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Board of Water Supply
City and County of Honolulu

Financial Statements and Supplemental Information for the Year Ended June 30, 2004 and Independent Auditors' Report

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

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BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

INTRODUCTION
JUNE 30, 2004

The Board of Water Supply, City and County of Honolulu ("Board") is pleased to present its Annual Financial Report for fiscal year 2004. This introduction provides an overview of the mission, organization, and operations of the Board. The following management's discussion and analysis is intended to provide the reader with an easily understandable analysis of the Board's financial performance and to enable the reader to assess all aspects of its financial position. Financial statements presenting the financial position and results of operations of the Board in conformity with accounting principles generally accepted in the United States of America, accompanied by the independent auditors' report, follow the management's discussion and analysis.

Mission

The mission of the Board is to improve the quality of life in our community by providing world-class water services. The mission serves as the foundation for the Board's vision to share its water management expertise and provide services statewide and throughout the Pacific: to benefit our global communities, to benefit our community by maintaining reasonable rates, to provide professional development opportunities for its staff, and to support the growth of Hawaii's economy.

The Board's Strategic Business Plan includes six major goals:

1. Provide world-class customer service.
2. Establish a performance culture at all levels.
3. Develop our staff and renew the Board's ohana.
4. Expand water resources and assure long-term viability.
5. Improve infrastructure reliability.
6. Identify growth opportunities.

These goals are further supported by specific business initiatives executed by the Board's operating unit leaders and their staff.

Organization and Business

The Board of Water Supply is a semi-autonomous municipal agency created pursuant to the Revised Charter of the City and County of Honolulu ("City"). The Board has full control of all water systems of the City, including water rights and water sources, together with all materials, supplies, and equipment, all real and personal property used or useful in connection with such water systems, and properties used or useful in connection with such water systems. The Board has been in existence since 1929.

The Mayor of the City and County of Honolulu appoints five of the seven members of the Board of Directors. The other two members, the Chief Engineer of the Department of Facility Maintenance of the City and the Director of Transportation of the State of Hawaii, are members ex-officio of the Board of Directors.

The Board consists of twelve operating units—Business Development, Communications, Compliance, Customer Care, Finance, Human Resources, Information Technology, Maintenance, Operations, Recycled Water, Security, and Water Resources. All are under the direction of the Manager and Chief Engineer, who is appointed by the Board of Directors, and the Deputy Manager and Chief Engineer.

The Board of Directors has the power to fix and adjust rates and charges for the furnishing of water and water services so that the revenues derived shall be sufficient to make the water system self-supporting. Rates and charges are determined on the basis of a recommendation by the Manager, subject to approval of the Board of Directors. Such rates are not subject to regulation by any governmental body or authority.

The Board receives no revenues from taxation and depends solely upon revenues derived from its activities to pay for its operations and liquidation of indebtedness. The Board may receive funds from the federal, state, or county governments for capital improvement projects.

The Board services 161,496 accounts and a residential population of 896,019. The service area covers the island of Oahu and is 606 square miles. The customer base includes the residential population, businesses and industries, and agriculture. Of the total accounts, 149,773 are residential (92.8%), representing 60.8% of the total amount received from water sales in fiscal year 2004; 10,896 are commercial and industrial (6.7%), representing 38.2% of the total amount received from water sales in fiscal year 2004; and 827 are agricultural (0.5%), representing 1.0% of the total amount received from water sales in fiscal year 2004.

The Board provides high quality water at reasonable rates, while protecting the long-term viability of Oahu's water resources and enhancing the environment. In addition to providing potable water of 150 million gallons per day ("mgd"), the Board delivers approximately 8 mgd of recycled water to Ewa and Campbell Industrial Park users in West Oahu.

Looking Ahead

The Board has adopted a strategic plan that commits itself to become a world-class organization. In 1999, the Board entered into a five-year re-engineering program to transform itself into a highly competitive provider of water utility-related services. This program seeks to improve customer service and achieve greater operational efficiencies and effectiveness. The Board has realized benefits of this program. At the outset of this program, staffing was at 658 positions. At the end of fiscal year 2004, there were 558 positions, a change of 15% with no layoffs. Even with the decrease in staffing, the Board has been able to support the water system's growth, as well as take on significant projects to modernize its business systems and change its work practices.

It is anticipated that significant costs and personnel resources will be required in the next one to two years before cost savings are fully realized. In fiscal 2004, the Board completed implementation of an automated financial accounting system. As a result, the finance area was reorganized to optimize new work functions, and work processes throughout the Board were re-engineered. In addition, a multi-skilled worker pilot began in fiscal 2004, with encouraging results as the Board has experienced operational and technological improvements in field operations.

In fiscal year 2004, the Board began implementing two major computerized information systems—the Computerized Maintenance Management System and the Customer Information System. The success of these technology programs is vital to the Board realizing efficiencies and effectiveness in its business and core operations.

The Board is looking to expand its core business by responding to opportunities to own and/or operate military water systems. Additionally, the Board is sharing its expertise with developing water utilities in the Asia Pacific region. Projects in the Asia Pacific region included:

- Conducted a water system assessment and provided emergency water testing services to Pohnpei Utilities in the Federated States of Micronesia.

- Entered into an alliance agreement to provide technical assistance to the Local Water Utilities in the Philippines.

- Performed water quality testing and assisted in setting up a water meter calibration test bench for American Samoa.

- Provided chlorination equipment and practices assessment for Saipan's water utility.

Projects such as these help to promote the Board's presence and build relationships in the Asia Pacific region. These initiatives bring in new revenues and provide opportunities for the staff to acquire and develop new skills and to venture into new career paths.

The Board's Research and Facility Improvement Program ("RFIP") and Capital Improvement Program ("CIP") are approximately $477 million over the next five years. The Board's primary continuing effort will be the repair and replacement of pipelines to ensure reliability of service and the adequacy of water supply for future generations, with approximately $261 million or 55% of the Board's total RFIP and CIP budgeted for the repair and replacement of pipelines. Of the remaining amount, 17% is budgeted for research and development, storage, pumping, and water treatment projects, 15% for source projects, and 13% for facilities projects.

The Board is well positioned financially to support ongoing and future re-engineering efforts and execution of its capital program and strategic plan. Its annual revenues, at an average of $102.2 million over the past five years, have been relatively stable due to the large residential accounts that make up its customer base. Its high cash reserves provide flexibility for funding future capital improvements. Its low debt service affords the Board ample capacity to issue bonds as evidenced by the $100.0 million water system revenue bonds issued in January 2004. For the ninth year in a row, the Board has not raised its water rates due to prudent financial management.

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INDEPENDENT AUDITORS' REPORT

The Board of Directors
Board of Water Supply
City and County of Honolulu:

We have audited the statement of net assets of the Board of Water Supply (the "Board"), a component unit of the City and County of Honolulu, as of June 30, 2004, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the year then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at June 30, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis information on pages 7 to 12 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This information is the responsibility of the management of the Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules as of and for the year ended June 30, 2004 are presented for the purpose of additional analysis and are not a required part of the basic financial statements. Such supplemental schedules have been subjected to the auditing procedures applied in our audit of the financial statements and, in our opinion, are fairly stated in all material respects when considered in relation to the financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 3, 2004, on our consideration of the Board's internal control over financial reporting and our tests of its compliance and other matters. The purpose of that report is to describe the scope of our testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

As discussed in Note 12, in fiscal year 2004, the Board changed the method used to calculate depreciation expense.

Deloitte & Touche LLP

November 3, 2004

This section presents management's discussion and analysis of the Board's financial condition and activities for the year ended June 30, 2004. This information should be read in conjunction with the financial statements.

Financial Highlights

Management believes that the Board's financial condition is very strong. While water rates and charges remained the same for the ninth year in a row, the Board maintains a strong financial performance and a manageable capital improvements program. Outstanding debt is relatively low, cash reserves are high, and all debt covenants were exceeded. Key financial highlights are listed below:

- Total cash and investments are $199.1 million at June 30, 2004.
- Total assets at year-end are $1,262.4 million and exceed liabilities by $1,000.2 million.
- The Board's unrestricted current assets at June 30, 2004 are 1.7 times its related current liabilities.
- The Board issued $100.0 million in water system revenue bonds in January 2004.
- The Board's debt to equity ratio is 22.1% at June 30, 2004, indicating a large capacity to issue additional debt.
- Operating revenues for fiscal year 2004 are $101.2 million, $4.4 million lower than in fiscal year 2003 reflecting the impact on volume from heavier rainfall in fiscal year 2004 than in fiscal year 2003.
- Net assets increased $8.5 million in fiscal year 2004, reflecting a $2.4 million increase from operations and a $6.1 million increase as a result of a change in accounting principle.

Overview of Financial Report

The Board is a semi-autonomous unit of the City and County of Honolulu. The 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.

Management's discussion and analysis ("MD&A") represents management's analysis and comments on the Board's financial condition and performance. Summary financial data, key financial and operational indicators used in the Board's strategic plan, annual report, budget, bond resolutions, and other management tools were used for this analysis.

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 the financial statements. The statement of net assets presents the resources and obligations of the Board at June 30, 2004. The statement of revenues, expenses and changes in net assets presents the results of operations for the year then ended, and the resultant ending net assets balance.

The statement of cash flows presents changes in cash and cash equivalents (short term investments with original maturities of three months or less from the date of acquisition), resulting from operating, investing, capital and related financing activities, and noncapital financing activities.

The notes to the financial statements provide required disclosures and other information necessary for the fair presentation of the financial statements. The notes detail information about the Board's significant accounting policies, significant account balances, related party transactions, employee benefit plans, commitments, contingencies, and other significant events. Supplementary information on outstanding bonds and net revenue requirements are also included.

Financial Analysis

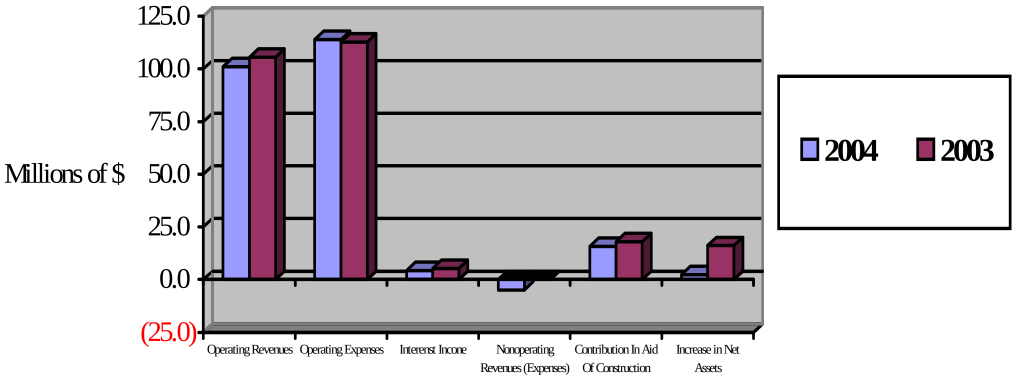
Results of Operations

CONDENSED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

	June 30,		%
	2004	2003	Variance
	(in thousands)		
Operating revenues	$ 101,165	$ 105,647	(4.2)%
Operating expenses:			
Depreciation	34,913	33,837	3.2 %
Administrative and general	29,363	29,891	(1.8)%
Water reclamation	4,210	4,128	2.0 %
Other operating expenses	45,412	44,988	0.9 %
Total operating expenses	113,898	112,844	0.9 %
Operating loss	(12,733)	(7,197)	(76.9)%
Nonoperating revenues (expenses):			
Interest income	4,429	5,367	(17.5)%
Others	(5,128)	(234)	(2091.5)%
Nonoperating revenues (expenses)–net	(699)	5,133	(113.6)%
Contributions in aid of construction	15,819	18,124	(12.7)%
Increase in net assets	$ 2,387	$ 16,060	(85.1)%

The increase in net assets for the fiscal year ending June 30, 2004 was $2.4 million, which is $13.7 million lower than last year's increase. The changes in revenues and expenses are explained below.

Statement of Revenues, Expenses and Changes in Net Assets



Operating revenues for fiscal year 2004 were $101.2 million, 4.2% lower than fiscal year 2003 revenues of $105.6 million. Water revenues in fiscal year 2004 were negatively impacted by an increase in rainfall reducing demand (average rainfall for the year was almost twice the prior year). In fiscal year 2004, residential and commercial consumption declined by 3.4% and 5.2%, respectively. Industrial consumption, including recycled water, increased by 12.3%. For the ninth year in a row, water rates and charges remained unchanged.

Total operating expenses increased to $113.9 million in fiscal year 2004, an increase of $1.1 million from fiscal year 2003. Factors contributing to this increase are explained below.

Depreciation expense increased by $1.1 million from fiscal year 2003. This was attributable to depreciation on the $55.8 million in capitalized assets during the year offset by depreciation in the prior year on assets that were disposed or retired during 2004.

Administrative and general expenses decreased $0.5 million, with a reduction in consulting fees more than offsetting an increase in payroll as the Board is now in the later stages of its re-engineering program. Since 1999, the Board has undertaken an effort to significantly re-engineer the organization to transform it into a highly competitive, world-class organization. The goals are to provide world-class customer service, establish a performance culture at all levels, develop staff, expand water resources, assure long-term viability, improve infrastructure reliability, and identify growth opportunities. In the early years of this program, specialized services were retained to help the Board in this effort. In the past 12 months, the Board began hiring an executive team to oversee this re-engineering effort and daily operations.

Major re-engineering accomplishments during fiscal year 2004 included completing the implementation of an automated financial accounting system, reorganizing the Finance and IT units, re-engineering related operating and finance work processes throughout the Board, improving the geographic information system, completely re-designing the Board's external internet and intranet websites, and implementing a multi-skilled worker pilot program for field workers.

Water reclamation expenses include expenses of the Honouliuli Recycled Water Facility, which is in its fourth year of operation. In 2004, water sales, which are included in operating revenues, increased by 11.5% due to increasing volume while water reclamation expenses remained flat.

The Board's interest income decreased by 17.5% to $4.4 million due to significantly lower rates. The balance of cash and investments increased significantly during the year resulting from the issue of $100.0 million in water system revenue bonds in January.

Other nonoperating revenues decreased by $5.8 million due primarily to realized and unrealized losses from investments.

Contributions in aid of construction result from water system facilities charges that are levied against all new developments and residential properties requiring water from the Board's systems, except those developments that have paid for and installed a complete water system, including sources, transmission, and daily storage facilities. In addition, contributions of capital assets from governmental agencies, developers, and customers are recorded as contributions in aid of construction at their cost. While there was significant construction activity on the island of Oahu in 2004, it was not at the level of 2003. As a result, contributions in aid of construction decreased by $2.3 million to $15.8 million.

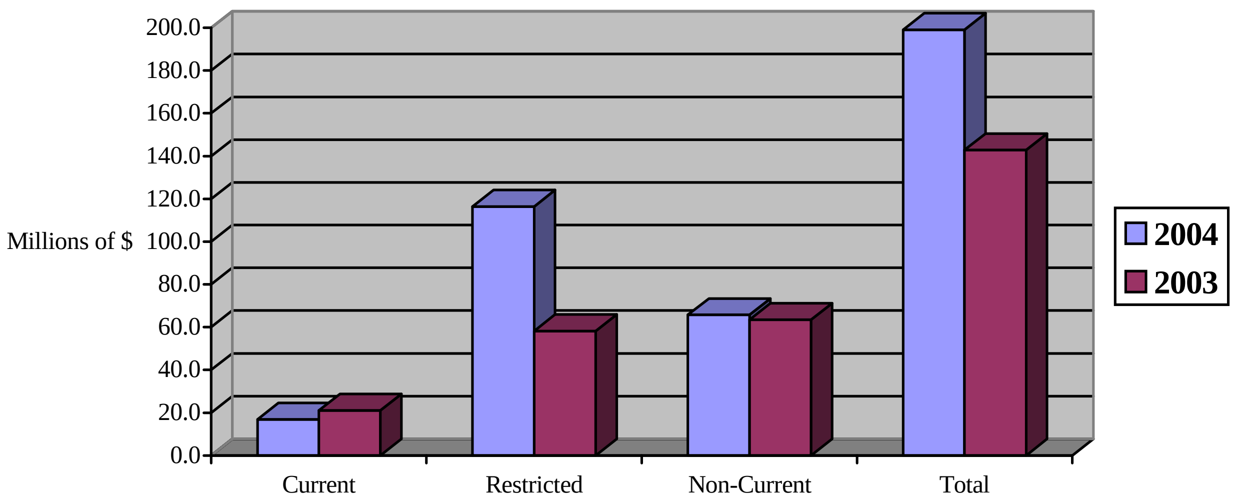
Financial Condition

CONDENSED STATEMENTS OF NET ASSETS

	June 30, 2004	June 30, 2003	% Variance
	(in thousands)		
Current assets:			
Cash and investments	$ 16,944	$ 21,024	(19.4)%
Other current assets	19,373	20,369	(4.9)%
Restricted assets:			
Cash and investments	116,420	58,223	100.0 %
Other restricted assets	2,099	843	149.0 %
Investments	65,701	63,546	3.4 %
Other assets	2,583	2,732	(5.5)%
Property, plant and equipment–net of accumulated depreciation	1,039,267	979,759	6.1 %
Total assets	$ 1,262,387	$ 1,146,496	10.1 %
Current liabilities	$ 29,596	$ 25,194	17.5 %
Other liabilities	12,808	11,470	11.7 %
Bonds payable, noncurrent	219,801	118,180	86.0 %
Total liabilities	262,205	154,844	69.3 %
Net assets:			
Invested in capital assets–net of related debt	876,242	863,803	1.4 %
Restricted for capital activity and debt service	48,925	46,228	5.8 %
Unrestricted	75,015	81,621	(8.1)%
Total net assets	1,000,182	991,652	0.9 %
Total liabilities and net assets	$ 1,262,387	$ 1,146,496	10.1 %

The Board's financial condition remains strong at year-end.

Cash and Investments



The Board's total cash and investments increased by $56.3 million in 2004 from $142.8 million in 2003. This is the result of issuing $100.0 million in water system revenue bonds in January, partially offset by expenditures to fund operations and capital projects.

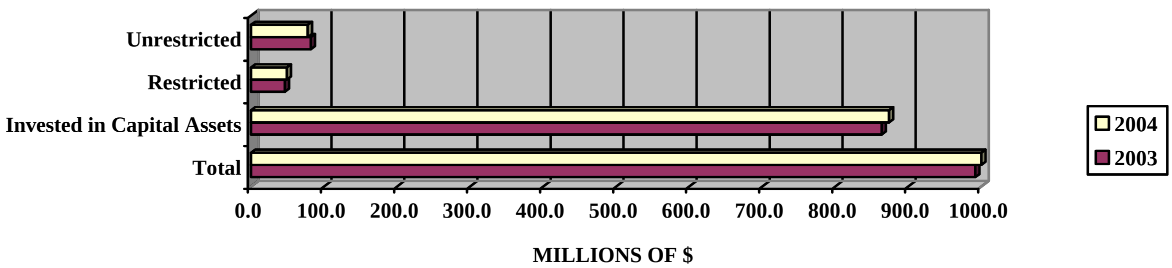
At June 30, 2004, the Board's cash and investments balance of $199.1 million exceeds the total annual operating budget for fiscal year 2005 of $107.9 million, which includes $12.6 million of capital projects anticipated to be funded from the operating budget. This is before taking into account operating fund revenues for fiscal year 2005, which are projected to be $109.5 million. The unrestricted portion of cash and investments at June 30, 2004 of $82.6 million represents 104.6% of the Board's total operating expenses for fiscal year 2004 excluding depreciation.

The Board's current ratio (current assets divided by current liabilities) is 3.5 and 1.9 for June 30, 2004 and 2003, respectively. The increase is the result of an accrual of a $2.6 million litigation liability at June 30, 2004, offset by funds obtained via the $100.0 million bond issue in January 2004. The Board's unrestricted current assets at June 30, 2004 are 1.7 times its related current liabilities.

The Board issues long term bonds to finance part of its capital improvement program, and during January of 2004, the Board issued $100.0 million in water system revenue bonds. Even with this issue, the Board's debt to equity ratio is very low at 22.1% at June 30, 2004 (the ratio was 12.0% at June 30, 2003), indicating significant additional borrowing capacity.

Net assets increased 0.2% from $997.8 million in fiscal year 2003 to slightly over $1.0 billion in fiscal year 2004.

NET ASSETS



Capital Assets and Long Term Debt

During the year, the Board capitalized $55.8 million to its utility plant in service. Major assets added were Kailua Reservoir, $7.2 million; Nanakuli distribution main, $5.4 million; Waipio Heights Well Granular Activated Carbon, $3.0 million; financial accounting system upgrade, $2.1 million; various transmission and distribution mains, $20.2 million; and various well additions and renovations, $5.9 million.

All outstanding debt has been assigned ratings of Aa3 from Moody's Investors Service, AA from Standard and Poor's, and AA from Fitch.

Rate Covenant

The Board is required by its bond resolution, among other things, to fix, charge, and collect such rates and other charges in each fiscal year to meet the net revenue requirement for such fiscal year. The net revenue requirement, which is reflected in the Supplemental Schedule of Net Revenue requirement, is the greater of the sum of the aggregate debt service and required deposits for the year or 1.20 times the aggregate debt service for the year and 1.00 times the support facility reimbursement obligations outstanding as of the end of the fiscal year (the Board has none). The Board's net revenue for 2004 for purposes of this requirement is 2.76 times the requirement. The Board's revenue bond debt service coverage for the fiscal year ending June 30, 2004 is 3.31. The bond covenant for debt service coverage is 1.20.

Request for Information

This financial report is designed to provide a general overview of the Board of Water Supply's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Board of Water Supply, City and County of Honolulu.

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

STATEMENT OF NET ASSETS
JUNE 30, 2004

ASSETS

CURRENT ASSETS:	
Cash and cash equivalents	$ 16,943,776
Interest receivable	710,052
Customer receivables:	
Billed, less allowances of $1,775,135 for uncollectible accounts	5,732,459
Unbilled	6,929,343
Other receivables	1,292,077
Materials and supplies	4,251,433
Prepaid expenses	457,684
Total current assets	36,316,824
RESTRICTED ASSETS:	
Cash and cash equivalents	65,383,839
Investments	51,035,733
Other receivables, less allowances of $2,458,563 for uncollectible accounts	1,619,785
Interest receivable	479,465
Total restricted assets	118,518,822
INVESTMENTS	65,700,930
BOND ISSUE COSTS, Net of accumulated amortization of $152,727	2,583,357
CAPITAL ASSETS:	
Land	30,090,079
Infrastructure	1,020,003,814
Buildings and improvements	121,880,839
Equipment and machinery	178,417,457
Construction work in progress	155,756,645
	1,506,148,834
Accumulated depreciation	(466,881,609)
Capital assets–net	1,039,267,225
TOTAL	$1,262,387,158

(Continued)

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

STATEMENT OF NET ASSETS
JUNE 30, 2004

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES:	
Payable from current assets:	
Contracts payable, including retainages	$ 5,014,689
Accounts payable	10,572,374
Accrued vacation, current portion	2,086,958
Accrued interest payable	3,635,734
	21,309,755
Payable from restricted assets:	
Contracts payable, including retainages	7,145,636
Bonds payable, current portion	1,135,000
Other	6,032
	8,286,668
Total current liabilities	29,596,423
OTHER LIABILITIES:	
Restricted–customer advances	4,531,656
Accrued vacation–noncurrent portion	4,573,960
Accrued workers' compensation	2,704,580
Other	997,726
Total other liabilities	12,807,922
BONDS PAYABLE—Less current portion	219,800,728
Total liabilities	262,205,073
COMMITMENTS AND CONTINGENCIES	
NET ASSETS:	
Invested in capital assets–net of related debt	876,242,031
Restricted for capital activity and debt service	48,924,964
Unrestricted	75,015,090
Total net assets	1,000,182,085
TOTAL	$1,262,387,158

See notes to financial statements. (Concluded)

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEAR ENDED JUNE 30, 2004

OPERATING REVENUES:	
Water sales	$ 99,877,649
Other, principally contract and service fees	1,287,634
Total operating revenues	101,165,283
OPERATING EXPENSES:	
Depreciation	34,913,406
Administrative and general	29,362,939
Power and pumping	16,279,150
Maintenance	11,750,048
Transmission and distribution	9,879,748
Water reclamation	4,210,302
Customers' accounting and collection	3,937,177
Central administrative services expense fees	3,300,000
Water treatment	151,984
Source of supply	113,278
Total operating expenses	113,898,032
LOSS FROM OPERATIONS	(12,732,749)
NONOPERATING REVENUES (EXPENSES):	
Interest income	4,429,022
Interest expense–net of interest capitalized of $4,590,586	(1,296,963)
Realized and unrealized loss on investments	(3,845,250)
Federal operating grants	405,991
Loss from disposal of capital assets	(726,383)
Other	333,713
Nonoperating expenses–net	(699,870)
CONTRIBUTIONS IN AID OF CONSTRUCTION	15,819,311
INCREASE IN NET ASSETS	2,386,692
NET ASSETS, BEGINNING OF YEAR:	
As previously reported	991,651,949
Change in accounting principle	6,143,444
As restated	997,795,393
NET ASSETS, END OF YEAR	$ 1,000,182,085

See notes to financial statements.

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2004

OPERATING ACTIVITIES:	
Cash received from customers	$ 102,016,742
Payments to suppliers for goods and services	(65,020,536)
Payments to employees for services	(26,247,762)
Other revenues–net	481,930
Net cash provided by operating activities	11,230,374
INVESTING ACTIVITIES:	
Proceeds from maturity of investments	208,950,470
Purchase of investments	(200,737,633)
Interest on investments	4,232,133
Net cash provided by investing activities	12,444,970
CAPITAL AND RELATED FINANCING ACTIVITIES:	
Acquisition and construction of capital assets–net of contributions in aid of construction	(53,582,328)
Proceeds from issuance of bonds	104,968,184
Cost for issuance of bonds	(1,263,969)
Principal paid on bonds	(2,090,000)
Interest paid on bonds	(3,808,048)
Customer advances for capital projects	200,000
Net cash provided by capital and related financing activities	44,423,839
NONCAPITAL FINANCING ACTIVITIES—Federal grants received	230,000
NET INCREASE IN CASH AND CASH EQUIVALENTS	68,329,183
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	13,998,432
CASH AND CASH EQUIVALENTS, END OF YEAR (Including $65,383,839 in restricted accounts)	$ 82,327,615

(Continued)

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2004

RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH PROVIDED BY OPERATING ACTIVITIES:	
Loss from operations	$ (12,732,749)
Adjustments to reconcile loss from operations to net cash provided by operating activities:	
Depreciation	35,790,308
Provision for doubtful accounts	142,816
Provision for workers' compensation	433,745
Other revenues	481,930
Change in operating assets and liabilities:	
Customer receivables	2,024,815
Materials and supplies	(401,515)
Other receivables	(1,316,172)
Prepaid expenses and other	(336,936)
Accounts payable	(13,036,970)
Accrued vacation	125,107
Other liabilities	55,995
Net cash provided by operating activities	$ 11,230,374

SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES:	
• Contributions of capital assets from government agencies, developers and customers that are recorded as contributions in aid of construction at their cost or estimated cost	$ 7,530,785
• Capital assets included in accounts and contracts payable	15,857,166
• Interest capitalized in capital assets	4,590,586
• Amortization of bond issue costs	67,433
• Amortization of bond premium/discount	(122,256)
• Amortization of deferred loss on refunding	255,089

See notes to financial statements. (Concluded)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Operations—The Charter of the City and County of Honolulu provides for the operation of the Board of Water Supply ("Board") as a semi-autonomous body of the City and County of Honolulu government ("City"). The Board has full and complete authority to manage, control and operate the City's water system and related properties.

Financial Statement Presentation—The Board is a component unit of the City (the primary government).

The Board follows Governmental Accounting Standards Board ("GASB") Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*. Under GASB No. 20, the Board applies all applicable Financial Accounting Standards Board ("FASB") pronouncements and Accounting Principles Board opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Board does not apply FASB statements and interpretations issued after November 30, 1989.

Basis of Accounting—The accompanying financial statements are presented using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

The Board distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the Board'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 nonoperating revenues and expenses.

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Actual results could differ from those estimates.

Regulation and Water Rates—Article VII of the Revised Charter of the City and County of Honolulu ("City Charter") states that the Board's seven-member board has the authority to establish and adjust water rates and charges so that the revenues derived shall be sufficient to make the Board self-supporting. The Board is required to follow certain procedures that include holding public hearings before implementing changes in the water rate schedules.

Cash and Cash Equivalents—The Board considers all cash on hand, demand deposits, and short-term investments (including restricted assets) with original maturities of three months or less from the date of acquisition to be cash and cash equivalents.

Investments—Investments are stated at fair value. Fair value has been determined based on quoted market prices. The cost of securities sold is generally determined by the weighted average method.

Materials and Supplies—Materials and supplies are stated at the lower of weighted average cost (which approximates the first-in, first-out method) or market. The costs of materials and supplies are recorded as expenses when consumed rather than when purchased.

Restricted Assets—Restricted assets are comprised of cash and cash equivalents, investments and receivables maintained in accordance with bond resolutions, agreements and formal actions of the Board for the purpose of funding certain debt service payments, construction, improvements, and renewal and replacements of the water system. Restricted assets comprise the following:

- The debt service account accumulates transfers from the operating account throughout the fiscal year to make principal and interest payments on the outstanding water revenue bonds.

- The renewal and replacement account provides funding for improvements, reconstruction, emergency or extraordinary repairs, and renewals or replacements of the water system.

- The improvement account holds the proceeds of the series bond issuance pursuant to the series resolution or series certificate. These proceeds are only applied to costs specified in the applicable series resolution or series certificate.

- The special expendable account collects customer deposits from the assessment of water system facilities charges and negotiated agreements. Disbursements from the account are restricted to the construction of water source, storage, and transmission facilities, including the related land, engineering, and design work.

Capital Assets—Capital assets include those assets in excess of $100,000 for buildings, structures, and infrastructure, and $5,000 for equipment and machinery with a useful life of more than one year. Capital assets are stated at cost and include contributions by governmental agencies, private subdividers, and customers at their cost or estimated cost of new construction.

Major replacements, renewals, and betterments are capitalized. Interest costs are capitalized during the construction period of major capital projects. The Board also capitalizes certain indirect costs to construction work based upon actual construction direct labor. Maintenance, repairs, and replacements that do not improve or extend the lives of the assets are charged to expense.

Assets are depreciated over their estimated useful lives using the straight-line method. Depreciation on both purchased and contributed assets is charged against operations. In fiscal year 2004, the Board changed the method of calculating depreciation expense from an asset group basis to an individual asset basis. See Note 12.

The ranges of estimated economic useful lives of capital assets are as follows:

Source of Supply Plant	20 to 100 years
Pumping Plant	20 to 50 years
Water Treatment Plant	20 to 30 years
Transmission and Distribution Plant	13-1/3 to 50 years
General Plant	8 to 50 years

Bond Issue Costs, Original Issue Discount or Premium and Deferred Loss on Refundings—Bond issue costs are deferred and are amortized over the life of the respective issue on a straight-line basis.

Original issue discount or premium and deferred loss on refundings are amortized using the effective interest method over the terms of the respective issues and are added to or offset against the bonds payable in the statement of net assets.

Accrued Vacation and Compensatory Pay—Vacation is earned at the rate of one and three-quarters working days for each month of service. Vacation days may be accumulated to a maximum of ninety days as of the end of the calendar year and are convertible to pay upon termination.

The Board accrues a liability for compensated absences and additional amounts for certain salary-related payments including payroll taxes and fringe benefits.

Water System Facilities Charge—A water system facilities charge is levied against all new developments and residential properties requiring water from the Board's systems, except those developments that have paid for and installed a complete water system, including source, transmission, and daily storage facilities. The amounts collected are initially recorded as customer advances and are recognized as contributions in aid of construction when water service is made available to the customer. The use of these funds is restricted to the construction of water facilities.

Net Assets—Net assets comprise the various net earnings from operating and nonoperating revenues, expenses, and contributions in aid of construction. Net assets 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, consists 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 is 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 assets not included in the above categories.

Revenue Recognition—The Board's policy is to bill customers on a cyclical monthly or bi-monthly basis for water usage. The accrual for unbilled water revenues and related receivables reflected in the accompanying financial statements is based on estimated usage from the latest meter reading date to the end of the fiscal period.

Pension Expense—The Board's contributions to the Employees' Retirement System of the State of Hawaii are based upon actuarial computations and include current service costs and amortization of prior service costs. The Board's policy is to fund pension costs accrued.

Risk Management—The Board 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, and (5) employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. The Board is partially self-insured for workers' compensation claims and judgments as discussed in Note 11.

New Accounting Pronouncements—In May 2002, the GASB issued Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*. This Statement provides additional guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. The Board adopted this statement effective July 1, 2003. The adoption of this Statement did not have a significant impact on the financial statements.

In March 2003, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3*. This Statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this Statement are also to be disclosed. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2004. Management has not completed its determination of the additional disclosures that may be required, once the provisions of this Statement are implemented.

In November 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This Statement establishes accounting and financial reporting standards for impairment of capital assets and also clarifies and establishes accounting requirements for insurance recoveries. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2004. Management has not completed its determination of the impact on the financial statements once the provisions of this Statement are implemented.

2. CASH AND INVESTMENTS

The Board's portfolio is managed by various investment managers. These investments consist mainly of mutual funds and U.S. government securities, which are recorded at fair value based on quoted market prices.

At June 30, 2004, investments consisted of the following:

	Cost	Fair Value
Mutual funds	$ 16,541	$ 16,558
U.S. government treasury obligations	68,155,315	66,945,191
U.S. government agencies	44,822,125	44,584,471
Treasury bills–short-term	5,217,776	5,190,443
Total	$118,211,757	$116,736,663

Cash deposited with the City is maintained in separate accounts by the Department of Budget and Fiscal Services of the City. The Hawaii Revised Statutes ("HRS") provide for the City's Director of Finance to deposit the cash with any national or state bank or federally insured financial institution authorized to do business in the State of Hawaii, provided that all deposits are fully insured or collateralized.

The HRS authorize the Board to invest, with certain restrictions, in obligations of the State of Hawaii or the United States, in federally insured savings accounts, time certificates of deposit, and bank repurchase agreements with federally insured financial institutions authorized to do business in the State of Hawaii.

These balances were fully insured or collateralized with securities held by the bank with which it has an investment management agreement, or by the City's agent in the City's name.

3. RESTRICTED ASSETS

At June 30, 2004, restricted assets were held for the following purposes:

Construction	$ 111,193,387
Renewals and replacements	2,004,111
Bond interest and redemption	5,321,324
Total	$ 118,518,822

4. CAPITAL ASSETS

Capital assets activity during 2004 was as follows:

	Balance, July 1, 2003	Additions	Transfers	Retirements	Balance, June 30, 2004
Depreciable assets:					
Infrastructure	$ 979,913,704	$ 6,397	$ 41,008,470	$ (924,757)	$ 1,020,003,814
Buildings and improvements	117,750,636		4,130,629	(426)	121,880,839
Equipment and machinery	169,197,374	1,958,286	8,680,746	(1,418,949)	178,417,457
Total depreciable assets	1,266,861,714	1,964,683	53,819,845	(2,344,132)	1,320,302,110
Less accumulated depreciation	(432,628,257)	(35,790,308)		1,536,956	(466,881,609)
Total depreciable assets–net	834,233,457	(33,825,625)	53,819,845	(807,176)	853,420,501
Land	30,090,079				30,090,079
Construction work in progress	121,578,439	87,998,051	(53,819,845)		155,756,645
Capital assets–net	$ 985,901,975	$ 54,172,426	$ -	$ (807,176)	$ 1,039,267,225

The beginning balance of accumulated depreciation at July 1, 2003 reflects an adjustment to decrease the amount previously reported of $438,771,701 by $6,143,444. The adjustment is the result of a change in depreciation method, as described in Note 12.

Depreciation of $876,902 was allocated to various functions and not to depreciation expense.

The Board received $80,793 in proceeds from the sale of capital assets.

5. ACCRUED VACATION

At June 30, 2004, accrued vacation consisted of the following:

2004	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 6,535,811	$ 2,212,065	$ (2,086,958)	$ 6,660,918	$ 2,086,958	$ 4,573,960

6. BONDS PAYABLE

At June 30, 2004, bonds payable consisted of the following:

Water System Revenue Bonds, Series 2001, annual principal due ranging from $1,090,000 to $4,210,000 through July 1, 2032, with interest ranging from 3.5% to 5.5%	$ 64,730,000
Water System Revenue Bonds, Series 2002, annual principal due commencing July 1, 2003, ranging from $1,000,000 to $3,300,000 through July 1, 2031, with interest at the monthly auction rates (1.20% to 1.26% per annum at June 30, 2004)	52,450,000
Water System Revenue Bonds, Series 2004, annual principal due commencing July 1, 2005, ranging from $1,890,000 to $6,245,000 through June 30, 2034, with interest ranging from 2% to 5%	100,000,000
Total	217,180,000
Add unamortized premium	4,825,213
Less unamortized discount	(559,307)
Less deferred loss on refunding	(510,178)
Less current portion	(1,135,000)
Noncurrent portion	$219,800,728

Principal and interest payments on water system revenue bonds are to be paid from the Board's revenue. Water system revenue bonds are subject to redemption on and after specific dates prior to maturity at the option of the Board at 100 percent of the principal amount plus accrued interest without premium.

Bonds payable activity during 2004 was as follows:

	Balance, July 1, 2003	Additions	Reductions	Balance, June 30, 2004	Current Portion
Water System Revenue Bonds:					
Series 2001	$ 65,820,000	$ -	$(1,090,000)	$ 64,730,000	$ 1,135,000
Series 2002	53,450,000		(1,000,000)	52,450,000	
Series 2004		100,000,000		100,000,000	
Total	$ 119,270,000	$ 100,000,000	$(2,090,000)	$ 217,180,000	$ 1,135,000

Future bond principal and interest payments are as follows:

	Principal	Interest	Total
Year ending June 30,			
2005	$ 1,135,000	$ 8,123,000	$ 9,258,000
2006	4,070,000	8,380,000	12,450,000
2007	4,220,000	8,276,000	12,496,000
2008	4,350,000	8,175,000	12,525,000
2009	4,505,000	8,053,000	12,558,000
2010-2014	25,475,000	38,014,000	63,489,000
2015-2019	31,775,000	32,887,000	64,662,000
2020-2024	40,370,000	25,762,000	66,132,000
2025-2029	51,495,000	16,415,000	67,910,000
2030-2033	49,785,000	4,886,000	54,671,000
Total	$217,180,000	$158,971,000	$376,151,000

In February 2001, the Board created an irrevocable trust with an escrow agent to retire $32,460,000 of the Board's outstanding 1992 general obligation water bonds. The escrow agent will pay all future debt service payments on the 1992 Series bonds out of the irrevocable trust. Consequently, the 1992 Series bonds were considered to be defeased and the liability for the bonds was removed from the Board's financial statements in 2001. At June 30, 2004, the outstanding 1992 Series defeased bonds amounted to $27,925,000.

In May 2001, the Board issued $66,600,000 in water system revenue bonds to retire $16,395,000 of the Board's outstanding 1996 Series bonds with the remainder to fund the Board's capital improvement projects. An irrevocable trust with an escrow agent was funded to provide for all future debt service payments on the 1996 Series bonds. Consequently, the 1996 Series bonds were considered to be defeased and the liability for those bonds was removed from the Board's financial statements in 2001. At June 30, 2004, the outstanding 1996 Series defeased bonds amounted to $14,995,000.

In March 2002, the Board issued $54,400,000 in water system revenue bonds, which consisted of $30,000,000 of Series 2002A and $24,400,000 of Series 2002B bonds. Proceeds of the issuance were primarily used to fund the acquisition of a water reclamation facility.

In January 2004, the Board issued $100,000,000 in water system revenue bonds. Proceeds of the issuance will be used to fund capital improvement projects.

7. NET ASSETS

At June 30, 2004, net assets consisted of the following:

Invested in Capital Assets—net of related debt:	
Property, plant and equipment–net	$1,039,267,225
Less water system revenue bonds payable	(220,935,728)
Add unspent debt proceeds	57,910,534
	876,242,031
Restricted for Capital Activity and Debt Service:	
Restricted cash and cash equivalents	65,383,839
Restricted investments	51,035,733
Restricted interest receivable	479,465
Restricted other receivables	1,619,785
Less:	
Unspent debt proceeds	(57,910,534)
Contracts payable, including retainages	(7,145,636)
Customer advances	(4,531,656)
Other payable from restricted assets	(6,032)
	48,924,964
Unrestricted	75,015,090
Total net assets	$1,000,182,085

8. RELATED PARTY TRANSACTIONS

Billing and Collection Services—The Board has an agreement with the Department of Environmental Services, City and County of Honolulu to provide certain services through June 30, 2004, relating to the billing and collection of sewer service charges. Fees related to these services were negotiated at approximately $100,000 per year through fiscal 2004. The revenues related to these fees are included in other operating revenues in the accompanying statement of revenues, expenses and changes in net assets.

Central Administrative Services Expense Fee—During fiscal year 2000, the Board entered into an agreement with the City to pay a Central Administrative Services Expense ("CASE") fee for treasury, personnel, purchasing, and other services that the City provides to the Board on an on-going basis. The Board's Charter allows for a CASE fee to the extent that it represents a reasonable charge for services necessary for the Board to perform its duties. Although CASE fees for fiscal years subsequent to 2001 are currently being negotiated between the Board and the City, the Board paid its best estimate of approximately $3,300,000 for the years ended June 30, 2004 and 2003.

Ewa Villages Water System Facilities Charge—Based upon negotiations with the City, the Board agreed to deviate from its standard policies regarding a developer's responsibility to construct the related water system infrastructure for the City's low-income housing development known as Ewa Villages. The size of the development required the City to build a specified water system and convey it to the Board. The City began construction of the water system infrastructure; however, the Board subsequently agreed to complete the unfinished phases of the work.

The Board agreed to negotiate a water system facility charge with the City to consider only the portion of the total infrastructure costs that will benefit the Ewa Villages project. The Board's estimation of the total cost of the existing and proposed infrastructure was approximately $28.9 million, of which the City's share was approximately $7.6 million. Although both the Board and the City agree with this amount, the two parties are determining the extent the City satisfied this obligation through costs it incurred in its initial phase of construction. As of June 30, 2004, the Board has recorded a receivable and related allowance for uncollectible accounts of approximately $1.9 million related to this water system facility charge to the City.

Amounts Due to/from the City—Amounts due from the City approximated $563,000 as of June 30, 2004, and are included in accounts receivable. Amounts due to the City approximated $3,325,000 as of June 30, 2004, and are included in accounts payable.

9. EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plan

Substantially all eligible employees of the Board are members of the Employees' Retirement System of the State of Hawaii ("ERS"), a cost-sharing multiple-employer employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. All contributions, benefits, and eligibility requirements are established by HRS Chapter 88 and can be amended by legislative action.

Prior to June 30, 1984, the plan consisted of only a contributory option. Effective July 1, 1984, legislation was enacted to create a new noncontributory option for members of the ERS. Eligible employees hired for the first time or those returning to service after June 30, 1984 without vested benefit status automatically become participants of the noncontributory retirement option. Members of the ERS who were in service on June 30, 1984 had the option to elect the new noncontributory retirement option. Benefits vest after five and ten years of credited service under the contributory and noncontributory options.

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

Most covered employees of the contributory option are required to contribute 7.8% of their salary. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 18 years from July 1, 1998.

The Board's policy is to fund its required contribution annually. The payroll for employees of the Board covered by the ERS for the year ended June 30, 2004 was approximately $26,423,000; the Board's total payroll was approximately $27,020,900. The contribution requirement for the year ended June 30, 2004 was approximately $2,595,000, which represented approximately 9.8% of the Board's covered payroll for the fiscal year. The Board's contribution requirement for fiscal year 2004 represented approximately 1.1% of the total contribution requirement for all employers.

ERS issues a Comprehensive Annual Financial Report ("CAFR") that includes financial statements and required supplementary information, which may be obtained from the following address: Employees' Retirement System of the State of Hawaii, 201 Merchant Street, Suite 400, Honolulu, Hawaii 96813.

Early Retirement Incentive

Act 212 of the 1994 regular session of the State Legislature authorized an early retirement incentive to state and county employees with at least 25 years of service as of December 31, 1994. Qualifying employees received two additional years of service credits for purposes of calculating their retirement benefits.

Act 216 of the 2000 State Legislative Session lowered the employer contributions to the System by extending the payment schedule for the actuarial present value cost of the early retirement incentive bonus from 5 to 19 years beginning with System payments for the year ended June 30, 2001. The retirement contribution liability related to this program as of June 30, 2004 was approximately $590,000.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State of Hawaii Public Employees Health Fund provides certain health care and life insurance benefits, in accordance with State statutes, to all employees who retire from the Board on or after attaining age 62 with at least 10 years of service or age 55 with at least 30 years of service under the noncontributory plan, and age 55 with at least 5 years of service under the contributory plan. Currently, 538 Board retirees and surviving dependents are eligible to receive health care benefits and 416 Board retirees are eligible to receive life insurance benefits. Retirees credited with at least 10 years of service excluding sick leave credit qualify for free medical insurance premiums. However, retirees with less than 10 years must assume a portion of the monthly premiums. All disabled retirees who retire after June 30, 1984, with less than 10 years of service, also qualify for free medical insurance premiums. Free life insurance coverage and dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive a reimbursement of the basic medical coverage premiums. Contributions are based upon negotiated collective bargaining agreements and are funded by the Board as accrued. The amounts allocated to the Board for the year ended June 30, 2004 aggregated approximately $3,007,000 and are included as expenses in the accompanying financial statements.

Deferred Compensation Plan

All full-time employees are eligible to participate in the City and County of Honolulu's Public Employees' Deferred Compensation Plan ("Plan"), adopted pursuant to Internal Revenue Code Section 457. The Plan permits eligible employees to defer a portion of their salary until future years. The deferred compensation amounts are not available to employees until termination, retirement, death, or unforeseeable emergency.

A trust fund (annuity contract) was established to protect plan assets from claims of general creditors and from diversion to any uses other than paying benefits to participants and beneficiaries. Accordingly, the Board has excluded the Plan's assets and liabilities from the financial statements because the Board and City do not have significant administrative involvement in the Plan or perform the investment function for the Plan.

10. COMMITMENTS

At June 30, 2004, accumulated sick leave aggregated approximately $21,158,000. Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit, but can be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 or more unused sick days is entitled to additional service credit in the ERS.

Other commitments, primarily for utility plant construction, approximated $153,000,000 at June 30, 2004.

11. CONTINGENCIES

Workers' Compensation Self-Insurance Liability

The Board is self-insured for workers' compensation and disability claims below $500,000 and in excess of $1,000,000. Such claims are reported to and managed by the City's Workers' Compensation Division (the "Division"). The Board provides reserves for claims not covered by insurance that in the opinion of the Division will result in probable judgment against the Board.

The liability for losses and loss adjustment expenses is comprised of two components: Case reserves and incurred but not reported loss reserves ("IBNR"). Case or outstanding loss reserves represent estimates of ultimate costs to settle reported claims. These estimates are determined on a case-by-case basis by the Division. The total reserves recorded by the Board were approximately $2,705,000 at June 30, 2004.

Safe Drinking Water

The Board 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 believes that the Board is in full compliance with the requirements of the Act and is not aware of any matters under the Act that may materially affect the Board's customer service area.

Other Legal Matters

The Board 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, after considering insurance coverage, will not have a material adverse affect on the Board's financial position, results of operations, or liquidity.

Credit Risk

Financial instruments, which potentially expose the Board to concentrations of credit risk, consist primarily of investments in debt securities and accounts receivable from retail customers. Credit risk related to investments in debt securities has been mitigated by limiting such investments to debt obligations of the U.S. government and agencies. The Board's customer base is concentrated among commercial, industrial, residential, and governmental customers located within the City. Although the Board is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 2004, except as provided in the allowance for uncollectible accounts. The Board manages its credit exposure through procedures designed to identify and monitor credit risk.

12. CHANGE IN ACCOUNTING PRINCIPLE

In fiscal year 2004, the Board changed the method used to calculate depreciation expense. Prior to fiscal year 2004, depreciation was calculated based on asset groups, but commencing in fiscal year 2004, depreciation is being calculated based on individual assets. The Board believes that this change in accounting principle is preferable, as it results in a more accurate calculation of depreciation of the individual capital assets held by the Board.

As required by GASB Statement No. 34, *Basic Financial Statements—and Management*'s *Discussion and Analysis—-for State and Local Governments*, the impact of the accounting change on the accumulated depreciation of the capital assets on hand at July 1, 2003 has been accounted for by restating net assets and capital assets. Such restatement had the effect of increasing net assets and capital assets by $6,143,444 at July 1, 2003.

13. SUBSEQUENT EVENT

In October 2001, a general contractor filed a lawsuit against the Board seeking additional compensation for work done on a construction project that was undertaken in 1999 and still in progress at June 30, 2004. In August 2004, the parties to the litigation submitted this matter to mediation. As a result of the mediation, the parties executed a settlement agreement dated August 25, 2004. Under the terms of the settlement, the parties agreed to resolve all of the plaintiff's claims, and the Board agreed to issue a change order whereby the Board would pay to the plaintiff $2,500,000 plus one half of the applicable Hawaii general excise tax, or $52,000.

Because the lawsuit was filed prior to June 30, 2004, the effects of the settlement agreement have been reflected in the fiscal year 2004 financial statements by increasing capital assets—construction work in progress and contracts payable by $2,552,000.

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BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

SUPPLEMENTAL SCHEDULE FOR BONDS PAYABLE
JUNE 30, 2004

	Last Installment	Interest Rate	Bond Dated	Maturing Serially From	Call Dates (1)	Outstanding June 30, 2004
Water System Revenue Bonds:						
Series 2001:	2005	4.000	5/15/2001	7/1/2004	(2)	$ 1,035,000
	2005	3.500	5/15/2001	7/1/2004	(2)	100,000
	2006	5.000	5/15/2001	7/1/2005	(2)	1,130,000
	2006	3.700	5/15/2001	7/1/2005	(2)	50,000
	2007	3.875	5/15/2001	7/1/2006	(2)	1,240,000
	2008	4.000	5/15/2001	7/1/2007	(2)	1,285,000
	2009	5.000	5/15/2001	7/1/2008	(2)	1,165,000
	2009	4.125	5/15/2001	7/1/2008	(2)	175,000
	2010	5.000	5/15/2001	7/1/2009	(2)	1,105,000
	2010	4.250	5/15/2001	7/1/2009	(2)	300,000
	2011	5.000	5/15/2001	7/1/2010	(2)	250,000
	2011	4.375	5/15/2001	7/1/2010	(2)	1,220,000
	2012	5.000	5/15/2001	7/1/2011	(2)	200,000
	2012	4.500	5/15/2001	7/1/2011	(2)	1,335,000
	2013	5.375	5/15/2001	7/1/2012	7/1/2011	535,000
	2013	4.600	5/15/2001	7/1/2012	7/1/2011	1,075,000
	2014	4.700	5/15/2001	7/1/2013	7/1/2011	1,685,000
	2015	5.500	5/15/2001	7/1/2014	7/1/2011	1,765,000
	2016	5.500	5/15/2001	7/1/2015	7/1/2011	1,860,000
	2017	5.500	5/15/2001	7/1/2016	7/1/2011	1,735,000
	2017	5.000	5/15/2001	7/1/2016	7/1/2011	230,000
	2018	5.000	5/15/2001	7/1/2017	7/1/2011	2,070,000
	2019	5.125	5/15/2001	7/1/2018	7/1/2011	2,175,000
	2020	5.125	5/15/2001	7/1/2019	7/1/2011	2,285,000
	2021	5.125	5/15/2001	7/1/2020	7/1/2011	2,405,000
	2022	5.125	5/15/2001	7/1/2021	7/1/2011	2,525,000
	2023	5.250	5/15/2001	7/1/2022	7/1/2011	2,655,000
	2024	5.250	5/15/2001	7/1/2023	7/1/2011	2,795,000
	2025	5.250	5/15/2001	7/1/2024	7/1/2011	2,940,000
	2026	5.250	5/15/2001	7/1/2025	7/1/2011	3,095,000
	2027	5.250	5/15/2001	7/1/2026	7/1/2011	3,260,000
	2028	5.250	5/15/2001	7/1/2027	7/1/2011	3,430,000
	2029	5.250	5/15/2001	7/1/2028	7/1/2011	3,610,000
	2030	5.250	5/15/2001	7/1/2029	7/1/2011	3,800,000
	2031	5.250	5/15/2001	7/1/2030	7/1/2011	4,000,000
	2032	5.250	5/15/2001	7/1/2031	7/1/2011	4,210,000
						64,730,000

(1) Call dates indicated are optional.
(2) Noncallable.

(Continued)

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

SUPPLEMENTAL SCHEDULE FOR BONDS PAYABLE
JUNE 30, 2004

	Last Installment	Interest Rate	Bond Dated	Maturing Serially From	Outstanding June 30, 2004
Water System Revenue Bonds:					
Series 2002:	2006	(1)	3/5/2002	7/1/2005	$ 1,000,000
	2007	(1)	3/5/2002	7/1/2006	1,050,000
	2008	(1)	3/5/2002	7/1/2007	1,100,000
	2009	(1)	3/5/2002	7/1/2008	1,150,000
	2010	(1)	3/5/2002	7/1/2009	1,200,000
	2011	(1)	3/5/2002	7/1/2010	1,300,000
	2012	(1)	3/5/2002	7/1/2011	1,350,000
	2013	(1)	3/5/2002	7/1/2012	1,400,000
	2014	(1)	3/5/2002	7/1/2013	1,450,000
	2015	(1)	3/5/2002	7/1/2014	1,550,000
	2016	(1)	3/5/2002	7/1/2015	1,600,000
	2017	(1)	3/5/2002	7/1/2016	1,650,000
	2018	(1)	3/5/2002	7/1/2017	1,750,000
	2019	(1)	3/5/2002	7/1/2018	1,850,000
	2020	(1)	3/5/2002	7/1/2019	1,900,000
	2021	(1)	3/5/2002	7/1/2020	2,000,000
	2022	(1)	3/5/2002	7/1/2021	2,100,000
	2023	(1)	3/5/2002	7/1/2022	2,200,000
	2024	(1)	3/5/2002	7/1/2023	2,300,000
	2025	(1)	3/5/2002	7/1/2024	2,400,000
	2026	(1)	3/5/2002	7/1/2025	2,500,000
	2027	(1)	3/5/2002	7/1/2026	2,600,000
	2028	(1)	3/5/2002	7/1/2027	2,750,000
	2029	(1)	3/5/2002	7/1/2028	2,850,000
	2030	(1)	3/5/2002	7/1/2029	3,000,000
	2031	(1)	3/5/2002	7/1/2030	3,150,000
	2032	(1)	3/5/2002	7/1/2031	3,300,000
					52,450,000

(1) Interest rates are at the auctioned rate.

(Continued)

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

SUPPLEMENTAL SCHEDULE FOR BONDS PAYABLE
JUNE 30, 2004

	Last Installment	Interest Rate	Bond Dated	Maturing Serially From	Call Dates (1)	Outstanding June 30, 2004
Water System Revenue Bonds:						
Series 2004:						
Uninsured serial bonds:	2005	2.000	1/18/2004	7/1/2005	(2)	$ 1,890,000
	2006	2.000	1/18/2004	7/1/2006	(2)	1,930,000
	2007	2.000	1/18/2004	7/1/2007	(2)	1,965,000
	2008	3.000	1/18/2004	7/1/2008	(2)	2,015,000
Insured serial bonds:	2009	3.000	1/18/2004	7/1/2009	(2)	2,080,000
	2010	3.000	1/18/2004	7/1/2010	(2)	2,140,000
	2011	3.000	1/18/2004	7/1/2011	(2)	2,205,000
	2012	3.500	1/18/2004	7/1/2012	(2)	2,280,000
	2013	4.000	1/18/2004	7/1/2013	(2)	2,365,000
	2014	4.000	1/18/2004	7/1/2014	(2)	2,465,000
	2015	4.750	1/18/2004	7/1/2015	7/1/2014	2,575,000
	2016	4.750	1/18/2004	7/1/2016	7/1/2014	2,700,000
	2017	4.750	1/18/2004	7/1/2017	7/1/2014	2,830,000
	2018	4.750	1/18/2004	7/1/2018	7/1/2014	2,970,000
	2019	4.750	1/18/2004	7/1/2019	7/1/2014	3,115,000
	2020	4.750	1/18/2004	7/1/2020	7/1/2014	3,265,000
	2021	5.000	1/18/2004	7/1/2021	7/1/2014	3,430,000
	2022	5.000	1/18/2004	7/1/2022	7/1/2014	3,605,000
	2023	5.000	1/18/2004	7/1/2023	7/1/2014	3,790,000
	2024	5.000	1/18/2004	7/1/2024	7/1/2014	3,985,000
	2025	5.000	1/18/2004	7/1/2025	7/1/2014	4,185,000
Insured term bonds	2026-2033	5.000	1/18/2004	7/1/2033	7/1/2014	42,215,000
						100,000,000
						$ 217,180,000

(1) Call dates indicated are optional.
(2) Noncallable.

(Concluded)

BOARD OF WATER SUPPLY
CITY AND COUNTY OF HONOLULU

SUPPLEMENTAL SCHEDULE OF NET REVENUE REQUIREMENT
YEAR ENDED JUNE 30, 2004

REVENUES:		
Water sales		$ 99,877,649
Interest		4,429,022
Other		1,693,625
Total revenues		106,000,296
DEDUCTIONS:		
Operating expenses		113,898,032
Less depreciation expense		(35,790,308)
Total deductions		78,107,724
Net revenues		$ 27,892,572
NET REVENUE REQUIREMENT:		
Greater of:		
1) Aggregate debt service for 2004		$ 8,414,221
Required deposits—Reimbursable obligation fund		
		8,414,221
2) Aggregate debt service for 2004		8,414,221
	x	1.20
		10,097,065
Net revenue requirement		$ 10,097,065

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

The Board of Directors
Board of Water Supply
City and County of Honolulu:

We have audited the financial statements of the Board of Water Supply, City and County of Honolulu (the "Board") as of and for the year ended June 30, 2004, and have issued our report thereon dated November 3, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Board's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect the Board's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The Board did not reconcile its cash accounts to the City and County of Honolulu's ledger balances on a timely basis throughout the year. The balance of such cash accounts totaled $13,339,885 at June 30, 2004. Failure to reconcile the accounting records on a timely basis may result in errors or irregularities going undetected.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Board's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards.*

This report is intended solely for the information and use of the Board of Directors, management, and the City and County of Honolulu and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

November 3, 2004