

BOARD OF WATER SUPPLY of the COUNTY OF KAUA'I

SPECIAL BOARD MEETING

**Second Floor, Microbiology Lab Bldg
Kaua'i County Department of Water
4398 Pua Loke Street, Lihu'e, Kaua'i, Hawai'i 96766**

WEDNESDAY, NOVEMBER 5, 2014

1:00 p.m.

Or soon thereafter

- A. CALL TO ORDER
- B. ROLL CALL
- C. ACCEPTANCE OF AGENDA
- D. NEW BUSINESS
 - 1. Draft Audit of Financial Statements for FY 2013-2014
- E. ADJOURNMENT

**Department of Water
County of Kauai**

Financial Statements
As of June 30, 2014 and 2013
Together with Independent Auditor's Report

DRAFT

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Independent Auditor's Report

To the Board of Water Supply
Department of Water, County of Kauai:

Report on the Financial Statements

We have audited the accompanying financial statements of the Department of Water (the Department), a component unit of the County of Kauai, Hawaii, as of and for the years ended June 30, 2014 and 2013, and the related notes to the financial statements, which collectively comprise the Department's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits 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 audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Water, County of Kauai, as of June 30, 2014 and 2013, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and the schedule of funding progress for the Hawaii Employer-Union Health Benefits Trust Fund on pages 4 through 8 and page 42, respectively, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Department's basic financial statements. The accompanying Supplemental Schedules I and II are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The accompanying Supplemental Schedules I and II are the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying supplemental information in Schedules I and II is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December __, 2014 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Department's internal control over financial reporting and compliance.

KMH LLP

Honolulu, Hawaii
December __, 2014

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Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2014

The Department of Water of the County of Kauai is a semi-autonomous agency consisting of a Board of Water Supply, Manager and Chief Engineer, and support staff. The Board of Water Supply is responsible for the management, control, and operation of the County of Kauai's water system. This discussion and analysis is designed to assist the reader in focusing on the significant financial issues and activities and to identify any significant changes in financial position. We encourage readers to consider the information presented here in conjunction with the financial statements.

Financial Highlights

- Total assets at fiscal year-end June 30, 2014 were \$278.1 million (M) and exceeded liabilities by \$175.9M.
- Total net position at June 30, 2014 increased by \$3.2M or 2%, and is basically the result of the current year's operations and capital contributions.
- Total cash and investments at June 30, 2014 were \$56.9M, an increase of \$400 thousand (K) from the prior year.
- The Department's liquidity ratio is 2.7 for FY 2014 and 2.4 for FY 2013.
- The debt to equity ratio, including capital leases, is 55% for FY 2014 and 57% for FY 2013.
- Operating revenues for FY 2014 were \$28.5M, an increase of \$500K from FY 2013. The Department implemented the 3rd year water rate increase of 11.2% as approved in the water rate study. On another side, the fiscal year to date billed water usage dropped by 500MG or (11%) as compared to prior year. The net result was a 2% revenue increase.
- Operating expenses for the current year totaled \$24.4M, a \$3M increase as compared to the prior year. Details of this increase are further explained on page 7 and 8.
- Long-term debt at June 30, 2014 decreased by \$605K from the prior year. In the current year, the Department received \$3.5M in new SRF loan proceeds and made \$4.1M in principal payments for both the State Revolving Fund (SRF) loans and Bonds which resulted in the net decrease.

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2014

Overview of the Financial Statements

The financial statements are presented using the economic resources measurement focus and accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred. The 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 basic financial statements include a statement of net assets, a statement of revenues, expenses and changes in net assets, a statement of cash flows, and notes to basic financial statements. The statement of net assets presents all of the Department's assets and liabilities and provides information on the nature of its resources and obligations. The statement of revenues, expenses and changes in net assets presents the results of operations and the resulting change in net assets for the year. The statement of cash flows presents changes in cash resulting from operating activities, capital and related financing activities, and investing activities.

The notes to the basic financial statements provide required disclosures and additional information that is essential to a full understanding of the data provided in the basic financial statements. In addition to the basic financial statements and accompanying notes, this report also presents certain supplementary information on utility plant in service and selective account classifications.

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2014

Financial Analysis

Statements of Net Position - Condensed
June 30, 2014 and 2013

	2014	2013 (As Restated)	% Change
Assets:			
Current and Other Assets	\$ 25,325,084	\$ 27,475,400	(8%)
Capital Assets, net	216,331,945,	216,007,163	2%
Other Non-current Assets	36,348,847	34,967,205	4%
Deferred Outflow – Deferred Refunding Costs	82,476	98,758	(16%)
Total assets and deferred outflows	\$ 278,088,352	\$ 278,548,526	-
Liabilities:			
Current Liabilities	\$ 9,515,738	\$ 11,684,211	(19%)
Long-term Debt, net	89,476,016	90,489,567	(1%)
Other Long-term Liabilities	3,195,196	3,699,110	(14%)
Total liabilities	\$ 102,186,950	\$ 105,872,888	(3%)
Net Position:			
Invested in Capital Assets, net of related debt	\$ 142,308,655	\$ 142,804,876	(1%)
Restricted	172,932	969,667	(82%)
Unrestricted	33,419,815	28,901,095	16%
Total net position	\$ 175,901,402	\$ 172,675,638	2%

Statements of Revenues, Expenses and Change in Net Position - Condensed
June 30, 2014 and 2013

	2014	2013 (As Restated)	% Change
Operating Revenues	\$ 28,484,059	\$ 27,964,725	2%
Operating Expenses	24,439,379	21,473,066	14%
Income from operations	4,044,680	6,491,659	(38%)
Non Operating Expenses	(3,659,154)	(3,621,446)	1%
Capital Contributions	2,840,238	3,483,083	(18%)
Change in net position	\$ 3,225,764	\$ 6,353,296	(49%)

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2014

The Department's financial condition remains positive at the year-end. As described earlier, net position is the reported difference between assets and liabilities and which over time, may serve as a useful indicator of the Department's overall financial position. Total assets and deferred outflows at year-end for the Department was \$278.1M which exceeded liabilities by \$175.9M (net position). Total net position increased by \$3.2M, or 2% higher from FY 2013.

Total cash and investments (including restricted funds) increased by \$450K from \$56.5M in FY 2013 to \$56.9M in FY 2014.

The Department's liquidity ratio is (current assets divided by current liabilities) 2.7 for FY 2014 and 2.4 for FY 2013.

The Department finances part of its capital improvement and rehabilitation program through long-term bond issues and State Revolving Fund loans. The debt to equity ratio, including capital leases, for FY 2014 and FY 2013 was 55% and 57%, respectively. The debt service coverage, including capital leases, for FY 2014 is 1.85 which is above the Department's debt service coverage target of 1.5.

The increase in net position for FY 2014 amounted to \$3.2M and is basically a result of the current year's operations and capital contributions. Key elements of this increase are as follows:

FY 2014 operating revenues exceeded our operating expenses by \$4.0M while the non-operating (investment) income was exceeded by non-operating (interest) expenses by \$3.7M. This resulted in income before contributions of \$400K. Capital contributions totaled \$2.8M so in total, the change in net position was \$3.2M.

Total operating expenses increased from \$21.5M in FY 2013 to \$24.4M in FY 2014, an increase of \$3.0M or 14% higher. Due to negotiated union contracts, salaries and wages was up by a total of \$499K or 11% higher and a corresponding increase in employee pension and benefits amounted to \$192K. In addition, Engineering allocations previously capitalized were charged to operating expenses. Following are the major components of the operating expenditures:

Depreciation expenses increased by \$400K; this is attributable to capitalized assets added to property, plant and equipment last year.

Administrative and general expenses increased by \$1.8M or 36% higher from the previous year. There were several components of this increase and these were: Outside Services - \$657K, the two main projects were the implementations of Financial Accounting System and Kauai Water Use & Development Plan Update; County Contra Account expenditure - \$271K; Insurance & Workers Compensation - \$287K, Settlement Claims - \$175K, and the remaining can be accounted from increased Salaries & Wages and corresponding employee pensions and benefits.

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2014

Power and pumping expenses increased by \$296K or 8% higher from the previous fiscal year. One main increase was due to the increased cost of purchased power for pumping which was \$92K higher from last year. Increased salaries and wages plus related employee benefits was also a factor.

Transmission and distribution expenses increased by \$384K. A water system major repair for \$100K was noted in addition to the Engineering Allocations charges which were previously capitalized in the prior years.

Source of supply expenses increased by \$211K. A reclass of an "existing" capital project and "cancelled" during the fiscal year was expensed to source of supply expenses. This contributed to the increase in this category.

Capital contributions, which are included in non-operating income amounted to \$2.8M for FY 2014, a decrease of \$643K or (18%) as compared from last year's \$3.5M in capital contributions.

Capital Assets and Debt Administration

Capital assets are made up of property, plant and equipment. As of June 30, 2014, the Department had net capital assets of \$216.3M. Utility plant additions completed in FY 2014 amounted to \$15.2M. Major capital asset additions included:

Eleele Twin Tanks	\$2.3 million
Haena Steel Tank	\$0.7 million
Waipouli Main Replacement	\$2.0 million
Wailua – Houselots Main Replacement	\$4.3 million
Pipelines, Waipouli Hauki, Olohena Roads	\$1.8 million
Wainiha Booster Pump Building	\$1.3 million

Long-term debt obligations outstanding as of June 30, 2014 amounted to \$93.2M which consisted of \$67.6M in public improvement bonds and \$25.6M in State Revolving Fund (SRF) loans. It was noted earlier that long-term debt decreased by \$605K. The Department made a total of \$4.0M in principal payments for both the State Revolving Fund (SRF) loans and Bond amortization; on the other hand, the Department also received \$3.4M in new SRF loan proceeds which resulted in a net decrease of long term debt obligations. More detailed information about the Department's long-term debt is provided in Note 6 of the notes to the basic financial statements.

Department of Water, County of Kauai

Statements of Net Position
June 30, 2014 and 2013

	2014	2013 (As Restated)
<u>Assets and Deferred Outflows</u>		
Current Assets:		
Cash	\$ 17,968,523	\$ 17,105,705
Equity interest in pooled investments	2,719,567	4,519,250
Receivables:		
Accounts, net of allowance for doubtful accounts of approximately \$281,000 and \$412,000, respectively	1,796,992	2,557,178
Unbilled accounts	1,210,677	1,102,851
Grants and subsidies	591,237	1,278,068
Accrued interest	20,541	16,267
Total receivables	<u>3,619,447</u>	<u>4,954,364</u>
Materials and supplies	931,086	794,114
Prepaid expenses	86,461	101,967
Total current assets	<u>25,325,084</u>	<u>27,475,400</u>
Restricted Assets:		
Facility reserve charge funds:		
Cash	-	739,693
Equity interest in pooled investments	1,734,174	1,924,000
Accounts receivable and other	5,795	5,606
Total facility reserve charge funds	<u>1,739,969</u>	<u>2,669,299</u>
Bond funds:		
Cash	278,625	380,692
Equity interest in pooled investments	22,711,290	24,649,550
Accrued interest	98,283	107,858
Total bond funds	<u>23,088,198</u>	<u>25,138,100</u>
Total restricted assets	<u>24,828,167</u>	<u>27,807,399</u>
Equity Interest in Pooled Investments - Noncurrent	11,520,680	7,159,806
Utility Plant:		
In service	308,467,928	293,790,071
Accumulated depreciation	(99,659,170)	(93,031,575)
Total utility plant	<u>208,808,758</u>	<u>200,758,496</u>
Construction work in progress	7,523,187	15,248,667
Total property, plant and equipment	<u>216,331,945</u>	<u>216,007,163</u>
Total assets	<u>278,005,876</u>	<u>278,449,768</u>
Deferred Outflow of Resources - Deferred Refunding Costs, net	82,476	98,758
Total assets and deferred outflows	<u>\$ 278,088,352</u>	<u>\$ 278,548,526</u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Net Position (continued)

June 30, 2014 and 2013

	<u>Liabilities and Net Position</u>	
	<u>2014</u>	<u>2013</u> (As Restated)
Current Liabilities:		
Current portion of long-term debt	\$ 4,385,000	\$ 4,034,944
Current portion of capital lease obligation	623,000	592,000
Accounts payable and accrued liabilities	3,101,877	4,159,999
Contracts payable, including retainages	468,209	1,819,379
Customer advances for construction	37,681	100,319
Accrued vacation and compensatory pay	475,000	479,000
Customer deposits	421,032	494,631
Due to primary government	3,939	3,939
Total current liabilities	<u>9,515,738</u>	<u>11,684,211</u>
Long-Term Debt, Net of Current Portion and Unamortized Premiums	89,476,016	90,489,567
Capital Lease Obligation, Net of Current Portion	2,611,665	3,214,775
Accrued Vacation and Compensatory Pay, Net of Current Portion	583,531	484,335
Total liabilities	<u>102,186,950</u>	<u>105,872,888</u>
Commitments and Contingencies		
Net Position:		
Invested in capital assets, net of related debt	142,308,655	142,804,876
Restricted for capital activity and debt service	172,932	1,077,525
Unrestricted	33,419,815	28,793,237
Total net position	<u>\$ 175,901,402</u>	<u>\$ 172,675,638</u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Revenues, Expenses and Changes in Net Position
For the Years Ended June 30, 2014 and 2013

	2014	2013 (As Restated)
Operating Revenues:		
Water sales	\$ 26,429,465	\$ 25,837,871
Other water revenue:		
Public fire protection service	1,782,210	1,511,190
Other	272,384	615,664
Total operating revenues	<u>28,484,059</u>	<u>27,964,725</u>
Operating Expenses:		
Depreciation and amortization	7,323,987	6,936,653
Administrative and general	6,732,279	4,962,548
Power and pumping	3,909,311	3,613,639
Transmission and distribution	4,131,902	3,747,917
Source of supply	1,479,292	1,267,990
Customer accounting and collection	651,599	688,517
Purification	211,009	255,802
Total operating expenses	<u>24,439,379</u>	<u>21,473,066</u>
Income from operations	<u>4,044,680</u>	<u>6,491,659</u>
Non-Operating Income (Expenses):		
Investment income	241,781	294,022
Interest expense, net of amounts capitalized	(3,900,935)	(3,915,468)
Total non-operating expenses	<u>(3,659,154)</u>	<u>(3,621,446)</u>
Income before contributions	385,526	2,870,213
Capital contributions	2,840,238	3,483,083
Change in net position	3,225,764	6,353,296
Net Position at Beginning of Year, as restated	<u>172,675,638</u>	<u>166,322,342</u>
Net Position at End of Year	<u>\$ 175,901,402</u>	<u>\$ 172,675,638</u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Cash Flows

For the Years Ended June 30, 2014 and 2013

	2014	2013 (As Restated)
Cash Flows from Operating Activities:		
Cash received from customers	\$ 27,081,636	\$ 26,423,289
Cash payments to suppliers for goods and services	(13,359,364)	(10,207,034)
Cash payments to employees for services	(4,878,167)	(4,472,533)
Other cash receipts	2,054,594	2,126,854
Net cash provided by operating activities	<u>10,898,699</u>	<u>13,870,576</u>
Cash Flows from Capital and Related Financing Activities:		
Proceeds from issuance of public improvement bonds	-	3,100,706
Acquisition and construction of capital assets	(6,209,973)	(11,799,951)
Proceeds from revolving fund loan	3,487,703	400,548
Principal paid on revolving fund loan	(1,670,985)	(1,598,095)
Payments for bond issuance costs	-	(31,010)
Principal paid on public improvement bond maturities	(2,422,000)	(531,000)
Principal paid on capital lease obligation	(572,110)	(544,978)
Cash paid for defeasance of public improvement bond	-	(3,069,696)
Interest paid on long-term debt	(5,312,634)	(5,416,409)
Proceeds from state government capital grants	-	4,080
Proceeds from BAB Subsidy	935,081	1,016,308
Net proceeds from FRC Program	1,073,300	761,300
Net cash used in capital and related financing activities	<u>(10,691,618)</u>	<u>(17,708,197)</u>
Cash Flows from Investing Activities:		
Purchases of investments	(31,851,410)	(11,856,347)
Sales and maturities of investments	31,544,458	16,805,467
Interest on investments	120,929	487,860
Net cash (used in) provided by investing activities	<u>(186,023)</u>	<u>5,436,980</u>
Net increase in cash (including restricted cash)	21,058	1,599,359
Cash (including restricted cash),		
Beginning of Year	<u>18,226,090</u>	<u>16,626,731</u>
Cash (including \$278,625 and \$1,120,385		
 in restricted cash, respectively), End of Year	<u><u>\$ 18,247,148</u></u>	<u><u>\$ 18,226,090</u></u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Cash Flows (continued)
For the Years Ended June 30, 2014 and 2013

	2014	2013 (As Restated)
Reconciliation of Cash Flows from Operating Activities:		
Income from operations	\$ 4,044,680	\$ 6,491,659
Depreciation and amortization expense	7,323,987	6,936,653
Bad debt (recovery) expense	(55,763)	108,517
(Increase) decrease in assets:		
Accounts receivable, net	815,760	48,075
Unbilled accounts and other receivables	(107,826)	428,826
Materials and supplies	(136,972)	54,045
Prepaid expenses and other assets	15,506	198,535
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(1,022,270)	87,569
Accrued vacation and compensatory pay	95,196	108,607
Post-retirement healthcare benefits payable	-	(848,051)
Due to primary government	-	3,939
Customer deposits	(73,599)	252,202
Net cash provided by operating activities	<u>\$ 10,898,699</u>	<u>\$ 13,870,576</u>

Supplemental Disclosure of Non-cash Capital and Related Financing Activities:

The Department received approximately \$838,000 and \$514,000 for the years ended June 30, 2014 and 2013, respectively, in contributions of property, plant and equipment from governmental agencies, developers and customers which are recorded as contributions at estimated fair value at the date of donation.

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

1. Background

On May 10, 1960, by authority of Act 20, Session Laws of Hawaii 1960, the Board of Water Supply (the Board) of the County of Kauai, Hawaii (the County) was created. The County transferred to the Board the operation and management of the water transmission and distribution systems. Under Act 20, the Board has the power to make and alter rules and regulations relating to the management, control, operation, preservation and protection of the waterworks. The rules and regulations adopted by the Board have the force and effect of law.

As of January 2, 1969, under a new charter for the County, the policy-making responsibility for the water system was retained by the Board. The Board, however, is specifically stated to be an executive department of the County government. To the extent that they were not in conflict with the provisions of the charter, laws governing the County water supply which were in existence at the time of the enactment of the charter continued in effect. The water system is now being operated as the Department of Water, County of Kauai (the Department), a self-supporting component unit (enterprise fund) of the County which renders water services throughout the island.

The Department is responsible for establishing rates for services based upon current operating costs and expected future capital and operating revenue requirements. The rates determined by the Department are subject to approval by the Board. Effective July 1, 2013, the Board raised rates an average of 10 percent, the service charge rate an average of 11 percent, and the agricultural service charge rates an average of 6 percent. Effective July 1, 2012, the Board raised rates an average 9 percent and raised the service charge rate an average of 12 percent.

2. Summary of Significant Accounting Policies

a. Financial Statement Presentation

The Department is a component unit of the County (the primary government). The accompanying financial statements present only the activities of the Department and do not include other organizations, activities and functions of the County.

b. Basis of Accounting

The accompanying financial statements are presented using the economic resources measurement focus and the accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

2. Summary of Significant Accounting Policies (continued)

b. Basis of Accounting (continued)

Effective July 1, 2013, the Department implemented Government Accounting Standards Board (GASB) Statement No. 65, "Items Previously Reported as Assets and Liabilities" (GASB 65). GASB 65 reclassifies, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as revenues and expenses, certain items that were previously reported as assets and liabilities. GASB 65 requires debt issuance costs to be recognized as an expense in the period incurred. Previously, these costs were amortized over the life of the related debt issuance. The adoption of this statement was applied retroactively by restating financial statements for all periods presented. The effect on net position due to the implementation of GASB 65 is presented at Note 14.

The Department distinguishes operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services in connection with the Department's principal ongoing water operations. The principal operating revenues are from charges for water usage, while operating expenses include cost of services, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

c. Cash

The Department's cash include cash on hand, demand deposits and short-term investments with original maturities of three months or less from the date of acquisition.

d. Investments

The Department has stated its investments at fair value. Changes in the fair value of investments are recognized in the statements of revenues, expenses and changes in net position.

e. Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include revenue recognized related to unbilled accounts, accrued liability for workers' compensation claims and judgments and accrued liability for post-retirement health care benefits. Actual results could differ from those estimates.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

2. Summary of Significant Accounting Policies (continued)

f. Utility Plant in Service (UPIS) and Depreciation

In July 1966, a detailed report on the inventory and valuation of water utility properties of the Board was submitted by R. W. Beck and Associates, Analytical and Consulting Engineers, of Seattle, Washington. The estimated original cost of \$5.8 million and the reserve for depreciation of \$1.4 million were recorded in the accounts. Additions to the utility plant since the date of the valuation are stated at cost and include contributions by government agencies, private developers and customers at their fair value at the date of contribution.

The utility plant is depreciated using the straight-line basis by applying composite rates based on the useful lives below. The composite rates are applied to beginning plant balances including contributions in aid of construction to calculate depreciation expense for the year.

The estimated useful lives of the various individual and group assets are as follows:

Motor vehicles	7 to 10 years
Equipment and machinery	5 to 20 years
Buildings and improvements	40 to 50 years
Transmission and distribution equipment	18 to 63 years

Normal maintenance and repairs are charged to operations as incurred. All expenditures for major additions, betterments and replacements for the utility plant are capitalized, and expenditures for the general plant greater than \$5,000 are capitalized. The Department capitalizes certain indirect costs to construction work orders based upon actual construction direct labor hours.

g. Capitalization of Interest

Interest costs have been capitalized, in accordance with accounting principles generally accepted in the United States of America, based on an average of expended costs through the end of the year. Capitalized interest in 2014 and 2013 was approximately \$400,000 and \$434,000, respectively.

h. Material and Supplies

Materials and supplies are stated at lower of average cost (which approximates the first-in, first-out method) or market.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

2. Summary of Significant Accounting Policies (continued)

i. Deferred Outflows of Resources

Deferred outflows of resources represent consumptions of net position that apply to future periods and will not be recognized as an outflow of resources (expenditures) until then. The amount consists of deferred charges on refunding bonds resulting from the difference between the carrying value of debt and its reacquisition price. This amount is deferred and amortized over the shorter of the life of the refunded or refunding debt on a basis that approximates the effective-interest method.

j. Revenue Recognition

The Department recognizes revenue on the accrual method of accounting as services are rendered. Revenue recognized for services rendered but not billed is reflected as unbilled accounts in the accompanying statements of net assets.

k. Risk Management

The Department is exposed to various risks of loss from: (1) torts, (2) theft of, damage to and destruction of assets, (3) employee injuries and illnesses, (4) natural disasters, (5) employee health, dental and accident benefits, and (6) miscellaneous others. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims in excess of this commercial coverage was not significant in any of the three preceding years. Prior to July 1, 2001, the Department was self-insured for workers' compensation claims and judgments.

l. Capital Contributions

For the years ended June 30, 2014 and 2013, the following transactions represent voluntary non-exchange transactions, recorded at fair value, and are included as non-operating income in the statements of revenues, expenses and changes in net position:

	2014	2013
Facility reserve charge fees	\$ 1,069,000	\$ 780,000
Build America Bond interest subsidies	933,000	988,000
Contributions of property, plant and equipment from governmental agencies, developers and customers	838,000	514,000
SRF Loan forgiveness	-	1,201,000
Total	<u>\$ 2,840,000</u>	<u>\$ 3,483,000</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

l. Capital Contributions (continued)

At June 30, 2014 and 2013, the Department recorded approximately \$386,000 and \$387,000, respectively, of accrued interest subsidies in grants and subsidies receivable in the accompanying statements of net position.

m. Facilities Reserve Charge (FRC)

Under the authority provided to the Board mentioned in Note 1, the Department assesses a fee to commercial and residential developers based upon the number and size of water meters installed at respective projects. These fees are restricted to fund the capital improvements of the water supply system and recorded as contributions in the statements of revenues, expenses and changes in net position.

n. Net Position

Net position comprise the various net earnings from operating and non-operating revenues, expenses and contributions in aid of construction. Net position are classified in the following three components: invested in capital assets, net of related debt; restricted for capital activity and debt service; and unrestricted net assets. Invested in capital assets, net of related debt, consist of capital assets, net of accumulated depreciation and reduced by outstanding debt that is attributable to the acquisition, construction or improvement of those assets. Debt related to unspent proceeds or other restricted cash and investments at year-end are not included in the calculation of invested in capital assets, net of related debt. Restricted for capital activity and debt service consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted consists of all other net position not included in the above categories.

3. Deposits

The Department's deposits consist of cash on hand, cash held at financial institutions and cash held at the County of Kauai.

At June 30, 2014 and 2013, the carrying value of the Department's cash deposits amount to approximately \$18,247,000 and \$18,226,000, respectively, of which approximately \$5,977,000 and \$1,116,000, respectively, were held by the County in the County's name. The bank balances at June 30, 2014 and 2013 amounted to approximately \$18,873,000 and \$19,052,000, respectively. The Director of Finance has arranged for all of the Department's deposits at June 30, 2014 and 2013 to be collateralized with securities held by the pledging financial institution in the County's name.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

4. Investments

The Department's investments are controlled by the Director of Finance of the County of Kauai and are generally invested in certificates of deposit, repurchase agreements, government sponsored entity securities (i.e., Federal Home Loan Bank notes and bonds, Federal Home Loan Mortgage Corporation bonds, and Federal National Mortgage Association notes and bonds) with federally insured financial institutions and mutual funds. The Department's investment vehicles are consistent with the investment guidelines contained in the Hawaii Revised Statutes (HRS).

The Department participates in an investment pool with the County. The Department's portion of this pool is displayed on the statements of net position as equity interest in pooled investments. The following is the composition of the Department's portion of these investments as of June 30, 2014 and 2013:

2014:	Fair Value (approximate)	Maturity (in years)	
		0-1	1-5
Government sponsored entities and other agencies	\$ 32,474,000	\$ 15,479,000	\$ 16,995,000
Money market funds	407,000	407,000	-
Other fixed income	820,000	820,000	-
US corporates	4,242,000	1,200,000	3,042,000
Total	<u>\$ 37,943,000</u>	<u>\$ 17,906,000</u>	<u>\$ 20,037,000</u>

2013:	Fair Value (approximate)	Maturity (in years)	
		0-1	1-5
Government sponsored entities and other agencies	\$ 29,219,000	\$ 12,755,000	\$ 16,464,000
US governments	3,332,000	3,332,000	-
Other fixed income	2,020,000	2,020,000	-
Money market funds	2,009,000	2,009,000	-
US corporates	97,000	97,000	-
Total	<u>\$ 36,677,000</u>	<u>\$ 20,213,000</u>	<u>\$ 16,464,000</u>

As of June 30, 2014 and 2013, excluded from the above disclosures is approximately \$743,000 and \$1,576,000, respectively, of non-negotiable certificates of deposit which are classified as equity interest in pooled investments in the statements of net position, but are considered deposits for the purposes of this disclosure.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

4. Investments (continued)

Interest Rate Risk – State law limits the Department’s investment portfolio to maturities of less than five years. The Department does not have a formal investment policy that further limits investment maturities.

Credit Risk – State law limits investments to the top rating issued by nationally recognized statistical rating organizations (NRSROs). The Department has no investment policy that would further limit its investment choices. As of June 30, 2014, with the exception of the Department’s investment in certain fixed income and money market funds which was not rated, all of the Department’s investments were rated Baa-AA.

Custodial Credit Risk – For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Department will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party.

Concentration of Credit Risk – The Department places no limit on the amount which may be invested in any one issuer. As of June 30, 2014, more than 5 percent of the Department’s investments are held in the following: Fannie Mae (32%), Federal Home Loan Bank (27%), Freddie Mac (18%), First Hawaiian Bank (9%).

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

5. Property, Plant and Equipment

Property, plant and equipment activity during 2014 and 2013 was as follows:

	Balance June 30, 2013 (as restated)	Additions	Reductions/ Transfers	Balance June 30, 2014
Utility Plant in Service	\$ 293,790,071	\$ 15,374,249	\$ (696,392)	\$ 308,467,928
Accumulated Depreciation	(93,031,575)	(7,323,987)	696,392	(99,659,170)
	<u>200,758,496</u>	<u>8,050,262</u>	<u>-</u>	<u>208,808,758</u>
Construction in Progress	15,248,667	7,760,582	(15,486,062)	7,523,187
Total	<u>\$ 216,007,163</u>	<u>\$ 15,810,844</u>	<u>\$(15,486,062)</u>	<u>\$ 216,331,945</u>

	Balance June 30, 2012 (as restated)	Additions	Reductions/ Transfers	Balance June 30, 2013 (as restated)
Utility Plant in Service	\$ 282,650,130	\$ 12,169,317	\$ (1,029,376)	\$ 293,790,071
Accumulated Depreciation	(87,055,306)	(6,936,653)	960,384	(93,031,575)
	<u>195,594,824</u>	<u>5,232,664</u>	<u>(68,992)</u>	<u>200,758,496</u>
Construction in Progress	14,564,576	11,274,954	(10,590,863)	15,248,667
Total	<u>\$ 210,159,400</u>	<u>\$ 16,507,618</u>	<u>\$(10,659,855)</u>	<u>\$ 216,007,163</u>

In 2014 and 2013, no impairment losses were identified by the Department.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities

Bonds Payable

The full faith and credit of the County is pledged for the payment of the Department's obligations. The County has the power and is obligated to levy ad valorem taxes, without limitation as to rate or amount, on all real property subject to taxation by the County.

At June 30, 2014 and 2013, approximately \$2.6 million of the Department's portion of general obligation bonds outstanding are considered defeased and are not reflected in the accompanying statements of net position.

On July 10, 2012, the Department issued through the County \$2,745,000 in general obligation bonds, with a premium of approximately \$356,000 and an average interest rate of 4.00 percent, for the purpose of refunding \$3,245,000 of outstanding 2005A Serial bonds, with an average rate of 4.13 percent. The net proceeds of the issuance was \$3,069,696 after payment of \$31,010 in underwriting fees and other issuance costs. The net proceeds were transferred to an escrow deposit account to redeem the outstanding 2005A Series bonds.

The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of approximately \$175,000. The Department completed the current refunding to reduce its total debt service payments over the next 16 years by approximately \$225,000 and to obtain an economic gain (difference between the present values of the old and new debt service payments) of approximately \$158,000. In the statements of net position as of June 30, 2014 and 2013, the Department reported net deferred charges on refunding bonds in this category of \$82,476 and \$98,758, respectively.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

Bonds Payable (continued)

As of June 30, 2014 and 2013, bonds payable consisted of the following:

	<u>2014</u>	<u>2013</u> (As Restated)
Public Improvement Bonds--County Series 2012A, last installment 2029. Maturing serially from August 1, 2016. Interest rate – 3.00 to 5.00 percent. Date issued – July 10, 2012. Original amount - \$2,745,000.	\$ 2,745,000	\$ 2,745,000
Public Improvement Bonds--County Series 2011A, last installment 2025. Maturing serially from August 1, 2012. Interest rate – 2.00 to 5.00 percent. Date issued – July 7, 2011. Original amount – \$5,125,000.	4,225,000	4,505,000
Build America Bonds--County Series 2010A, last installment 2033. Maturing serially from August 1, 2013. Interest rate – 1.96 to 5.76 percent. Date issued – March 24, 2010. Original amount - \$60,000,000.	58,125,000	60,000,000
Public Improvement Bonds--County Series 2005A, last installment 2021. Maturing serially from August 1, 2008. Interest rate – 3.25 to 5.00 percent. Date issued – November 10, 2005. Original amount – \$6,485,000.	2,505,000	2,755,000
Public Improvement Bonds--County Series 1980, last installment 2015. Maturing serially from March 1, 1983. Interest rate – 5 percent. Date issued – April 7, 1980. Original amount – \$300,000.	18,000	35,000
Total bonds payable	<u>\$ 67,618,000</u>	<u>\$ 70,040,000</u>
Premium on bond issuance	<u>672,797</u>	<u>731,011</u>
Total bonds payable, net	<u><u>\$ 68,290,797</u></u>	<u><u>\$ 70,771,011</u></u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

Bonds Payable (continued)

The approximate annual debt service requirements through 2019 and in five-year increments thereafter to maturity as of June 30, 2014 are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Years ending June 30:			
2015	\$ 2,593,000	\$ 3,233,000	\$ 5,826,000
2016	2,655,000	3,155,000	5,810,000
2017	2,800,000	3,064,000	5,864,000
2018	2,910,000	2,959,000	5,869,000
2019	2,950,000	2,844,000	5,794,000
2020-2024	16,045,000	12,173,000	28,218,000
2025-2029	17,975,000	8,049,000	26,024,000
2030-2034	19,690,000	2,731,000	22,421,000
	<u>\$ 67,618,000</u>	<u>\$ 38,208,000</u>	<u>\$ 105,826,000</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

Loans Payable

As of June 30, 2014 and 2013, the loans payable consisted of the following:

	2014	2013
State Revolving Fund (SRF) Loan – Stable 1.0 MG Tank, last installment 2029. Interest rate – .260 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – March 15, 2009. Original amount \$7,274,996.	\$ 5,748,238	\$ 6,123,590
SRF Loan – Poipu Road 16 Inch Main Replacement, last installment 2027. Interest rate – .160 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2007. Original amount - \$5,595,979.	3,463,297	3,726,747
SRF Loan – Wailua Houselots Main Replacement, last installment 2033. Interest rate -- .50 percent. Semi-annual loan fee rate – 0.5 percent. Date issued – April 15, 2013. Original amount - \$3,487,703.	3,429,662	-
SRF Loan – Kaunualii Highway 12 Inch Main Replacement, last installment 2029. Interest rate – .320 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – August 15, 2009. Original amount - \$3,989,537.	3,200,619	3,401,725
SRF Loan – Kapilimao 0.5 MG Tank, last installment 2030. Interest rate – .420 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2010. Original amount - \$3,793,779.	3,192,104	3,384,582
SRF Loan – Waha, Wawae & Niho Roads Main Replacement, last installment 2029. Interest rate – .320 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – August 15, 2009. Original amount - \$1,844,718.	1,559,197	1,657,160
SRF Loan – 16 Inch Waterline Replacement along Kuhio Highway, Leho Drive to North Papaloa Road, last installment 2026. Interest rate – .160 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – August 15, 2005. Original amount - \$2,481,289.	1,464,670	1,585,469
SRF Loan – Rehabilitate Lihue Steel Tanks 1 & 2, last installment 2025. Interest rate – .46 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2004. Original amount - \$1,243,017.	738,412	803,676

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

Loans Payable (continued)

	<u>2014</u>	<u>2013</u>
SRF Loan – Damage Repairs to Kokolau Tunnel, last installment 2021. Interest rate – 1.37 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – July 15, 2001. Original amount - \$1,755,329.	\$ 695,267	\$ 782,698
SRF Loan – Replace Pipeline at Hanapepe River Crossing and Control of Slope; Failure at Hanapepe Well No. 3, last installment 2023. Interest rate – .99 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – July 15, 2003. Original amount - \$1,345,040.	635,636	699,144
SRF Loan – Ornellas 0.2 MG Tank, last installment 2025. Interest rate – .58 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2005. Original amount - \$809,398.	475,087	516,803
SRF Loan – Kekaha Well, last installment 2022. Interest rate – 1.01 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – April 15, 2002. Original amount - \$1,097,536.	398,465	446,050
SRF Loan – Rehabilitation of 27 Inch Steel Pipeline – Hanapepe - Eleele Water System, last installment 2023. Interest rate – .99 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – July 15, 2003. Original amount - \$691,134.	354,270	389,661
SRF Loan – Wailua Homesteads Well No. 3, last installment 2024. Interest rate – .54 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – March 15, 2004. Original amount - \$418,967.	215,295	236,196
	<u>\$ 25,570,219</u>	<u>\$ 23,753,501</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

The approximate annual debt service requirements through 2019 and in five-year increments thereafter to maturity as of June 30, 2014 are as follows:

Years ending June 30:	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$ 1,792,000	\$ 838,000	\$ 2,630,000
2016	1,800,000	776,000	2,576,000
2017	1,807,000	713,000	2,520,000
2018	1,815,000	651,000	2,466,000
2019	1,823,000	588,000	2,411,000
2020-2024	8,824,000	2,002,000	10,826,000
2025-2029	6,597,000	666,000	7,263,000
2030-2033	1,112,000	34,000	1,146,000
	<u>\$ 25,570,000</u>	<u>\$ 6,268,000</u>	<u>\$ 31,838,000</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

Capital Lease Obligation

On February 19, 2004, the Department entered into a Water Treatment and Delivery Agreement (Agreement) with an unrelated third party developer. The Agreement requires the developer to build, operate and maintain a surface water treatment plant (SWTP) with a capacity of 3.0 million gallons per day (MGD). The Department is required to purchase, at a minimum, 2.0 MGD and also to provide the developer a credit towards its facility reserve charge. The term of the Agreement is 15 years and the Agreement also provides the Department with the option of accepting the dedication of the SWTP at no cost after the reimbursement date, as defined. The Department commenced water purchases on January 1, 2006. This arrangement has been recorded as a capital lease in the accompanying basic financial statements.

The capital lease obligation is amortized at an implicit rate of approximately 6.0 percent. The utility plant related to the SWTP facility approximated \$7,181,000 as of June 30, 2014 and 2013. The accumulated provision for depreciation related to the SWTP facility approximated \$4,538,000 and \$4,006,000 as of June 30, 2014 and 2013, respectively.

The annual requirements to amortize all capital lease obligations as of June 30, 2014 are approximately as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Years ending June 30:			
2015	\$ 623,000	\$ 178,000	\$ 801,000
2016	666,000	140,000	806,000
2017	693,000	99,000	792,000
2018	737,000	55,000	792,000
2019	516,000	12,000	528,000
	<u>\$ 3,235,000</u>	<u>\$ 484,000</u>	<u>\$ 3,719,000</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

6. Long-Term Liabilities (continued)

Changes in Long-term Liabilities

Long-term liability activity for the years ended June 30, 2014 and 2013 was as follows:

	Balance June 30, 2013 (as restated)	Additions	Reductions	Balance June 30, 2014	Approximate amounts due within one year
General obligation bonds payable	\$ 70,040,000	\$ -	\$ 2,422,000	\$ 67,618,000	\$ 2,593,000
Deferred costs - Premiums on bond issuance	731,010	-	58,213	672,797	-
Total bonds payable	70,771,010	-	2,480,213	68,290,797	2,593,000
Loans payable	23,753,501	3,487,703	1,670,985	25,570,219	1,792,000
Total long term debt	94,524,511	3,487,703	4,151,198	93,861,016	4,385,000
Compensated absences	963,335	504,136	408,940	1,058,531	475,000
Capital lease obligation	3,806,775	27,487	599,597	3,234,665	623,000
Total	\$ 99,294,621	\$ 4,019,326	\$ 5,159,735	\$ 98,154,212	\$ 5,483,000

	Balance June 30, 2012 (as restated)	Additions	Reductions	Balance June 30, 2013 (as restated)	Approximate amounts due within one year
General obligation bonds payable	\$ 71,071,000	\$ 2,745,000	\$ 3,776,000	\$ 70,040,000	\$ 2,422,000
Deferred costs - Premiums on bond issuance	431,782	355,706	56,478	731,010	-
Total bonds payable	71,502,782	3,100,706	3,832,478	70,771,010	2,422,000
Loans payable	25,260,298	91,298	1,598,095	23,753,501	1,613,000
Total long term debt	96,763,080	3,192,004	5,430,573	94,524,511	4,035,000
Compensated absences	854,728	511,990	403,383	963,335	479,000
Capital lease obligation	4,337,674	14,079	544,978	3,806,775	592,000
Total	\$101,955,482	\$ 3,718,073	\$ 6,378,934	\$ 99,294,621	\$ 5,106,000

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

7. Net Position

At June 30, 2014 and 2013, net position consisted of the following:

	2014	2013 (As restated)
Invested in Capital Assets, Net of Related Debt:		
Net property, plant and equipment	\$ 216,331,945	\$ 216,007,163
Less: Long term debt, net	(93,861,016)	(94,521,511)
Less: Capital lease obligation	(3,234,665)	(3,806,776)
Add: Unspent debt proceeds	22,989,915	25,030,242
Add: Deferred outflows – deferred refunding costs	82,476	98,758
	<u>142,308,655</u>	<u>142,804,876</u>
Restricted for Capital Activity and Debt Service:		
FRC net position	1,739,969	2,669,299
Restricted cash – Bond funds	278,625	380,692
Restricted investments – Bond funds	22,711,290	24,649,550
Restricted accrued interest – Bond funds	98,283	107,858
Less:		
Accrued interest payable	(1,665,320)	(1,699,632)
Unspent debt proceeds	(22,989,915)	(25,030,242)
	<u>172,932</u>	<u>1,077,525</u>
Unrestricted	<u>33,419,815</u>	<u>28,793,237</u>
Total net position	<u><u>\$ 175,901,402</u></u>	<u><u>\$ 172,675,638</u></u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

7. Net Position (continued)

As of June 30, 2014 and 2013, FRC net position consisted of the following:

	<u>2014</u>	<u>2013</u>
FRC assets restricted for utility plant construction:		
Cash	\$ -	\$ 739,693
Equity interest in pooled investments	1,734,174	1,924,000
Accounts receivable	4,600	-
Accrued interest receivable	<u>1,195</u>	<u>5,606</u>
	1,739,969	2,669,299
FRC liabilities	<u>-</u>	<u>-</u>
FRC net position	<u>\$ 1,739,969</u>	<u>\$ 2,669,299</u>

For the years ended June 30, 2014 and 2013, FRC change in net position consisted of the following:

	<u>2014</u>	<u>2013</u>
Contributions	\$ 1,073,300	\$ 761,300
Capital expenditures	(82,228)	(54,434)
Interest income	17,461	31,757
Transfers out	(1,942,038)	(2,982,299)
Other expenditures	<u>4,175</u>	<u>(28,604)</u>
Change in net position	(929,330)	(2,272,280)
FRC net position at beginning of year	<u>2,669,299</u>	<u>4,941,579</u>
FRC net position at end of year	<u>\$ 1,739,969</u>	<u>\$ 2,669,299</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

8. Employees' Retirement System

a. Description of Plan

All eligible employees of the State and counties are required by Hawaii Revised Statutes (HRS) Chapter 88, 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 is governed by a Board of Trustees. All contributions, benefits and eligibility requirements are established by HRS Chapter 88 and can be amended by legislative action. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

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

Both plan 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.

On July 1, 2006, a new hybrid contributory plan became effective pursuant to Act 179, SLH of 2004. Members in the hybrid plan are eligible for retirement at age 62 with 5 years of credited services or age 55 and 30 years of credit service. Members will receive a benefit multiplier of 2 percent for each year of credited service in the hybrid plan. The benefit payment options are similar to the current contributory plan. Almost 58,000 members, all members of the noncontributory plan and certain members of the contributory plan were eligible to join the new hybrid plan. Most of the new employees hired from July 1, 2006 are required to join the new hybrid plan.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

8. Employees' Retirement System (continued)

b. Funding Policy

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

The ERS provides basic pension benefits to individuals receiving pensions. Employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded accrued liability of the ERS. The ERS uses the entry age normal cost funding method to calculate the unfunded accrued liability. In 2002, the Legislature of the State of Hawaii approved Act 147 that extends the amortization period to liquidate the unfunded liability from 15 years to 29 years.

The Department's payroll for employees covered by the plan was approximately \$4,645,000, \$4,385,000, and \$4,285,000 for 2014, 2013, and 2012, respectively. The payroll for all of the Department's employees was approximately \$4,878,000, \$4,473,000, and \$4,368,000 for 2014, 2013, and 2012, respectively. The Department is required to contribute an actuarially determined amount to the ERS. The Department's contributions requirements as of June 30, 2014, 2013, and 2012 were approximately \$745,000, \$679,000, and \$642,000, respectively. The contribution rate was 16, 15.50, and 15 percent for the years ended June 30, 2014, 2013 and 2012, respectively.

9. Post-Retirement Health Care and Life Insurance Benefits

a. Plan Description

The Department provides certain other postemployment benefits (OPEB) other than pensions to all qualified employees. Pursuant to Chapter 87A of the HRS, the Department contributes to the Hawaii Employer-Union Health Benefits Trust Fund (EUTF). The EUTF was established to provide a single delivery system of health benefits for state and county workers, retirees and their dependents. The EUTF currently provides medical, dental, vision, and life insurance benefits. The EUTF issues an annual financial report that is available to the public. That report may be obtained by writing to the EUTF at 201 Merchant Street, Suite 1520, Honolulu, Hawaii 96813.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

9. Post-Retirement Health Care and Life Insurance Benefits (continued)

a. Plan Description (continued)

The eligibility requirements for retiree health benefits are as follows:

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

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

b. Funding Policy

For active employees, the employer's contributions are based upon negotiated collective bargaining agreements. Employer contributions for employees not covered by collective bargaining agreements and for retirees are prescribed by the HRS.

The Department is required to contribute the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarial liabilities over 30 years. The current ARC rate for the Department is approximately 19% of annual covered payroll.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

9. Post-Retirement Healthcare and Life Insurance Benefits (continued)

c. Annual OPEB Cost

The following table shows the components of the Department's annual OPEB cost for 2014 and 2013, the amount actually contributed to the plan, and changes in the Department's net OPEB asset to EUTF:

	2014	2013
Annual required contribution	\$ 879,000	\$ 850,000
Interest on net OPEB asset	(4,000)	-
Adjustment to the ARC	3,000	-
Annual OPEB Cost	878,000	850,000
Contributions made	879,000	870,000
Increase in net OPEB asset	1,000	20,000
Net OPEB asset – beginning of year	50,000	30,000
Net OPEB asset – end of year	<u>\$ 51,000</u>	<u>\$ 50,000</u>

The Department's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2014, 2013 and 2012 were approximately as follows:

Fiscal Year Ended June 30,	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Asset
2012	\$ 1,109,000	98.2%	\$ 30,000
2013	850,000	102.4%	50,000
2014	878,000	100.1%	51,000

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

9. Post-Retirement Healthcare and Life Insurance Benefits (continued)

d. Funded Status and Funding Progress

The funded status of the plan as of July 1, 2013, the effective date of the most recent biennial actuarial valuation, was as follows:

Actuarial accrued liability (AAL)	\$ 12,607,000
Assets	<u>3,864,000</u>
Unfunded AAL (UAAL)	<u>\$ 8,743,000</u>
Covered payroll	\$ 4,512,000
UAAL as a percentage of covered payroll	193.8%

Actuarial valuations of an ongoing plan involve estimate of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality and healthcare cost trends. Amounts determined regarding the funded status of the plan and the ARC are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes of the financial statements, presents multiyear trend information that shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

9. Post-Retirement Healthcare and Life Insurance Benefits (continued)

e. Actuarial Methods and Assumptions

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. Significant methods and assumptions from the Department's actuarial valuation were as follows:

Valuation date	July 1, 2013
Actuarial cost method	Entry age normal
Amortization method	Level percentage of pay, closed
Amortization period	30 years
Actuarial assumptions:	
Investment rate of return	7%
Healthcare cost trend rate:	
Medical and prescription drug (PPO)	Initial rate of 9%, declining to a rate of 5% after 10 years
Medical and prescription drug (HMO)	Initial rate of 7.5%, declining to a rate of 5% after 10 years
Dental	4%
Vision	3%
Medicare Part B	5%
Projected salary increases	3.5%
Inflation rate	3%

The number of participants as of July 1, 2013, the effective date of the most recent biennial OPEB valuation, follows. There have been no significant changes in the number of covered or the type of coverage since that date.

Active employees	74
Retired employees	47
Deferred vested employees	<u>5</u>
Total	<u><u>126</u></u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

10. Deferred Compensation Plan

The Department offers its employees, through the County, a deferred compensation plan established in accordance with Internal Revenue Code Section 457. The plan, available to all full-time Department employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death or an unforeseeable emergency. The plan's assets have been placed in trust accounts with the plan administrators for exclusive benefit of participants and their beneficiaries and are not considered assets of the County or the Department.

In accordance with GASB Statement 32, *Accounting and Financial Reporting Code Section 457 – Deferred Compensation Plans*, the Department has excluded the plan assets from the financial statements. All such amounts are not subject to the claims of the Department or the County's general creditors.

11. Commitments and Contingencies

a. Sick Leave

Accumulated sick leave as of June 30, 2014 and 2013 was approximately \$1,409,000 and \$1,719,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. As a result, no liability for sick pay is recorded in the accompanying financial statements. However, a public employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS.

b. Workers' Compensation Insurance

Prior to July 1, 2001, the Department was fully self-insured for workers' compensation claims. Beginning July 1, 2001, the Department purchases insurance with a deductible of \$500,000. Claims are reported to and managed by the County. The Department provides reserves for claims not covered by insurance that in the opinion of counsel will result in probable judgment against the Department. These reserves include an estimate of claims that have been incurred but not reported (IBNR). Claim liabilities, including IBNR, are based on the estimated ultimate cost of settling the claims. Claims liabilities are estimated by a case-by-case review of all claims and the application of historical experience to outstanding claims. As of June 30, 2014 and 2013, the workers' compensation liability amounted to approximately \$184,000 and \$118,000, respectively, and is recorded in accounts payable and accrued liabilities on the accompanying statements of net position.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

11. Commitments and Contingencies

c. Safe Drinking Water Act

The Department is subject to the requirements of the Safe Drinking Water Act (the Act) which is administered by the State of Hawaii Department of Health on behalf of the United States Environmental Protection Agency. Management indicated that the Department is in full compliance with the requirements of the Act and is not aware of any matters under the Act that materially affected or is currently affecting the Department's customer service area.

d. Other Legal Matters

The Department is party to various legal proceedings arising in the normal course of business. The outcome of individual matters is not predictable. However, management believes that the ultimate resolution of all such matters will not have a material adverse effect on the Department's financial position or results of operations.

e. Other

Other commitments, primarily for utility plant construction, approximated \$5,033,000 and \$15,262,000 at June 30, 2014 and 2013, respectively.

12. Related Party Transactions

The Department charges the County for fire protection services (hydrant use) at agreed-to rates that approximate the cost for such services. The County provides certain services to the Department and charges the Department for these services at an amount equal to the charge for fire protection services. The amounts charged approximated \$1,782,000 and \$1,511,000 in 2014 and 2013, respectively.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

13. New Pronouncement for Financial Reporting

In June 2012, GASB issued Statement No. 68 (GASB 68), *Accounting and Reporting for Pensions (an amendment of GASB Statement No. 27)*. GASB 68 amends the accounting guidance related to employers' accounting for pension plans administered through trusts or similar arrangements and requires the recognition of a liability for the employers' accumulated obligation for pension benefits. GASB 68 also provides additional guidance regarding the recognition of annual costs of pension benefits and revises the disclosure requirements for the notes to the financial statements and required supplementary information. GASB 68 will be effective for the Department's financial statements for the year ending June 30, 2015. Management is currently assessing the impact of GASB 68 on its financial position and results of operations and has not determined if the adoption will have a material effect on its financial statements.

14. Restatements

The Department restated amounts previously reported to write off \$1,847,292 of construction in progress that was previously capitalized. For the year ended June 30, 2013, \$570,485 was expensed in the statements of changes in net position. The remaining \$1,276,807 was recorded to beginning net position as of July 1, 2013. The Department also restated amounts previously reported to reverse duplicate accrued investment income of \$2,273,516. For the year ended June 30, 2013, \$98,396 was charged to investment income in the statements of changes in net position. The remaining \$2,175,119 was charged to beginning net position as of July 1, 2013.

In 2014, the Department implemented GASB 65. The implementation of GASB 65 resulted in the restatement of prior year financial statements due to the write off of debt issuance costs that were previously capitalized as other assets. Net position as of July 1, 2013, was decreased by \$572,289 as a result of the implementation of GASB 65.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2014 and 2013

14. Restatements (continued)

The results of these adjustments had the following impact to the previously reported amounts as of and for the year ended June 30, 2013:

	Net Position Beginning of Year	Operating Expenses	Investment Income	Net Position End of Year
Balance, as previously reported	\$170,346,557	\$ (20,904,079)	\$ 392,418	\$ 177,367,236
Construction in progress adjustment	(1,276,807)	(570,485)	-	(1,847,292)
Accrued interest receivable adjustment	(2,175,119)	-	(98,396)	(2,273,515)
Implementation of GASB 65	(572,289)	1,498	-	(570,791)
Balance as restated	\$166,322,342	\$ 21,473,066	\$ 294,022	\$ 172,675,638

Department of Water, County of Kauai

Schedule of Funding Progress for the
Hawaii Employer-Union Health Benefits Trust Fund

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
7/1/2009	\$ 930,000	\$ 13,531,000	\$ 12,601,000	7%	\$ 4,424,000	285%
7/1/2011	2,281,000	11,586,000	9,305,000	20%	4,368,000	213%
7/1/2013	3,864,000	12,607,000	8,743,000	31%	4,512,000	194%

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See accompanying independent auditor's report.

Department of Water, County of Kauai

Schedule I

Supplemental Schedule of Utility Plant in Service
For the Year Ended June 30, 2014

	June 30, 2013				June 30, 2014
	Balance	Adjustments	Additions	Retirements	Balance
Cost Basis:					
Water Utility Plant:					
Source	\$ 9,298,876	\$ -	\$ -	\$ -	\$ 9,298,876
Pumping	43,575,290	-	1,639,859	(34,636)	45,180,513
Water Treatment	9,407,875	-	33,066	-	9,440,941
Transmission & Distribution	219,651,971	-	13,085,965	(660,893)	232,077,043
General	9,908,673	-	437,792	(863)	10,345,602
	<u>291,842,685</u>	<u>-</u>	<u>15,196,682</u>	<u>(696,392)</u>	<u>306,342,975</u>
Land and Land Rights:					
Source	837,879	-	-	-	837,879
Pumping	156	-	-	-	156
Water Treatment	150	-	-	-	150
Transmission & Distribution	469,237	-	-	-	469,237
	<u>1,307,422</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,307,422</u>
Intangible Assets:					
Easements	35,722	-	-	-	35,722
Software	604,242	-	177,567	-	781,809
	<u>639,964</u>	<u>-</u>	<u>177,567</u>	<u>-</u>	<u>817,531</u>
Total	<u>\$ 293,790,071</u>	<u>\$ -</u>	<u>\$ 15,374,249</u>	<u>\$ (696,392)</u>	<u>\$ 308,467,928</u>
Accumulated Depreciation:					
Water Utility Plant:					
Source	\$ 4,542,889	\$ -	\$ 202,160	\$ -	\$ 4,745,049
Pumping	19,584,669	12,348	1,605,801	(34,636)	21,168,182
Water Treatment	5,819,244	-	711,266	-	6,530,510
Transmission & Distribution	57,331,526	439,701	3,826,582	(660,893)	60,936,916
General	5,179,960	-	511,263	(863)	5,690,360
Intangible Assets - Software	573,287	-	14,866	-	588,153
Total	<u>\$ 93,031,575</u>	<u>\$ 452,049</u>	<u>\$ 6,871,938</u>	<u>\$ (696,392)</u>	<u>\$ 99,659,170</u>

See accompanying independent auditor's report.

Department of Water, County of Kauai

Schedule II

Supplemental Schedule of Selective Account Classifications (in 000's)
For the Five Years Ended June 30, 2014

	2014	2013 (As Restated)	2012 *	2011 *	2010 *
<u>Statements of Net Position</u>					
Utility plant in service	\$ 308,468	\$ 293,790	\$ 282,650	\$ 244,193	\$ 223,914
Net Position:					
Invested in capital assets, net	\$ 142,309	\$ 142,805	\$ 142,688	\$ 132,139	\$ 124,943
Restricted for capital activity					
and debt service	173	1,078	3,197	2,483	3,977
Unrestricted	33,419	28,793	24,462	14,494	16,533
Total	\$ 175,901	\$ 172,676	\$ 170,347	\$ 149,116	\$ 145,453
<u>Statements of Revenues, Expenses and Changes in Net Position</u>					
Resources:					
Water sales	\$ 26,429	\$ 25,838	\$ 21,283	\$ 19,829	\$ 18,772
Other	2,055	2,126	1,239	970	1,014
Total	28,484	27,964	22,522	20,799	19,786
Operating Expenses:					
Depreciation	7,324	6,937	6,163	5,743	5,898
Administrative and general	6,732	4,963	5,115	4,165	4,299
Power and pumping	3,909	3,614	4,015	3,323	3,178
Transmission and distribution	4,132	3,748	3,502	3,017	3,441
Accounting and collection	652	688	606	591	584
All other	1,690	1,523	962	824	1,054
Total	24,439	21,473	20,363	17,663	18,454
Non-Operating (Expense) Income	(3,659)	(3,621)	(2,991)	(3,552)	(1,031)
Contributions	2,840	3,483	22,063	4,079	7,664
Increase in net position	\$ 3,226	\$ 6,353	\$ 21,231	\$ 3,663	\$ 7,965

* Not adjusted for restatement

See accompanying independent auditor's report.

**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***

Independent Auditor's Report

To the Board of Water Supply
Department of Water, County of Kauai:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Department of Water, County of Kauai (the Department), as of and for the years ended June 30, 2014 and 2013, and the related notes to the financial statements, which collectively comprise the Department's basic financial statements, and have issued our report thereon dated **December __**, 2014.

Internal Control over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control that we considered to be material weaknesses. However, we identified certain deficiencies in internal control as described in the accompanying schedule of findings and questioned costs as items 2014-01 and 2014-02 that we considered to be significant deficiencies.

The Department's responses to the internal control findings identified in our audit are described in the accompanying schedule of findings and questioned costs. The Department's response was not subjected to the auditing procedures applied in our audit and, accordingly, we express no opinion on the response.

Compliance and Other Matters

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

Purpose of this Report

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

KMH LLP

Honolulu, Hawaii

[DATE]

**REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM;
REPORT ON INTERNAL CONTROL OVER COMPLIANCE; AND REPORT ON
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS REQUIRED BY OMB
CIRCULAR A-133**

Independent Auditor's Report

To the Board of Water Supply
Department of Water, County of Kauai:

Report on Compliance for Each Major Federal Program

We have audited the Department of Water, County of Kauai's (the Department) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Department's major federal programs for the year ended June 30, 2014. The Department's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of the Department's major federal programs based on our audit of the types of compliance requirements referred to above. 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 on compliance for each major federal program. However, our audit does not provide a legal determination of the Department's compliance.

Opinion on Each Major Federal Program

In our opinion, the Department complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2014.

Report on Internal Control Over Compliance

Management of the Department is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the Department's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over compliance.

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

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

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of Federal Awards Required by OMB Circular A-133

We have audited the financial statements of the Department as of and for the year ended June 30, 2014, and have issued our report thereon dated December __, 2014, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. 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 financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditure of federal awards is fairly stated in all material respects in relation to the financial statements as a whole.

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

KMH LLP

Honolulu, Hawaii

[DATE]

Department of Water, County of Kauai

Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 2014

<u>Federal Grantor Pass-Through Grantor Program Title</u>	<u>Federal CFDA Number</u>	<u>Pass- Through Grantor's Number</u>	<u>Award</u>	<u>Current Expenditures</u>	<u>Cumulative Expenditures</u>	<u>Remaining Balance</u>
Environmental Protection Agency--	66.468	99-6000449				
Passed-Through State Department of Health--						
Drinking Water Treatment Revolving Loan Fund:						
PH I Wailua Houselots Main Replacement DW413-0008			\$ 4,671,000	\$ 2,762,835	\$ 4,463,084	\$ 207,916
Kahili Horizontal Directional Drilled Well DW400-0004			<u>2,000,000</u>	<u>80,650</u>	<u>531,212</u>	<u>1,468,788</u>
Total			<u>\$ 6,671,000</u>	<u>\$ 2,843,485</u>	<u>\$ 4,994,296</u>	<u>\$1,676,704</u>

Department of Water, County of Kauai

Notes to Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 2014

1. Basis of Presentation

The accompanying schedule of expenditures of federal awards includes the federal grant activity of the Department and is presented on the accrual basis of accounting. 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. Loan Security

The Department has pledged its future water revenues as security for repayment of the loans. See Note 6 of the financial statements for further discussion about the loans.

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section I – Summary of Auditors’ Results

Financial Statements

Type of auditors’ report issued:

Unqualified

Internal control over financial reporting:

- Material weakness(es) identified? Yes No
- Significant deficiency(ies) identified that are not considered to be material weakness(es)? reported Yes None

Noncompliance material to financial statements noted? Yes No

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? Yes No
- Significant deficiency(ies) identified that are not considered to be material weakness(es)? Reported Yes None

Type of auditor’s report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? Yes No

Identification of major programs:

<u>CFDA Number</u>	<u>Name of Federal Program or Cluster</u>
66.468	Drinking Water Treatment Revolving Loan Fund

Dollar threshold used to distinguish between type A and type B programs? \$300,000

Auditee qualified as low-risk auditee? Yes No

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section II. Financial Statement Findings

Finding No.: 2014-01

Write-off of Construction in Progress – Significant Deficiency

Criteria: In accordance with GASB Statement No. 34, paragraph 18, capitalizable costs include not just the cost to purchase or construct an asset, but also any charges necessary to place the asset into its intended location and condition for use. In addition, feasibility studies or other costs incurred before it is probable an asset will be constructed or acquired is not capitalizable costs and should be expensed during the year it is incurred.

Condition, cause & context: During the process of implementing changes to its accounting system, the Department's consultants identified about \$1.8 million of costs in construction in progress that were improperly capitalized in previous years. Approximately \$1.2 million related to two feasibility studies that should have been expenses when incurred. The remaining costs related to repair and maintenance work orders that were not expensed on a timely basis. Feasibility studies of this magnitude are infrequent and unusual and for one of the projects, approximately \$0.5 million was funded by a state grant. The error was caused by the fact that the reviews of the construction in progress details were not setup to identify feasibility projects and to remove the repair and maintenance work orders on a regular basis.

Effect: The Department recorded a restatement adjustment to reduce net position as of July 1, 2012 by approximately \$1.3 million and increase operating expenses in the statement of revenues, expenses and changes in net position for the year ended June 30, 2013 by approximately \$0.6 million.

Recommendation: Management should modify procedures over the review of the construction in progress schedules to identify and properly expense feasibility studies and repair and maintenance work orders.

Department Reply: The Department concurs with this finding. One of the main goals of the Financial Accounting System's (FAS) implementation is streamlining the chart of accounts. In preparation for this implementation, a CPA hired by the IT Consultants worked with Accounting staff to prepare accounting data for conversion to the new re-defined accounting system. It was identified through this process that certain costs which had been previously recorded as construction in progress were not directly attributable to capital projects. Fiscal reviewed with the Engineers the statuses of these projects and adjusted the value of Construction in Progress accordingly.

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section II. Financial Statement Findings (continued)

A new standard operating procedure is in place. We started this during the department's annual budget process where the Engineers were required to prepare and submit separate budget for capitalized and non-capitalized job costs. Each new project must identify each project element from the planning process, designing, and executing water infrastructure projects to ensure proper job costing.

Contact Person: Marites Yano

Target Completion Date: Effective immediately

Finding No.: 2014-02

Reconciliation of Investment Account – Significant Deficiency

Criteria: All journal entries should be supported by appropriate documentation.

Condition, cause & context: In prior years, the Waterworks Controller recorded entries to accrue interest income related to the Build America Bond (BAB) investments of approximately \$2.3 million. These entries were recorded based on discussions with the County Treasurer and a schedule provided by the County Treasurer that is used to determine the BAB investment balance at year end. In the current year, the Waterworks Controller determined that these entries inadvertently duplicated interest income related to the BAB investments. Based on our discussion with the County Treasurer, we determined the Waterworks Controller misinterpreted the BAB investment schedule provided as this schedule was not intended to present detailed information for the Department to properly record investment activity in the BAB account during the year. Obtaining the appropriate documentation to determine the investment activity in the BAB investment account would have prevented the erroneous entries from being recorded.

Effect: In FY2014, the Department recorded a restatement adjustment to write off accrued interest receivable of approximately \$2.3 million.

Recommendation: When journal entries are prepared, appropriate documentation should be obtained to ensure that entry is properly recorded.

Department Reply: The Department's Short Term Investment is pooled with the County's Investment portfolio which is managed by the County Treasurer. On a monthly basis, the DOW records the investment activities based on the statements prepared and provided by the County Treasurer. Accrued Interest Income is recorded at year end using interest rates provided from the county treasury statements.

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section II. Financial Statement Findings (continued)

In FY 2012, a separate statement of BAB Interest Income was provided by the County Treasurer. The Waterworks Controller contacted the County Treasury regarding same and the entry was made to reflect the difference of Accrued Interest that had not been recorded. Because the amount involved was \$2M, this Journal Entry was brought to KMH Auditors' attention by the Waterworks Controller at that time.

This year, the error was caught by the Department after further review and analysis of the BAB investment activities provided by the County Treasury was done. A discussion and further clarification was held with the County Treasury and a more detailed report was also obtained to verify the accuracy of the numbers recorded.

Contact Person: Marites Yano

Target Completion Date: Effective immediately

Section III. Federal Award Findings and Questioned Costs

No matters were reported.

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section IV. Summary Schedule of Prior Audit Findings

This section contains the current status of our prior audit recommendations. The recommendations are referenced to the pages of the previous audit report for the year ended June 30, 2013 dated December 3, 2013.

<u>Recommendations</u>	<u>Status</u>
<p>2013-01 Inadequate Use of Accounting Software</p> <p>For several years, the Department has been in progress with the installation of its accounting software. Although the main modules were fully in place, the implementation of the payroll module was delayed and the Department decided last year not to pursue the implementation of the last module. The Department had installed the system with hopes of increasing its ability to provide timely and accurate financial reporting. Instead the software, as implemented, has not performed as expected. The following are some of the issues noted:</p> <ul style="list-style-type: none">• Too many general ledger accounts;• Reports not designed to allow for regular financial reporting;• Significant amount of processing done outside of system – CWIP <p>The Department has taken steps puts to consolidate certain general ledge accounts to simplify the closing process. Inadequate use of accounting software puts more pressure on the Departments accounting staff to complete its closing procedures and limits its ability to analyze the information to identify potential errors.</p> <p>We encourage management to continue its efforts with working with a consultant to provide detailed recommendations and training to properly utilize the accounting software.</p>	<p>Resolved. The Department worked with a consultant to consolidate their general ledger accounts and move their fixed assets into the accounting software. The Department also worked on report mapping and now provides monthly reports to the Board of Directors and Project Managers.</p>

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section IV. Summary Schedule of Prior Audit Findings (continued)

<u>Recommendations</u>	<u>Status</u>
<p>2013-02 Timely Reconciliation of Sales Entries</p> <p>We noted during the audit process that management had not reconciled revenues on a monthly basis. These reconciliations were not performed until after the end of the fiscal year. Timely reconciliations are crucial in determining proper account balances. In addition, this condition contributed to the length of the annual closing process.</p> <p>Revenues should be reconciled regularly and all related adjustments recorded on a timely basis.</p>	<p>Resolved.</p>
<p>2013-03 Inventory – Book to Physical Adjustments</p> <p>During audits in prior years, we noted a book to physical adjustment recorded after annual physical inventory account. The book to physical adjustments continued to occur without any clear indication from management on why these adjustments were occurring. In addition, we noted that in early 2013 operations management authorized their consultant to temporarily provide the rights to certain DOW staff to make direct changes to the inventory system databases to “true-up” the inventory balances.</p> <p>Management should review detailed inventory procedures to identify the potential cause of the large adjustments. In addition, management should consider increasing the frequency of the inventory counts.</p>	<p>Resolved.</p>

Department of Water, County of Kauai

Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2014

Section IV. Summary Schedule of Prior Audit Findings (continued)

<u>Recommendations</u>	<u>Status</u>
2013-04 Review of Journal Entries	
<p>During the course of the audit, we discovered the following errors:</p> <ul style="list-style-type: none">• Non-accrual of receivable related to State Revolving Fund (SRF) loan forgiveness (grant) of approximately \$891,000. Management did identify the need to write-off loan balance related to this new SRF loan term, however their assessment of the issue was incomplete.• Overstatement of capitalized interest of \$120,000. Reviews were completed for this entry, but did not identify the error in the calculation.• Improper journal entry related to prior years capitalization of engineering labor of approximately \$291,000. Although this entry was discussed, there was no documentation that a review was performed on this entry by the Waterworks Controller.	Resolved.

During the past year, management has taken steps to record adjustments prior to the audit. As a result of this effort, total adjustments decreased from 17 audit adjustments in the prior year to 8 audit adjustments in the current year.

All journal entries should be appropriately reviewed.