OVERVIEW

Audit of the Office of Hawaiian Affairs

Report No. 05-03, April 2005

Summary

With over $300 million in assets, the Office of Hawaiian Affairs (OHA) is constitutionally the main vehicle for the State to meet its trust responsibilities to native Hawaiians and Hawaiians. Section 10-3, Hawaii Revised Statutes (HRS), reflects this constitutional mandate, and at least once every four years the Auditor is required to conduct an audit of OHA, pursuant to Section 10.14.55, HRS. OHA has shown little improvement in its ability to serve Hawaiians since our last audit in 2001. We found that the Board of Trustees still has not provided the State with a comprehensive master plan for bettering the conditions of native Hawaiians and Hawaiians. Although OHA has developed a strategic plan, the need for a comprehensive master plan still exists to serve as a foundation for OHA's programs, as well as the programs of other agencies that provide services to Hawaiians.

We also found that OHA is still grappling with the effects of poorly planned reorganizations. During FY2001-02 and FY2002-03, OHA hired numerous employees to fill a variety of positions, including key managerial positions. Yet, in the midst of organizational change, OHA lacks basic policies and procedures to guide the actions of its staff, and its organizational charts and functional statements are inconsistent. This situation is compounded by confusion among program directors on how OHA's priorities translate into the agency's budget. In addition, we found that OHA's casual administration of its finances does not demonstrate respect for its fiduciary duty to all Hawaiians. Certain protocol and trustee expenditures appear questionable. In addition, tighter oversight of the Native Hawaiian Revolving Loan Fund is needed to prevent deterioration of loan recipients' financial condition. The fund continues to experience high delinquencies and defaults among its loan recipients, jeopardizing the availability of resources to future Hawaiian entrepreneurs.

The certified public accounting firm of KPMG LLP (KPMG) reviewed OHA's investment portfolio and found that the agency has taken a number of important and well-reasoned steps in investing its assets. Directly supervising its money managers in the past, OHA now retains two investment advisors, each of which oversees selected money managers for OHA's classes of long-term investments; the agency also revised its investment policy statement and conducted a new asset allocation study. However, KPMG found continuing deficiencies that do not ensure compliance with OHA's fiduciary obligations. Generally, OHA's investment policy statement and investment oversight procedures lack key components, and OHA's lack of advisor oversight prevents the Board of Trustees from receiving sufficient information to evaluate the investment advisors' performance.

KPMG found duties and responsibilities related to trust fund investments are not clearly laid out in OHA's investment policy statement. In addition, critical

benchmarks for the trust fund have not been established for its investment advisors, as well as for the actions and investment decisions of OHA and its board. In addition, KPMG concluded that the lack of historical data and performance standards results in a material weakness. KPMG also found that OHA has not addressed the use of passive investments, as well as ceded land payments, in its investment policy statement. If OHA's passive assets were in line with its peer median and certain conditions were in place, fees would be reduced, saving the agency more than $300,000 annually. KPMG also found that OHA has not created an independent function to oversee investment advisors or a standard set of contracts for the retention of investment advisors, resulting in substantially different performance measures for each of its two investment advisors.

Recommendations and Response

We recommended the Board of Trustees resurrect efforts to create a comprehensive master plan and that OHA develop appropriate management tools such as policies and procedures on action planning and budgeting. We recommended that OHA revise its Administrative Financial Manual of Guides to clarify the purposes and uses of petty cash, protocol allocations, and trustee allowances and that it provide tighter oversight of loans made from the Native Hawaiian Revolving Loan Fund. KPMG also offered several technical recommendations on OHA's investment policy statement and investment processes.

In its written response, which included a draft *2005 Master Plan,* the Board of Trustees did not disagree with our recommendations or the recommendations of KPMG. The trustees acknowledged that portions of the report will aid in improving OHA's services, but "question[ed] the substance and wording of much of [the] report." In particular, the board questioned our findings on the lack of a comprehensive master plan, unsubstantiated and questionable expenditures, and rates of delinquency and default on loans under the Native Hawaiian Revolving Loan Fund.

However, nothing offered by OHA amounts to the comprehensive master plan at issue or to appropriate substantiation of questionable expenditures. With respect to our findings on the revolving loan fund, our intent is to present a complete reading of the fund's health—not only for current borrowers, but for future Hawaiian entrepreneurs as well. OHA asserted that our calculation of a delinquency rate incorrectly included non-performing loan amounts intended for charge-off by the agency. But these non-performing loan amounts were still on OHA's books at the time of our audit, and a reading of the revolving fund's overall status without these amounts would be misleading. We confirmed with the Administration for Native Americans that our calculation was an acceptable approach. Even forms filed with the U.S. Securities and Exchange Commission report combined rates.

Our final report contains a few minor editorial changes for purposes of accuracy and style.

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