Financial Examination of the Department of Budget and Finance

Report No. 10-03
March 2010

Background

State Constitution – Article VII, Section 10:

"It shall be the duty of the auditor to conduct post-audits of the transactions, accounts, programs and performance of all departments, offices and agencies of the State and its political subdivisions, to certify to the accuracy of all financial statements issued by the respective accounting officers and to report the auditor's findings and recommendations to the governor and to the legislature …"

(emphasis added)

Background (continued)

- Gubernatorial vetoes 2002, 2003
- Audit Revolving Fund (Act 4/SSLH 2003)
- Legislative budget bill (Act 1 of each session appropriates general fund portion of audit costs)
- FY2005 audits – 9 contracts: CAFR, DOE, DOH, DHS, DOT (approx. $2.5 million annually)
- FY2008 audits – 29 contracts: all depts except UH, HHSC, HHRF (approx. $5.5 million annually)

Background (continued)

FY2007 CAFR audited by Deloitte & Touche (administered by Office of the Auditor):

- Noted failure of SLARS auctions in early 2008
- SLARS held by State were classified as long-term (> 5 year maturities)
- For FY2008 CAFR, B&F resistance to writedown; Deloitte & Touche insistence
- Material weakness and $114 million writedown

HAWAII

COMPREHENSIVE ANNUAL FINANCIAL REPORT

FOR THE FISCAL YEAR
ENDED JUNE 30, 2008

RUSS K. SAITO
COMPTROLLER

Prepared by Accounting Division
Department of Accounting and General Services

Independent Audit Contracted and Administered by
Office of the State Auditor

Deloitte.

Deloitte & Touche LLP
1132 Bishop St
Ste. 1200
Honolulu, HI 96813-2870
USA

Tel: +1 808 543 0700
Fax: +1 808 526 0225
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

The Auditor
State of Hawaii:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Hawaii as of and for the year ended June 30, 2008, which collectively comprise the State of Hawaii's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of Hawaii's management. Our responsibility is to express an opinion on the respective financial statements based on our audit. We did not audit the financial statements of the Department of Transportation – Airports and Harbors Divisions, which are major enterprise funds, the Water Pollution Control Revolving Fund, the Drinking Water Treatment Revolving Loan Fund, and the Employer-Union Health Benefits Trust Fund, which are nonmajor enterprise funds, and the University of Hawaii, the Hawaii Housing Finance and Development Corporation, the Hawaii Public Housing Authority, the Hawaii Tourism Authority, the Hawaii Hurricane Relief Fund, and the Hawaii Community Development Authority, which are discretely presented component units. These financial statements reflect the following percentages of total assets and program revenues or additions for the indicated opinion units:

Opinion Unit	Percent of Opinion Unit's Total Assets	Percent of Opinion Unit's Total Program Revenues / Additions
Governmental Activities	0%	0%
Business-Type Activities	87%	84%
Aggregate Discretely Presented Component Units	91%	69%
Fiduciary Funds	34%	100%

Those financial statements listed above were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for the Department of Transportation – Airports and Harbors Divisions, the Water Pollution Control Revolving Fund, the Drinking Water Treatment Revolving Loan Fund, the Employer-Union Health Benefits Trust Fund, the University of Hawaii, the Hawaii Housing Finance and Development Corporation, the Hawaii Public Housing Authority, the Hawaii Tourism Authority (which contains a qualification as to the amounts due to the State of Hawaii, the effect of which, in our opinion, is not material in relation to the basic financial statements), the Hawaii Hurricane Relief Fund, and the Hawaii Community Development Authority, is based solely on the reports of the other auditors. The reports on the Employer-Union Health Benefits Trust Fund, and the Hawaii Community Development Authority contain an explanatory paragraph relating to the restatement of the fiscal year 2007 financial statements. The reports on the Department of Transportation – Airports Division, the University of Hawaii, and the Hawaii Tourism Authority contain an explanatory paragraph relating to the adoption of Government Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the respective basic financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the State of Hawaii's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, 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 and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the reports of other auditors, the basic financial statements referred to above present fairly, in all material respects, the respective net assets or financial position of the governmental activities, business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Hawaii, as of June 30, 2008, and the respective changes in financial position (and respective cash flows where applicable), thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis, on pages 16 to 32, as well as the Schedules of Revenue and Expenditures – Budget and Actual (Budgetary Basis) and Schedules of Funding Progress for the Employer-Union Health Benefits Trust Fund and the Hawaii State Teachers Association Voluntary Employees Beneficiary Association Trust, on pages 120 to 125, are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the State of Hawaii's management. We and other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the respective basic financial statements that collectively comprise the State of Hawaii's basic financial statements. The introductory section, combining and individual fund statements and schedules, and the statistical section, are presented for purposes of additional analysis and are not a required part of the basic financial statements. This supplementary information is the responsibility of the State of Hawaii's management. The combining and individual fund statements and schedules have been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections have not been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements, and accordingly, we express no opinion on them.

As discussed in Note 11 to the financial statements, the State of Hawaii adopted the provisions of Government Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, on July 1, 2007.

As discussed in Note 15 to the financial statements, net assets and fund balance at June 30, 2007 have been restated.

Deloitte + Touche LLP

May 22, 2009

evaluating the impact that GASB 54 will have on its financial statements.

GASB Statement No. 55 — The GASB issued Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments* (GASB 55), effective upon issuance in March 2009. This Statement incorporates the hierarchy of generally accepted accounting principles (GAAP) for state and local governments into the GASB's authoritative literature. The "GAAP hierarchy" consists of the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP, and the framework for selecting those principles. The State believes that this Statement will make it easier to identify and apply all relevant guidance when preparing future financial statements.

GASB Statement No. 56 — The GASB issued Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* (GASB 56), effective upon issuance in March 2009. This Statement incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statement on Auditing Standards. The three issues not included in the authoritative literature that establishes accounting principles are: related party transactions, going concern considerations, and subsequent events. The GASB believes that presentation of principles used in the preparation of financial statements is more appropriately included in accounting and financial reporting standards rather than in the auditing literature. The State believes that the Statement will improve financial reporting by bringing the authoritative accounting and financial reporting literature together in one place.

2. CASH AND INVESTMENTS

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

Cash — The State maintains approximately 20 bank accounts for various purposes at locations throughout the State and the nation. Bank deposits are under the custody of the Director of Finance. For financial statement reporting purposes, cash and cash equivalents consist of cash, time certificates of deposit, and money market accounts. Cash and cash equivalents also include repurchase agreements and U.S. government securities with original maturities of three months or less.

The carrying amount of the State's unrestricted and restricted deposits (cash, time certificates of deposit, and money market accounts) as of June 30, 2008, was $2,212,455,000 and $423,420,000, respectively, for the Primary Government and $199,703,000 for the Fiduciary Funds.

Information relating to the bank balance, insurance, and collateral of cash deposits is determined on a statewide basis and not for individual departments or divisions. Total bank balances of deposits for the

Primary Government and Fiduciary Funds amounted to $1,827,069,000 at June 30, 2008. Of that amount, $1,826,709,000 represents bank balances covered by federal deposit insurance or by collateral held either by the State Treasury or by the State's fiscal agents in the name of the State. Bank balances of $527,459,000 represents deposits with the U.S. Department of the Treasury for the State's Unemployment Trust Fund, which were uncollateralized and the Special Revenue Funds' and Proprietary Funds' cash in bank, which was uninsured and uncollateralized. The Special Revenue Funds' and Proprietary Funds' cash balances were held by fiscal agents in the State's name for the purpose of satisfying outstanding bond obligations. Accordingly, these deposits were exposed to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the State's deposits may not be returned to it. For demand or checking accounts and time certificates of deposit, the State requires that the depository banks pledge collateral based on the daily available bank balances to limit its exposure to custodial credit risk. The use of daily available bank balances to determine collateral requirements results in the available balances being under-collateralized at various times during the fiscal year. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State. The State also requires that no more than 60% of the State's total funds available for deposit and on deposit in the State Treasury may be deposited in any one financial institution.

Investments — The State holds investments both for its own benefit and as an agent for other parties. The State's investment of funds not required for immediate payments are predominantly comprised of U.S. government securities.

The following tables present the State's investments and maturities at June 30, 2008 (amounts expressed in thousands).

		Maturity (in years)		
	Fair Value	Less than 1	1–5	>5
Investments — Primary Government:				
Student loan auction rate securities	$ 610,052	$ -	$ -	$ 610,052
Certificates of deposit	94,897	94,897	-	-
U.S. government securities	637,164	152,920	484,244	-
Repurchase agreements	13,557	13,150	407	-
	$ 1,355,670	$ 260,967	$ 484,651	$ 610,052
Investments — Fiduciary Funds:				
Student loan auction rate securities	$ 28,925	$ -	$ -	$ 28,925
Certificates of deposit	4,499	4,499	-	-
U.S. government securities	40,110	9,626	30,484	-
Repurchase agreements	643	623	20	-
	$ 74,177	$ 14,748	$ 30,504	$ 28,925

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.

The State's investments include auction rate securities collateralized by student loans issued by the federal government. Liquidity for these auction rate securities is typically provided by an auction process which allows holders to sell their notes and reset the applicable interest rate at predetermined intervals of 7 to 28 days. In 2008, auctions have failed and investors without the ability to hold such securities until maturity have taken significant losses. The auction failures appear to have been attributable to inadequate buyers and/or buying demand. In the event that there is a failed auction, the indenture governing the security generally requires the issuer to pay interest at a default rate that is generally above market rates for similar instruments. The securities for which auctions have failed will continue to accrue interest at the predetermined rate and be auctioned periodically until the auction succeeds, the issuer calls the securities, they mature, or the State is able to sell the securities to third parties. During 2008, the State recorded an impairment adjustment of $114,043,000 to reduce the carrying value of the State's auction rate securities to their fair value at June 30, 2008.

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

State of Hawaii

Report on Internal Control Over
Financial Reporting and on
Compliance and Other Matters
for the Year Ended June 30, 2008

SUBMITTED BY:
THE AUDITOR
STATE OF HAWAII

Deloitte.

Deloitte & Touche LLP
1132 Bishop Street
Suite 1200
Honolulu, HI 96813-2870
USA
Tel: +1 808 543 0700
Fax: +1 808 526 0225
www.deloitte.com

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

The Auditor
State of Hawaii:

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Hawaii (the "State") as of and for the year ended June 30, 2008, which collectively comprise the State's basic financial statements, and have issued our report thereon dated May 22, 2009. Our report was modified to include a reference to other auditors. 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. Other auditors audited the financial statements of the Department of Transportation — Airports and Harbors Divisions, which are major enterprise funds, the Water Pollution Control Revolving Fund, the Drinking Water Treatment Revolving Loan Fund, and the Employer-Union Health Benefits Trust Fund, which are nonmajor enterprise funds, and the University of Hawaii, the Hawaii Housing Finance Development Corporation, the Hawaii Public Housing Authority, the Hawaii Tourism Authority (which report contains a qualification as to the amounts due to the State, the effect of which, in our opinion, is not material in relation to the basic financial statements), the Hawaii Hurricane Relief Fund, and the Hawaii Community Development Authority, which are discretely presented component units, as described in our report on the State's financial statements. The reports on the Employer-Union Health Benefits Trust Fund and the Hawaii Community Development Authority contain an explanatory paragraph relating to the restatement of the fiscal year 2007 financial statements. The reports on the Department of Transportation – Airports Division, the University of Hawaii, and the Hawaii Tourism Authority contain an explanatory paragraph relating to the adoption of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the State's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State's internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we would consider to be significant deficiencies or material weaknesses.

A *control deficiency* 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 misstatements on a timely basis.

A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. Of the control deficiencies in internal control over financial reporting described in the accompanying schedule of findings and responses, we consider items 2008-5, 2008-6, 2008-7, and 2008-8 to be significant deficiencies in internal control over financial reporting.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over financial reporting described in the accompanying schedule of findings and responses, we consider items 2008-1, 2008-2, 2008-3, and 2008-4 to be material weaknesses in internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses.

Compliance and Other Matters

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

The State's financial statements for the year ended June 30, 2006, were audited by other auditors who issued a Report on Internal Control over Financial Reporting and on Compliance and Other Matters dated March 13, 2007. The State's responses to the prior-year findings are described in Appendix III. We did not audit the State's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Auditor and the State of Hawaii, and the management of the State and is not intended to be, and should not be, used by anyone other than these specified parties.

Deloitte + Touche LLP

May 22, 2009

CURRENT-YEAR FINDINGS
State of Hawaii
Year Ended June 30, 2008

MATERIAL WEAKNESSES

2008-1 — INTERNAL CONTROL OVER FINANCIAL REPORTING

Criteria

Management is responsible for establishing and maintaining internal control over financial reporting, the objectives of which are to provide management with reasonable, but not absolute, assurance that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP).

Condition

The State's internal control over financial reporting could be improved. In fiscal year 2007, we identified multiple significant deficiencies that, when considered in the aggregate, indicate that a material weakness exists in the internal control over financial reporting. These deficiencies continued to exist in fiscal year 2008. Such significant deficiencies include the following:

Financial Statement Preparation Process

The process used by the Department of Accounting and General Services (DAGS) to obtain the required information from the State departments and agencies to prepare the Comprehensive Annual Financial Report (CAFR) (e.g., preparing governmental fund financial statements on a modified accrual basis and the government-wide financial statements on an accrual basis) is inefficient and very time consuming. In addition, there is no enforcement of the timetable that is established to ensure that all of the departments and agencies submit accurate information on a timely basis.

Numerous audit adjustments were required to correct accounting and reporting errors made in the current year, as well as in the prior year.

Accounting Records

DAGS does not maintain, nor does it ensure that all State departments and agencies maintain, complete subsidiary ledgers of all assets and liabilities of the governmental activities of the State, such as capital assets. This appears to be a violation of Hawaii Revised Statutes (HRS) Chapter 40-3, which states, "The comptroller shall also keep ledgers in which the comptroller shall open, arrange, and keep in a methodical and systematic manner the various state accounts so that the status and condition of all … assets and liabilities … of the State may at any time be ascertained and known."

Cause

Financial Statement Preparation Process

DAGS is responsible for preparing the CAFR for the State. The CAFR includes governmental fund financial statements prepared on a modified accrual basis of accounting and government-wide financial statements prepared on a full accrual basis. Since the State's financial accounting and management information system (FAMIS) is maintained using the cash basis of accounting, DAGS is required to prepare accounting entries to convert the cash basis of accounting to the modified accrual basis of accounting to prepare governmental fund financial statements, and then convert to the accrual basis of accounting to prepare government-wide financial statements. As part of the closing process in fiscal year 2008, a total of 266 accounting entries were posted, which were characterized as follows:

- 52 top-sided government-wide entries, of which eight were audit adjustments. These entries were prepared without a trial balance or a fund-to-government-wide financial statement conversion worksheet.
- 214 fund financial statement entries, of which 15 were audit adjustments.

Information necessary to prepare such accounting entries must be obtained from the State departments and agencies. In fiscal year 2008, DAGS tried to use a formal reporting information package to obtain the financial information, but did not receive adequate responses from the departments, and thus had to revert back to the use of informal e-mails, telephone calls, and spreadsheets. As a result, the information received often was neither uniform, nor in a format that could easily be used. In addition, the departments and agencies were often late in submitting the required information, which caused a delay in the preparation of the CAFR.

DAGS is responsible for ensuring that the CAFR is prepared in accordance with the pronouncements of the Governmental Accounting Standards Board (GASB).

Accounting Records

Because the State's accounting system is maintained on the cash basis of accounting, certain financial statement accounts, such as capital assets and certain liabilities, must be maintained using separate subsidiary ledgers. These subsidiary ledgers should be kept by the State departments and agencies, or if the information is maintained on a statewide basis, by DAGS. However, there is no monitoring effort undertaken to ensure that all financial statement accounts are supported by accounting records.

Effect

Because of the inadequate internal control over financial reporting discussed above, material misstatements in the financial presentation due to error or fraud could occur and not be detected on a timely basis; accordingly, we believe the above collectively represent a material weakness in internal control over financial reporting.

Recommendation

DAGS should establish a well-defined, systematic, and orderly process for financial reporting that includes a comprehensive set of policies and procedures necessary to establish internal control over financial reporting. The process and its key attributes (e.g., overall timing, methodology, format, and frequency of analyses) should be formally documented, approved, communicated to other departments and agencies, and monitored on a regular basis.

Required analyses (including the format, timeline, preparers, and reviewers) should be prepared, updated, and distributed on a regular basis. DAGS should have processes in place at the end of each accounting period to ensure that all reconciliations are appropriately performed and independently reviewed. Subsidiary records should be reconciled to the general ledger on a regular basis, and all reconciling items should be identified, investigated, and resolved on a timely basis.

DAGS should have a process in place to ensure that the trial balances used to prepare the financial statements are final, contain all valid journal entries, and include the results of all departments and agencies for which consolidation is appropriate, and that accounting periods in the accounting system are closed to prevent subsequent posting of transactions.

An independent review of the financial statements and all related disclosures using a GAAP financial statement presentation checklist should be performed by DAGS personnel to ensure completeness, consistency across accounting periods, and compliance with GAAP and the State's accounting and disclosure policies.

Adherence to these policies and procedures will facilitate the processing of complete, accurate, and timely financial information while mitigating the risk of misstatement due to error or fraud.

2008-2 — AUCTION RATE SECURITIES

Criteria

Fair Value

In accordance with GAAP, the State adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, in 1998. GASB Statement No. 31 requires investments to be recorded at fair value. Under GAAP, the most reliable measure of fair value is defined as quoted market prices, if available. Quoted market prices are easy to obtain; reliable and verifiable; and well understood by investors, creditors, and other users of financial information. Although quoted market prices are not available for all debt securities, including auction rate securities, GAAP requires that a reasonable estimate of fair value can be made or obtained for them. The estimate of fair value should consider market prices for similar investments and the results of valuation techniques, including, but not limited to, discounted cash flow analysis, matrix pricing, option-adjusted spread models, and fundamental analysis. GAAP dictates that management may require judgment when determining fair value, but notes that a considerable degree of judgment is also needed when complying with other long-standing accounting and reporting requirements.

Treasury Investment Policy

The objective of the State's Treasury Investment Policy is the safe and prudent investment of the State's investment pool so as to preserve the invested funds, provide ample liquidity to fund cash needs or scheduled liabilities, as necessary, and to achieve a rate of return commensurate with the general market for the quality of investment vehicles. The Treasury Investment Policy includes, but is not limited to, the following requirements/guidelines:

- Maturity Restrictions — Each investment will be made with the intention of holding the investment to maturity, which shall not exceed five years in accordance with HRS Section 36-21.
- Investment Rating — Each investment in student loan-backed auction rate securities shall maintain a Triple-A rating.

Condition

Fair Value

The Department of Budget and Finance (B&F) is responsible for the operation of the State's internal investment pool. The investment pool is utilized to maximize returns for participating State departments and agencies, and investment earnings are allocated to State departments and agencies based on their average daily balance in the investment pool on a monthly basis. B&F provides the investment information to DAGS, which, in turn, updates the investment information in FAMIS. The information in FAMIS is then used by DAGS to prepare the CAFR. Additionally, various State departments and agencies rely upon reports generated from FAMIS to prepare their stand-alone financial statements.

At June 30, 2008, the investment pool included student loan-backed auction rate securities of approximately $1.1 billion, which represented approximately 24% of the State's investment pool valued at $4.5 billion. These auction rate securities were recorded at cost, or par value. Beginning in 2008, auctions for these securities began to fail, which meant that the securities no longer had an active trading market. This resulted in investors who did not have the ability to hold such securities until maturity sustaining significant losses. This situation implied that the par value of the securities was not representative of its fair value. At our insistence, B&F sought the help of its investment broker to assist in determining the fair value of the auction rate securities at June 30, 2008. Based on the information provided by the investment broker and on its own analysis, B&F recorded an impairment loss of $114 million to reduce the carrying value of the auction rate securities to their fair value at June 30, 2008.

Treasury Investment Policy

At June 30, 2008, the State's investments in auction rate securities did not meet the following requirements of the State's Treasury Investment Policy:

- Maturity Restrictions — Although the State's auction rate securities contractually provided for liquidity through the auction process at predetermined intervals of seven to 28 days, because of the failure of the Dutch auction process, the actual maturities of such securities ranged between eight and 38 years, which exceeded the maximum five-year maturity restriction required by HRS Section 36-21.
- Investment Rating — At June 30, 2008, the investment pool included three less than AAA-rated auction rate securities (i.e., AA-rated) with par and fair values of $54.3 million and $36.3 million, respectively.

Cause

Fair Value

Prior to the failure of the Dutch auction process in 2008, the State had the ability to freely buy and sell its auction rate securities without incurring any losses. When auctions started to fail in 2008, the State believed that it had the intent and ability to hold the auction rate securities until the market recovered, and accordingly, believed that continuing to record the auction rate securities at par value was appropriate. However, as GAAP requires that such investments be recorded at fair value, the State should have written down the auction rate securities from par value to fair value, in spite of its intent and ability to hold the securities until their maturities.

Treasury Investment Policy

As auction rate securities are designed to be bought, sold, or held at auctions taking place at predetermined intervals of between seven to 28 days, the State believed that the maturities of these securities approximated the auction periods, and therefore were in compliance with the State's policy whereby the term of an investment would not exceed five years. The State's belief was correct, as long as the auctions were being held. However, when the auctions failed, the maturity period of the securities converted to the maturities of the student loans receivable, which were held as collateral for these auction rate securities, and such loans were due over periods ranging from eight to 38 years.

While all auction rate securities were AAA-rated upon purchases, certain securities were subsequently downgraded to AA-rated. Due to the auction failure, the state was not able to liquidate its investments in AA-rated auction rate securities by June 30, 2008.

Effect

The State's lack of adequate internal control over the measurement and valuation of its investments caused the State to record a $114 million impairment adjustment to its investment pool on an untimely basis (i.e., 11 months after the end of the 2008 fiscal year). The State's lack of internal controls to determine if potential investments met its investment policy relating to grade, and maturity, caused it to violate its policy in fiscal year 2008. This lack of adequate internal controls could result in a material misstatement of the State's investments not being detected on a timely basis, and we believe that this situation represents a material weakness in internal control over investments.

Recommendation

B&F should perform an internal review of the carrying values of all of the investments to ensure that they are all recorded at fair value in accordance with GAAP. B&F should also consider hiring an independent third-party specialist to assist it in determining the fair value of any hard-to-value investments and ensure that all assumptions used in the investment valuation are made available to the investment pool's participants. B&F should also perform a regular review of the investment pool to ensure that the investments are in alignment with the objectives and requirements of the State's Treasury Investment Policy.

Examination Objectives

1. Examine the effectiveness of the financial accounting and financial reporting processes and related internal controls of the Department of Budget and Finance, and recommend improvements to such internal controls as applicable.

2. Assess the adequacy, efficiency, and effectiveness of the department's organizational structure, systems, procedures, and practices over its financial administration functions and recommend improvements as applicable.

3. Make recommendations as appropriate.

United States Government Accountability Office

GAO

By the Comptroller General of the United States

July 2007

Government Auditing Standards

July 2007 Revision

GAO Accountability * Integrity * Reliability

GAO-07-731G

Use and Application of GAGAS

Introduction

1.01 Auditing is essential to government accountability to the public. Audits and attestation engagements provide an independent, objective, nonpartisan assessment of the stewardship, performance, or cost of government policies, programs, or operations, depending upon the type and scope of the audit.

1.02 The concept of accountability for use of public resources and government authority is key to our nation's governing processes. Government officials entrusted with public resources are responsible for carrying out public functions legally, effectively, efficiently, economically, ethically, and equitably.[1] Government managers are responsible for providing reliable, useful, and timely information for accountability of government programs and their operations. (See appendix I paragraph A1.08 for additional information on management's responsibility.) Legislators, government officials, and the public need to know whether (1) government manages public resources and uses its authority properly and in compliance with laws and regulations; (2) government programs are achieving their objectives and desired outcomes; (3) government services are provided effectively, efficiently, economically, ethically, and equitably; and (4) government managers are held accountable for their use of public resources.

Purpose and Applicability of GAGAS

1.03 The professional standards and guidance contained in this document, commonly referred to as generally accepted government auditing standards (GAGAS), provide a framework for conducting high quality

[1]The term "equity" in this context refers to the approaches used by a government, nonprofit, or other organizations that manage or carry out government programs to provide services to the public in a fair manner within the context of the statutory boundaries of the specific government programs.

processing of transactions by service organizations;[12] and (5) auditing compliance with regulations relating to federal award expenditures and other governmental financial assistance in conjunction with or as a by-product of a financial statement audit.

Attestation Engagements

1.23 Attestation engagements can cover a broad range of financial or nonfinancial objectives and may provide different levels of assurance about the subject matter or assertion depending on the users' needs. Attestation engagements result in an examination, a review, or an agreed-upon procedures report on a subject matter or on an assertion about a subject matter that is the responsibility of another party. The three types of attestation engagements are:

a. Examination: Consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter is based on (or in conformity with) the criteria in all material respects or the assertion is presented (or fairly stated), in all material respects, based on the criteria.

b. Review: Consists of sufficient testing to express a conclusion about whether any information came to the auditors' attention on the basis of the work performed that indicates the subject matter is not based on (or not in conformity with) the criteria or the assertion is not presented (or not fairly stated) in all material respects based on the criteria. As stated in the AICPA SSAE, auditors should not perform review-level work for reporting on internal control or compliance with laws and regulations.

[12]A service organization is the entity or a segment of an entity that provides services to a user organization that are part of the user organization's information system. A user organization is an entity that has engaged a service organization. (See AU Section 324, *Service Organizations.*)

General, Field Work, and Reporting Standards for Attestation Engagements

Introduction

6.01 This chapter establishes standards and provides guidance for attestation engagements conducted in accordance with generally accepted government auditing standards (GAGAS). For attestation engagements, GAGAS incorporate the American Institute of Certified Public Accountants (AICPA) general standard on criteria, and the field work and reporting standards and the related Statements on Standards for Attestation Engagements (SSAE), unless specifically excluded or modified by GAGAS.[77,78] This chapter identifies the AICPA general standard on criteria[79] and the field work and reporting standards for attestation engagements and prescribes additional standards for attestation engagements performed in accordance with GAGAS.

6.02 For attestation engagements performed in accordance with GAGAS, chapters 1 through 3 and 6 apply.

AICPA General and Field Work Standards for Attestation Engagements

6.03 The AICPA general standard related to criteria is as follows:

The practitioner [auditor] must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.

6.04 The two AICPA field work standards for attestation engagements are as follows:

[77] To date, the Comptroller General has not excluded any field work standards, reporting standards, or SSAE.

[78] See AT Section 50, *SSAE Hierarchy.*

[79] GAGAS incorporate only one of the AICPA general standards for attestation engagements.

b. reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse (see paragraphs 6.33 through 6.43);

c. reporting views of responsible officials (see paragraphs 6.44 through 6.50);

d. reporting confidential or sensitive information (see paragraphs 6.51 through 6.55); and

e. distributing reports (see paragraph 6.56).

Reporting Auditors' Compliance with GAGAS

6.32 When auditors comply with all applicable GAGAS requirements, they should include a statement in the attestation report that they performed the engagement in accordance with GAGAS. (See paragraphs 1.12 and 1.13 for additional requirements on citing compliance with GAGAS.) GAGAS do not prohibit auditors from issuing a separate report conforming only to the requirements of other standards.

Reporting Deficiencies in Internal Control, Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse

6.33 For attestation engagements, auditors should report, as applicable to the objectives of the engagement, and based upon the work performed, (1) significant deficiencies in internal control, identifying those considered to be material weaknesses; (2) all instances of fraud and illegal acts unless inconsequential; and (3) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the subject matter of the engagement.

Deficiencies in Internal Control

6.34 For all attestation engagements, auditors should report the following deficiencies in internal control:

a. Significant deficiency: a deficiency in internal control, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report data reliably in accordance with the applicable criteria or framework such that there is more than a remote[85] likelihood that a misstatement of the subject matter that is more than inconsequential[86] will not be prevented or detected.

b. Material weakness: a significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the subject matter will not be prevented or detected.

6.35 Determining whether and how to communicate to entity officials internal control deficiencies that have an inconsequential effect on the subject matter is a matter of professional judgment. Auditors should document such communications.

Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse

6.36 Under GAGAS, when auditors conclude, based on sufficient, appropriate evidence, that any of the following either has occurred or is likely to have occurred, they should include in their report the relevant information about

[85] The term "more than remote" used in the definitions for significant deficiency and material weakness means "at least reasonably possible." The following definitions apply: (1) Remote—The chance of the future events occurring is slight. (2) Reasonably possible—The chance of the future events or their occurrence is more than remote but less than likely. (3) Probable—The future events are likely to occur.

[86] "More than inconsequential" indicates an amount that is less than material, yet has significance. A misstatement is "inconsequential" if a reasonable person would conclude that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the subject matter. If a reasonable person would not reach such a conclusion, that misstatement is "more than inconsequential."

Summary of Findings

Material Weaknesses

1. Lax management of the State's $3.8 billion treasury has increased risk and reduced available funds.

2. The Financial Administration Division has failed to perform essential functions.

Summary of Findings (continued)

Significant Deficiencies

1. The Budget Division's informal and undocumented budget process lacks transparency and leaves the department vulnerable.

2. Inattention to information technology management exposes the department to unnecessary risk.

Summary of Findings (continued)

Independent Accountant's Report on Internal Controls

In the opinion of Accuity LLP, because of the effects of the noted material weaknesses on the achievement of the objectives of the control criteria, the department has not maintained effective financial accounting and financial reporting processes and related internal controls for the fiscal year ended June 30, 2009.

HAWAII REVISED STATUTES

COMPRISING THE STATUTES
OF THE STATE OF HAWAII,
CONSOLIDATED, REVISED, AND ANNOTATED

VOLUME 1
2009 REPLACEMENT
(Including Acts of the 2009 Regular and Special Sessions)

TITLES 1-5, CHAPTERS 1-42F

PUBLISHED BY AUTHORITY

for the proper disbursements of all appropriations for his department. The responsibility of the director of finance, in these cases, shall be limited to the payment of the aggregate amount of appropriations made by the legislature. [CC 1859, §477; RL 1925, §1251; RL 1935, §2210; RL 1945, §5811; RL 1955, §132-11; am L Sp 1959 2d, c 1, §14; am L 1963, c 114, §1; HRS §36-5]

§36-6 Report to legislature. The director of finance shall make an annual report to the legislature of the transactions and business of the director's department, showing the revenue and expenditure for the preceding year, and giving a full and detailed estimate of the revenue and expenditure for the succeeding year. [CC 1859, §470; RL 1925, §1244; RL 1935, §2203; RL 1945, §5804; RL 1955, §132-4; am L Sp 1959 1st, c 13, §2; am L Sp 1959 2d, c 1, §14; am L 1963, c 114, §1; HRS §36-6; gen ch 1985]

§36-7 Director's certificates, evidence. The director of finance may certify, under the seal of the director's department, copies of vouchers and other documents deposited in the director's office; and copies so certified shall be as valid evidence in any court as the originals. [CC 1859, §476; RL 1925, §1250; RL 1935, §2209; RL 1945, §5810; RL 1955, §132-10; am L Sp 1959 2d, c 1, §14; am L 1963, c 114, §1; HRS §36-7; gen ch 1985]

§36-8 Director may administer oaths. The director of finance may administer all necessary oaths connected with the duties of the director's department. [CC 1859, §475; RL 1925, §1249; RL 1935, §2208; RL 1945, §5809; RL 1955, §132-9; am L Sp 1959 2d, c 1, §14; am L 1963, c 114, §1; HRS §36-8; gen ch 1985]

Case Notes

Cited: 13 H. 85.

PART II. INVESTMENTS; TRANSFERS

§36-21 Short-term investment of state moneys. (a) The director of finance may invest any moneys of the State which in the director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State and where in the director's judgment the action will not impede or hamper the necessary financial operations of the State in:

(1) Any bonds or interest-bearing notes or obligations:
  (A) Of the State (including state director of finance's warrant notes issued pursuant to chapter 40);
  (B) Of the United States;
  (C) For which the faith and credit of the United States are pledged for the payment of principal and interest;
(2) Federal Farm Credit System notes and bonds;
(3) Federal Agricultural Mortgage Corporation notes and bonds;
(4) Federal Home Loan Bank notes and bonds;
(5) Federal Home Loan Mortgage Corporation bonds;
(6) Federal National Mortgage Association notes and bonds;
(7) Student Loan Marketing Association notes and bonds;
(8) Tennessee Valley Authority notes and bonds;
(9) Securities of a mutual fund whose portfolio is limited to bonds or securities issued or guaranteed by the United States or an agency thereof or repurchase agreements fully collateralized by any such bonds or securities;

(10) Securities of a money market mutual fund that is rated AAA, or its equivalent, by a nationally recognized rating agency or whose portfolio consists of securities that are rated as first tier securities by a nationally recognized statistical rating organization as provided in 17 Code of Federal Regulations section 270.2a-7;
(11) Federally insured savings accounts;
(12) Time certificates of deposit;
(13) Certificates of deposit open account;
(14) Repurchase agreements with federally insured banks, savings and loan associations, and financial services loan companies;
(15) Student loan resource securities including:
 (A) Student loan auction rate securities;
 (B) Student loan asset-backed notes;
 (C) Student loan program revenue notes and bonds; and
 (D) Securities issued pursuant to Rule 144A of the Securities Act of 1933, including any private placement issues;

 issued with either bond insurance or overcollateralization guaranteed by the United States Department of Education; provided all insurers maintain a triple-A rating by Standard & Poor's, Moody's, Duff & Phelps, Fitch, or any other major national securities rating agency;
(16) Commercial paper with an A1/P1 or equivalent rating by any national securities rating service; and
(17) Bankers' acceptances with an A1/P1 or equivalent rating by any national securities rating service;

provided that the investments are due to mature not more than five years from the date of investment. Income derived from those investments shall be a realization of the general fund; provided that, except as provided by Act 79, Session Laws of Hawaii 2009, income earned from moneys invested by the general funds, special funds, bond funds, and trust and agency funds on an investment pool basis shall be paid into and credited to the respective funds based on the contribution of moneys into the investment pool by each fund. As used in this section, "investment pool" means the aggregate of state treasury moneys that are maintained in the custody of the director of finance for investment and reinvestment without regard to fund designation.

(b) Except with respect to an early withdrawal penalty on an investment permitted by this section, the amount of such penalty being mutually agreed at the time of acquisition of such investment, no investment permitted by this section shall require or may in the future require payments by the State, whether unilateral, reciprocal, or otherwise, including margin payments, or shall bear interest at a variable rate which causes or may cause the market price of such investment to fluctuate; provided that such limitation shall not apply to money market mutual funds which:

(1) Invest solely in:
 (A) Direct and general obligations of the United States of America; or
 (B) Obligations of any agency or instrumentality of the United States of America the payment of the principal and interest on which are unconditionally guaranteed by the full faith and credit of the United States of America;
(2) Are rated at the time of purchase "AAAm-G" or its equivalent by Standard & Poor's Ratings Group; and

(3) Are open-end management investment companies regulated under the Investment Company Act of 1940, as amended, which calculate their current price per share pursuant to Rule 2a-7 (17 Code of Federal Regulations section 270.2a-7) promulgated under such act.

(c) Furthermore, the State shall not acquire any investment or enter into any agreement in connection with the acquisition of any investment or related to any existing investment held by the State, which would require or may in the future require any payment by the State, whether unilateral, reciprocal, or otherwise, such as swap agreements, hedge agreements, or other similar agreements. For purposes of this section, a swap or hedge payment is any payment made by the State in consideration or in exchange for a reciprocal payment by any person, such as a variable rate payment in exchange for a fixed rate payment, a fixed rate payment in exchange for a variable rate payment, a payment when a cap or a floor amount is exceeded, or other similar payment. [L 1945, c 59, §1; am L 1947, c 244, §1; RL 1955, §132-12; am L 1959, c 119, §1; am L Sp 1959 2d, c 1, §14; am L 1963, c 114, §1; HRS §36-21; am L 1977, c 105, §1; am L 1982, c 155, §1; gen ch 1985; am L 1988, c 78, §1; am L 1993, c 107, §1; am L 1995, c 109, §1; am L 1996, c 117, §1; am L 1997, c 47, §1; am L 1998, c 119, §1 and c 273, §1; am L 1999, c 160, §23; am L 2000, c 26, §1; am L 2001, c 39, §1; am L 2009, c 79, §31]

Attorney General Opinions

Interest from moneys deposited in qualified depository credited to special fund. Interest on other short term investments credited to general fund. Att. Gen. Op. 85-22.

§36-22 Loans for federal-aid projects. (a) The director of finance may make loans to any state agency from the general, special, and revolving funds of the State for the purpose of enabling the State to prepay the costs reimbursable by the federal government on federal aid projects, when the director determines that:

(1) There are any moneys of the State which in the director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State and where in the director's judgment the action will not impede or hamper the necessary financial obligations of the State.
(2) The project is authorized in compliance with section 103-7.
(3) Federal aid in the form of reimbursable funds has been committed to the project in an amount sufficient to repay the principal on the loan.
(4) Federal reimbursement is expected to be received within a reasonable period of time after the loan is made.

(b) In addition to any other conditions that the director of finance may impose, any loan made pursuant to this section shall be subject to the following conditions:

(1) The full amount of the loan must be repaid to the fund from which the loan was made upon final settlement of accounts with the participating federal agency.
(2) The term of the loans shall not exceed one calendar year from the time of the loan; provided, at the option of the director, the loans or the balances thereof may be renewed annually.

(c) The director may, in the director's discretion, require payment of interest on any loan made, the rate of interest not to exceed that which the State could have realized if it invested the same in time certificates of deposit.

(d) The director shall have the option at any time to recall the loan and

STATE OF HAWAII
TREASURY INVESTMENT POLICY

I. STATEMENT OF PURPOSE

The purpose of this policy is to outline objectives, provide guidelines, and set forth reporting procedures for the investment of cash assets of the State in excess of current requirements.

II. STATEMENT OF OBJECTIVES

The objective of the cash management investment program shall be the safe and prudent investment of short-term cash assets so as to:

A. Preserve invested funds.

B. Provide requisite liquidity to fund cash needs or scheduled liabilities as appropriate.

C. Achieve a rate of return commensurate with the general market for the quality of investment vehicles hereinafter described.

III. POLICY GUIDELINES

These policy guidelines shall be applicable until they are reviewed and, if appropriate, revised.

A. SAFETY

The overriding consideration in the investment of short-term cash assets is the preservation of capital. While it is inconsistent with this policy to allow uninvested cash to remain idle and without interest, nothing herein should be construed to justify not complying with safe, prudent investment practices in an effort to maximize yield.

1. Credit Risk

a. The State shall mitigate credit risk by:

(1) Investing only in those securities allowed in Section III.F of this policy.

1/11/99

(2) Utilizing qualified financial institutions, securities dealers and investment advisers as defined in Section III.H of this policy.

(3) Diversifying assets as to issuer, when practical, as described in Section III.G below.

(4) Monitoring the credit worthiness of the portfolio assets on a continuing basis.

(5) Requiring collateral on deposits with financial institutions.

2. Market Risk

a. The State shall limit market risk by restricting the quality of and limiting the maturity of investments.

(1) While it is generally appropriate to invest funds for the longest term possible consistent with the expected cash requirements, the use of sound judgment in accepting reinvestment risk to optimize return is expected.

(2) It is contrary to principles of sound cash management to invest with the intention of selling securities to meet cash needs. However, in the event of unanticipated cash needs, then securities may be sold prior to maturity.

B. LIQUIDITY

1. Liquidity is enhanced by the proper structuring of portfolio maturities to meet unanticipated cash obligations.

2. The proper structuring of portfolio maturities notwithstanding, as necessary, securities that ensure liquidity (marketable without taking a loss in principle) in the event of unforeseen cash needs shall be selected.

C. YIELD

1. Yield on the State's investment portfolio is of secondary importance compared to the safety and liquidity objectives described above.

Investments are limited to relatively low-risk securities in anticipation of earning a market rate of return commensurate with the risk being assumed. While it may occasionally be necessary for the State to sell a security prior to maturity to meet unanticipated cash needs, **trading securities for the sole purpose of realizing trading profits is prohibited.**

D. MATURITY RESTRICTIONS

1. The following maturity guidelines will apply to individual investment transactions and to the portfolio as a whole.

   a. Individual security maturities shall not exceed five years in accordance with Section 36-21, HRS.

   b. Each investment will be made with the intention of holding the investment to maturity.

E. PROHIBITION AGAINST SPECULATIVE ACTIVITIES

1. This policy specifically prohibits borrowing funds for the sole purpose of leveraging the portfolio.

2. This policy prohibits the State from engaging in any investment activity that would be considered speculative according to the principles of conservative investment management.

3. Section 36-21, HRS, prohibits investments in selected derivative-like products.

F. INVESTMENTS

The following describes allowable securities. The allowable securities shall be denominated in United States (U.S.) dollars.

1. State of Hawaii securities.

2. U.S. Treasury Securities.

3. U.S. Federal Agency Securities - Limited to Federal Farm Credit Bank, Federal Home Loan Bank, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Corporation.

c. Be open-end management investment companies regulated under the Investment Company Act of 1940, as amended, which calculate their current price per share pursuant to Rule 2a-7 (17 Code of Federal Regulations section 270.2a-7) promulgated under such act. Must be managed by financial institutions or securities dealers qualified to do business with the State as set forth in Section III.H.

7. Repurchase Agreements (REPOs) must be issued by financial institutions or securities dealers qualified to do business with the State as set forth in Section III.H of this policy. REPOs must be collateralized with securities authorized under Section 38-3, HRS. A written agreement, entitled "Master Repurchase Agreement," must be executed in advance of any such transactions.

8. Commercial Paper issued by financial institutions rated a minimum of A1/P1 or equivalent by a major national securities rating agency.

9. Bankers' Acceptances issued by financial institutions rated a minimum of A1/P1 or equivalent by a major national securities rating agency.

G. DIVERSIFICATION

The Treasury Investment Policy addresses four areas of diversification.

1. By depository as defined in Section 36-21, HRS: No more than 60% of Treasury deposits shall be deposited in any one depository.

2. By types of investment instruments:

    a. U.S. Treasuries: No limit

    b. State of Hawaii Government Securities: No limit 20%

    c. Repurchase Agreement: Up to 70%

    d. Certificate of Deposits: Up to 50%

    e. U.S. Government Agencies: Up to 50%

    f. Auction Rate Securities: Up to 20%

The investment report will contain a management summary that will describe the status of the portfolio. The management summary should be presented in a manner that will allow the

Director of Finance to determine whether investment activity during the month being reported on has adhered to this investment policy.

B. EXTERNAL REPORTS

The investment adviser will provide monthly reports of its management of the account assets and will meet in person with the Director of Finance and the Administrator at least annually.

C. DISTRIBUTION

A copy of the monthly investment reports shall be provided to the Director of Finance.

V. POLICY EXCEPTIONS

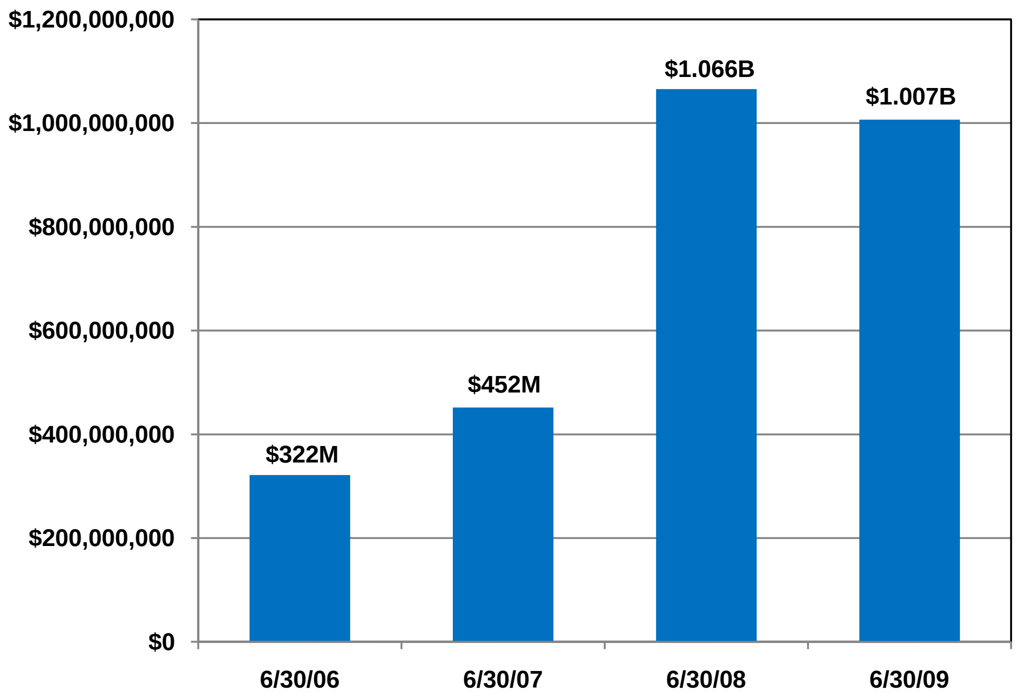
This policy provides guidelines for the management of the short-term investment portfolio. Under some circumstances, investment transactions that are appropriate for the State and entirely within the spirit of this investment policy as described in Section II, STATEMENT OF OBJECTIVES, may not fall within the prescribed quantitative guidelines contained in this policy. When the Administrator determines that an investment transaction is in the best interest of the State and is consistent with the objectives of this investment policy, the transaction is permitted even though it may not be consistent with the quantitative guidelines, subject to the following controls:

A. Exceptions shall be approved by the Administrator prior to being executed.

B. Significant exceptions shall also be approved by the Director of Finance.

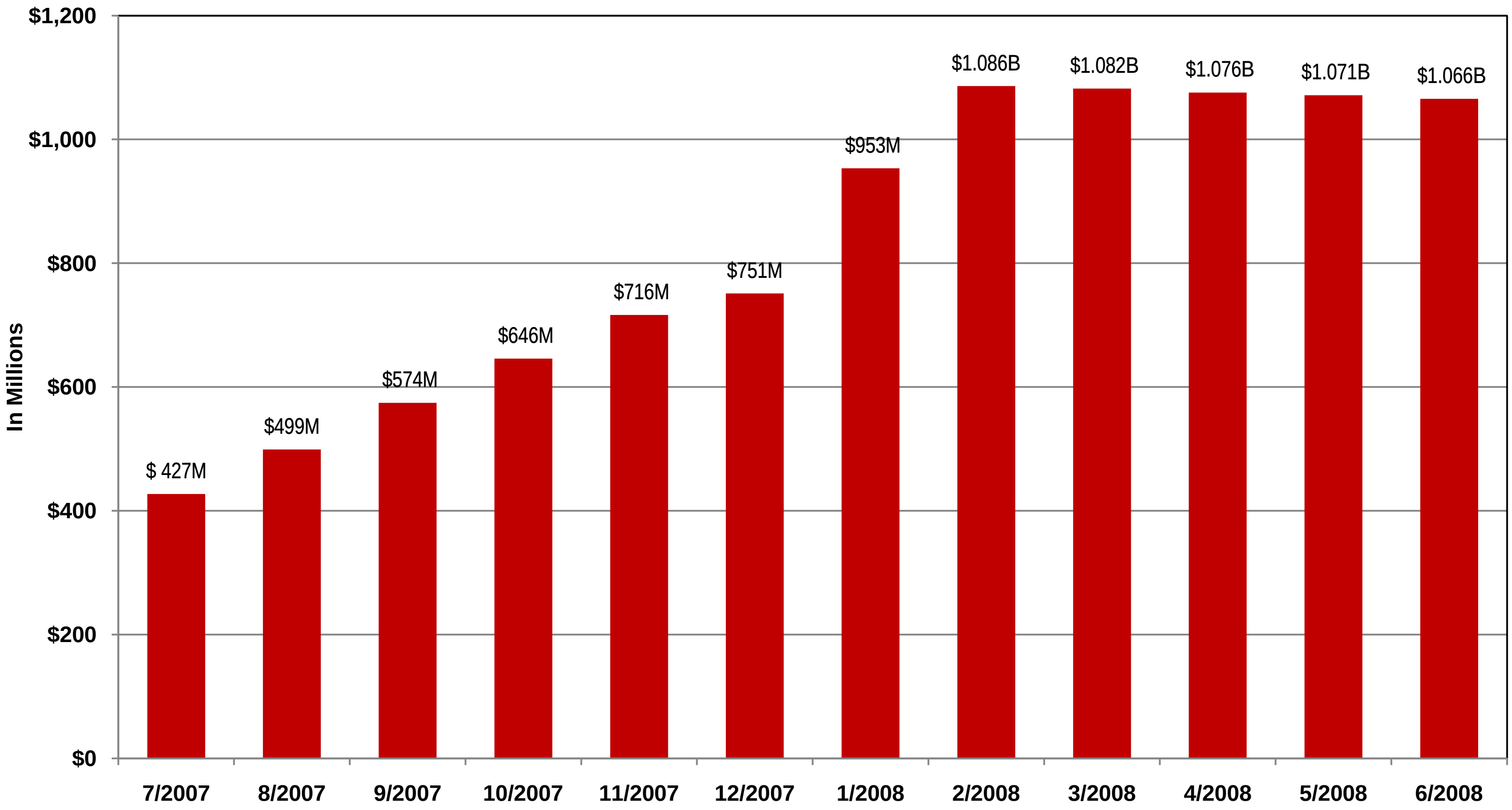
C. Inadvertent breach of the policy shall be immediately reported to the Director of Finance.

State of Hawai‘i Investments in Auction-Rate Securities
June 30, 2006 to June 30, 2009

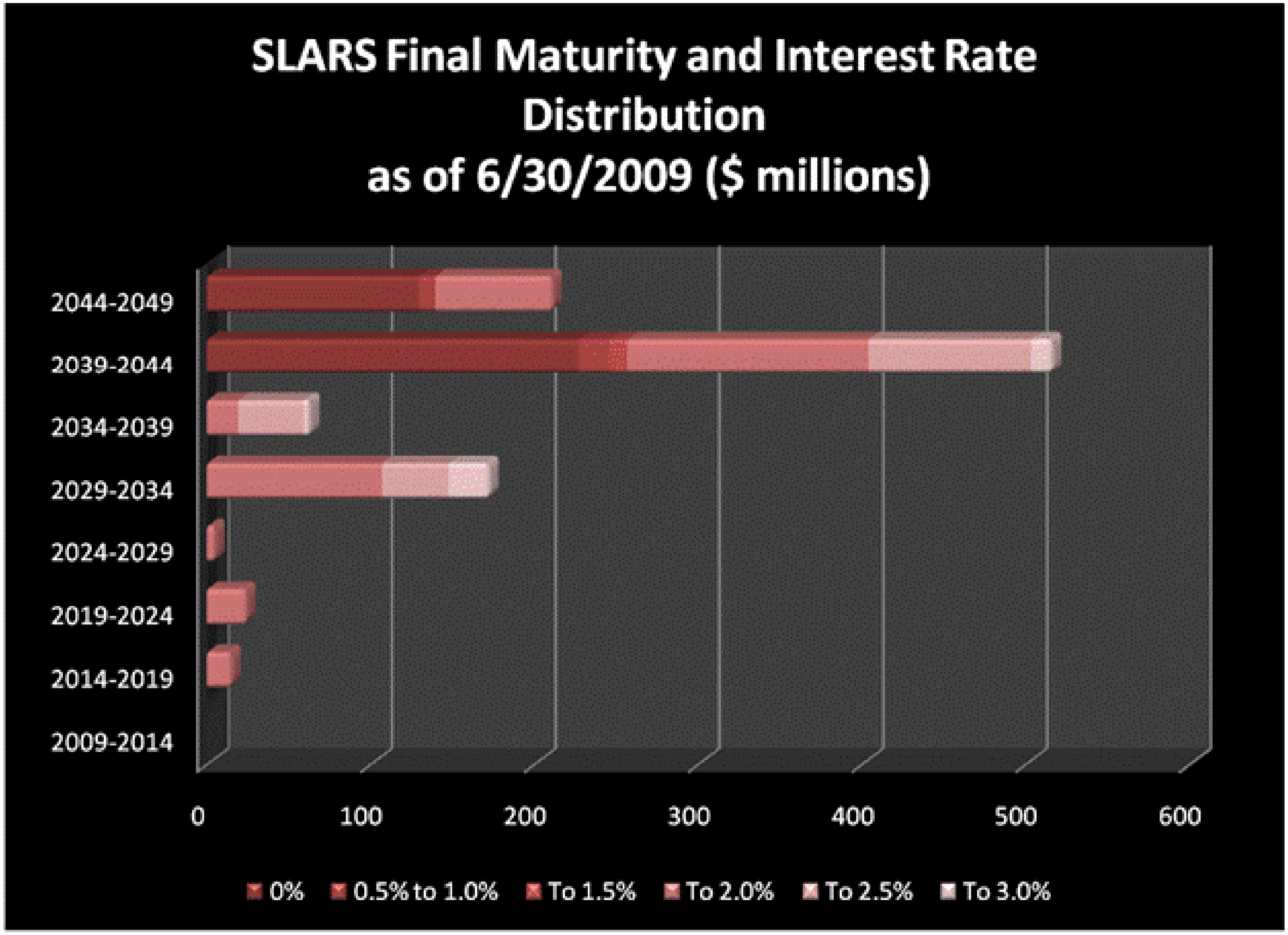


Source: Compiled from information provided by the Department of Budget and Finance

State of Hawai‘i Investments in Auction-Rate Securities
Fiscal Year 2008 by Month



Source: Compiled from information provided by the Department of Budget and Finance


SLARS Final Maturity and Interest Rate Distribution
as of 6/30/2009 ($ millions)
2044-2049
2039-2044
2034-2039
2029-2034
2024-2029
2019-2024
2014-2019
2009-2014
0
100
200
300
400
500
600
0%
0.5% to 1.0%
To 1.5%
To 2.0%
To 2.5%
To 3.0%

Exceptions to Maximum Investments Allowed
(Figures shown in bold exceed allowable percentages)

Month	Investments in Auction-Rate Securities Must Not Exceed 20% of the Total Portfolio	Repurchase Agreements by Issuer Must Not Exceed 70% of the Total Portfolio	CDs by Issuer Must Not Exceed 50% of the Total Portfolio	
			FHB	CPB
July 2008	**29.00%**	**81.00%**	21.90%	48.83%
August 2008	**29.49%**	65.15%	22.34%	47.79%
September 2008	**30.19%**	64.60%	22.25%	47.60%
October 2008	**30.47%**	**71.91%**	33.76%	41.10%
November 2008	**32.13%**	60.00%	37.45%	38.24%
December 2008	**31.12%**	42.19%	**60.65%**	23.02%
January 2009	**32.63%**	69.48%	**50.13%**	28.81%
February 2009	**33.86%**	**78.97%**	29.23%	39.60%
March 2009	**35.87%**	**85.12%**	19.91%	49.54%
April 2009	**37.88%**	65.08%	13.84%	**53.50%**
May 2009	**37.48%**	65.84%	7.12%	**57.73%**
June 2009	**30.47%**	33.69%	**61.21%**	10.96%

FHB = First Hawaiian Bank
CPB = Central Pacific Bank

Source: Investment Pool Composition Historical schedule prepared by the Department of Budget and Finance

AUCTION RATE SECURITIES HOLDERS SURVEY

Pluris
Valuation Advisors LLC

SEPTEMBER 30, 2009

OVERVIEW

Each quarter Pluris Valuation Advisors publishes a survey for holders of auction rate securities. The ARS Holders Survey has been compiled through searches of public filings in the public record as of September 30, 2009. This primarily includes 10-Qs filed for the second quarter by calendar year companies. For the majority of the holders in this survey, the data includes their holdings as of various dates in late 2008 and late 2009 and the accounting treatment of the holdings. Given the special circumstances of underwriters and brokers of ARS, firms within the financial sector have been excluded from our survey.

In total, Pluris found 430 holders of ARS, with the holdings having a total par value of $21 billion. The survey found that 395 firms had adjusted down the value of these investments, while 35 firms still account for their ARS holdings at par value. The aggregate impairment amount for the 395 firms with impaired holdings totals $4.2 billion, and includes both temporary and other-than-temporary impairments.

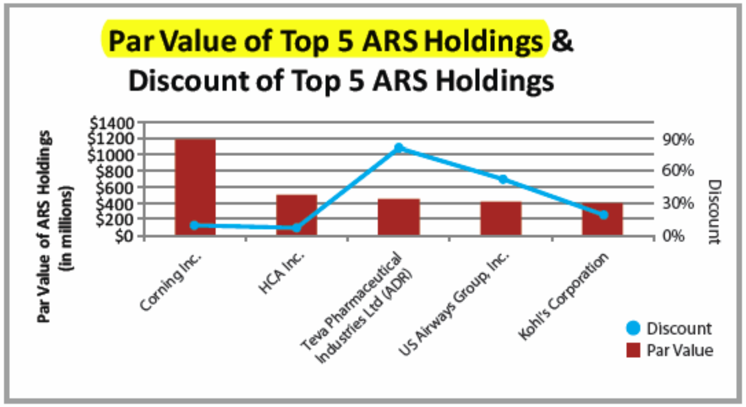
The observed discounts from par varied significantly: discounts ranged from 68% to 100% for companies making the most aggressive adjustments. Alternatively, approximately 8% of the companies surveyed did not take any discounts at all. Holders of student loan auction rate securities were found to be more likely to discount their holdings than holders of other types of auction rate securities.

The data indicates that illiquidity in the auction rate securities market has impacted the majority of the firms holding these short term investments which once had characteristics of cash. Although many firms have already realized the impact of the failure of the ARS market, other companies are continuing to delay taking impairments on their portfolio, while analyzing the landscape of the market and the subsequent impact on valuation. This delayed effect can often be attributed to the disconnect between liquidity and security value. Many investors might think of impairment as something that primarily results from deterioration in credit quality – an increase in default risk – and would not intuitively associate a reduction in liquidity with a drop in value.

As mentioned above, a small number of companies continue to value auction rate securities at par. However, the majority of firms in our survey are adjusting the value (i.e., taking an impairment) to reflect continued illiquidity in the market. Overall, however, the average discount from par has decreased from 26% in the three months ended in June, 2009 to 22% in the three months ended in September, 2009.

TOP ARS HOLDERS

The 5 largest holders of ARS and the impairments recognized on their respective ARS holdings are presented in the chart below. Corning Inc. is currently the largest holder of ARS. As of June 30, 2009, the most recent date data was available at the time this survey was conducted, Corning held $1.1 billion in auction rate securities, net of a temporary impairment of $84 million. The 5 largest holders hold approximately 14% of the total par amount studied in this survey. Their recorded impairments of $761 million represented 18% of total impairments observed in this survey.



ABOUT PLURIS

Pluris Valuation Advisors is a leading valuation services firm based in New York City. We value financial instruments, transactions and events for financial reporting, tax and litigation support. Pluris was founded to bring clarity and consistency in the valuation of illiquid securities, including auction rate securities. We specialize in the valuation of illiquid and distressed securities, and bankruptcy claims. Pluris combines valuation and accounting expertise in its development and application of valuation methodology to assist our clients in their compliance with US GAAP, IFRS, and the IRS. Our proprietary LiquiStat™ database enables us to value illiquid and distressed securities based on empirical market data. We serve public and private companies and their advisors nationwide.

FOR MORE INFORMATION:

Brent Blankenship, Head of Business Development
Pluris Valuation Advisors LLC
26 Broadway, Suite 1202
212-248-4500
bblankenship@pluris.com
www.pluris.com

$571,000,000
AUCTION RATE STUDENT LOAN-BACKED NOTES
Series 2006-1

NEXTSTUDENT MASTER TRUST I
Issuer

NEXTSTUDENT EDUCATION LOAN FUNDING, LLC
Depositor

NEXTSTUDENT INC.
Seller

...college funding made simple.™

We are offering our notes in the following nine series:

Series	Original Principal Amount	Interest Rate	Final Maturity Date	Price to Public	Initial Purchasers' Discount	Proceeds to the Issuer[1]
Series 2006A-1	$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	$ 72,545,200
Series 2006A-2	$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	$ 72,545,200
Series 2006A-3	$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	$ 72,545,200
Series 2006A-4	$ 72,800,000	Auction Rate	June 1, 2041	100%	0.35%	$ 72,545,200
Series 2006A-5	$ 68,500,000	Auction Rate	June 1, 2041	100%	0.35%	$ 68,260,250
Series 2006A-6	$ 68,500,000	Auction Rate	June 1, 2041	100%	0.35%	$ 68,260,250
Series 2006A-7..................	$ 57,100,000	Auction Rate	June 1, 2041	100%	0.35%	$ 56,900,150
Series 2006A-8..................	$ 57,100,000	Auction Rate	June 1, 2041	100%	0.35%	$ 56,900,150
Series 2006B-1	$ 28,600,000	Auction Rate	June 1, 2041	100%	0.35%	$ 28,499,900
Total	$571,000,000					$ 569,001,500

(1) Before deducting expenses, estimated to be $856,500.

The notes will be secured by student loans made under the Federal Family Education Loan Program. The notes are issued by a trust and constitute obligations of the trust payable solely from the student loans and other assets of the trust. The notes are not obligations of NextStudent Education Loan Funding, LLC or NextStudent Inc. or any of their affiliates.

The notes have not been registered under the Securities Act of 1933, as amended (the "Securities Act"), or any state securities laws, and, unless so registered, may not be offered or sold except pursuant to an exemption from or in a transaction not subject to the registration requirements of the Securities Act and applicable state securities laws. Accordingly, the notes are being offered and sold only to "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) in compliance with Rule 144A and to "institutional accredited investors" as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act.

All of the Class A notes offered pursuant to this offering memorandum will be rated AAA by Fitch Ratings and Aaa by Moody's Investors Service, Inc. The Class B notes offered pursuant to this offering memorandum will be rated A by Fitch Ratings and A2 by Moody's Investors Service, Inc.

Neither the SEC nor any state securities commission has approved or disapproved of these notes or determined that this offering memorandum is accurate or complete. Any representation to the contrary is a criminal offense.

You should carefully consider the risk factors beginning on page 12 of this offering memorandum.

The initial purchasers named below are offering the notes subject to approval of certain legal matters by their counsel. Delivery of the notes will be made on or about April 20, 2006, against payment in immediately available funds.

Citigroup

JPMorgan

Deutsche Bank Securities

RBC Capital Markets

The date of this offering memorandum is April 14, 2006

RISK FACTORS

You should consider the following risk factors in deciding whether to purchase the notes.

You may have difficulty selling your notes

We do not intend to list the notes on any securities exchange. As a result, we cannot assure you that a secondary market for the notes will develop. If a secondary market for the notes does develop, the spread between the bid price and the asked price for your notes may widen, thereby reducing the net proceeds to you from the sale of your notes. The initial purchasers intend to make a secondary market for the notes and may do so by offering to buy the notes from investors that wish to sell. However, the initial purchasers will not be obligated to make offers to buy the notes and may stop making offers at any time. In addition, the prices offered, if any, may not reflect prices that other potential purchasers would be willing to pay, were they to be given the opportunity. There have been times in the past where there have been very few buyers of asset-backed securities, and there may again be such a time in the future. As a result, you may not be able to sell your notes when you want to or you may not be able to obtain the price that you wish to receive.

The notes are payable solely from the trust estate and you will have no other recourse against us or against our other assets

The notes are payable solely from the funds and assets held in the trust estate created under the indenture. No insurance or guarantee of those notes will be provided by any government agency or instrumentality, by the issuer, the depositor, the seller or the master servicer, by any insurance company or by any other person or entity. Therefore, your receipt of payments on your notes will depend solely on:

- the amount and timing of payments and collections on the student loans held in the trust estate (including payments by the guarantee agencies) and interest paid or earnings on the funds held in the accounts established pursuant to the indenture; and
- amounts on deposit in the capitalized interest fund, the reserve fund and other funds or accounts held in the trust estate.

If those sources of funds are insufficient to repay your notes, you will have no additional recourse against the issuer, the depositor, the seller or the master servicer.

Our assets held in the trust estate may not be sufficient to pay our notes and you may be adversely affected by a high rate of prepayments

After the application of the proceeds of the notes, the initial pool balance and other assets in the trust estate is approximately 98.10% of the aggregate principal amount of the notes. If an event of default were to occur under the indenture and the issuer were required to redeem all the notes at a time when the aggregate principal balance of the outstanding notes exceeds the aggregate principal balance of the student loans, and accrued interest thereon, held in the trust estate and the other assets pledged as collateral for the notes, the amounts due on the notes may exceed the amount held in the trust estate. If this were to occur, we would be unable to repay in full all of the noteholders and this would affect the Class B notesholders before affecting the Class A noteholders.

Noteholders must rely primarily on interest payments on the student loans and other assets held in the trust estate, in excess of program operating expense and interest payable on the notes, to reduce the aggregate principal amount of the notes to the pool balance. The noteholders, especially Class B noteholders, could be adversely affected by a high rate of prepayments of the student loans, which would reduce the amount of interest available for this purpose. Prepayments may result from borrowers further consolidating or re-consolidating their student loans, borrower defaults and from voluntary full or partial prepayments, among other things. In addition, the principal balance of the student loans on which interest will be collected will be less than the principal amount of the notes for some period.

The interest rates on the notes are subject to limitations, which could reduce your yield

The interest rates on the notes may be limited by the maximum rate, which will be based on the least of the LIBOR rate for a comparable period plus a margin ranging from 1.50% to 3.50% depending upon the then-current ratings of the notes or the maximum rate permitted by law or, in certain circumstances, the net loan rate (which is based on the rates of return on the student loans, less specified administrative costs and net losses on the student loans). If, for any accrual period, the maximum rate is less than the auction rate determined in accordance with the auction procedures, interest will be paid on the notes at the maximum rate even though there may be sufficient available funds to pay interest at the auction rate.

For a payment date on which the interest rate for a series of notes is equal to the net loan rate, the excess of (a) the lower of (1) the amount of interest at the auction rate determined pursuant to the auction procedures for the notes and (2) the amount of interest at the maximum rate which would have been applied if the net loan rate were not a component of the maximum rate over (b) the net loan rate, will become a carry-over amount and will be allocated to the applicable notes on succeeding payment dates (and paid on the succeeding payment date) only to the extent that there are funds available for that purpose and other conditions are met. It is possible that such carry-over amount may never be paid. Any carry-over amount not paid at the time of mandatory redemption of a note will be extinguished. See "*DESCRIPTION OF THE NOTES—Maximum Rate and Interest Carry-overs*" in this offering memorandum.

You may not be able to sell some or all of your notes at an auction and you may not be able to retain some or all of your notes during an auction

You may not be able to sell some or all of your notes at an auction if the auction fails; that is, if there are more notes offered for sale than there are buyers for those notes. Also, if you place hold orders (orders to retain notes) at an auction only at a specified rate, and that specified rate exceeds the rate set at the auction, you will not retain your notes. If you submit a hold order for notes without specifying a minimum rate, and the auction sets a below-market rate, you may receive a below-market rate of return on your notes. See "*DESCRIPTION OF THE NOTES—Interest Rates*" in this offering memorandum.

As noted above, if there are more notes offered for sale than there are buyers for those notes in any auction, the auction will fail and you may not be able to sell some or all of your notes at that time. The relative buying and selling interest of market participants in your notes and in the auction rate securities market as a whole will vary over time, and such variations may be affected by, among other things, news relating to the issuer, the attractiveness of alternative investments, the perceived risk of owning the security (whether related to credit, liquidity or any other risk), the tax treatment accorded the instruments, the accounting treatment accorded auction rate securities, including recent clarifications of U.S. generally accepted accounting principles relating to the treatment of auction rate securities, reactions to regulatory actions or press reports, financial reporting cycles and market sentiment generally. Shifts of demand in response to any one or simultaneous particular events cannot be predicted and may be short-lived or exist for longer periods.

The student loans acquired with the note proceeds will be unsecured and the ability of any guarantee agency to honor its guarantee may become impaired

All of the student loans acquired with note proceeds and held in the trust estate will be unsecured. As a result, the only security for payment of a student loan will be the guarantee, if any, provided by a guarantee agency.

Deterioration in the financial condition of a guarantee agency and its ability to honor guarantee claims on defaulted student loans could result in a failure of that guarantee agency to make its guarantee payments in a timely manner. The financial condition of a guaranty agency could be adversely affected by a number of factors including, but not limited to, the amount of claims made against it as a result of borrower defaults, the amount of claims reimbursed to that guarantor from the Department of Education, which range from 75% to 100% of the 98% guaranteed portion of the loan depending on the date the loan was made and the performance of the guarantee agency and changes in legislation that may reduce expenditures from the Department of Education that support federal guarantee agencies or that may require guarantee agencies to pay more of their reserves to the Department of Education. The Higher Education Reconciliation Act of 2005, signed into law by President Bush on February 8, 2006, provides that the 98% guarantee will be reduced to 97% for all FFELP Loans first disbursed on or after July 1, 2006.

Education Loan Program. As a result, if the Department of Education or a guarantor were to determine that the indenture trustee owes a liability to the Department of Education or a guarantor on any student loan for which the indenture trustee is or was legal titleholder, including student loans held in the trust estate or other trust estates, the Department of Education or guarantor may seek to collect that liability by offset against payments due the indenture trustee under the trust estate. In the event that the Department of Education or a guarantor determines such a liability exists in connection with a trust estate using the shared lender identification number, the Department of Education or guarantor would be likely to collect that liability by offset against amounts due the indenture trustee under the shared lender identification number, including amounts owed in connection with the trust estate.

In addition, other trust estates using the shared lender identification number may in a given calendar quarter incur consolidation origination fees that exceed the interest subsidy and special allowance payments payable by the Department of Education on the loans in such other trust estates, resulting in the consolidated payment from the Department of Education received by the indenture trustee under such lender identification number for that quarter equaling an amount that is less than the amount owed by the Department of Education on the loans in that trust estate for that quarter.

You may incur losses or delays in payment on your notes if borrowers default on their student loans

The trust estate securing your notes will contain student loans made under the Federal Family Education Loan Program. In general, a guarantee agency reinsured by the Department of Education will guarantee 98% of each student loan held in the trust estate. As a result, if the borrower under one of those student loans defaults, the issuer will experience a loss of approximately 2% of the outstanding principal and accrued interest on the defaulted loan. The issuer will not have any right to pursue the borrower for the remaining 2% unguaranteed portion.

The Higher Education Reconciliation Act of 2005, signed into law by President Bush on February 8, 2006, provides that this 98% guarantee will be reduced to 97% for all student loans first disbursed on or after July 1, 2006. As a result, the issuer's loss for a defaulted student loan first disbursed on or after July 1, 2006 will increase to 3% of the outstanding principal and accrued interest on the defaulted student loan. The issuer will not have any right to pursue the borrower for the remaining 3% unguaranteed portion of the student loan.

If the issuer suffers a loss as a result of a borrower default and amounts in the capitalized interest fund and the reserve fund are not sufficient to cover that loss, you may suffer a delay in payment or a loss on your investment.

Borrowers of student loans are subject to a variety of factors that may adversely affect their repayment ability and our ability to pay the noteholders

For a variety of economic, social and other reasons, we may not receive all the payments that are actually due on the student loans held in the trust estate. Deterioration in economic conditions could be expected to adversely affect the ability or willingness of borrowers to repay student loans. Furthermore, student loans are not secured by any assets of the borrowers. Failures by borrowers to make timely payments of the principal and interest due on the student loans held in the trust estate will affect the revenues of the trust estate, which may reduce the amounts available to pay principal and interest due on the notes.

Relief granted to certain persons on active duty in military service or serving in the National Guard could reduce the amount of funds available to pay principal and interest on the notes

The Servicemembers Civil Relief Act may provide relief to borrowers who enter active military service and to borrowers in reserve status who are called to active duty after the origination of their student loans. The response of the United States to terrorist attacks domestically and abroad and issues in the Middle East may increase the number of citizens who are in active military service, including persons in reserve status who have been called or will be called to active duty.

The Servicemembers Civil Relief Act also limits the ability of a lender in the Federal Family Education Loan Program to take legal action against a borrower during the borrower's period of active duty and, in some cases, during an additional three month period thereafter. As a result, there may be delays in payment and increased losses on the student loans held in the trust estate.

The Higher Education Reconciliation Act of 2005 authorizes deferment for loans to a borrower first disbursed on or after July 1, 2001 for a period not in excess of three years during which the borrower is serving on active duty or is performing qualifying National Guard duty during a war or other military operation or national emergency (including in response to terrorist attacks). We do not know how many students may qualify for this deferment. If a substantial number of borrowers become eligible for this deferment, there could be an adverse effect on the total collections on our student loans and our ability to pay interest on the notes if there are insufficient funds in the capitalized interest fund and reserve fund.

The number and aggregate principal balance of student loans held in the trust estate that may be affected by the application of the Servicemembers Civil Relief Act and the deferment provided by the Higher Education Reconciliation Act of 2005 will not be known at the time the notes are issued.

Accordingly, payments received on student loans made to a borrower who qualifies for such relief may be subject to certain limitations during the borrower's period of active military duty. If a substantial number of borrowers under the student loans held in the trust estate become eligible for the relief provided under the Servicemembers Civil Relief Act or the Higher Education Reconciliation Act of 2005 there could be an adverse effect on the total collections on those student loans and our ability to pay interest on the notes if there are insufficient funds in the reserve fund.

Your notes may be repaid early due to any auction sale or exercise of the purchase option, and if this happens, your yield may be affected and you will bear reinvestment risk

The notes may be repaid before you expect them to be if:

- the indenture trustee successfully conducts an auction sale of the student loans remaining in the trust estate or
- the master servicer exercises its option to purchase all of the student loans remaining in the trust estate.

Either event would result in the early retirement of the outstanding notes. If this happens, your yield on your notes may be affected. You will bear the risk that you cannot reinvest the money you receive in comparable securities at as high a yield. The master servicer's option to purchase the student loans and the auction for the sale of student loans will occur only when the pool balance is 10% or less of the initial pool balance and as described in this offering memorandum under *"DESCRIPTION OF THE NOTES—Optional Purchase" and "—Auction of the Student Loans"*.

The security of confidential information received by the issuer, the master servicer and the subservicers relating to borrowers could be jeopardized

The issuer, the master servicer and the subservicer receive confidential information relating to borrowers. There can be no assurance that this information will not be subject to breaches of security, computer theft and other improper activity that could jeopardize the security of this information. Any such breach in security could expose the issuer, master servicer or the subservicers to litigation, loss of business, regulatory enforcement action or additional expense.

Less than all of the noteholders can approve amendments to the indenture or waive defaults under the indenture

Under the indenture, holders of specified percentages of the aggregate principal amount of the notes may amend or supplement provisions of the indenture and the notes and waive events of default and compliance provisions without the consent of the other noteholders. You will have no recourse if the noteholders vote and you disagree with the vote on those matters. The noteholders may vote in a manner that impairs our ability to pay principal and interest on your notes.

Book-entry registration may limit your ability to participate directly as a noteholder

The notes will be represented by one or more certificates registered in the name of Cede & Co., the nominee for The Depository Trust Company, and will not be registered in the names of the noteholders. As a noteholder, you will be able to exercise your rights only indirectly through The Depository Trust Company and its participating organizations.

The notes are not suitable investments for all investors

The notes are not a suitable investment if you require a regular or predictable schedule of payments or payment on any specific date. The notes are complex investments that should be considered only by investors who, either alone or with their financial, tax and legal advisors, have the expertise to analyze the prepayment, reinvestment, default and market risk, the tax consequences of an investment, and the interaction of those factors.

Certain actions can be taken without noteholder approval

The indenture will provide that the issuer and indenture trustee may undertake various actions based upon receipt by the indenture trustee of confirmation from each rating agency then rating any of the

From: Scott.A.Kami@hawaii.gov [mailto:Scott.A.Kami@hawaii.gov]
Sent: Monday, October 26, 2009 3:14 PM
To: Accuity LLP
Cc: Judy.A.Dang@hawaii.gov
Subject: Re: Auction-Rate Security Question

Accuity LLP

Act 47, SLH 1997, enacted statutory language that authorized the department to invest in Auction Rate Securities (ARS). The State began investing in ARS in approximately September, 1998. As the original decision to invest in ARS was made over 10 years ago, we do not have any records that reflect who made the original decision to invest in ARS.

As far as a "risk assessment", Act 47, SLH 1997 determined that investing in Student Loan ARS was acceptable and authorized investing in such instruments. The Department, along with many other institutional investors and professional money managers, were not aware of the impending disruption in the Student Loan ARS market. As far as a cost benefit analysis, in February 2008, prior to the disruption in the Student Loan ARS market, the Student Loan ARS yields were approximately two times the yield on similar 30-day treasury investments or 30-day bank certificates of deposit. Due to the substantial yield benefit, investments were made in the Student Loan ARS.

With respect to the investment portfolio's percentage of Student Loan ARS, I'll provide you with our comments no later than tomorrow, Tuesday, 10/27.

Thanks,
Scott

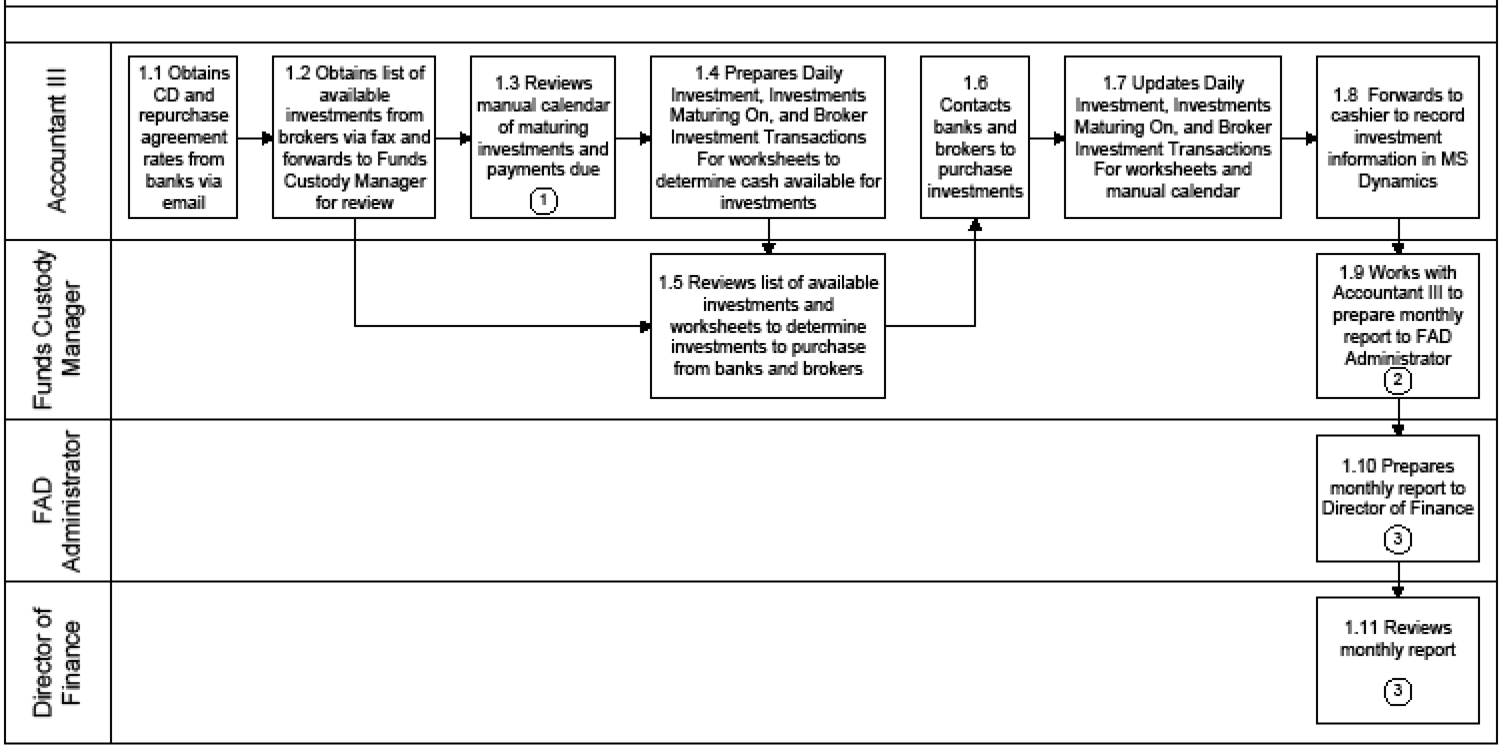
From: Scott.A.Kami@hawaii.gov [mailto:Scott.A.Kami@hawaii.gov]
Sent: Tuesday, October 27, 2009 2:12 PM
To: **Accuity LLP**
Cc: Judy.A.Dang@hawaii.gov
Subject: RE: Auction-Rate Security Question

Accuity LLP

While there was an increase in our position with ARS due to the very favorable interest rates, please keep in mind that while the amount of ARS may have been relatively stable after the market froze, the decline in the overall amount of funds available for investment caused the percentage to increase (i.e. numerator stayed constant, denominator decreased). As staff did not believe that the deviation from the 20% figure was significant, the Director was not consulted prior to increasing our position in ARS. I was informed of our increased holding due to the favorable yields.

Scott

Overview of the Investment Process



Notes:
1 = The estimate of excess cash funds is created manually and prone to manual input and calculation errors.
2 = Monthly reports were prepared but did not include all information required by the Investment Policy.
3 = Monthly report has not been prepared after June 2007. The June 2007 report did not include all the information required by the Investment Policy.

Director of Finance's Lack of Involvement in Investment Decisions

- **August 27, 2009 meeting**: Director specifically stated she has never been consulted prior to any investment purchases. (9 people in attendance: director, deputy director, 2 B&F staff, 2 Office of the Auditor personnel, 3 Accuity personnel)

- **January 19, 2010 meeting:** Director confirmed that she was not consulted prior to any investments in ARS, and also not involved in investments on a day-to-day basis. (7 people in attendance: director, deputy director, FAD administrator, 1 B&F staff, 1 Office of the Auditor personnel, 2 Accuity personnel).

Director of Finance's Lack of Involvement in Investment Decisions (continued)

- FAD administrator repeated the director's lack of involvement in decisions during various meetings directly with Accuity throughout the audit.

- FAD administrator also confirmed this, as well as his own apparent lack of involvement, in a 10/26/09 email to Accuity:

  "As staff did not believe that the deviation from the 20% figure was significant, the Director was not consulted prior to increasing our position in ARS. I was informed of our increased holding due to the favorable yields."

Information Included in the *Report to the Administrator* Compared to Requirements

Required information per the investment policy	Included
Inventory of portfolio of investments as of the date of the report with a percentage mix of the portfolio by type of investment	Yes *(but high-level and aggregated by bank-issued and govt-issued securities)*
Average portfolio maturity	Not included *(totals by range of maturity was included)*
Notations, which shall include the amounts and reasons, of the exceptions to the investment policy	Not included *(exceptions to the policy did exist but were not noted)*
Status of any investments that might require management attention (such as investments affected by a credit rating change, or similar circumstances that could have an effect on the value and collectability of the investment)	Not included
Information for all transactions occurring during the month, whether or not they have been fully settled as of the end of the month	Not included
Management summary that will describe the status of the portfolio. The management summary should be presented in a manner that will allow the director of finance to determine whether investment activity during the month being reported on has adhered to the investment policy.	Included

Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

Exhibit 2.6
Information Included in the *Report to the Director* Compared to Requirements

Required information per the investment policy	Included
Inventory of portfolio of investments as of the date of the report with a percentage mix of the portfolio by type of investment	Not included
Average portfolio maturity	Not included
Notations, which shall include the amounts and reasons, of the exceptions to the investment policy	Not included
Status of any investments that might require management attention (such as investments affected by a credit rating change, or similar circumstances that could have an effect on the value and collectability of the investment)	Not included
Information for all transactions occurring during the month, whether or not they have been fully settled as of the end of the month	Not included
Management summary that will describe the status of the portfolio. The management summary should be presented in a manner that will allow the Director of finance to determine whether investment activity during the month being reported on has adhered to the investment policy	(a)

Notes:

(a) While the *Report to the Director* is a management summary as required by the investment policy, it did not contain all of the information necessary for the Director of finance to determine whether the investment activity during the month and investment positions at the end of the month adhered to the investment policy.

Source: Prepared by Accuity LLP based on information provided by the Department of Budget and Finance

Lack of Investment Reporting to the Director of Finance

- **January 19, 2010 meeting:** Director acknowledged not receiving formal investment reports since July 2007 but stated she does receive other investment reports on a regular basis. When pressed, the director could not recall whether they were monthly or quarterly and what exactly the reports contained, but did promise to provide us with copies.

- In response to our follow up, the FAD administrator stated the following in a 2/4/10 email:

  "monthly reports to the Director (Exhibit 2) (while we believe that additional reports were provided to the Director beyond August 2007, we could not locate copies of those reports)."

From: Scott.A.Kami@hawaii.gov [mailto:Scott.A.Kami@hawaii.gov]
Sent: Thursday, February 04, 2010 4:17 PM
To: Accuity LLP
Cc: Tracy.M.Ban@hawaii.gov
Subject: Requested Items from Meeting

Accuity LLP,

Attached is a copy of our response to WAM/FIN as requested. Please note that I have provided Exhibit 3 referenced in our memorandum as you were previously provided with 1) a copy of the Investment Policy (Exhibit 1), 2) monthly reports to the Director (Exhibit 2) (while we believe that additional reports were provided to the Director beyond August 2007, we could not locate copies of those reports). Exhibit 4 is not related to the ARS issue and as such, we are not providing a copy.

I don't have any objections to providing you with all of the exhibits but the file would be quite large. If you require the additional exhibits, please let me know.

Thanks,
Scott

Moody's Investors Service

New Issue: MOODY'S REVISES STATE OF HAWAII'S OUTLOOK TO NEGATIVE FROM STABLE AND ASSIGNS Aa2 RATING TO G.O. BONDS OF 2010, TAXABLE SERIES DX (BUILD AMERICA BONDS - DIRECT PAY) AND G.O. REFUNDING BONDS OF 2010, SERIES DY

Global Credit Research - 04 Feb 2010

$4.7 BILLION OF OUTSTANDING G.O. DEBT AFFIRMED AT Aa2; OUTLOOK IS NEGATIVE

State
HI

Moody's Rating

ISSUE		RATING
General Obligation Refunding Bonds of 2010, Taxable Series DX (Build America Bonds - Direct Pay)		Aa2
Sale Amount	$312,000,000	
Expected Sale Date	02/09/10	
Rating Description	General Obligation	
General Obligation Refunding Bonds of 2010, Series DY		Aa2
Sale Amount	$222,325,000	
Expected Sale Date	02/09/10	
Rating Description	General Obligation	

Opinion

NEW YORK, Feb 4, 2010 -- Moody's Investors Service has assigned a Aa2 rating to the State of Hawaii's $312 million General Obligation Bonds of 2010, Taxable Series DX (Build America Bonds - Direct Pay) and $225 million General Obligation Refunding Bonds of 2010, Series DY. Concurrently, Moody's has revised the outlook on the state's rating to negative from stable and affirmed the outstanding Aa2 rating on approximately $4.7 billion outstanding general obligation bonds. The Aa2 rating incorporates the state's historical fiscal conservatism; actions to address significantly lower revenue growth; a tourism-based economy that experiences volatility tied to national and international economies; and a high debt burden.

As a heavily tourism dependent state, Hawaii's economy has been hurt by reduced travel due to the national and international recession. Consecutive downward revenue revisions in fiscal 2009 and continuing in fiscal 2010, beyond those already anticipated by the state, have resulted in further draws on already reduced reserves to achieve budget balance. Late last spring, the state closed a sizeable combined budget gap of $2.7 billion covering fiscal years 2009 through 2011. In addition, a correction to conveyance and general excise tax collections over the past two years resulted in very modest combined available reserves of less than 1% for fiscal year 2009. Based on the current revenue forecast, Hawaii now faces another large budget gap of $1.2 billion for the biennium, representing 12% of revenues. With reduced time to achieve ongoing savings in the current fiscal year (2010), the state will likely increase its use of one-time budget solutions to balance the budget and maintain liquidity. As in most other states, federal stimulus funds are providing significant funding flexibility and Hawaii has also taken steps to reduce ongoing spending and increase recurring revenues. The negative outlook reflects Hawaii's vulnerability to further downward revenue revisions given the uncertainty surrounding the timing and strength of the economic recovery and its impact on the state's vital tourism sector; tighter liquidity reflected in a fiscal 2009 retirement payment deferral and a proposed delay in fiscal 2010 income tax refunds; additional debt restructurings for budget relief; modest ending balances projected over the near term forecast horizon; and out-year structural gaps due to one-time solutions already incorporated in the enacted budget. Future credit reviews will focus on the state's revenue performance and success in achieving targeted spending reductions to balance the budget.

Hawaii plans to sell the current offerings the week of February 8. Proceeds of the refunding series will be used to refund outstanding bonds for significant upfront savings ($16 million in fiscal 2010 and $72 million in fiscal 2011), with negative savings in the out-years through 2020. The state has used similar refundings for one-time budget relief recently, contributing to structural budget imbalance beyond the current biennium. Proceeds of the new money series, which are being issued as taxable Build America Bonds - Direct Pay, will be used for various statewide projects.

LAST RATING ACTION AND METHODOLOGY

The last rating action was on October 13, 2009, when Moody's affirmed the Aa2 rating and stable outlook on the State of Hawaii's General Obligation Refunding Bonds of 2009, Series DT, DU, DV, DW and Taxable General Obligation Bonds of 2009 (Qualified School Construction Bonds), Series DS (Tax Credit Bonds).

The principal methodology used in rating the State of Hawaii's General Obligation Bonds of 2010, Taxable Series DX (Build America Bonds - Direct Pay) and General Obligation Refunding Bonds of 2010, Series DY) was Moody's State Rating Methodology, published in October 2004 and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Outlook

The negative outlook for Hawaii's credit rating reflects the state's vulnerability to further downward revenue revisions given the state's significant reliance on the tourism industry which has slowed dramatically and could face continued near term headwinds given the uncertainty of economic recovery at both the national and international level. The negative outlook also reflects Hawaii's narrowed financial operations as underscored by significantly lower reserve levels and payment deferrals that indicate liquidity challenges; and out-year structural gaps due to one-time solutions already incorporated in the enacted budget and proposed for the recently identified budget shortfall. Hawaii continues to exhibit strong management practices demonstrated in its willingness to reduce spending cuts, and its well-established quarterly economic and revenue forecasting process enables the state to identify budget gaps that may arise.

What would change the rating up?

*Rebuilding and maintenance of strong reserve levels.

*Broader economic diversification, sustained job growth, and reduced vulnerability to the tourism industry.

*Maintenance of structural budget balance.

*Annual funding of pension and OPEB annual required contributions.

What would change the rating down?

*Economic weakening leading to employment erosion.

*Further deterioration of revenue trends leading to budget imbalance, liquidity pressure, and narrowing of financial position.

*Increased use of non-recurring solutions to balance budget.

* Failure to adopt a plan to cover expenditures once federal stimulus monies are no longer available

Analysts

Nicole Johnson
Analyst
Public Finance Group
Moody's Investors Service

Nicholas Samuels
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

FitchRatings
KNOW YOUR RISK

Fitch : Info Center : Press Releases

Fitch Rates State of Hawaii GOs 'AA'; Outlook Negative

Ratings

02 Feb 2010 9:33 AM (EST)

Fitch Ratings-New York-02 February 2010: Fitch Ratings assigns an 'AA' rating to the following State of Hawaii general obligation (GO) bonds:

--$312 million GO bonds of 2010, Taxable series DX (Build America Bonds - Direct Payment);
--$222.3 million GO refunding bonds of 2010, series DY.

The bonds are expected to sell via negotiation on Feb. 10.

In addition, Fitch affirms the following ratings:
--$4.7 billion in outstanding State of Hawaii GO bonds.

The Rating Outlook is Negative.

RATING RATIONALE:
--With centralized administration, financial balance has been maintained during periods of economic and financial stress.
--Expected fund balance levels are lower than in recent years; hurricane reserve expected to remain intact.
--Extensive tourist infrastructure underpins an economy dominated by tourism, and the geographic location limits economic diversification efforts.
--Debt levels are high, reflecting in part the state's broad responsibilities, particularly in education, and debt amortizes at an above-average pace.
--The pension funding level has deteriorated, although the state has increased employer contributions in recent years.

WHAT CAN CAUSE A RATING DOWNGRADE:
-- Financial weakening beyond what is assumed in current state forecasts.
--Inability to make progress toward rebuilding a reserve position which offsets volatility present due to the state's tourism-based economy.

SECURITY:
General Obligations of the State of Hawaii, with the full faith and credit of the state pledged.

CREDIT SUMMARY:
The state of Hawaii's 'AA' rating is based on sound financial operations and a demonstrated willingness to maintain budgetary balance under stressful conditions. The Negative Outlook reflects the reduction in previously large balances necessitated by continued revenue underperformance, limiting the state's financial flexibility should revenues weaken further. A funding gap for the current biennial period has been identified, and the state's ability to implement proposed balancing solutions will influence future rating direction. Fitch notes Hawaii has a highly developed tourist economy which has contracted in the current recession, and the sector's outsized presence adds volatility to the state's revenues and overall financial position. The large military presence continues to be an important stabilizing factor, and notable employment growth in professional, educational, and health services in recent years added a measure of diversification. Debt levels are high though amortization remains well above average. Additionally, the state's pension funding levels have also weakened considerably over the last decade.

Hawaii's tourist industry relies heavily on California and Japan, although there has been increased visitation from other countries, most recently Canada. Following a weak period in the early- to mid-1990s caused by recessions in Japan and California and the sharp drop in 2001, the tourism sector saw strong growth that began in 2004 and continued to a record high in 2007, due in part to gains in domestic arrivals. The previous loss of two passenger air carriers and limited recovery of that service, combined with previously rising fuel costs and weakening consumer spending, played negatively on Hawaii's tourism industry in 2008 when arrivals dropped 10.8%. Through the third quarter of 2009, visitor arrivals by air were down a significant 5.9% from levels year-over-year. State projections indicate tourism will return to growth in 2010, though persistence of the global recession may delay that recovery.

INVESTMENT WRITE-DOWN ALLOCATION
JUNE 30, 2009

Dept		Code	Fund	FY08 Write-down	FY09 Adjust	FY09 Gain	FY09 Write-down	Cummulative Write-down
O	Budget and Finance	G	GENERAL FUND	42,167,950	(1,637,957)	(3,504,743)	43,447,679	80,472,929
A	Agriculture	S	SPECIAL FUNDS	653,979	63,730	(54,355)	1,198,463	1,861,817
B	DBEDT	S	SPECIAL FUNDS	916,396	89,303	(76,165)	1,424,302	2,353,836
B	DBEDT	T	TRUST AND AGENCY	2,987	291	(248)	272	3,302
B	DBEDT - HCDA	C	SPECIAL FUNDS	1,271,691	123,926	(105,695)	2,395,755	3,685,677
B	DBEDT - HHFDC	C	SPECIAL FUNDS	3,124,027	304,436	(259,650)	5,241,813	8,410,626
B	DBEDT - HHFDC	C	TRUST AND AGENCY	1,912,363	186,359	(158,944)	4,375,902	6,315,680
C	DLNR	S	SPECIAL FUNDS	1,593,942	155,329	(132,479)	2,617,868	4,234,661
C	DLNR	T	TRUST AND AGENCY	88,916	8,665	(7,390)	226,148	316,339
C	DLNR - Kaahoolawe	T	TRUST AND AGENCY	657,046	64,029	(54,610)	911,143	1,577,609
D	Transp - Admn	S	SPECIAL FUNDS	252,789	24,634	(21,010)	452,452	708,865
D	Transp - Admn	T	TRUST AND AGENCY	291,734	28,429	(24,247)	190,971	486,887
D	Transp - Airport	P	SPECIAL FUNDS	19,952,028	725,506	(1,658,291)	27,701,660	46,720,903
D	Transp - Harbors	P	SPECIAL FUNDS	8,129,236	(2,305,849)	(675,653)	8,389,669	13,537,404
D	Transp - Highways	S	SPECIAL FUNDS	9,531,657	(120,493)	(792,213)	14,110,122	22,729,073
D	Transp - Highways	T	TRUST AND AGENCY	261,191	25,453	(21,709)	408,084	673,020
E	Education	S	SPECIAL FUNDS	769,455	74,983	(63,952)	1,547,579	2,328,065
E	Education	T	TRUST AND AGENCY	345,648	33,683	(28,728)	675,151	1,025,754
H	Health	S	SPECIAL FUNDS	3,845,303	374,724	(319,598)	7,508,608	11,409,037
H	Health Water Pollution	P	SPECIAL FUNDS	4,621,763	450,390	(384,133)	7,463,021	12,151,042
H	Health Drinking Water	P	SPECIAL FUNDS	585,333	57,041	(48,649)	1,122,987	1,716,711
I	HHL	S	SPECIAL FUNDS	780,658	76,075	(64,884)	1,281,899	2,073,749
I	HHL	T	TRUST AND AGENCY	5,745,966	559,943	(477,570)	6,152,607	11,980,946
J	Judiciary	S	SPECIAL FUNDS	312,233	30,427	(25,951)	574,391	891,100
K	Human Services	S	SPECIAL FUNDS	29,500	2,875	(2,452)	46,490	76,413
K	Human Services - HPHA	C	SPECIAL FUNDS	150,568	14,673	(12,514)	249,537	402,264
L	Labor	S	SPECIAL FUNDS	867,862	84,573	(72,131)	1,245,481	2,125,784
M	DAGS	S	SPECIAL FUNDS	1,722,483	167,856	(143,162)	3,193,674	4,940,850
M	DAGS	T	TRUST AND AGENCY	164,645	16,045	(13,684)	261,657	428,662
N	Attorney General	S	SPECIAL FUNDS	174,276	16,983	(14,485)	339,292	516,066
N	Attorney General	T	TRUST AND AGENCY	86,098	8,390	(7,156)	125,934	213,266
O	B&F - EUTF	P	TRUST AND AGENCY	1,456,447	141,930	(121,051)	3,024,650	4,501,976
R	DCCA	S	SPECIAL FUNDS	1,265,023	123,276	(105,141)	2,247,435	3,530,594
R	DCCA	T	TRUST AND AGENCY	157,382	15,337	(13,081)	277,110	436,748
V1	Public Safety	S	SPECIAL FUNDS	52,538	5,120	(4,367)	106,443	159,734
V1	Public Safety	T	TRUST AND AGENCY	13,614	1,327	(1,132)	35,852	49,661
Y3	Leg Auditor	S	SPECIAL FUNDS	21,679	2,113	(1,802)	336,831	358,820
Z1	OHA	S	SPECIAL FUNDS	1,516	148	(126)		1,537
Z1	OHA	T	TRUST AND AGENCY	64,624	6,298	(5,371)		65,550
	TOTAL			**114,042,546**	**(0)**	**(9,478,522)**	**150,908,932**	**255,472,956**

Note: Adjustment made in FY09 is to reflect reduction in investment pool income from the bond pool.
Bond pool did not contain ARS at the close of FY08.

Gain relates to securities repaid at par value in FY09

MONTH June YEAR 2009

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
	1 14.5 DS 1957	2 5,550 2, 2.5	3 13, 5.4, 14.4 10, 20, 19.25 ACC 1,757 3-500-BOH 20-FHBS DN BK*	4 10, 25 6.50	5 8, 27.725, 550 20-FHB 10, 10 5 BOH 10-FHB 10-LPB 10-TEW ML 50W	6 10, 10, 19, 9.1
7 ML 500 5,500, 300	8 10-BOH 15-BOH 10-TEW 3,465-bkgd 5-hmb 13-cpb	9 5.25 2, 2.5 37-FHB 46,142, 4018 EUTF CPB	10 15, 10, 3.9, 5, 10, 20 19.25, 13, 5.4, 14.4 42.5-BOH ML 5.0 15-cpb ACS 2.11W	11 5, 5, 2.65, 100 1,850, 2.1, 5, 6.5 Holiday SB 100 6-CDARS CPB	12 9.85, 12.1, 10, 10, 10 33.75, 9050, 10, 10 10.8, 27.725, 550 10, 10 SB 550 ML 500	13
14 EUTF 15,595	15 1-BOH 20-FHB 20-FHB 4-bkgd 10-Tew 10-hmb 15-cpb ML 50W	16 10,65, 1.2, 20 49, 18.85, 8.95 2, 2.5 SBPC 450	17 5, 10, 3.9, 19.6 PIG 500 ML 50W 19.25 34-BOH 13.54 15-CPB 14.4, 10 15-cpb 20 ACS 2.500	18 10, 3.2, 16, 6.9 10, 10, 26.7 ML 50W SBPC ML 5MW 250 150 1MM-CPB	19 11.55, 20, 11.55 30-FHB 23.5 dc 11-BOH 30-FHB 15-cpb SBPC 500 350	20 11, 9.4, 10, 12 21.9 8, 27.725, 550, 10 10, 1
21 Return FHB for Bond proceeds	22 5 ML 50W dc 15-FHB 15 FHB ML 200W BF 900W-FHB HHFDC	23 5, 3, 20, 5.4 5, 2, 2.5 ML 50W	24 6, 25, 19.25, 13 5.4, 14.4, 10, 20 ACS 2.450 18-cpb	25 48.8, 19.45, 6.5 1,000 CPB-CDARS 600W CPB CDARS Change to repo @ .25 91 days	26 9, 42.65, 10 5, 5, 9.35, 10, 10 6.85, 27.725, 550, 10 10	27
28	29 14,450 20 BOH	30 5.550 10-FHB 30-BOH 10-BOH 10-FHB 70-FHB 10-TEW 10-cpb	2.2.5 96 big banks 20 small 116	EUTF	8.938	

National Conference of State Legislatures

Peer Review

Hawaii Office of the Auditor

August 2007

NATIONAL CONFERENCE
of STATE LEGISLATURES

The Forum for America's Ideas

August 20, 2007

Ms. Marion Higa
State Auditor
Hawaii Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813

Dear Auditor Higa:

At your request, and under the terms of a 2007 contract executed with the National Conference of State Legislatures, we have reviewed the internal quality control system employed by the State of Hawaii's Office of the Auditor for its performance audit engagements for the period from 2004 through early 2007.

In our opinion, the Office's internal quality control system was designed and employed effectively during the period reviewed. Consequently, we provide reasonable assurance that the Office was in conformance with applicable professional standards, as defined in the 2003 Revision to United States Government Auditing Standards issued by the Comptroller General of the United States, during the period reviewed.

We base our assessment on observations made during an on-site review conducted June 20-22, 2007. It included a review of the Office's policy guide, personnel handbook, five randomly selected audit reports, and selected personnel records, as well as interviews with several of the Office's professional staff. We note that the conduct of our review was not impaired in any way. We were granted full access to relevant reports, working papers and other supporting documentation, and staff.

Our conclusions follow. All references are to the 2003 Revision to United States Government Auditing Standards.

> *The Office's internal control policies and procedures are comprehensive and appropriate (3.49).*
>
> *Staff possess the combined knowledge and skills to perform assigned work competently (3.39).*
>
> *Appropriate professional judgment is used (3.33).*
>
> *A documented system of procedures is in place to ensure independence is maintained (3.03).*
>
> *Performance audit standards relating to planning (7.02), supervision (7.44), evidence (7.48), documentation (7.66), and reporting (8.02, 8.07, 8.38, and 8.54) were complied with in the five audit reports we reviewed.*

National Conference of State Legislatures

We appreciate the courtesy and cooperation extended to us in conducting this review. We commend you for your willingness to contract for this peer review to independently confirm the quality of your performance audits.

Sincerely,

Janice Mueller
State Auditor
Wisconsin Legislative Audit Bureau

Max Arinder
Executive Director
Mississippi Joint Committee on Performance Evaluation and Expenditure Review

Manu Patel
Deputy Director for Performance Audit
New Mexico Legislative Finance Committee

John Schaff
Legislative Auditor General
Utah Office of the Legislative Auditor General

Bob Boerner
Program Principal
National Conference of State Legislatures

National Conference of State Legislatures

Peer Review

Hawaii Office of the Auditor

Introduction

The Hawaii Office of the Auditor (Office) contracted with the National Conference of State Legislatures (NCSL) to organize a team of peers from around the nation to review and evaluate the internal quality control system that the Office employed for its performance audit engagements for the period from 2004 through early 2007.

To accomplish the goal of evaluating the Office's internal quality control system, NCSL organized a project team consisting of four highly experienced and respected program evaluators from Mississippi, New Mexico, Utah, and Wisconsin, and the National Legislative Program Evaluation Society staff liaison. (See appendix for names, addresses, and qualifications of the peer review team.)

Methodology

The Office has adopted the government auditing standards issued by the Comptroller General of the United States (often referred to as the "Yellow Book") as the principles by which it performs work.

The peer review team consulted existing professional standards for conducting performance audits. Five reports completed by the Office during the compliance period were selected for review. The reports were randomly selected individually by members of the peer review team from a listing of reports released between April 2004 and March 2007 that had been prepared by Office staff.

Each peer review team member took lead responsibility for one of the reports. This included reviewing the report in depth, reviewing the supporting working papers, and interviewing the Office staff who worked on the report. Senior managers and selected performance audit staff were interviewed. The peer review team discussed its preliminary conclusions with the Auditor, the Deputy Auditor/In-House Counsel, and Office managers onsite.

Compliance with Standards

The peer review team's conclusions follow. All references are to the 2003 Revision to United States Government Auditing Standards.

The Office's internal control policies and procedures are comprehensive and appropriate (3.49).

Staff possess the combined knowledge and skills to perform assigned work competently (3.39).

Appropriate professional judgment is used (3.33).

A documented system of procedures is in place to ensure independence is maintained (3.03).

Performance audit standards relating to planning (7.02), supervision (7.44), evidence (7.48), documentation (7.66), and reporting (8.02, 8.07, 8.38, and 8.54) were complied with in the five audit reports reviewed.

The reviewers were particularly impressed with the comprehensiveness of the Office's "Manual of Guides." The internal control policies are comprehensive and delineate clear procedures for monitoring quality throughout the course of a project and ensuring an auditable record.

In addition, the reviewers found compliance with relevant standards for continuing professional education, hiring, performance evaluation, and the project assignment process.

Staff Competency

Based on an analysis of personnel data, the reviewers concluded that management and research analysts at the Office possess the combined knowledge and skills to perform assigned work competently. Further, the reviewers found the following:

- Top management selects audit teams with an eye toward the competencies of the staff and the demands of the project. Where resources do not allow an exact match, consultation with knowledgeable staff not assigned to the project is encouraged as needed. Final review by experienced senior staff is a routine component of project execution.

- Factors considered in team selection are interests, experience, knowledge, and special competencies.

- Copies of "Staff Qualifications Questionnaires" for the project revealed an eclectic, well-trained staff that possessed the needed knowledge, skills, and abilities to perform the work required for this review.

- Interviews with upper management reveal efforts to keep the Office on the leading edge of service to the state.

Specific Observations and Recommendations

The reviewers believe that several report-specific observations and recommendations, if implemented, may enhance the quality and accuracy of performance audits issued by the Office. The reviewers also noted some instances of noncompliance with the Office's procedures. However, these instances, which follow, had no material effect on the final reports issued by the Office.

- In one instance, a reviewer found an example of a selective analysis. It was reported that an entity had losses in four of the past six years. However, the report did not appropriately disclose that in more recent years, net assets had actually increased.

- All four reviewers found instances in which an audit team's findings, analysis, and conclusions were not adequately supported by source documents that were maintained in the working papers.

- In one instance, the Office's own internal review procedure identified a lack of supporting documentation; however, the internal reviewer's suggested change was not incorporated in the final published report.

- One reviewer found several instances of inconsistency in rounding financial information.

- All four reviewers noted that staff with less than two years of experience were assigned responsibility for the Office's internal reference review process, leading to some errors.

- All four reviewers noted a lack of uniformity in decisions to utilize qualitative versus quantitative methods.

- One reviewer noted one instance of a strong tone in a final report that implied knowledge of an auditee's thoughts or motivations without adequate documentation.

- The reviewers noted that staff turnover and the attendant issues of training and supervision may have contributed to the instances they observed.

The Office is in the process of completing an externally facilitated strategic planning effort that should provide a blueprint for the future of quality audit and evaluation efforts. As part of that effort, *the reviewers recommend:*

- *improved documentation and retention of source documents;*
- *additional reference review training for less-experienced staff;*
- *an increase in the use of "summary documents" to tie together complex working papers, ensure an appropriate audit trail, and facilitate external review; and*
- *an extension of the Office's current strategic planning efforts to provide staff training to address the stated observations.*

Appendix A – Reports Reviewed

The following reports were selected for review.

Number	Project Name
05-05	"Audit of Selected Agencies' Procurement of Professional Services Contracts"
05-07	"Follow-Up Audit of the Foster Board Payment Program"
07-03	"Management of Student Housing Services at the University of Hawai'i at Mānoa Part I"
07-04	"Audit of the Child Support Enforcement Agency"
05-01	"Audit of Na Wai Ola Waters of Life Charter School"

Appendix B – Peer Review Team

Max Arinder

Max Arinder is the Executive Director of the Mississippi Legislature's Joint Committee on Performance Evaluation and Expenditure Review (PEER). He has been the PEER Committee's Executive Director for 11 years and previously served as Chief of Planning and Support for 15 years. Max has been actively involved with NCSL throughout his career, serving as a trainer, consultant, drafting team member, Executive Committee member and officer, delegation leader and member of foreign exchange programs, and panelist. He was the Staff Chair of NCSL for the 2003-04 conference year. Max has a Ph.D. in experimental psychology from the University of Southern Mississippi.

Max Arinder
Executive Director
Mississippi Legislature's Joint Committee on PEER
P.O. Box 1204
Jackson, Mississippi 39215
(601) 359-1226
E-mail: arinder@peer.state.ms.us

Bob Boerner

Bob Boerner is a Program Principal in the legislative information services program of NCSL. He specializes in several topic areas, including cable television, consumer rights, and telecommunications, and serves as staff liaison to the National Legislative Program Evaluation Society. He conducted a sunset review of the Arizona Office of the Auditor General, a review of how Florida's Office of Program Policy Analysis and Government Accountability (OPPAGA) reports are used by key stakeholders, and the peer review of OPPAGA in 2002 and 2006. He supervises NCSL's program to facilitate peer reviews of legislative program evaluation offices. He has been a member of the Colorado Bar since 1989.

Bob Boerner
Program Principal
National Conference of State Legislatures
7700 East First Place
Denver, Colorado 80230
(303) 364-7700
E-mail: Bob.Boerner@ncsl.org

Janice Mueller

Janice Mueller is the Wisconsin State Auditor. She was appointed to this position by the leaders of the Wisconsin Legislature in March 1998. She leads and directs the operations of the nonpartisan Legislative Audit Bureau, which conducts both financial audits and program evaluations of state agencies and programs. Jan received a bachelor of arts degree in political science from Central Michigan University in December 1974.

The Legislative Audit Bureau has been nationally recognized as a leader in the field of financial auditing and program evaluation. In 2002, the Bureau received the National Legislative Program Evaluation Society's *Award for Excellence in Evaluation* in recognition of its adherence to the highest performance standards across a body of evaluative work. In addition, in both 2003 and 2006 the Legislative Audit Bureau received unqualified opinions on its financial auditing work from the National State Auditors Association.

Janice Mueller
Wisconsin State Auditor
Wisconsin Legislative Audit Bureau
22 East Mifflin Street, Suite 500
Madison, Wisconsin 53703
(608) 266-2818
E-mail: janice.mueller@legis.wisconsin.gov

Manilal (Manu) Patel

Manu Patel is a Deputy Director for Performance Audit for the New Mexico Legislative Finance Committee. He was Vice-President for Finance and Administration at New Mexico Highlands and was a Deputy State Auditor with the Office of the State Auditor, Santa Fe, New Mexico. Manu worked in the financial, performance and program evaluation field for the last 31 years. During that period, he participated as a team member in two peer reviews of other states' audit organizations. Manu received his Master of Business Administration degree in 1972 from the Eastern New Mexico University. He is a Certified Public Accountant licensed by the New Mexico State Board of Public Accountancy since September 1980.

Manu Patel
Deputy Director for Performance Audit
New Mexico Legislative Finance Committee
325 Don Gaspar, Suite 101
Santa Fe, New Mexico 87501
(505) 986-4550
E-Mail: Manu.Patel@state.nm.us

John Schaff

John Schaff is the Utah Legislative Auditor General. He has been with the Office of the Legislative Auditor General for 30 years, serving as an audit supervisor, audit manager, and deputy director. The Legislature appointed him Auditor General in 2004. From 1970 to 1977, John was employed with the United States General Accounting Office, where he worked in the Denver Regional Office as an auditor and supervisor. John has been actively involved with training state and local government audit agencies. He has served in various functions for the National Legislative Program Evaluation Society of NCSL. John is a Certified Internal Auditor. He graduated from the University of Utah in 1970 with a bachelor of science degree in management and a minor in accounting.

John Schaff
Utah Legislative Auditor General
Office of the Legislative Auditor General
130 State Capitol
Salt Lake City, Utah 84114
(801) 538-1033
E-mail: jschaff@utah.gov