
Printing	3,313	-	3,313
Telephone	16,443	-	16,443
Training	7,003	-	7,003
Travel and subsistence, in-state	4,402	-	4,402
Travel and subsistence, out-of-state	25,493	-	25,493
Other	2,309	-	2,309
Capital outlays			
Equipment and furniture	62,363	(50,547)	11,816
Total expenditures/expenses	<u>8,371,021</u>	<u>5,770</u>	<u>8,376,791</u>
Excess of revenues over expenditures	<u>249,202</u>	<u>(5,770)</u>	<u>243,432</u>
Net change in fund balance	249,202	(249,202)	-
Change in net position	-	243,432	243,432
Fund balances/net position			
Beginning of the fiscal year	6,952,943	(260,310)	6,692,633
End of the fiscal year	<u>\$ 7,202,145</u>	<u>\$ (266,080)</u>	<u>\$ 6,936,065</u>

See accompanying notes.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
BUDGETARY COMPARISON SCHEDULE - GENERAL FUND
FISCAL YEAR ENDED JUNE 30, 2014**

	Final	Actual on Budgetary Basis	Variance
Budgetary Balance at July 1, 2013	\$ 2,588,846	\$ 2,588,846	\$ -
Resources (inflows)			
State appropriations	5,599,977	5,599,977	-
Reimbursements	860,326	2,678,165	(1,817,839)
Net investment gain	-	21,205	(21,205)
Amounts available	<u>9,049,149</u>	<u>10,888,193</u>	<u>(1,839,044)</u>
Charges to appropriations (outflows)			
Current			
Personal services	2,344,149	2,153,577	190,572
Contractual services	6,494,916	5,069,842	1,425,074
Equipment rental and maintenance	20,000	15,504	4,496
Office supplies and postage	45,500	44,180	1,320
Printing	7,000	3,313	3,687
Training	12,000	6,828	5,172
Travel and subsistence, in-state	4,800	4,402	398
Travel and subsistence, out-of-state	42,000	30,891	11,109
Other	2,000	2,309	(309)
Capital outlays			
Equipment, furniture and books	76,784	60,866	15,918
	<u>9,049,149</u>	<u>7,391,712</u>	<u>1,657,437</u>
Lapsed appropriations	<u>-</u>	<u>480,217</u>	<u>(480,217)</u>
Budgetary Balance at June 30, 2014	<u><u>\$ -</u></u>	<u><u>\$ 3,016,264</u></u>	<u><u>\$ (3,016,264)</u></u>

See accompanying notes.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
BUDGETARY RECONCILIATION - GENERAL FUND
FISCAL YEAR ENDED JUNE 30, 2014**

Sources/inflows of resources

Actual amounts (budgetary basis) available	\$ 10,888,193
Differences between budgetary basis and GAAP basis	
Lapsed appropriations	(577,795)
On-behalf fringe benefits	898,671
Audit Revolving Fund beginning balance	<u>(2,588,846)</u>
Total revenues per governmental fund financial statement	<u><u>\$ 8,620,223</u></u>

Uses/outflows of resources

Actual amounts (budgetary basis) charged to appropriations	\$ 7,391,712
Differences between budgetary basis and GAAP basis	
Reserved for encumbrances	(5,115,391)
Payment of prior year expenditures	5,017,229
Expenditures paid with future appropriations	178,800
On-behalf fringe benefits	<u>898,671</u>
Total expenditures per governmental fund financial statement	<u><u>\$ 8,371,021</u></u>

See accompanying notes.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS
JUNE 30, 2014**

NOTE 1 - 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 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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 Funds Types

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

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

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued

Measurement Focus and Basis of Accounting

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

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

Governmental fund financial statements - Governmental fund financial statements are reported using the current financial resources 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 Position and Governmental Fund Balance Sheet
- Statement of Activities and Governmental Fund Revenues, Expenditures and Changes in Fund Balance
- Budgetary Comparison Schedule – General Fund
- Budgetary Reconciliation – General Fund
- Notes to the Basic Financial Statements

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued

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.

Appropriations

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

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 position.

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.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued

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.

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.

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.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

**NOTE 3 - EXPLANATION OF DIFFERENCES BETWEEN THE GOVERNMENTAL FUND
BALANCE SHEET AND STATEMENT OF NET POSITION**

"Total fund balance" of the Agency's general fund of \$7,202,145 differs from the "net position" of governmental activities of \$6,936,065 reported in the statement of net position. This difference primarily results from the long-term economic focus of the statement of net position and the current financial resources focus of the governmental fund balance sheet.

Capital-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 position includes those capital assets among the assets of the Agency as a whole.

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 position. The balance of compensated absences payable at June 30, 2014, was \$334,427.

**NOTE 4 - 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 \$249,202 differs from the "change in net position" for governmental activities of \$243,432 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.

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 position decreased by the amount of depreciation expense charged for the fiscal year. As of June 30, 2014, the Agency had \$68,347 invested in capital assets. There was a net increase of \$36,292 from the end of the prior fiscal year in capital assets.

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 \$42,062.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 5 - BUDGETING AND BUDGETARY CONTROL

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues and budgeted expenditures in the 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, 2014, are further explained in the Budgetary Reconciliation - General Fund.

NOTE 6 - 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, which in the State Director of Finance's judgment, are 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.

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.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 6 - CASH AND CASH EQUIVALENTS - continued

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.

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, 2014, the carrying amount of total bank balance was approximately \$2,000, which is insured by the Federal Deposit Insurance Corporation.

NOTE 7 - CAPITAL ASSETS

The changes in capital assets were as follows:

	Balance July 1, 2013	Increases	Decreases	Balance June 30, 2014
Governmental activities				
Equipment and furniture, at cost	\$ 100,107	\$ 50,547	\$ -	\$ 150,654
Less accumulated depreciation	68,052	14,255	-	82,307
Governmental activities capital assets, net	<u>\$ 32,055</u>	<u>\$ 36,292</u>	<u>\$ -</u>	<u>\$ 68,347</u>

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 8 - 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, 2014, was as follows:

Balance at June 30, 2013	\$ 292,365
Additions	179,945
Reductions	<u>(137,883)</u>
Balance at June 30, 2014	<u>\$ 334,427</u>
Due within one year	<u>\$ 121,772</u>

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

NOTE 9 - NON-IMPOSED EMPLOYEE FRINGE BENEFITS

Payroll fringe benefit costs of the Agency's employees funded by state appropriations (general fund) are assumed by the State and are not charged to the Agency's operating funds. These costs, totaling approximately \$899,000 for the fiscal year ended June 30, 2014, have been reported as revenues and expenditures of the Agency's general fund.

NOTE 10 - 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 is governed by a Board of Trustees. All contributions, benefits and eligibility requirements are established by HRS Chapter 88 and can be amended by legislative action. 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 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813, or through the ERS's website: ers.hawaii.gov.

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.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 10 - RETIREMENT BENEFITS - continued

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 with 30 years of credited service. Members 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 noncontributory plan and certain members of the contributory plan were eligible to join the new hybrid plan. Most of the new employees hired from July 1, 2006 were required to join the hybrid plan.

Effective July 1, 2012, the hybrid contributory plan was revised by Act 163, SLH of 2011. Members joining the hybrid plan on or after that date are eligible for retirement at age 65 with 10 years of credited service or age 60 with 30 years of credited service. Members will receive a benefit multiplier of 1.75% for each year of credited service in the hybrid plan. The benefit options remain similar to the current contributory plan.

Covered employees of the contributory plan who became members on or before June 30, 2012 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. Covered employees of the hybrid plan who became members on or before June 30, 2012 are required to contribute 6% 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 paid by the State on behalf of the Agency for the fiscal years ended June 30, 2014, 2013, and 2012, were approximately \$355,000, \$286,000, and \$293,000, respectively, at the rate of 16.50%, 15.50% and 15.00% of compensation, respectively.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 10 - RETIREMENT BENEFITS - continued

Post-Retirement Health Care and Life Insurance Benefits

The State provides certain health care and life insurance benefits to all qualified employees. Pursuant to Act 88, SLH of 2001, the State contributes to the Hawaii Employer-Union Health Benefits Trust Fund (EUTF), an agent multiple-employer defined benefit plan that replaced the Hawaii Public Employees Health Fund effective July 1, 2003. The EUTF was established to provide a single delivery system of health benefits for state and county workers, retirees and their dependents. The EUTF issues an annual financial report that is available to the public. That report may be obtained by writing to the EUTF at P.O. Box 2121, Honolulu, Hawaii 96805-2121.

For employees hired before July 1, 1996, the State pays 100% of the base monthly contribution for employees retiring with 10 years or more of credited service, and 50% of the base monthly contribution for employees retiring with fewer than 10 years of credited service. Retirees in this category can elect a family plan to cover dependents.

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.

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.

Post-retirement health care and life insurance benefits paid by the State on behalf of the Agency for the fiscal years ended June 30, 2014, 2013 and 2012 were approximately \$223,000, \$191,000 and \$155,000, respectively.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 11 - 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 \$200 million, except for earthquake, which individually has a \$100 million loss, and terrorism, which is \$50 million per occurrence and a \$10,000 deductible.

Crime Insurance

The State also has a crime insurance policy for various types of coverages with a limit of loss of \$10 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.

General Liability (including torts)

Liability claims under \$10,000 and automobile claims under \$15,000 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 limit 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 below \$15,000 are administered by the risk management office of the Department of Accounting and General Services. 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.

**OFFICE OF THE AUDITOR
STATE OF HAWAII
NOTES TO THE BASIC FINANCIAL STATEMENTS - continued
JUNE 30, 2014**

NOTE 11 - RISK MANAGEMENT - continued

Reserve for Losses

At June 30, 2014, 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, 2014, was approximately \$19,000.

NOTE 12 - COMMITMENTS AND CONTINGENCIES

Encumbrances

Encumbrances totaled approximately \$5,115,000 as of June 30, 2014.

Accumulated Sick Leave

Employees earn sick leave credits at the rate of one and three-quarters working days for each month of service without limit. Sick leave can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS. Accumulated sick leave as of June 30, 2014, amounted to approximately \$981,000.

Litigation

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

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, 2014 amounted to approximately \$16,000. Future lease commitments for the operating leases are approximated as follows:

Fiscal Year Ending June 30,	
2015	\$ 12,600
2016	12,600
2017	<u>9,400</u>
	<u>\$ 34,600</u>

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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
Office of the Auditor
State of Hawaii

We have audited, 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, the financial statements of the governmental activities and general fund of the Office of the Auditor of the State of Hawaii (Agency), as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Agency's basic financial statements, and have issued our report thereon dated October 5, 2015.

Internal Control over Financial Reporting

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

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

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Agency's financial statements are free 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 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*.

Purpose of this Report

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

Choo, Osada & Lee, CPAs, Inc.

Honolulu, Hawaii
October 5, 2015