



**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Basic Financial Statements and Single Audit Reports

Year ended June 30, 2006

(With Independent Auditors' Reports Thereon)

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Basic Financial Statements and Single Audit Reports

Year ended June 30, 2006

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SECTION I
INTRODUCTION



KPMG LLP
PO Box 4150
Honolulu, HI 96812-4150

March 29, 2007

The Director of the
Department of Business,
Economic Development and Tourism
State of Hawaii:

We have completed the audit of the basic financial statements of the Department of Business, Economic Development and Tourism, State of Hawaii (the Department), as of and for the year ended June 30, 2006. We have also audited the Department's compliance with requirements applicable to its major federal financial assistance programs. We submit herein our reports on the Department's basic financial statements and federal financial assistance programs.

The audit objectives and scope of the financial audit were as follows.

AUDIT OBJECTIVES

1. To provide opinions on the fair presentation of the Department's basic financial statements and the schedule of expenditures of federal awards as of and for the year ended June 30, 2006, in accordance with U.S. generally accepted accounting principles.
2. To consider the Department's internal control over financing reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the basic financial statements.
3. To perform tests of the Department's compliance with laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes), that could have a direct and material effect on the determination of financial statement amounts.
4. To consider the Department's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance.
5. To provide an opinion on the Department's compliance with applicable laws, regulations, contracts, and grants that could have a direct and material effect on each major program.

The Director of the
Department of Business,
Economic Development and Tourism
State of Hawaii
March 29, 2007
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SCOPE OF AUDIT

We performed an audit of the Department's basic financial statements and schedule of expenditures of federal awards as of and for the year ended June 30, 2006, in accordance with auditing standards generally accepted in the United States of America, as adopted by the American Institute of Certified Public Accountants, the standards for financial and compliance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the provisions of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

ORGANIZATION OF REPORT

Our report is organized into four sections as follows:

1. Section I, entitled "Introduction," describes the objectives and scope of our financial audit and the organization and contents of this report.
2. Section II, entitled "Financial Section," contains the Department's basic financial statements and notes as of and for the year ended June 30, 2006, and our report thereon.
3. Section III, entitled "Compliance and Internal Control over Financial Reporting," contains our report on the Department's internal control over financial reporting and on compliance and other matters based upon our audit of the Department's basic financial statements.
4. Section IV, entitled "Compliance and Internal Control over Federal Awards," contains our report on the Department's compliance and internal control over federal awards in accordance with OMB Circular A-133, a schedule of expenditures of federal awards, and a schedule of findings and questioned costs.

We would like to take this opportunity to express our appreciation to the personnel of the Department of Business, Economic Development and Tourism for the cooperation and assistance extended to us during our audit. We will be pleased to discuss any questions that you or your associates may have regarding our recommendations.

Very truly yours,

KPMG LLP

SECTION II
FINANCIAL SECTION



KPMG LLP
PO Box 4150
Honolulu, HI 96812-4150

Independent Auditors' Report

The Director of the
Department of Business,
Economic Development and Tourism
State of Hawaii:

We have audited the accompanying financial statements of the governmental activities and each major fund of the Department of Business, Economic Development and Tourism, State of Hawaii (the Department), as of and for the year ended June 30, 2006, which collectively comprise the Department's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the Hawaii Tourism Authority (the Authority), a blended component unit of the Department, which represents 76% and 77% of the assets and revenues, respectively, of the governmental activities, and which represents 49% and 84% of the assets and revenues, respectively, of the Economic Development Special Revenue Fund. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinions, insofar as they relate to the amounts included for the Authority, are based solely on the report of the 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 Department'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 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 report of the other auditors provide a reasonable basis for our opinions.

As discussed in note 1, the financial statements of the Department are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and major fund information of the State of Hawaii (the State) that are attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of the State as of June 30, 2006, and the changes in its financial position for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, based on our audit and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of the Department as of June 30, 2006, and the respective changes in financial position and the respective budgetary comparison for the General and Economic Development Special Revenue Funds for the year then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 29, 2007 on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 5 through 12 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We 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.

KPMG LLP

March 29, 2007

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2006

As management of the Department of Business, Economic Development and Tourism, State of Hawaii (the Department), we offer readers of the Department's basic financial statements this narrative overview and analysis of the financial activities of the Department for the fiscal year ended June 30, 2006.

Financial Highlights

- The assets of the Department exceeded its liabilities at June 30, 2006 by \$375.5 million (net assets).
- Of the total net assets, the amount of \$46.5 million or 12.4% was unrestricted and may be used by the Department for its operations and activities in achieving its goal of sustainable growth of Hawaii's economy.
- The Department's liabilities reported in the statement of net assets decreased during the current fiscal year to \$31.3 million, a decrease of \$7.3 million or 18.8% from the prior year.
- At June 30, 2006, the Department reported combined ending fund balances of \$49.1 million. Of this amount, \$12.5 million or 25.6% of the total fund balances is available for spending at the Department's discretion (unreserved fund balance) and the remaining \$36.5 million represents amounts reserved for specific purposes.

Overview of the Basic Financial Statements

This discussion and analysis is intended to serve as an introduction to the Department's basic financial statements. The Department's basic financial statements are comprised of three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to basic financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

Government-Wide Financial Statements

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

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

The statement of activities presents information showing how the Department's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected tax revenue and unused vacation leave).

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Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Department uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The funds of the Department can be divided into two categories, Governmental Funds and Fiduciary Funds.

Governmental Funds

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

Because the focus of Governmental Funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for Governmental Funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Department's near-term financing decisions. Both the Governmental Funds balance sheet and the Governmental Funds statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between Governmental Funds and governmental activities in the government-wide financial statements.

Information is presented separately in the Governmental Funds balance sheet and in the Governmental Funds statement of revenues, expenditures, and changes in fund balances for the General Fund, Economic Development Special Revenue Fund, and Capital Projects Fund.

The Department adopts an annual appropriated budget for its General Fund and Economic Development Special Revenue Fund. A budgetary comparison statement has been provided for these funds to demonstrate compliance with this budget. The budgetary comparison statement for the General Fund and the Economic Development Special Revenue Fund is located in the basic financial statements.

Fiduciary Funds

Fiduciary Funds are used to account for resources held for by the Department in an agency capacity.

Notes to Basic Financial Statements

The notes to basic financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

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Government-Wide Financial Analysis

The following is a financial analysis on the governmental activities of the Department. Net assets are a useful indicator of a government's financial position. For the Department, total assets exceeded liabilities by \$375.5 million, and increased \$1.8 million or 0.5% over the course of this fiscal year's operations.

The following table was derived from the government-wide statement of net assets:

Net Assets		
June 30, 2006 and 2005		
(Amounts in thousands)		
	FY 2006	FY 2005 (as restated)*
Assets:		
Current and other assets	\$ 77,803	\$ 75,521
Capital assets	328,994	336,770
Total assets	406,797	412,291
Liabilities:		
Long-term liabilities, net of current portion	1,935	1,923
Other liabilities	29,394	36,671
Total liabilities	31,329	38,594
Net assets:		
Invested in capital assets	328,994	336,770
Unrestricted	46,474	36,927
Total net assets	\$ 375,468	\$ 373,697

*These amounts have been restated. See note 3 for further explanation.

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Management's Discussion and Analysis

June 30, 2006

Analysis of Net Assets

By far the largest portion of the Department's net assets (\$329.0 million or 87.6%) reflects its investment in capital assets (e.g., land, buildings, and equipment), less any related debt used to acquire those assets that is still outstanding. The Department uses these capital assets to provide governmental services to the public and businesses; consequently, these assets are not available for future spending.

The remaining balance of unrestricted net assets of \$46.5 million or 12.4% of the total net assets may be used to meet the Department's ongoing obligations for its operations relating to business and economic development.

Current and other assets increased by \$2.3 million or 3.0% from the prior fiscal year, due primarily to increase in program revenues and funds appropriated for new capital improvement projects.

During the current fiscal year, capital assets decreased by \$7.8 million or 2.3%, due primarily to the recording of current year depreciation expense, which was offset by current year additions for capital improvement projects of the Foreign-Trade Zone Division and the Hawaii Tourism Authority (the Authority).

Total liabilities decreased by \$7.3 million or 18.8% from the prior fiscal year, due primarily to a \$9.4 million decrease in the amount owed by the Authority to the State Department of Budget and Finance for debt service on general obligation bonds used to construct the Hawaii Convention Center.

Changes in Net Assets

The following financial information was derived from the government-wide statement of activities and reflects how the Department's net assets changed during the fiscal year.

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Management's Discussion and Analysis

June 30, 2006

Changes in Net Assets

Years ended June 30, 2006 and 2005

(Amounts in thousands)

	<u>FY 2006</u>	<u>FY 2005 (as restated)*</u>
Revenues:		
Program revenues:		
Charges for services	\$ 18,913	\$ 13,083
Operating grants and contributions	13,584	13,377
General revenues:		
Transient accommodations tax	102,404	96,334
State-allotted appropriations	11,909	13,237
Other	4,318	3,172
Total revenues	<u>151,128</u>	<u>139,203</u>
Expenses:		
Hawaii Tourism Authority	109,857	103,694
Natural Energy Laboratory of Hawaii Authority	11,414	10,246
High Technology Development	5,138	5,034
Office of Planning	4,346	4,006
General Support for Economic Development	3,401	3,191
Strategic Industries	3,256	3,209
Strategic Marketing and Support	2,823	2,263
Economic Planning and Research for Economic Development	2,762	2,500
Hawaii Strategic Development Corporation	2,524	146
Foreign-Trade Zone	1,881	1,828
Creative Industries	1,326	1,763
Land Use Commission	589	536
Aloha Tower Development Corporation	40	3,827
Total expenses	<u>149,357</u>	<u>142,243</u>
Changes in net assets before transfers	1,771	(3,040)
Transfers	—	(1,397)
Changes in net assets	1,771	(4,437)
Net assets, beginning, as restated	<u>373,697</u>	<u>378,134</u>
Net assets, end	<u>\$ 375,468</u>	<u>\$ 373,697</u>

*These amounts have been restated. See note 3 for further explanation.

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Management's Discussion and Analysis

June 30, 2006

Analysis of Changes in Net Assets

The Department's net assets increased by \$1.8 million or 0.5% during the fiscal year ended June 30, 2006 primarily due to the current fiscal year's total revenues exceeding the current fiscal year's total expenses.

Total revenues for the Department were \$151.1 million for FY 2006. Of this total, the amount of \$102.4 million or 67.8% was from the transient accommodations tax revenues received by the Authority, which increased by \$6.1 million or 6.3% from the prior fiscal year due to the strength of the State's tourism industry. Revenues generated by program charges for services were \$18.9 million or 12.5% of the total, the State-allotted appropriations made up 7.9% of the total, and federal grants and other sources provided the balance in total revenues. Revenues generated by program charges for services increased by \$5.8 million or 44.6% from the prior fiscal year primarily due to the operations of the Hawaii Convention Center.

Total expenses for the Department were \$149.4 million for FY 2006. The expenses were for the following programs administered by the Department: the Authority, Natural Energy Laboratory of Hawaii Authority (NELHA), Office of Planning, High Technology Development Corporation, Hawaii Strategic Development Corporation, Strategic Industries, Strategic Marketing and Support, Creative Industries, Economic Planning and Research for Economic Development, General Support for Economic Development, Aloha Tower Development Corporation, Land Use Commission, and the Foreign-Trade Zone. The largest expenses were for the Hawaii Tourism Authority of \$109.9 million or 73.6% of the total expended, which increased \$6.2 million or 5.9% from the prior fiscal year primarily due to increases in the Convention Center's operating costs.

Financial Analysis of the State's Individual Funds

As noted earlier, the Department uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the Department's Governmental Funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the Department's financing requirements. In particular, the unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the Department's Governmental Funds reported combined ending fund balances of \$49.1 million, an increase of \$0.5 million or 1.0% from the prior fiscal year. Approximately \$12.5 million or 25.6% of this total amount constitutes the unreserved fund balance, which is available for spending at the Department's discretion in the coming fiscal year.

The General Fund is the Department's primary operating fund. At the end of the current fiscal year, the fund balance of the Department's General Fund was \$3.5 million, which reflects a decrease of 1.0% over the prior fiscal year.

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Management's Discussion and Analysis

June 30, 2006

The Economic Development Special Revenue Fund accounts for all programs related to the development and promotion of industry and international commerce, energy development and management, economic research and analysis, and the utilization of resources. At the end of the current fiscal year, the fund balance of the Economic Development Special Revenue Fund was \$42.8 million, of which \$10.6 million was unreserved and available for the Department's expenses.

The Capital Projects Fund accounts for financial resources used for the acquisition or construction of major capital facilities. The fund balance of the Capital Projects Fund at the end of the current year was \$2.7 million.

Fiduciary Funds

The Department maintains an Agency Fund for the funds held in the bank account for out-of-state operations and security deposits for the Foreign-Trade Zone Division, NELHA, and the High Technology Development Corporation.

General Fund Budgetary Highlights

The difference between the General Fund original budget of \$11.0 million and the final budget of \$11.1 million was \$0.1 million. Actual expenditures were \$10.8 million for FY 2006 resulting in a variance between the final budget and actual expenditures on a budgetary basis of \$0.3 million.

Capital Assets

The Department's investment in capital assets as of June 30, 2006 amounted to \$329.0 million (net of accumulated depreciation of \$92.1 million). This investment in capital assets includes land, buildings and improvements, machinery, and equipment. Major capital improvement project expenses for the fiscal year ended June 30, 2006 included the Onshore Distribution System and the HOST Park infrastructure upgrade projects at NELHA, the Refurbishment and Upgrades, Maui Research and Technology Center of the High Technology Development Corporation, and the Pier 2 Warehouse and Office Improvements project at the Foreign-Trade Zone Division.

Additional information on the Department's capital assets can be found in note 8 of the notes to basic financial statements.

Due to State Department of Budget and Finance

At the end of the current fiscal year, the outstanding principal and interest amounts required to be reimbursed by the Authority to the State Department of Budget and Finance (Budget and Finance) were \$294.9 million and \$207.3 million, respectively. This entire amount was comprised of general obligation bonds, which are backed by the full faith and credit of the State and whose proceeds were used to fund the construction of the Hawaii Convention Center.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2006

The Authority's ability to reimburse Budget and Finance is contingent upon continued receipt of future transient accommodations tax allocations from the State. In addition, the ultimate responsibility for debt service payments to the bondholders of the general obligation bonds remains with the State through Budget and Finance. Accordingly, the obligation to reimburse Budget and Finance for debt service as described above has not been recorded in the Department's basic financial statements. However, the Authority's obligation to reimburse Budget and Finance in accordance with the mutually agreed-upon payment plan represents a commitment of the Authority.

For the current fiscal year, the Authority was required to reimburse Budget and Finance \$26.2 million for debt service. At the end of the current fiscal year, the unpaid amount due to Budget and Finance was \$11.5 million.

Additional information on the Department's due to State Department of Budget and Finance can be found in note 9 of the notes to the basic financial statements.

Economic Factors and Next Year's Budget

The Council on Revenues in September 2006 estimated that the State's General Fund tax growth rate would be 6.0% in fiscal 2007, 6.0% in fiscal 2008, and 4.1% in fiscal 2009. While the State's economy continues to strengthen, the Governor's budget policy mandates that all departments maintain fiscal discipline in managing its resources. Consultant and personal services contracts greater than \$25,000 and the filling of positions continue to require the approval of the Governor and other expenditure controls implemented in fiscal 2006 continue to be in force.

Updates to revenue projections issued by the Council on Revenues will impact the Governor's policy on budget formulation and, accordingly, the Department's future budget.

Requests for Information

Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Director, Department of Business, Economic Development and Tourism, P.O. Box 2359, Honolulu, Hawaii 96804. General information about the Department can be found at the State's website, <http://www.hawaii.gov/dbedt>.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Statement of Net Assets

June 30, 2006

Assets		
Cash:		
Cash in state treasury (note 5)	\$	38,328,287
Cash in bank (note 5)		246,660
Petty cash		35,850
Total cash		38,610,797
Receivables:		
Accounts, net (note 6)	\$	444,680
Transient accommodations tax		8,574,969
Due from Hawaii Convention Center		1,575,193
Loans, net (note 6)		2,268,103
Due from grantor		767,291
Interest		12,861
Total receivables, net		13,643,097
Investments (note 5)		16,745,807
Investment in venture capital limited partnerships, at cost (note 2)		8,803,515
Capital assets, net (note 8):		
Land and construction in progress		159,472,703
Other capital assets, net		169,521,298
Capital assets, net		328,994,001
Total assets		406,797,217
Liabilities		
Liabilities:		
Vouchers payable		2,999,003
Accrued payroll		633,597
Due to State Department of Budget and Finance (note 9)		11,542,586
Due to other state agencies (notes 2 and 7)		8,738,607
Due to State General Fund		35,850
Deferred revenues		4,773,233
Accrued vacation (note 10):		
Due within one year		670,943
Due in more than one year		1,935,303
Total liabilities		31,329,122
Commitments and contingencies (notes 7, 9, 10, 11, 12, and 13)		
Net Assets		
Invested in capital assets		328,994,001
Unrestricted		46,474,094
Total net assets		\$ 375,468,095

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Statement of Activities

Year ended June 30, 2006

	Program expenses (notes 7, 9, 10, 11, and 13)	Program revenues		Net expense and change in net assets
		Charges for services	Operating grants and contributions	
Governmental activities:				
Hawaii Tourism Authority (note 8)	\$ 109,857,401	\$ 12,018,472	\$ —	\$ (97,838,929)
Natural Energy Laboratory of Hawaii Authority	11,414,338	2,788,300	8,396,424	(229,614)
High Technology Development Corporation	5,137,505	967,821	2,199,669	(1,970,015)
Office of Planning	4,346,027	—	2,315,914	(2,030,113)
General Support for Economic Development	3,401,225	—	—	(3,401,225)
Strategic Industries	3,255,558	180,305	658,934	(2,416,319)
Strategic Marketing and Support	2,823,118	2	13,237	(2,809,879)
Economic Planning and Research for Economic Development	2,761,549	—	—	(2,761,549)
Foreign-Trade Zone	1,880,448	1,653,405	—	(227,043)
Hawaii Strategic Development Corporation	2,524,299	—	—	(2,524,299)
Creative Industries	1,326,308	—	—	(1,326,308)
Land Use Commission	589,387	—	—	(589,387)
Aloha Tower Development Corporation	40,162	1,304,770	—	1,264,608
Total governmental activities	<u>\$ 149,357,325</u>	<u>\$ 18,913,075</u>	<u>\$ 13,584,178</u>	<u>(116,860,072)</u>
General revenues:				
Transient accommodations tax				102,404,128
State-allotted appropriations, net of reversions and lapses				11,909,304
Nonimposed employee fringe benefits (note 12)				2,598,956
Interest				1,980,416
Lapsed appropriations related to previous years				(421,984)
Other				160,304
Total general revenues				<u>118,631,124</u>
Change in net assets				<u>1,771,052</u>
Net assets at July 1, 2005, as previously reported				382,791,552
Prior-period adjustment (note 3)				<u>(9,094,509)</u>
Net assets at July 1, 2005, as restated				373,697,043
Net assets at June 30, 2006				<u>\$ 375,468,095</u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Balance Sheet – Governmental Funds

June 30, 2006

Assets	<u>General</u>	<u>Economic Development Special Revenue</u>	<u>Capital Projects</u>	<u>Total Governmental Funds</u>
Cash in state treasury (note 5)	\$ 1,933,149	\$ 33,668,274	\$ 2,726,864	\$ 38,328,287
Cash in bank (note 5)	—	246,660	—	246,660
Petty cash	12,000	23,850	—	35,850
Receivables:				
Accounts, net (note 6)	—	444,680	—	444,680
Loans, net (note 6)	2,219,640	48,463	—	2,268,103
Interest	12,597	264	—	12,861
Due from grantor	—	767,291	—	767,291
Transient accommodations tax receivable	—	8,574,969	—	8,574,969
Due from Hawaii Convention Center	—	1,575,193	—	1,575,193
Investments (note 5)	—	16,745,807	—	16,745,807
Investment in venture capital limited partnerships, at cost (note 2)	—	8,803,515	—	8,803,515
Total assets	<u>\$ 4,177,386</u>	<u>\$ 70,898,966</u>	<u>\$ 2,726,864</u>	<u>\$ 77,803,216</u>
Liabilities and Fund Balances				
Liabilities:				
Vouchers payable	\$ 346,230	\$ 2,629,062	\$ 23,711	\$ 2,999,003
Accrued payroll	278,478	355,119	—	633,597
Due to State Department of Budget and Finance (note 9)	—	11,542,586	—	11,542,586
Due to other state agencies (notes 2 and 7)	—	8,738,607	—	8,738,607
Due to State General Fund	12,000	23,850	—	35,850
Deferred revenues	—	4,773,233	—	4,773,233
Total liabilities	<u>636,708</u>	<u>28,062,457</u>	<u>23,711</u>	<u>28,722,876</u>
Fund balances:				
Reserved for encumbrances	1,580,475	32,156,194	2,396,753	36,133,422
Reserved for capital projects	—	—	306,400	306,400
Reserved for other purposes	—	95,524	—	95,524
Unreserved (note 13)	1,960,203	10,584,791	—	12,544,994
Total fund balances	<u>3,540,678</u>	<u>42,836,509</u>	<u>2,703,153</u>	<u>49,080,340</u>
Total liabilities and fund balances	<u>\$ 4,177,386</u>	<u>\$ 70,898,966</u>	<u>\$ 2,726,864</u>	
Amounts reported in the statement of net assets are different because:				
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the governmental funds				328,994,001
Accrued vacation reported in the statement of net assets does not require the use of current financial resources and, therefore, is not reported as liabilities in the governmental funds				(2,606,246)
Net assets of governmental activities				<u>\$ 375,468,095</u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Statement of Revenues, Expenditures, and Changes in Fund Balances -- Governmental Funds
Year ended June 30, 2006

	General	Economic Development Special Revenue	Capital Projects	Total Governmental Funds
Revenues:				
Transient accommodations tax	\$ —	\$ 102,404,128	\$ —	\$ 102,404,128
Charges for current services	—	18,913,075	—	18,913,075
Intergovernmental	—	13,584,178	—	13,584,178
State-allotted appropriations, net of reversions and lapses	10,409,304	—	1,500,000	11,909,304
Nonimposed employee fringe benefits (note 12)	2,598,956	—	—	2,598,956
Interest	(2,945)	1,983,361	—	1,980,416
Other	—	160,304	—	160,304
Total revenues	<u>13,005,315</u>	<u>137,045,046</u>	<u>1,500,000</u>	<u>151,550,361</u>
Expenditures (notes 8, 10, 11, 12, and 13):				
Hawaii Tourism Authority	25,000	103,315,016	—	103,340,016
Natural Energy Laboratory of Hawaii Authority	193,785	11,171,556	—	11,365,341
Office of Planning	2,123,873	2,287,021	—	4,410,894
High Technology Development Corporation	1,107,618	3,294,244	—	4,401,862
Strategic Industries	1,051,319	2,187,021	—	3,238,340
General Support for Economic Development	2,943,935	—	—	2,943,935
Economic Planning and Research for Economic Development	1,342,756	1,446,751	—	2,789,507
Strategic Marketing and Support	2,130,785	434,470	—	2,565,255
Hawaii Strategic Development Corporation	114,410	2,405,826	—	2,520,236
Foreign-Trade Zone	—	1,474,727	—	1,474,727
Creative Industries	1,193,362	—	—	1,193,362
Land Use Commission	582,787	—	—	582,787
Aloha Tower Development Corporation	—	55,684	—	55,684
Capital outlays	—	—	676,662	676,662
Total expenditures	<u>12,809,630</u>	<u>128,072,316</u>	<u>676,662</u>	<u>141,558,608</u>
Excess of revenues over expenditures	<u>195,685</u>	<u>8,972,730</u>	<u>823,338</u>	<u>9,991,753</u>
Other financing sources (uses):				
Transfers out	(151,796)	—	—	(151,796)
Transfers in	—	151,796	—	151,796
Lapsed appropriations related to previous years	(81,404)	—	(340,580)	(421,984)
Total other financing sources (uses), net	<u>(233,200)</u>	<u>151,796</u>	<u>(340,580)</u>	<u>(421,984)</u>
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses	<u>(37,515)</u>	<u>9,124,526</u>	<u>482,758</u>	<u>9,569,769</u>
Fund balances, July 1, 2005, as previously reported	3,578,193	42,806,492	2,220,395	
Prior period adjustment (note 3)	—	(9,094,509)	—	
Net assets at July 1, 2005, as restated	<u>3,578,193</u>	<u>33,711,983</u>	<u>2,220,395</u>	
Fund balances, June 30, 2006	<u>\$ 3,540,678</u>	<u>\$ 42,836,509</u>	<u>\$ 2,703,153</u>	
Amounts reported in the statement of net assets are different because:				
Governmental funds report capital outlays as expenditures; however, in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which depreciation exceeded capital outlays in the current period				(7,775,865)
Accrued vacation reported in the statement of activities does not require the use of current financial resources and, therefore, is not reported as expenditures in the governmental funds				(22,852)
Change in net assets				<u>\$ 1,771,052</u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Statement of Revenues and Expenditures – Budget and Actual
(Budgetary Basis) – General and Economic Development Special Revenue Funds
Year ended June 30, 2006

	General Fund			Economic Development Special Revenue Fund			Variance favorable (unfavorable)
	Original budget	Final budget	Actual (budgetary basis)	Original budget	Final budget	Actual (budgetary basis)	
Revenues:							
State-allotted appropriations, net of reversions and lapses	\$ 10,982,567	\$ 11,145,804	\$ 10,826,299	\$	\$	\$	\$
Transient accommodations tax	—	—	—	99,868,000	99,868,000	103,404,128	3,536,128
Other	—	—	—	40,241,257	40,340,875	17,595,627	(22,745,248)
Total revenues	10,982,567	11,145,804	10,826,299	140,109,257	140,208,875	120,999,755	(19,209,120)
Expenditures:							
Hawaii Tourism Authority (note 9)	25,000	25,000	25,000	117,200,000	117,225,347	111,214,148	6,011,199
Natural Energy Laboratory of Hawaii Authority	169,993	173,892	154,035	3,709,604	3,724,171	3,210,812	513,359
High Technology Development Corporation	936,930	947,482	921,934	5,371,030	5,380,056	1,023,800	4,356,256
Office of Planning	1,580,561	1,690,713	1,659,350	—	—	—	—
Aloha Tower Development Corporation	—	—	—	1,533,386	1,568,200	791,119	777,081
Strategic Industries	1,198,347	1,185,167	1,144,428	1,861,769	1,861,769	189,903	1,671,866
General Support for Economic Development	2,250,586	2,324,116	2,305,169	—	—	—	—
Economic Planning and Research for Economic Development	977,480	1,003,776	1,001,785	1,327,887	1,331,179	1,323,151	8,028
Foreign-Trade Zone	—	—	—	1,955,541	1,968,113	1,526,451	441,662
Strategic Marketing and Support	1,852,208	1,775,605	1,775,976	2,821,915	2,821,915	262,032	2,559,883
Land Use Commission	591,200	599,716	465,695	—	—	—	—
Hawaii Strategic Development Corporation	92,848	94,632	94,540	—	—	—	—
Creative Industries	1,307,414	1,325,705	1,278,387	4,328,125	4,328,125	151,957	4,176,168
Total expenditures	10,982,567	11,145,804	10,826,299	140,109,257	140,208,875	119,693,373	20,515,502
Excess of revenues over (under) expenditures	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 1,306,382	\$ 1,306,382

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Statement of Fiduciary Net Assets

Fiduciary Fund

June 30, 2006

	<u>Agency Fund</u>
Assets:	
Cash in state treasury (note 5)	\$ 254,152
Cash in bank (note 5)	34,154
Total assets	<u>288,306</u>
Liabilities:	
Deposits payable	<u>288,306</u>
Net assets	<u>\$ —</u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
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Notes to Basic Financial Statements

June 30, 2006

(1) Financial Statement Presentation

(a) *The Financial Reporting Entity*

The Department of Business, Economic Development and Tourism (the Department) is a department of the State of Hawaii (the State). The Department's basic financial statements present the financial position and changes in financial position of only that portion of the governmental activities and major fund information of the State that are attributable to the transactions of the Department. The State Comptroller maintains the central accounts for all State funds and publishes comprehensive financial statements for the State annually, which include the Department's financial activities.

The objective of the Department is to make broad policy determinations with respect to economic development within the State and to stimulate research (through research and demonstration projects) in industrial and economic development that offer the most immediate promise to expand the State's economy. In addition, the Department endeavors to gain an understanding of those functions and activities of other governmental agencies and of private agencies that are related to the field of economic development. The Department also encourages initiative and creative thinking in harmony with the objectives of the Department.

The State has defined its reporting entity in accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*. This statement establishes standards for defining and reporting on the financial reporting entity. The basic criterion for including a potential component unit within the reporting entity is financial accountability. Other criteria include legal standing and fiscal dependency.

The Department's basic financial statements consist of the financial activities of the Department and certain other agencies of the State that are administratively attached to the Department. The following agencies are blended component units of the State and are included in the Department's basic financial statements:

- Aloha Tower Development Corporation
- Hawaii Strategic Development Corporation
- Hawaii Tourism Authority
- High Technology Development Corporation
- Land Use Commission
- Natural Energy Laboratory of Hawaii Authority
- Office of Planning

The Department's basic financial statements do not include the financial statements of the Hawaii Community Development Authority (HCDA). Complete financial statements for HCDA may be obtained at the HCDA administrative offices.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Notes to Basic Financial Statements

June 30, 2006

The basic financial statements of the Department have been prepared in conformity with U.S. generally accepted accounting principles (GAAP), as applicable to governmental units. The GASB is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

(b) *Government-Wide and Fund Financial Statements*

The government-wide financial statements, which are the statement of net assets and the statement of activities, report information of all of the nonfiduciary activities of the Department. The effect of interfund activity has been removed from these government-wide financial statements.

The statement of activities demonstrates the degree to which the direct expenses of a given function are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include charges to customers who purchase, use, or directly benefit from goods or services provided by a given function. Program revenues also include grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. State allotments and other items not properly included among program revenues are reported instead as general revenues. Resources that are dedicated internally are reported as general revenues rather than program revenues.

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

The financial activities of the Department are recorded in individual funds, each of which is deemed to be a separate accounting entity. The Department uses fund accounting to report on its financial position and results of operations. Fund accounting is designed to demonstrate the legal compliance and to aid financial management by segregating transactions related to certain government functions or activities. A fund is a separate accounting entity with a self-balancing set of accounts.

Separate financial statements are provided for governmental funds and fiduciary funds. However, the fiduciary funds are not included in the government-wide financial statements. Major individual governmental funds are reported as separate columns in the fund financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

The financial activities of the Department that are reported in the accompanying fund financial statements have been classified into the following major governmental funds. In addition, a description of the Department's fiduciary fund is as follows.

Governmental Fund Types

The Department reports the following major governmental funds:

General Fund

This fund is the Department's primary operating fund. It accounts for all financial activities of the Department, except those required to be accounted for in another fund. The annual operating budget as authorized by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted.

Economic Development Special Revenue Fund

This fund accounts for all programs related to the development and promotion of industry and international commerce, energy development and management, economic research and analysis, and the utilization of resources.

Capital Projects Fund

This fund accounts for financial resources to be used for the acquisition or construction of major capital facilities.

Fiduciary Fund Type

Agency Fund

This fund accounts for assets held by the Department in an agency capacity.

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting and Measurement Focus

The accounting policies of the Department conform to GAAP applicable to state and local governments as prescribed by GASB through its statements and interpretations. The government-wide statement of net assets and statement of activities are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of these activities are included on the statement of net assets.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2006

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities generally are included on the balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets.

The modified accrual basis of accounting is used by all governmental fund types and trust funds. Under the modified accrual basis of accounting, revenues such as interest are recognized when susceptible to accrual (i.e., when they become both measurable and available to finance operations of the fiscal year or liquidate liabilities existing at year-end).

Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after year-end to liquidate liabilities existing at the end of the fiscal year. The Department considers receivables collected within 60 days after year-end to be available and recognizes them as revenues of the current year. Expenditures are recorded when the related fund liability is incurred.

The Department reports deferred revenues on its statement of net assets and balance sheet. Deferred revenues arise when both the “measurable” and “available” criteria for recognition are not met in the current period. Deferred revenues also arise when the Department receives resources before it has a legal claim to them, as when grant monies are received prior to the incurrence of qualifying expenditures. In subsequent periods, when both revenue recognition criteria are met, or when the Department has a legal claim to the resources, the liability for the deferred revenue is removed from the statement of net assets and balance sheet and revenue is recognized.

Encumbrances represent commitments related to unperformed contracts for goods or services. Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of resources are recorded to reserve that portion of the applicable appropriation, is utilized in the governmental funds. Encumbrances outstanding at year-end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will generally be honored during the subsequent fiscal year.

(b) Investments

Investments in venture capital limited partnerships are carried at cost, which amounted to \$8,803,515 at June 30, 2006. The fair value of these investments approximated \$5,715,476 at June 30, 2006. Fair value of the Department’s limited partnership interests is based on the fair value of the underlying securities owned by the limited partnerships obtained from international and national security exchanges or is based on estimated values. The Department has outstanding commitments to fund these venture capital funds of \$2,174,709 at June 30, 2006.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

(c) Capital Assets

Capital assets are not capitalized in the funds used to acquire or construct them. Instead, capital acquisition and construction are reflected as expenditures in governmental funds, and the related assets are reported in the statement of net assets. Capital assets acquired by purchase are recorded at cost. Donated fixed assets are valued at the estimated fair market value on the date received. Maintenance, repairs, minor replacements, renewals, and betterments are charged to operations as incurred. Major replacements, renewals, and betterments are capitalized. Capital assets are defined as assets with an initial individual cost of \$5,000 or more and are depreciated on the straight-line method over the estimated useful lives of the respective assets (land improvements – 15 years, buildings and improvements – 30 years, and furniture, fixtures, and equipment – 5 to 7 years). Depreciation is recorded on capital assets on the government-wide statement of activities.

(d) Accrued Vacation Payable and Sick Leave

Employees hired on or before July 1, 2001 earn vacation at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn vacation at rates ranging between 1 and 2 working days for each month of service, depending upon the employees' years of service and job classifications. Each employee is allowed to accumulate a maximum of 90 days of vacation as of the end of the calendar year. All vacation pay is accrued when incurred in the government-wide financial statements. A liability for these amounts is reported in the governmental funds only if they have matured, for example, as a result of employee resignations and retirements.

Sick leave is not convertible to pay upon termination of employment and is recorded as an expenditure when taken.

(e) Program Revenues

The Department charges various program fees that include office space and facility rental fees, ground rent fees, storage service fees, maintenance fees, and facility management fees.

Federal grant and assistance awards made on the basis of entitlement periods are recorded as revenue when available and entitlement occurs. All other federal reimbursement-type grants are recorded as receivables and revenues when the related expenditures are incurred.

(f) Transient Accommodations Tax

In accordance with Sections 237D-2 and 237D-6.5, Hawaii Revised Statutes (HRS), a portion of the funding for the Department's economic development special revenue fund operations is derived from 49.9% of the transient accommodations tax collected. The transient accommodations tax is assessed at a rate of 7.25% on the gross rental or gross rental proceeds derived from providing transient accommodations.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2006

If the amount of TAT revenues deposited into the Tourism Special Fund exceeds \$62,292,000 in any fiscal year, the next \$1,000,000 of revenues deposited in excess of \$62,292,000 are deposited to the Department of Land and Natural Resources (DLNR). On June 30, 2006, \$1,000,000 was due to DLNR.

Act 209, SLH 2006 increased the maximum amount of transient accommodations tax deposited into the Convention Center Fund from \$31,000,000 to \$33,000,000, effective July 1, 2006. Act 235, SLH 2005 increased the transient accommodations tax allocation to the Tourism Fund to 34.2%, effective July 1, 2007.

(g) *Nonexchange Transactions*

In accordance with GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, the Department records grant revenue only when all eligibility requirements have been met and amounts are available.

(h) *Intrafund and Interfund Transactions*

Transfers of financial resources within the same fund are eliminated. Transfers from funds receiving revenues to funds through which the resources are to be expended are recorded as transfers.

(i) *Use of Estimates*

The preparation of basic financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as disclosure of contingent assets and liabilities at the date of the basic financial statements, and the reported amounts of revenues, expenditures, and other financing sources and uses during the reporting period. Actual results could differ from those estimates.

(j) *New Accounting Pronouncements*

Governmental Accounting Standards Board Statement No. 42

The State adopted GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, effective July 1, 2005. This statement establishes guidance for accounting and reporting for the impairment of capital assets and for insurance proceeds. GASB Statement No. 42 did not have an impact on the Department's basic financial statements for the fiscal year ended June 30, 2006.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2006

Governmental Accounting Standards Board Statement No. 46

The State adopted GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation—an amendment of GASB Statement No. 34*, effective July 1, 2005. This statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to the government—such as citizens, public interest groups, or the judiciary—can compel a government to honor. GASB Statement No. 46 did not have an impact on the Department’s basic financial statements for the fiscal year ended June 30, 2006.

Governmental Accounting Standards Board Statement No. 47

The State adopted GASB Statement No. 47, *Accounting for Termination Benefits*, effective July 1, 2005. This statement establishes standards for employers accounting of benefits associated with either voluntary or involuntary terminations. GASB Statement No. 47 did not have an impact on the Department’s basic financial statements for the fiscal year ended June 30, 2006.

(3) Prior-Period Adjustment

The financial statement of the Hawaii Tourism Authority (the Authority) as of June 30, 2005 did not recognize reimbursements to the State Department of Budget and Finance relating to debt service payments for general obligations bonds in the correct period. Accordingly, net assets as of July 1, 2005 have been restated to reflect the correct amount of reimbursements that should have been recorded.

As a result of the restatement, net assets as of July 1, 2005 decreased by \$9,094,509. For the year ended June 30, 2005, expenditures reported in the statement of activities would have decreased by \$233,400 and the change in net assets would have increased by \$233,400.

(4) Budgeting and Budgetary Control

The budget of the Department is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes (1) the programs, services, and activities to be provided during the fiscal year, (2) the estimated revenues available to finance the operating plan, and (3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented, and controlled.

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues in the statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds are those estimates as compiled and reviewed by the Department. Budgeted expenditures are derived primarily from the General Appropriations Act of 2005 (Act 178, Session Laws of Hawaii (SLH) 2005), and from other authorizations contained in the State Constitution, HRS, and other specific appropriations acts in various SLH. Federal financial assistance program revenues are not included in the statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2006

All expenditures of these appropriated funds are made pursuant to the appropriations in the fiscal 2004 – 2006 biennial budget. The general and economic development special revenue funds have legally appropriated annual budgets. Capital projects fund appropriated budgets are for projects that may extend over several fiscal years.

The final legally adopted budget in the accompanying statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds represents the original appropriations, transfers, and other legally authorized legislative and executive changes.

The legal level of budgetary control is maintained at the appropriation line item level by department, program, and source of funds as established in the appropriations act. The Governor is authorized to transfer appropriations between programs within the same department and source of funds; however, transfers of appropriations between departments generally require legislative authorization. Records and reports reflecting the detail level of control are maintained by and are available at the Department. During the fiscal year ended June 30, 2006, there were no expenditures in excess of appropriations at the legal level of budgetary control.

To the extent not expended or encumbered, general and economic development special revenue funds appropriations generally lapse at the end of the fiscal year for which the appropriations are made. The State Legislature specifies the lapse dates and any other contingencies which may terminate the authorizations for other appropriations.

Budgets adopted by the State Legislature for the general and economic development special revenue funds are presented in the accompanying statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds. The Department's annual budget is prepared on the modified accrual basis of accounting with several differences from the preparation of the statement of revenues, expenditures, and changes in fund balances, principally related to (1) encumbrance of purchase orders and contract obligations, (2) accrued revenues and expenditures, and (3) unbudgeted programs (federal award programs). The first two differences represent departures from GAAP.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements
June 30, 2006

A reconciliation of the budgetary to GAAP basis operating results for the fiscal year ended June 30, 2006 follows:

	General	Economic Development Special Revenue	
Excess of revenues over expenditures – actual (budgetary basis)	\$ —	\$ 1,306,382	
Reserved for encumbrances at year-end	1,580,475	25,940,228	*
Expenditures for liquidation of prior-year encumbrances	(1,204,071)	(6,704,975)	*
Net accrued revenues and expenditures	(413,919)	(11,806,208)	*
Unbudgeted revenues and other financing sources net of expenditures and other financing uses	—	389,099	
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses – GAAP basis	\$ (37,515)	\$ 9,124,526	

* Amounts reflect the balances related to budgeted programs only.

(5) Cash and Investments

(a) Cash in State Treasury

The State Director of Finance is responsible for the safekeeping of all monies paid into the state treasury. The State Director of Finance pools and invests any monies of the State, which in the Director's judgment, are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

The State established a policy whereby all unrestricted and certain restricted cash is invested in the State's investment pool. Cash accounts that participate in the investment pool accrue interest based on the average weighted cash balances of each account. The Department records the pooled assets as cash in state treasury.

For demand or checking accounts and time certificates of deposit, the State requires that the depository banks pledge collateral based on daily available bank balances. The use of daily available bank balances to determine collateral requirements results in the available balances being undercollateralized 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.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2006

Interest Rate Risk

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

Credit Risk

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

Custodial Risk

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

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2006

The carrying value of the Department's cash in state treasury at June 30, 2006 was \$38,582,439 (\$38,328,287 for the Governmental Funds and \$254,152 for the Fiduciary Fund). Information relating to the cash in state treasury is determined on a state-wide basis and not for individual departments or divisions. Information regarding the carrying amount and corresponding bank balances of the cash (which includes the Department's cash in state treasury) and collateralization of the cash balances is included in the comprehensive annual financial report of the State. The Department's share of the cash in state treasury, as summarized in the table below, is 0.9%:

	Fair value	Maturity (in years)		
		Less than 1	1-5	30
(Amounts expressed in thousands)				
State Treasury:				
Cash and cash equivalents	\$ 2,248,159	2,248,159	—	—
Investments:				
Certificates of deposit	76,644	18,299	58,345	—
U.S. government securities	1,466,725	182,135	1,284,579	11
Repurchase agreements	581,288	331,952	249,336	—
Total investments	<u>2,124,657</u>	<u>532,386</u>	<u>1,592,260</u>	<u>11</u>
Total State Treasury	<u>\$ 4,372,816</u>	<u>2,780,545</u>	<u>1,592,260</u>	<u>11</u>

(b) Cash in Bank

The carrying value of the Department's cash in bank balance of \$280,814 (\$246,660 for the Governmental Funds and \$34,154 for the Fiduciary Fund) equals the bank balance and was uncollateralized at June 30, 2006. Such balance primarily represents the Department's bank accounts maintained for out-of-state operations and security deposits held for the Foreign-Trade Zone Division, the High Technology Development Corporation, and the Natural Energy Laboratory of Hawaii Authority.

(c) Investments

The Authority has short-term investments maturing in less than one year, which consist of U.S. government securities amounting to \$16,745,807 at June 30, 2006. The Authority does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Notes to Basic Financial Statements

June 30, 2006

(6) Accounts and Loan Receivable

At June 30, 2006, accounts and loans receivable consisted of the following:

	Accounts receivable	Loans receivable
Foreign-Trade Zone Division	\$ 50,924	\$ —
Natural Energy Laboratory of Hawaii Authority	307,561	—
High Technology Development Corporation	137,392	—
Financial Assistance Branch:		
Hawaii Capital Loan Program	—	4,343,595
Hawaii Community-Based Development Loan Program	—	4,964
Hawaii Innovation Development Loan Program	—	145,950
Hawaii Disaster Commercial Loan Program	—	43,499
	495,877	4,538,008
Less allowance for doubtful accounts	(51,197)	(2,269,905)
Accounts and loans receivable, net	\$ 444,680	\$ 2,268,103

(7) Due to Other State Agencies

The Aloha Tower Development Corporation (the ATDC), a blended component unit of the Department, is a State agency established under HRS Chapter 206J, primarily to redevelop the Aloha Tower complex in Honolulu. The complex encompasses Piers 5 to 23 of Honolulu Harbor. In September 1993, the State Department of Transportation – Harbors Division (Harbors) entered into a lease with the ATDC (ATDC lease) which grants the leasehold interest in portions of the Aloha Tower complex to the ATDC. The ATDC is required annually to reimburse Harbors for any losses in revenues during the term of the lease caused by any action of the ATDC or the developer and to provide replacement facilities for maritime activities at no cost to Harbors.

In September 1993, the ATDC subleased lands surrounded by Piers 8 and 9 and a portion of land surrounded by Pier 10 to a developer and entered into a capital improvements, maintenance, operations, and securities agreement (Operations Agreement) with the developer and Harbors. Harbors continues to operate the harbor facilities at Piers 8, 9, and 10. The lease between the ATDC and the developer requires the developer to construct, at the developer's cost, various facilities as designated in the developer's proposal and to reimburse Harbors for all losses in revenues and increased expenses which may be incurred by Harbors. The ATDC, Harbors, and the developer agreed that in lieu of reimbursing Harbors for losses in revenues during the construction period, the developer would perform certain work to repair the structure of Piers 8 through 11, the cost of which would otherwise be incurred by Harbors. The developer offset the maximum allowable cost of repair of \$1,100,000 against its obligation to Harbors for losses in revenues.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

As of June 30, 2006, the first phase of the Aloha Tower complex development has been completed.

Pursuant to this Operations Agreement, the developer is current on amounts owed to the ATDC as of June 30, 2006. Pursuant to the ATDC lease, the ATDC owes Harbors approximately \$7,738,607 as of June 30, 2006. This amount is reflected in the economic development special revenue fund in the Department's basic financial statements.

(8) Capital Assets

Changes in capital assets during the fiscal year ended June 30, 2006 were as follows:

	<u>Balance, July 1, 2005</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance, June 30, 2006</u>
Capital assets not being depreciated:				
Land	\$ 134,446,508	\$ —	\$ —	\$ 134,446,508
Construction in progress	27,468,020	676,662	(3,118,487)	25,026,195
Total capital assets not being depreciated	<u>161,914,528</u>	<u>676,662</u>	<u>(3,118,487)</u>	<u>159,472,703</u>
Other capital assets:				
Land improvements	311,128	—	—	311,128
Buildings and improvements	252,089,876	3,556,196	(237,000)	255,409,072
Equipment	6,007,947	283,451	(390,151)	5,901,247
Total other capital assets	<u>258,408,951</u>	<u>3,839,647</u>	<u>(627,151)</u>	<u>261,621,447</u>
Less accumulated depreciation for:				
Land improvements	(259,274)	(20,742)	—	(280,016)
Buildings and improvements	(79,598,373)	(8,461,407)	142,200	(87,917,580)
Furniture, fixtures, and equipment	(3,695,966)	(472,791)	266,204	(3,902,553)
Total accumulated depreciation	<u>(83,553,613)</u>	<u>(8,954,940)</u>	<u>408,404</u>	<u>(92,100,149)</u>
	<u>174,855,338</u>	<u>(5,115,293)</u>	<u>(218,747)</u>	<u>169,521,298</u>
Total capital assets being depreciated, net	<u>\$ 336,769,866</u>	<u>\$ (4,438,631)</u>	<u>\$ (3,337,234)</u>	<u>\$ 328,994,001</u>

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

During the fiscal year ended June 30, 2006, depreciation expense was charged to functions of the Department as follows:

Hawaii Tourism Authority	\$	7,122,981
High Technology and Strategic Development		716,452
General Support for Economic Development		427,462
Strategic Marketing and Support		397,185
Foreign-Trade Zone		211,431
Natural Energy Laboratory of Hawaii Authority		73,352
Economic Planning and Research for Economic Development		1,910
Strategic Industries		1,573
Office of Planning		1,501
Land Use Commission		1,093
		<u>8,954,940</u>
Total depreciation expense	\$	<u>8,954,940</u>

(9) Due to State Department of Budget and Finance

During the period in October 1992 through April 1998, the State issued a series of general obligation bonds whose proceeds were used to fund the construction of the Hawaii Convention Center (the Center). These bonds are obligations of the State and are secured by the State's full faith and credit. The debt service for the general obligation bonds are to be primarily funded by an allocated portion of the State's transient accommodations tax revenue and revenue generated from the operation of the Center. Prior to July 1, 2002, these funds were collected and accounted for by the State Department of Budget and Finance (Budget and Finance).

Effective July 1, 2002, the Convention Center Enterprise Special Fund (the Convention Center Fund) was established by Act 253, Session Laws of Hawaii 2002 (Act 253). In accordance with Act 253, the Convention Center Fund was placed within the Hawaii Tourism Authority (the Authority), a blended component unit and an administratively attached agency of the Department, and was created to receive all revenues generated from the Center's operations and an allocated portion of the revenues received from the State's transient accommodations tax. Act 253 further states that all funds collected by the Convention Center Fund are to be used to pay all expenses arising from the use and operation of the Center and to use those funds collected to fund debt service payments. However, responsibility for debt service payments to the bondholders of the general obligation bonds referred to above remains with the State through Budget and Finance.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

Upon creation of the Convention Center Fund, the Authority and Budget and Finance entered into an agreement whereby the Authority agreed to reimburse Budget and Finance for debt service payments, which differs from the actual debt service payments to bondholders, in accordance with a predetermined payment plan. The terms of the payment plan require the Authority to reimburse Budget and Finance for principal and interest payments at an imputed interest rate of 6.00% through January 1, 2025. At June 30, 2006, the outstanding principal and interest amounts required to be reimbursed by the Authority were \$294,905,289 and \$207,251,128, respectively. The scheduled payments to maturity for each of the next five years and thereafter in five-year increments are as follows:

	<u>Principal</u>		<u>Interest</u>		<u>Total</u>
2007	\$ 8,740,000	\$	17,694,317	\$	26,434,317
2008	9,265,000		17,169,917		26,434,917
2009	9,815,000		16,614,017		26,429,017
2010	10,405,000		16,025,117		26,430,117
2011	11,030,000		15,400,817		26,430,817
2012 – 2016	65,890,000		66,247,887		132,137,887
2017 – 2021	88,180,000		43,962,087		132,142,087
2022 – 2025	91,580,289		14,136,969		105,717,258
	<u>\$ 294,905,289</u>	<u>\$</u>	<u>207,251,128</u>	<u>\$</u>	<u>502,156,417</u>

The Authority's ability to reimburse Budget and Finance is contingent upon continued receipt of future transient accommodations tax allocations from the State. Accordingly, the obligation to reimburse Budget and Finance for debt service as described above has not been recorded in the Department's basic financial statements. However, the Authority's obligation to reimburse Budget and Finance in accordance with the mutually agreed upon payment plan represents a commitment of the Convention Center Fund.

For the year ended June 30, 2006, the Authority was required to reimburse Budget and Finance \$26,186,667 for debt service. At June 30, 2006, the unpaid amount of principal and interest due to Budget and Finance was \$11,542,586, which is recorded as due to Budget and Finance in the accompanying basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM**

STATE OF HAWAII

Notes to Basic Financial Statements

June 30, 2006

(10) Accrued Vacation

Changes in accrued vacation payable during the fiscal year ended June 30, 2006 were as follows:

Balance, July 1, 2005		\$	2,583,394
Additions			953,369
Deletions			<u>(930,517)</u>
Balance, June 30, 2006			2,606,246
Less current portion			<u>(670,943)</u>
		\$	<u><u>1,935,303</u></u>

(11) Retirement Benefits

(a) *Employees' Retirement System of the State of Hawaii*

All eligible employees of the Department are required by Chapter 88, HRS, to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. All contributions, benefits, and eligibility requirements are established by Chapter 88, HRS, and can be amended by legislative action. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at City Financial Tower, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

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

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

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

Most covered employees of the contributory option are required to contribute 7.8% of their salary. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 27 years from June 30, 2002.

Measurement of assets and actuarial valuations are made for the entire ERS and are not separately computed for individual participating employers such as the Department. For the years ended June 30, 2006, 2005, and 2004, the Department made contributions amounting to \$1,337,146, \$1,366,660, and \$1,087,891, respectively, which are equal to their required contributions.

(b) *Postretirement Healthcare and Life Insurance Benefits*

In addition to providing pension benefits, the State, pursuant to HRS Chapter 87, provides certain healthcare and life insurance benefits to all qualified employees.

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

For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75% of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the State pays the entire healthcare premium.

There are currently approximately 25,000 state retirees receiving such benefits. Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive reimbursement of the basic medical coverage premium. Contributions are financed on a pay-as-you-go basis. For the fiscal year ended June 30, 2006, the Department's contribution for postretirement healthcare and life insurance benefits was approximately \$814,399.

Effective July 1, 2003, the Hawaii Employer-Union Health Benefit Trust Fund (EUTF) replaced the Hawaii Public Employees Health Fund under Act 88, SLH of 2001. The EUTF was established to provide a single delivery system of health benefits for state and county employees, retirees, and their dependents.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

(12) Nonimposed Employee Fringe Benefits

Payroll fringe benefit costs of employees of the Department funded by state appropriations (General Fund) are assumed by the State and are not charged to the Department's operating funds. These costs, totaling \$2,598,956 for the fiscal year ended June 30, 2006, have been reported as revenues and expenditures within the Department's general fund.

Payroll fringe benefit costs related to federally-funded salaries are not assumed by the State and are recorded as expenditures in the Department's economic development special revenue fund.

(13) Commitments and Contingencies

(a) Leases

The Department leases office facilities and equipment under various operating leases expiring through 2009. Future minimum lease commitments of noncancelable operating leases as of June 30, 2006 were as follows:

Fiscal year ending June 30:	
2007	\$ 220,100
2008	210,300
2009	166,600
2010	155,800
2011	70,000
Thereafter	—
	<u>\$ 822,800</u>

The Department's rental expenditures for the fiscal year ended June 30, 2006 were approximately \$133,000.

(b) Accumulated Sick Leave

Employees hired on or before July 1, 2001 earn sick leave credits at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn vacation at the rate of one and one-quarter or one and three-quarters working days for each month of service, depending upon the employees' years of service and job classification. Sick leave credits may accumulate without limit, but may be taken only in the event of illness and are not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. At June 30, 2006, accumulated sick leave approximated \$8,476,000 for the Department.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

(c) *Deferred Compensation Plan*

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

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

(d) *Risk Management*

GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, establishes accounting and financial reporting standards for risk financing and insurance-related activities of state governmental entities and requires the recordation of a liability for risk financing and insurance-related losses if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. The excess layers insured with commercial insurance companies are consistent with the prior fiscal year. Settled claims have not exceeded the coverage provided by commercial insurance companies in any of the past three fiscal years. A summary of the State's underwriting risks is as follows:

Property Insurance

The State has an insurance policy with a variety of insurers in a variety of layers for property coverage. The deductible for coverage is 3% of loss subject to a \$250,000 per occurrence minimum. This policy includes windstorm, earthquake, flood damage, tsunami, and volcanic action coverage. The limit of loss per occurrence is \$100,000,000, except for flood and earthquake which individually is a \$50,000,000 aggregate loss, and terrorism which is \$50,000,000 per occurrence.

The State also has a crime insurance policy for various types of coverages with a limit of loss of \$10,000,000 per occurrence with a \$500,000 deductible per occurrence. Losses not covered by insurance are paid from legislative appropriations of the State's General Fund.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2006

General Liability (including Torts)

Claims under \$10,000 are handled by the risk management office of the Department of Accounting and General Services. All other claims are handled by the Department of the Attorney General. The State has personal injury and property damage liability, including automobile and public errors and omissions, insurance policy in force with a \$4,000,000 deductible per occurrence. The annual aggregate per occurrence is \$10,000,000.

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

Self-Insured Risks

The State generally self-insures its automobile no-fault and workers' compensation losses. Automobile losses are administered by third-party administrators. The State administers its workers' compensation losses.

(e) Litigation

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

SECTION III
COMPLIANCE AND INTERNAL CONTROL
OVER FINANCIAL REPORTING



KPMG LLP
PO Box 4150
Honolulu, HI 96812-4150

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

To the Director of the
Department of Business,
Economic Development and Tourism
State of Hawaii:

We have audited the financial statements of the governmental activities and each major fund of the Department of Business, Economic Development and Tourism, State of Hawaii (the Department), as of and for the year ended June 30, 2006, which collectively comprise the Department's basic financial statements, and have issued our report thereon dated March 29, 2007, which included a reference to the report of 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.

Our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants, and other matters did not include the Hawaii Tourism Authority, which was audited by the other auditors as referred to in the previous paragraph. The findings, if any, of those other auditors are not included herein.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes) and procurement rules, directives, and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance and other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Department's management and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

March 29, 2007

SECTION IV
COMPLIANCE AND INTERNAL CONTROL
OVER FEDERAL AWARDS



KPMG LLP
PO Box 4150
Honolulu, HI 96812-4150

**Report on Compliance with Requirements Applicable to
Each Major Program and on Internal Control over
Compliance in Accordance with OMB Circular A-133**

To the Director of the
Department of Business,
Economic Development and Tourism
State of Hawaii:

Compliance

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

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

In our opinion, the Department complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2006. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as Finding 06-01.

Internal Control over Compliance

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

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the governmental activities and each major fund of the Department as of and for the year ended June 30, 2006, and have issued our report thereon dated March 29, 2007. Our audit was performed for the purpose of forming opinions on the financial statements that collectively comprise the Department's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the Department's management and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

March 29, 2007

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Schedule of Expenditures of Federal Awards
Year ended June 30, 2006

Federal grantor/pass-through grantor/program title	CFDA number	Grant number	Federal program award amount	Federal expenditures
RESEARCH AND DEVELOPMENT CLUSTER				
DEPARTMENT OF DEFENSE				
Research and Technology Development:				
National Defense Center of Excellence for Research in Ocean Sciences	12.910	MDA972-02-2-0002	\$ 24,102,000	\$ 6,782,296 *
DEPARTMENT OF TRANSPORTATION				
Research and Technology Development:				
Hawaii Center for Advanced Transportation Technologies	12.910	DTRS56-99-T-0017	4,009,129	36,300 *
U.S. AIR FORCE				
Research and Technology Development:				
Hawaii Center for Advanced Transportation Technologies	12.910	OSMORD03270371	886,700	30,775 *
		OSMORD04270281	1,800,000	301,866 *
		OSMORD04270611	293,070	12,000 *
		OSMORD05270412	2,803,000	1,528,478 *
		F3QCAR6074M005	3,060,000	38,000 *
Subtotal CFDA 12.910			<u>1,911,119</u>	
Total Research and Development Cluster			<u>8,729,715</u>	
OTHER PROGRAMS				
DEPARTMENT OF COMMERCE				
Coastal Zone Management Administration Awards:				
Hawaii Coastal Zone Management Program	11.419	NA17OZ2333	2,295,000	230,775 *
		NA17OZ1600	400,000	17,500 *
		NA03NOS4190082	2,311,000	505,058 *
		NA04NOS4190038	2,305,000	424,172 *
		NA05NOS4191060	2,213,000	858,374 *
Subtotal CFDA 11.419			<u>2,035,879</u>	
Coastal Services Center:				
NOAA 2002 Coral Reef Conservation Program	11.473	EA133C-02-CN-0050	162,000	17,489
Economic Adjustment Assistance:				
Virtual Business Incubator	11.307	07 79 05532	300,000	9,230
Manufacturing Extension Partnership:				
Manufacturing Extension Partnership (MEP), a Cooperative Agreement	11.611	7ONANB3H2000	819,498	374,646

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT AND TOURISM
STATE OF HAWAII**

Schedule of Expenditures of Federal Awards

Year ended June 30, 2006

Federal grantor/pass-through grantor/program title	CFDA number	Grant number	Federal program award amount	Federal expenditures
OTHER PROGRAMS, continued				
DEPARTMENT OF COMMERCE, continued				
Habitat Conservation:				
Hawaii Island Benthic Habitat Mapping and Classification	11.463	NA04NMF4630366	\$ 2,500,000	\$ 1,125,982
Market Development Cooperator Program (MDCP Grant):				
Market Development Cooperator Program	11.112	03-02584	399,500	13,237
Total Department of Commerce				3,576,463
ENVIRONMENTAL PROTECTION AGENCY				
Brownfield Pilots Cooperative Agreements:				
Brownfields Economic Redevelopment Hawaii Assessment Demo Pilot	66.811	BP-98966301 BL97943301-0	200,000	15,993
Brownfields Cleanup Revolving Loan Fund Grant			2,000,000	6,359
Subtotal CFDA 66.811				22,352
Brownfield Assessment and Cleanup Cooperative Agreement:				
Brownfield Assessment Cooperative Agreement	66.818	BF96915601-0	400,000	13,638
Total Environmental Protection Agency				35,990
DEPARTMENT OF ENERGY				
State Energy Programs:				
State Energy Program (SEP) Formula Grant	81.041	DE-FG51-02R021337 DE-FG51-05R021608	385,079	46,499
Subtotal CFDA 81.041			324,000	212,771
Special Projects:				
Cooling Climates				
Power Parks	81.119	DE-FG51-00R021191	190,000	64,430
Rebuild America 7		DE-FC51-02R021399	450,000	62,000
Rebuild America 6		DE-FG51-04R021585	128,899	29,628
Rebuild America 5		DE-FG51-03R021496	95,346	5,252
SEP - Assessment of Hawaii's Geothermal Resource		DE-FG51-02R021401	106,244	18,000
SEP - FEMP 6		DE-FG51-03R021488	42,753	40,459
Subtotal CFDA 81.119		DE-FG51-03R021484	75,000	5,000
Distributed Energy Resources Center: NELHA Gateway Project	81.049	DE-FG02-00CHI1066	3,945,000	16,326

**DEPARTMENT OF BUSINESS,
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Schedule of Expenditures of Federal Awards
Year ended June 30, 2006

<u>Federal grantor/pass-through grantor/program title</u>	<u>CFDA number</u>	<u>Grant number</u>	<u>Federal program award amount</u>	<u>Federal expenditures</u>
OTHER PROGRAMS, continued				
DEPARTMENT OF ENERGY, continued				
Energy Efficiency and Renewable Energy Information Dissemination, Outreach, Training, and Technical Analysis Assistance:				
NELHA Energy Efficiency and Renewable Energy Activities	81.117	DE-FC51-02R021359	\$ 450,000	\$ 205,143
SEP Initiatives 2		DE-FC51-02R028606	39,200	9,421
Geo-Powering the West		DE-FC51-03R028607	20,000	9,560
Wind Support 2		DE-FC51-02R028608	27,065	2,449
UH Solar Program		DE-FC51-03R028609	15,000	522
Energy Star		DE-FC51-03R028610	37,500	18,494
Energy Star 2		DE-FC51-05R028612	15,000	10,000
Geothermal Outreach		DE-FG36-04R021598	150,000	24,000
Subtotal CFDA 81.117			<u>279,589</u>	
Pacific Regional Biomass Energy Program:				
Bioenergy Program Support 3	81.079	DE-FC51-02R021318	222,189	70,405
Development and Deployment of Distributed Energy Activities:				
Development and Deployment of Distributed Energy Activities	N/A	ZDJ-4-33660-01	412,562	24,000
Total Department of Energy				<u>874,359</u>
Total Expenditures of Federal Awards				<u>\$ 13,216,527</u>

(*) Denotes major federal program.

See accompanying notes to schedule of expenditures of federal awards and report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with OMB Circular A-133.

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Notes to Schedule of Expenditures of Federal Awards

Year ended June 30, 2006

(1) Basis of Presentation

The Department's basic financial statements are prepared in conformity with U.S. generally accepted accounting principles, as described in the notes to the basic financial statements. The accompanying schedule of expenditures of federal awards includes the federal grant activity of the Department and is presented on the cash basis of accounting, which is the same basis of accounting used to prepare federal grant reports. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

(2) Subrecipients

Of the federal expenditures presented in this schedule, the Department provided federal awards to subrecipients as follows:

<u>Program title</u>	<u>CFDA number</u>	<u>Amount provided to subrecipients</u>
Pacific Regional Biomass Program: Bioenergy Program Support 3	81.079	\$ 41,393
Coastal Zone Management Administration Awards: Hawaii Coastal Zone Management Program	11.419	1,165,008
State Energy Programs: Formula Grant	81.041	79,428
Special Projects	81.119	76,000
Distributed Energy Resources Center: NELHA Gateway Project	81.049	245,469
Energy Efficiency and Renewable Energy Information Dissemination, Outreach, Training, and Technical Analysis Assistance: Energy Star 2	81.117	10,000
Geothermal Outreach	81.117	24,000

**DEPARTMENT OF BUSINESS,
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Schedule of Findings and Questioned Costs
Year ended June 30, 2006

(1) Summary of Auditors' Results

- (a) The type of report issued on the basic financial statements: **Unqualified opinion**
- (b) Reportable conditions in internal control were disclosed by the audit of the basic financial statements: **None reported**

Material weaknesses: **None noted**
- (c) Noncompliance which is material to the basic financial statements: **None noted**
- (d) Reportable conditions in internal control over major programs: **None reported**

Material weaknesses: **None noted**
- (e) The type of report issued on compliance for major programs: **Unqualified opinion**
- (f) Any audit findings which are required to be reported under Section .510(a) of OMB Circular A-133: **Yes**
- (g) Major programs:

Research and Development Cluster:

Department of Defense:
12.910 – National Defense Center of Excellence for Research in Ocean Sciences

Department of Transportation:
12.910 – Hawaii Center for Advanced Transportation Technologies

U.S. Air Force:
12.910 – Hawaii Center for Advanced Transportation Technologies

Other Programs:

Department of Commerce:
11.419 – Hawaii Coastal Zone Management Program
- (h) Dollar threshold used to distinguish between Type A and Type B programs: **\$396,496**
- (i) Auditee qualified as a low-risk auditee under Section .530 of OMB Circular A-133: **No**

**DEPARTMENT OF BUSINESS,
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Schedule of Findings and Questioned Costs
Year ended June 30, 2006

(2) Findings Relating to the Basic Financial Statements Performed in Accordance with *Government Auditing Standards*

None noted

(3) Findings and Questioned Costs Relating to Federal Awards

Finding 06-01 – Subrecipient Monitoring – During the Award Monitoring – Absence of Supporting Documents for Reviews Performed

Information on the Federal Program: Department of Commerce, Hawaii Coastal Zone Management Program – CFDA #11.419, Federal Award Nos.: NA17OZ2333, NA03NOS4190082, NA04NOS4190038, Award Year: Various ranging from July 1, 2002 to June 30, 2007.

Specific Requirement: According to OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, Subpart D-Federal Agencies and Pass-Through Entities, §400 Responsibilities. (d) Pass-through entity responsibilities are:

- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending \$500,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
- Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.

Condition: During our subrecipient monitoring testwork, we noted that 2 of the 18 subrecipients expended \$500,000 or more during their fiscal year; however, the Hawaii Coastal Zone Management Program (Program) did not obtain and review the single audit reports for those 2 subrecipients. As such, there was no management decision on any audit findings issued and the Program was unable to determine whether the subrecipient took appropriate and timely corrective action.

Questioned Cost: NA

Systemic or Isolated: Systemic

Effect: Failure to properly monitor subrecipients' activities results in noncompliance with federal guidelines.

**DEPARTMENT OF BUSINESS,
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Schedule of Findings and Questioned Costs

Year ended June 30, 2006

Recommendation: We recommend that management establish and enforce policies requiring subrecipients who receive more than \$500,000 of federal funding to submit audit reports to the Program on a timely basis to ensure compliance with OMB Circular A-133.

Views of Responsible Officials and Planned Corrective Action: The Hawaii CZM Program will amend agreement and contract language to require subrecipients that expend \$500,000 or more in federal awards during a fiscal year to submit a copy of their single audit report to our office.

Upon receipt of the single audit report, the CZM Program will review audit findings and follow up with the subrecipient on the status of corrective action, as needed.