AUDIT REPORT NO. 79--4
SEPTEMBER 1979

FINANCIAL AUDIT OF THE LOAN FUNDS OF THE DEPARTMENT OF HAWAIIAN HOME LANDS

A REPORT TO THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF HAWAII

SUBMITTED BY THE LEGISLATIVE AUDITOR OF THE STATE OF HAWAII

THE OFFICE OF THE LEGISLATIVE AUDITOR

The office of the legislative auditor is a public agency attached to the Hawaii State legislature. It is established by Article VII, Section 10, of the Constitution of the State of Hawaii. The expenses of the office are financed through appropriations made by the legislature.

The primary function of this office is to strengthen the legislature's capabilities in making rational decisions with respect to authorizing public programs, setting program levels, and establishing fiscal policies and in conducting an effective review and appraisal of the performance of public agencies.

The office of the legislative auditor endeavors to fulfill this responsibility by carrying on the following activities.

1. Conducting examinations and tests of state agencies' planning, programming, and budgeting processes to determine the quality of these processes and thus the pertinence of the actions requested of the legislature by these agencies.

2. Conducting examinations and tests of state agencies' implementation processes to determine whether the laws, policies, and programs of the State are being carried out in an effective, efficient, and economical manner.

3. Conducting systematic and periodic examinations of all financial statements prepared by and for all state and county agencies to attest to their substantial accuracy and reliability.

4. Conducting tests of all internal control systems of state and local agencies to ensure that such systems are properly designed to safeguard the agencies' assets against loss from waste, fraud, error, etc.; to ensure the legality, accuracy, and reliability of the agencies' financial transaction records and statements; to promote efficient operations; and to encourage adherence to prescribed management policies.

5. Conducting special studies and investigations as may be directed by the legislature.

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LEGISLATIVE AUDITOR

LEGISLATIVE AUDITOR
KEKUANAO'A BUILDING, RM. 500
465 SOUTH KING STREET
HONOLULU, HAWAII 96813

FINANCIAL AUDIT OF THE LOAN FUNDS OF THE DEPARTMENT OF HAWAIIAN HOME LANDS

Conducted by the

Office of the Legislative Auditor

State of Hawaii

and

Main Lafrentz & Co.

Certified Public Accountants

A Report to the Governor and the Legislature of the State of Hawaii

Submitted by the

Legislative Auditor of the State of Hawaii

Audit Report No. 79–4

September 1979

FOREWORD

This financial audit report is the result of the examination of the transactions, books, and accounts of the loan funds administered by the department of Hawaiian home lands. The audit was conducted by the office of the legislative auditor and the CPA firm of Main Lafrentz & Co.

This report is divided into three parts. Part I contains an introduction and some background of the loan funds. Part II presents our findings, comments, and recommendations regarding the financial and management practices and financial statements of the loan funds, including the opinion of the CPA firm on the accuracy of the financial statements. Part III contains the department of Hawaiian home lands' response to this report and our comments on the department's response.

The audit revealed a number of deficiencies in the financial accounting and internal control systems and the administration of the loan funds. The department states in its response that steps have been or are being taken to remedy the deficiencies cited in this report.

We wish to express our sincere appreciation for the cooperation and assistance extended by the officials and staff of the department of Hawaiian home lands.

Clinton T. Tanimura
Legislative Auditor
State of Hawaii

October 1979

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PART I

INTRODUCTION

Chapter 1

INTRODUCTION

This is a report on our financial audit of the transactions, books, and accounts of the loan funds administered by the department of Hawaiian home lands (HHL). The audit was conducted pursuant to Hawaii Revised Statutes, section 23–4, which requires the state auditor to conduct post-audits of all transactions and of all books and accounts kept by or for all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the office of the legislative auditor and by Main Lafrentz & Co., an independent certified public accounting (CPA) firm.

Objectives of the Audit

The objectives of the audit were:

1. To provide a basis for an opinion as to the reasonable accuracy of the financial statements of the loan funds administered by the department of Hawaiian home lands.

2. To ascertain whether or not expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with governing laws, rules and regulations, and policies and procedures.

3. To evaluate the adequacy, effectiveness, and efficiency of the systems and procedures for financial accounting and internal operational controls, and recommend improvements to such systems and procedures.

4. To determine whether the loan programs are being administered in accordance with sound and accepted loan principles and practices.

Scope of the Audit

The audit examined the financial statements of the loan funds of the department of Hawaiian home lands covering the fiscal year ended June 30, 1978.[1] It included tests of the financial and related records and an examination of the existing systems and procedures of accounting, reporting, and operational and internal controls.

Organization of the Report

This report is organized into three parts. Part I consists of the introduction (chapter 1) and some background on the loan funds of the department of Hawaiian home lands (chapter 2).

Part II (chapters 3 through 5) contains our findings, comments, and recommendations regarding the financial and management practices and financial statements of the loan funds of the department of Hawaiian home lands.

Part III contains the response of the department and our comments on the response.

[1]The audit was initiated in late 1975. A number of tests were conducted of the department's financial operations at that time. Subsequently, in 1978, additional review was conducted to verify previous tests and reflect conditions then prevailing.

Chapter 2

SOME BACKGROUND

The department of Hawaiian home lands was established by section 24 of Act 1 (the Hawaii State Government Reorganization Act of 1959), Second Special Session Laws of Hawaii 1959. The department is responsible for the administration of the Hawaiian Homes Commission Act, 1920, enacted by the Congress of the United States.

The department is headed by a commission of eight members, including the chairman, consisting of three members from the city and county of Honolulu, two from the county of Maui (one of whom is required to be a resident of the island of Molokai), and one each from the counties of Hawaii and Kauai. The members of the commission, who are appointed by the governor, serve without pay, except for the chairman, who serves in a full-time capacity.

Purpose of the Hawaiian Homes Commission Act

The Hawaiian Homes Commission Act does not contain a statement specifying the purpose of the act. However, the attorney general, in his opinion dated November 13, 1951, expressed the purpose as follows:

> "... to save the native Hawaiian race from extinction by reason of its inability to meet successfully the economic and sociologic changes brought about in the islands.... Hawaiians would be removed from the slums, be given land to work, and be taught to successfully live in the new cosmopolitan society ...."

In essence, the goal of the act is to help the Hawaiian people.

The Hawaiian Homes Programs

There are three programs to achieve the goal of helping the Hawaiian people: housing, farming and ranching, and education. There are loan activities in the housing and the farming and ranching programs, but not in the education program. Since this report is concerned with the department's administration of the loan funds, this report does not discuss the education program.

Briefly, the housing and farming and ranching programs involve:

1. The development and leasing to Hawaiians of available lands for farming, ranching, and residential purposes;

2. The lending of money to Hawaiians for the purchase or construction of homes, for making improvements, additions, or repairs to existing homes, and for ranching and farming purposes;

3. The providing of technical assistance to farmers in agricultural methods to increase productivity; and

4. The guaranteeing of loans made to Hawaiians by other governmental agencies or private institutions.

To carry out its housing and farming and ranching programs, the department has under its management approximately 190.4 thousand acres of land, located on the islands of Oahu, Hawaii, Molokai, Maui, and Kauai. Of this amount, 14 percent is currently being used by the department in its programs; 64 percent is leased to others (such as the sugar plantations); and 22 percent is used primarily for purposes of conservation.[1]

Loan Funds

The housing and the farming and ranching programs are supported by a variety of loan activities. These activities and funding source are described below. The description below is based on the law as it existed before the effective date of Act 229, SLH 1978. The 1978 act consolidated a number of the loan funds described below. The basic thrusts of the loan funds, however, were not altered by Act 229. The consolidation effected by Act 229 is explained in a subsequent section.

Hawaiian home loan fund. This loan fund was established by the Congress of the United States in the Hawaiian Homes Commission Act to loan to eligible native Hawaiians for the construction of dwellings and other permanent improvements, the purchase of livestock and farm and ranch equipment and supplies, and otherwise assisting in the development of homesteads and farm and ranch operations. Subsequently, by Act 259, SLH 1969, the purposes were expanded to include repairs and maintenance of dwellings and improvements. The maximum amount which may be loaned to a lessee is $35,000. The maximum term of any loan is 30 years, and loans bear interest at the rate of 2½ percent per annum on the unpaid principal.

This fund is financed by revenues from the leasing of cultivated sugarcane lands and from water licenses. Section 213(b) of the Hawaiian Homes Commission Act required that 30 percent of such revenues be deposited into this fund until the aggregate amount of the fund equaled $5 million. This aggregate amount was reached in 1964.

In 1965, the state legislature enacted Act 4. This act directed that 30 percent of the above-mentioned revenues received each year be deposited into a special revolving account within the Hawaiian home loan fund called "additional receipts," until an aggregate of $2.5 million[2] was reached. The increased statutory ceiling was reached in May 1976. The acts provided that 85 percent of the amounts deposited be transferred to the Hawaiian home development fund and the remaining 15 percent be retained in the special revolving account as "Additional Receipts–Loan Fund Portion."

Additional Receipts–Loan Fund Portion. This special revolving account was created to provide additional moneys over and above the amounts in the Hawaiian home loan fund, for loans to native Hawaiians. Loans from this account have been made for the repair, maintenance, or purchase, and the erection or improvement of dwellings on either Hawaiian home lands or non-Hawaiian home lands.

The maximum amount that can be loaned from this account is $35,000. Loans are repayable over a period not exceeding 30 years. Interest is charged at the rate of 2½ percent a year or higher. When a higher rate is charged by the department (e.g., when loans are made directly to lessees by government agencies or private lending institutions or when the department borrows moneys from these organizations to make the loans) the department may pay from this account, the difference between the 2½ percent and the higher rate of interest.

Hawaiian home farm loan fund. This fund was established to provide moneys for loans to lessees of agriculture tracts who are engaged in farming or ranching. Legislative appropriations to this fund have totaled $500,000.

[1]*Annual Report, Department of Hawaiian Home Lands 1977–78*, p. 18.

[2]The aggregate amount was increased to $5 million under Act 76, SLH 1972.

Hawaiian home repair loan fund. By Act 155, SLH 1969, the legislature appropriated $500,000 to the department to make loans to lessees of up to $10,000 for repairs or additions to existing homes.

Hawaiian loan guarantee fund. Act 130, SLH 1973, authorized the department to create this fund and appropriated $500,000 for its establishment. The purpose of this fund is to support, if necessary, the department's guarantee of repayment of loans made by governmental agencies or by private lending institutions to those holding Hawaiian home leases or licenses.

Hawaiian home general home loan fund. Act 72, SLH 1976, authorized the department to create this fund out of moneys appropriated by the legislature for the construction of homes, not otherwise set aside for a particular fund. The moneys in this fund are to be used to make loans to lessees for the purposes set forth by the legislature in the enactment appropriating the funds.

Anahola-Kekaha loan fund. Act 76, SLH 1972, authorized the department to create this fund. A total of $121,500 was appropriated by the legislature for the purpose of making home construction loans to residents of Anahola and Kekaha on the island of Kauai.

Hawaiian home commercial loan fund. Act 76, SLH 1972, authorized the department to create this fund for the purpose of making loans for mercantile establishments such as stores, markets, and service stations owned by lessees. Under Act 202, SLH 1972, the legislature appropriated $250,000 to finance the fund.

No loans have been made from the Hawaiian home commercial loan fund because the rules and regulations and other administrative procedures necessary to make such loans were never formulated by the department. The appropriation to this fund lapsed at June 30, 1977.

Keaukaha-Waiakea home construction fund. Act 176, SLH 1974, authorized the department to establish this fund for the purpose of making loans for home construction on vacant homestead lots in Keaukaha-Waiakea. However, no money has been appropriated for the fund.

Papakolea home replacement loan fund. Act 176, SLH 1972, appropriated $200,000 to the department to provide home replacement loans to lessees of Hawaiian home lands at Papakolea, Oahu. Subsequently, Act 170, SLH 1974, authorized the establishment of the fund.

Keaukaha-Waiakea home replacement loan fund. Act 176, SLH 1974, authorized the department to establish this fund. The fund is for making loans to lessees who are residents of Keaukaha-Waiakea on the island of Hawaii to construct replacement homes on their lots. Act 218, SLH 1974, appropriated $200,000 for this purpose.

Statewide replacement loan fund. Act 72, SLH 1976, authorized the department to create this fund from moneys previously appropriated ($5,250,000) to it by the legislature to make loans to lessees to construct replacement homes on their lots.

Other financial resources from borrowings. In addition to the loan funds described above, the department makes loans from moneys borrowed from the Hawaii housing authority and the model cities housing development corporation. Under the Hawaiian Homes Commission Act, the department may borrow funds from governmental agencies or private lending institutions.

The funds borrowed from the Hawaii housing authority are used to make loans of up to a maximum of $25,000, for periods not exceeding 20 years, and at an interest rate of 7½ percent per annum. The interest rate of 7½ percent per annum is the same as that being charged the department by the Hawaii housing authority. Loans are made to lessees of Hawaiian home lands to construct new homes or to replace homes. These loans are not restricted to any income level.

Funds borrowed from the model cities housing development corporation are being used to make loans to lessees in the Nanakuli area on Oahu. Loans of up to $20,000 are made at an interest rate of 2½ percent per annum for periods of up to 20 years.

Fund Consolidation Under Act 229, SLH 1978

Act 229, SLH 1978, consolidated existing funds administered by the department into seven revolving and seven special funds. Its effect on the loan funds was to consolidate the Hawaiian home general home loan fund, the Anahola-Kekaha loan fund, the Hawaiian home commercial loan fund, and the Keaukaha-Waiakea home construction fund into the Hawaiian home general loan fund.

It also consolidated the Papakolea home replacement loan fund, the Keaukaha-Waiakea home replacement fund, and the statewide replacement fund into a new revolving fund, the Hawaiian home replacement loan fund. The purpose of this new fund is to make loans to lessees to construct replacement homes on their residence lots.

In addition to the above consolidations, Act 229 changed the name of the "Additional Receipts–Loan Fund Portion" to "Additional Receipts Loan Fund." It further created two new special funds which are the Hawaiian loan interest fund and the borrowed money fund.

Hawaiian loan interest fund. All interests received by the department on account of loans and investments made from any fund (except the borrowed money fund and the Hawaiian home loan fund) are required to be deposited into this fund. In essence, the fund was created to serve as a clearing account. At the end of each quarter all moneys in the fund are to be transferred to the Hawaiian home development fund, the Hawaiian home operating fund, and other loan funds in accordance with the rules adopted by the department.

Borrowed money fund. Moneys borrowed by the department from government agencies or private lending institutions are required to be deposited into this fund. Also, installments of principal and that part of the interest equal to the interest charged to the department by the lender and paid by the lessees on loans made to them from this fund must be deposited into this fund. The moneys in the fund may be used for the purposes set forth in section 214 of the Hawaiian Homes Commission Act.

Effect of Act 229, SLH 1978, on our audit. The legislature in Conference Committee Report No. 11, dated April 11, 1978, noted that the purposes of the act, among others, were to consolidate funds by function and source; to add new funds as depositories for interest charges and borrowed money; and to define the parameters of use of the various funds. The legislature stated that the act was further intended to facilitate the department's efforts to maintain orderly accounting; to establish a framework for utilizing private moneys for mortgage financing without cost to the State; and to enable maximum use of all moneys of the department.

The act became effective on June 5, 1978. This report, however, does not present the various loan funds as structured in Act 229. The accounting records of the department were not yet converted at June 30, 1978, to reflect the act's changes.

PART II

FINDINGS AND RECOMMENDATIONS

Chapter 3

FINANCIAL ACCOUNTING AND INTERNAL CONTROL

This chapter presents our findings and recommendations on the department of Hawaiian home lands' financial accounting practices and system of internal control as they apply to the loan funds administered by the department. The term, system of internal control, means the plan of organization and all of the methods and measures adopted within the department to check the accuracy and reliability of accounting data, to safeguard the department's assets, and to assure adherence of financial transactions to prescribed laws, policies, procedures, and rules and regulations of the State and the department.

Summary of Findings

The department's financial accounting and internal control systems are deficient as follows:

1. The department's financial records are inaccurate and unverifiable. As a consequence, Main Lafrentz & Co. was unable to issue an audit opinion on the department's loan fund statements.

2. The department unnecessarily maintains a cash receipts journal and inefficiently handles billings and loan status reports.

3. Controls over expenditures are inadequate, and certain control procedures are not being complied with.

4. Interest charges are being incorrectly calculated.

No Audit Opinion

One of the basic purposes of a financial audit is the issuance of an audit opinion on the accuracy of the financial statements of the organization. Ordinarily, an auditor is able to attest to the reasonable accuracy of an organization's financial statements. However, in the audit of the department's loan funds, Main Lafrentz & Co. was unable to issue an audit opinion on the department's 1977–78 loan fund statements. After some initial audit fieldwork, it became apparent that the department's accounting and internal control systems were seriously deficient and the financial records were inaccurate, and that an extensive amount of work would be necessary before an audit opinion could be issued. Thus, further effort to examine the financial records and transactions for the purpose of formulating an audit opinion was terminated.

Inaccurate and Unverifiable Records

The audit disclosed discrepancies between the amounts shown in the department's records and the amounts reflected in the records maintained by the department of accounting and general services (DAGS). DAGS is responsible for maintaining the statewide accounting records on the financial transactions of the State. In addition, differences were noted even within the department's internal records. For instance, differences were noted between the general ledger accounts and the related subsidiary ledger accounts.

The discrepancies between the records have been reported in previous audits conducted of the department. In our audit report of the department for the fiscal year ended June 30, 1967,[1] we reported that various account balances did not agree with the related records maintained by DAGS. We recommended at that time that frequent, periodic reconciliations be made of the accounts. The department was audited again in 1972 by the state comptroller. His report[2] disclosed that the department's account balances had not been reconciled with DAGS' records for a number of years and that there were material differences between the two records at June 30, 1972.

We understand that, after considerable time and effort spent by the state comptroller's staff, the records of the department were reconciled with those of DAGS as of June 30, 1972. In addition, the department's internal records (i.e., general ledger and subsidiary ledgers) were reconciled by the state comptroller's staff.

The records, however, were almost immediately again out of balance. During fiscal year 1975–76, the department began its efforts again to reconcile the records. By the end of fiscal year 1977–78, through the use of additional staff including temporary help, many of the differences were reconciled. However, significant differences still exist.

The specific discrepancies are described below.

Discrepancies between department's and DAGS' records. The loan receivable records of the department as of June 30, 1978, do not agree with those maintained by DAGS. The department's general ledger loan receivable accounts for certain funds show a combined balance that is $111,778 greater than the combined balance shown in the related records maintained by DAGS. Table 3.1 compares the department's loan receivable ledger balance of loan funds with the balances shown on the general ledger records maintained by DAGS.

The table reveals that the department's loan receivable balances exceed (by $111,778) the balances shown in DAGS' records. The largest difference is in the Act 239 loan fund where the department's balance exceeds the DAGS' balance by $79,079. With wide discrepancies between the records, the department is not able to report with any certainty the true amount of its outstanding claims for the funds listed above. The primary reason for the differences appears to be the failure on the part of the department to continually furnish DAGS with information on the loan amounts and collections made on the loans. DAGS' only source for posting or recording loans and collections made by state agencies is the information furnished periodically by state agencies. In the case of the department, it has not transmitted all information to DAGS.

Discrepancies between department's general ledger and subsidiary ledger accounts. A general ledger consists of a group of accounts established to assist in the preparation of the balance sheet and other financial statements, reflecting the overall financial position and results of financial operations of a governmental unit. To keep the number of accounts in the general ledger to a manageable size, the individual transactions are not recorded in the general ledger. Instead, the individual transactions are recorded in a subsidiary ledger or ledgers and a control account is set up in the general ledger to record the aggregate of the individual transactions. The control account

[1]Legislative Auditor, *Financial Audit of the Department of Hawaiian Home Lands,* Audit Report No. 68–4, February 1968.

[2]KeNam Kim, state comptroller, *State of Hawaii, Department of Hawaiian Home Lands,* audit report for the period July 1, 1962 to June 30, 1972.

Table 3.1

Comparison of Loan Receivable Balances Between the Department and DAGS At June 30, 1978

	Department's general ledger	*DAGS**	*Difference*
Hawaiian home loan fund	$3,190,070	$3,157,670	$ 32,400
Act 239 loan fund	5,776,534	5,697,455	79,079
Hawaiian home repair loan fund	443,368	443,069	299
			$111,778

*Adjusted for certain reconciling items.

summarizes the transactions detailed in the subsidiary ledger.

Since the subsidiary ledger supports the general ledger control account, the figures in the subsidiary ledger and the control account should agree. However, for some of the loan funds, the amounts noted in the department's general ledger control accounts as loans receivable as of June 30, 1978 do not agree with the amounts shown in the subsidiary ledgers. In total, the amounts in the general ledger control accounts are $312,044 less than the amounts shown in the subsidiary ledgers. Additionally, the amounts reflected in the general ledger control accounts as loan commitments as of June 30, 1978, for a number of loan funds are, in total, $94,420 less than the amounts recorded in the related subsidiary ledgers.

1. Loans receivable. Table 3.2 displays the differences in loans receivable amounts as of June 30, 1978, between the general ledger control accounts and related subsidiary ledgers for some of the loan funds.

As the table shows, there are significant differences between the general ledger control accounts and the related subsidiary ledgers for the Hawaiian home loan fund and Act 239 loan fund. This means that, among other possible errors that could have occurred, the amounts of

Table 3.2

Comparison of Loan Receivable Balances Between the General Ledger And the Subsidiary Ledger Accounts At June 30, 1978

	Subsidiary	*General ledger*	*Difference*
Hawaiian home loan fund	$3,323,317	$3,190,070	$133,247
Act 239 loan fund	5,949,829	5,776,534	173,295
Hawaiian home repair loan fund	448,870	443,368	5,502
			$312,044

the loans, the payments received on the loans, or other charges such as unpaid interest charges were recorded in the subsidiary ledger but not in the general ledger, or vice versa, or incorrect amounts were recorded in one or the other ledger.

The general ledger control accounts and the related subsidiary ledgers serve as cross-checks or control on the accuracy with which transactions are recorded. In addition, the separate accounts serve as a means of identifying financial improprieties, should they occur. Discrepancies between the general ledger and subsidiary ledger need to be investigated immediately so that the reason for the differences can be identified and corrective action taken. If the general ledger and subsidiary ledger accounts are left unreconciled, this would defeat one of the control features of the accounting and internal control system. Besides the records being inaccurate, unreconciled differences make it easier for defalcations, if they should exist, to remain undetected. Of course, the longer the accounts are not reconciled, the more difficult it would be to locate the discrepancies.

*2. **Loan commitments.*** After a loan application is approved by the commission, the authorized loan amount is entered in the general ledger loan commitment control account and in the appropriate subsidiary ledger. The loan commitment accounts are used to record the disbursements of loan moneys and to assure that the disbursements do not exceed the authorized amount of the loan. The disbursements are usually made in installments and are entered in the ledgers as deductions from the authorized amount.

On home construction and home improvement loans, the department makes payments directly to the contractors. In many instances, the entire amount of the authorized loan is not required, in which case the unrequired balance is removed from the loan commitment ledger accounts. Thus, at any time, the balances in the accounts should represent the undisbursed amounts of loans on projects which are still in progress.

Table 3.3 shows the discrepancies in loan commitment balances as of June 30, 1978, between the general ledger control accounts and the subsidiary ledger accounts for several of the loan funds administered by the department.

As shown, the most significant difference is in the Hawaiian home general loan fund, where the general ledger has a balance of $43,734, and the subsidiary ledger accounts total $140,755, or $97,021 more than the general ledger balance.

The amount of the balance of undisbursed loan commitments directly affects what

Table 3.3

Comparison of Loan Commitment Balances Between the General Ledger And the Subsidiary Ledger Accounts At June 30, 1978

	General ledger	*Subsidiary ledger*	*Difference*
Hawaiian home loan fund	$ 8,229	$ 15,331	$ (7,102)
Hawaiian home repair loan fund	15,974	26,219	(10,245)
Statewide replacement loan fund	166,690	146,742	19,948
Hawaiian home general loan fund	43,734	140,755	(97,021)
			$ (94,420)

additional loans may be made. So long as there are differences in the balances shown in the general ledger and subsidiary ledger, the department is unable to ascertain absolutely the maximum amount of additional loans it can authorize for the respective loan funds.

Causes of poor condition of accounting records. In the past, the department has cited staff workload as the reason for the continued poor condition of the accounting records. In its report, *Annual Report, Department of Hawaiian Home Lands, 1975,* the department made reference to the discrepancies disclosed in our previous audit report (issued in 1968) and in the state comptroller's audit report of 1972. The department acknowledged in the annual report that it had not implemented the recommendations contained in our audit report, and that the accounting records were still not reconciled at the time the annual report was published. As an explanation, the department stated, in the annual report, that "this does not infer derelection of responsibility[,] rather it indicates the priorities elected when staff is limited."

We believe the department has erred in the past by treating the accounting function as an item of low priority. It is important that the accounting records be accurately maintained to provide the department's management with reliable financial information to plan and control the limited financial resources available to the department.

We were informed that, in the past, the department's accounting staff, especially a former fiscal officer, spent a significant amount of time on nonaccounting matters, such as administrative matters of the department. This diversion or prioritizing of effort and attention to nonaccounting matters was a contributing factor to the poor condition of the accounting records. Because of the diversion of effort, the account clerks were not given sufficient supervision, and their work was not adequately reviewed. Thus, errors in the recording of financial transactions were not detected. With proper and adequate supervision, the errors could presumably have been caught and immediate corrective action could have been taken. The present fiscal officer informed us that he spends most of his time on accounting matters and provides supervision to his staff.

The fiscal officer has stated, however, that the necessity of keeping up with the current fiscal workload has precluded the staff from reconciling the records. We have been informed that two accountants will be hired on a temporary basis to reconcile the remaining differences in the accounts.

Recommendations. *We recommend that:*

1. The department make a concerted effort to identify and correct all of the errors in its accounting records. In this regard, we recommend that the department proceed immediately with its plans to hire accountants on a temporary basis to assist it in reconciling the accounting records.

2. After the records are corrected, the department reconcile its accounting records with those of DAGS at least quarterly, and it reconcile its internal accounting records, such as the general ledger and subsidiary ledgers, on a monthly basis.

3. In the future, whenever discrepancies in the accounting records are disclosed, the commission, through its chairman, take action to ensure that the discrepancies are investigated immediately and appropriate corrections are made to the accounting records. The commission should direct the fiscal officer to report periodically to the commission on the reconciliations performed of the accounting records and on the condition of the accounting records.

4. The commission monitor the activities of the fiscal staff to ensure that the staff does not, as in the past, divert its efforts to matters which are of a nonaccounting nature.

Unnecessary and Inefficient Maintenance of Accounting Records

While the department contends that staff workload hampers the maintenance of accurate accounting records and prevents it from reconciling its records without the help of temporary employees, the audit disclosed that some of the workload can be reduced or eliminated by improvement of the department's accounting system. Specifically, the manual recording of the daily cash receipts into the cash receipts journal can be eliminated. Additionally, the department should secure computer services for billings and for accounting for collections on loans.

Unnecessary maintenance of cash receipts journal. The department maintains a cash receipts journal to account for collections on loans. The receipts are manually entered into the journal daily. The same information is entered separately onto the accounting machine for posting of receipts to the loan receivable ledgers. We believe that the accounting machine can be programmed to produce a cash receipts journal, as a byproduct of the postings to the loan receivable ledgers. This will eliminate the need to maintain a manually posted cash receipts journal.

Use of computer for billing and collections on loans. In late 1977, the department entered into a contract with a local bank to perform billing and collection services for two of its loan funds. This arrangement, which utilizes the bank's computer capabilities, is significantly more efficient than the department's previous manual procedures.

The bank's services have not been contracted for the other loan funds. For these other loans, the department bills and records collections manually. We believe that the bank's services should be contracted for all loan funds.

A computer has storage or memory capabilities. Thus, once the basic data are entered into the computer, monthly billings and reports on the status of loans can be easily generated by the computer. The present accounting machine, which is used for all but two loan funds, requires considerable effort and time in preparing billings and reports on the status of loans. A computer can also be programmed to compute the monthly interest on loans, a task which is now manually done. The servicing by a bank may also have a positive effect on collections since it would be convenient for borrowers to make payments at any bank branch.

The department wants to use the bank's computer services for all of its loan funds. The bank, however, requires that the department first certify to the correctness and accuracy of the accounts before they are turned over to the bank. This, of course, means that the department must first reconcile its accounts.

Recommendations. *We recommend that:*

1. The accounting machine be programmed to produce a cash receipts journal, and the department eliminate the manually posted cash journal.

2. The department obtain the computer services of the bank for all its loan funds as soon as possible. In this regard, the department should reconcile its records as soon as possible.

Noncompliance with and Inadequate Controls over Expenditures

The audit disclosed that the controls exercised by the department over unused purchase order forms are inadequate. This exposes the department to possible unauthorized purchases or expenditures. In addition, proper authorizations for payments to contractors are not being secured. These deficiencies are discussed in detail below.

Poor control over purchase order forms. A purchase order form is used by state agencies to order goods and services from vendors. The form, when issued to a vendor, becomes a contractual commitment for the goods or services ordered. It is therefore important that adequate controls be exercised over the supply of forms to prevent unauthorized use of the forms. In our audit, we noted that a supply of purchase order forms is kept in a tray on top of a desk in the fiscal office which is readily accessible to anyone who happens to be in the fiscal office. The forms, of course, should be kept in a safe place.

Proper approval of invoices lacking. As a means of controlling the disbursement of loan funds, the department requires that invoices of contractors be approved by lessees and project managers. Under this practice, no payment should be made to a contractor without written authority of both the lessee and the project manager noted on the contractor's invoice. This is to ensure that the claims are proper in terms of cost and the work authorized to be performed, and that the work has been satisfactorily performed.

Our review disclosed that invoices are not all being properly approved for payment. We noted that one invoice lacked the approval of the lessee and several lacked the approval of the project manager.

Recommendations. *We recommend that:*

1. The supply of purchase order forms be kept under lock and key.

2. The department take the steps necessary to ensure that invoices are properly approved to prevent unauthorized payments from being made.

Incorrect Computation of Interest Charges

The department is incorrectly computing interest charges on home construction and repair loans and new home loans in tract developments.

Section 215(2) of the Hawaiian Homes Commission Act, which deals with loan repayment, states that "[a]ll unpaid balances of principal shall bear interest . . . payable periodically or upon demand by the department, as the department may determine." The loan agreements which are executed on the department's Contract of Loan form states that "[i]nterest shall commence when the loan is first used in whole, or in part . . . ." Thus, it appears that the department has determined that interest shall be computed from the time a loan is first disbursed, whether in total or in installments.

Our review of the lessees' ledgers and inquiry on the department's procedures regarding computation of interest on loans disclosed the following practices.

Home construction and repair loans. In a home construction and repair loan, the loan amount is disbursed in installments as the construction work progresses. The department charges interest on the loan from on or about the date when the last or final disbursement of the loan amount is made. This practice is contrary to the intent of section 215 of the Hawaiian Homes Commission Act of 1920 and the loan agreement executed between the department and the borrower where interest charges are stated to commence from the time the first disbursement of the loan amount is made.

Departmental personnel informed us that interest is not charged because to do so would impose a financial burden on the lessees if they are required to pay concurrently both the interest cost on the new home being constructed, and rent for the old home during the period of construction. The department, however, does not appear to have been given this discretionary power by the statute.

New home loans in tract developments. In the case of loans to construct new homes in a tract development, the department does not execute loan documents until just before completion of construction although the identity of the probable lessee of each lot in the tract is known well in advance. Interest then commences on the entire amount of the loan to the lessee of each lot upon the execution of the documents. This, too, is not in keeping with the Hawaiian Homes Commission Act and the loan agreement.

Although large numbers of homes are sometimes under construction at one time, it is the practice of the contractors generally to request payment on a lot-by-lot basis as construction progresses. Therefore, the department has the information necessary to compute interest on each loan from the date of the first disbursement.

The department itself pays interest effective from the date it receives the first installment of proceeds on loans made to the department by the Hawaii housing authority and state retirement system to finance the department's loan programs. In addition, in the case of farm loans, the department computes interest on each loan installment amount effective from the date of the installment. The department informed us that this practice is followed with respect to farm loans because the borrower uses the proceeds for agricultural purposes to derive economic benefits and, since not many farm loans are made, computing interest effective from the date of each installment is not a major task.

This inconsistency in computing interest charges between farm loans and home construction and repair loans is inequitable. Interest should be properly and consistently computed for all borrowers to comply with the intent of the Hawaiian Homes Commission Act and the department's loan agreement.

Recommendation. *We recommend that the department compute interest charges on all future loans from the date of the first disbursement of the loan.*

Chapter 4

LOAN PROGRAM ADMINISTRATION

This chapter presents our findings and recommendations relating to the administration of the loan programs. Administrative activities include, among other things, the establishment of loan requirements or standards, the processing of lease and loan applications, the maintenance of a waiting list of applicants who have qualified for leases, the billing and collecting on loans, and actions on delinquent accounts.

Summary of Findings

In summary, our findings are as follows:

1. The lease and loan application records are inadequate, obsolete, and inaccurate. Documentations are inadequate to establish the applicants' qualifications for leases and loans, the data on applicants waiting for leases are not properly updated, and there are insufficient quantitative criteria to determine qualifications for leases and loans.

2. The records to assist in maintaining surveillance over delinquent accounts are incomplete, incorrect, and not timely kept.

3. Physical security over departmental documents and records is poor.

Lease and Loan Application Deficiencies

This section first describes generally the lease and loan application procedures and then discusses some of the shortcomings in the procedures.

Lease and loan application procedures. Under the Hawaiian Homes Commission Act and departmental policies and regulations, a person can qualify for a lease if the person (1) is of Hawaiian ancestry with at least 50 percent Hawaiian blood; (2) is at least 21 years of age; (3) is qualified to perform the conditions of the lease and is in need of financial assistance; (4) is not delinquent in the payment of taxes, rent, or other obligations owing the State or any of its political subdivisions; (5) does not have sufficient resources to secure financing from an outside source; and (6) does not own a residence in the State and neither does the applicant's spouse.

An applicant is required to complete a lease application form and a form which shows the applicant's ancestral background. The forms are reviewed by the department's personnel and, if the applicant meets the requirements, the applicant's name is added to the waiting list of qualified applicants for a lease. The department is required by its rules and regulations to contact each applicant on the list at least once every two years by sending by certified mail a form on which the applicant is required to update the information on file with the department.

When a lease becomes available, the department determines whether the applicant who is next in line for a lease still meets the qualifications for a lease. The department determines whether the applicant owns property in the

State by checking with the state department of taxation. An analysis is made of the net worth (assets minus liabilities) of the applicant and applicant's spouse on the basis of information supplied by the applicant and verified by the Credit Bureau of Hawaii.

If the applicant meets the lease requirements, the department then determines whether the applicant qualifies for a loan. Part XI, section 11.04, of the department's rules and regulations requires that the following criteria be used to determine loan qualification.

- The ratio of the applicant's gross income to monthly payments of principal and interest must be acceptable.
- The number of dependents which an applicant has must be considered in determining ability to repay the loan.
- For an applicant receiving public assistance from the department of social services and housing (DSSH), the monthly payment on the loan must be within the amount available for housing in accordance with current DSSH standards. If not, the applicant must be willing to assume the financial obligation imposed by the loan.
- The applicant must have satisfactory credit standing in the community.
- No loan can be made if the applicant is found to have sufficient resources or credit to secure financing from non-departmental sources.

A mortgage loan officer is responsible for reviewing the information submitted by the loan applicant and recommending approval or rejection of the loan. Where the loan officer recommends rejection, his reasons must be stated. The applicant's complete file containing all the forms and documents relating to his application for a lease and loan is then submitted to the chairman of the commission. The chairman reviews the recommendation of the loan officer and all the information submitted and decides whether to approve or reject the loan officer's recommendation. The chairman then notifies the commission of the decision made on the application which is then ratified by the commission.

Lack of documentation relating to 50 percent Hawaiian test. Before 1969, an applicant was merely required to submit a notarized statement indicating that he was at least 50 percent Hawaiian and stating the ancestral background of the applicant's father and mother. Since 1969, applicants have been required to furnish much more information as evidence of meeting the test of being at least 50 percent Hawaiian.

Form HH2 (Kumu Ohana) is used to diagram an applicant's family tree and serves as an aid in tracing parentage back to a full-blooded Hawaiian. The form requires the names of the applicant's ancestors and their bloodlines.

Documents which are required to be submitted to substantiate the information on Form HH 2 include certificates of birth and marriage. We were informed, however, that under current practices of the department the following are accepted in cases where the applicant is unable to submit the required documentation:

- Affidavits from eye witnesses who will attest to the Hawaiian ancestry of an applicant; or
- A notarized statement from the applicant which indicates 50 percent Hawaiian ancestry.

Our examination of individual file folders of lessees who received loans from various loan funds administered by the department revealed that many of the file folders did not contain a notarized statement by the applicant or any other evidence or documentation indicating that the applicant was at least 50 percent Hawaiian. Thus, there is no assurance that those lessees met the test of Hawaiian ancestry.

Failure to document tax clearance and property ownership. Our examination of individual file folders revealed no evidence that the department had determined whether the applicants were delinquent in the payment of taxes or other obligations due the State or whether the applicants already owned other residences in the State. In these cases, there is no assurance that the individuals who have been granted leases and loans had, in fact, qualified under the requirements of the department.

Inaccurate and obsolete waiting list. The waiting list maintained by the department is inaccurate and obsolete. The list contains many applicants whom the department has not been able to contact to update information about their status. Without current information, the department does not know whether these applicants are no longer interested in obtaining a homestead or unable currently to qualify for a homestead lease or possibly are deceased. The list also includes applicants who should probably be dropped from the list but whose names have not been deleted.

Both the applicants and the department have responsibilities to keep information current. Part IV, section 4.09, of the department's regulations requires applicants to notify the department, in writing, of any change in address within 15 days of such changes. But, a great many applicants do not inform the department of their address changes. The extent of this is noticeable when the department mails its newsletters to leaseholders and to applicants on the waiting list. In one particular mailing of 7000 newsletters, approximately 1400 were returned for address correction. It appears reasonable to assume that most of the 1400 newsletters returned were those sent to applicants on the waiting list.

The department's rules and regulations in part IV, section 4.10, state that the department shall contact applicants at least once every two years by sending to them by certified mail a form on which the applicant is to update the information on file with the department. Among other information, an applicant must indicate on the form any change of address and confirm area and type of lease preference. A sample of applicant folders was selected for examination to determine whether the applicants were contacted within the previous two years. Our examination disclosed that in the majority of the cases there was no documentation indicating that the form was sent to the applicants.

Department personnel informed us that, in the past, they were not sending the update form as required by the regulations because of heavy workload. We understand that, subsequent to our audit fieldwork, the waiting list was computerized and the forms are now, through the use of the computers, being sent to the applicants.

The department's rules and regulations in part IV, section 4.10, stipulate that, when an applicant does not respond to two successive requests for updated information, the department shall place the applicant on "deferred status" until the required information is received. Section 1.07 of the regulations defines deferred status as one where the applicant will not be considered for an award but will retain his position on the waiting list. According to the department's applications officer, however, it is the department's practice to continue to attempt to contact the applicant for updated information and also when leases become available even if previous attempts have been unsuccessful. Further, we were informed it is the department's practice not to delete any names from the waiting list even if the applicant continually fails for many years to respond to requests for updated information or to notices of the availability of a lease. Names are deleted only when the applicant specifically requests that his name be deleted.

The audit disclosed that many applicants who are still on the waiting list were bypassed and leases were offered to applicants further down the waiting list. The department informed us that these applicants were bypassed because they could not be located. However, the applicants' folders showed no documentation or evidence that the department had attempted to contact the applicants concerning the availability of a lease or the updating of information on the applicants. Without any documentation or evidence in the files, it remains uncertain whether attempts were in fact made to contact the applicants.

In May 1978, the department listed the names of applicants on the waiting list in the major newspapers of the State. The publication resulted in numerous calls about persons on the list and in some names being deleted. However, the list is still obsolete and inaccurate. The September 30, 1978 computer listing contains the names of 5914 applicants. Departmental personnel estimate that as many as 1000 to 1500 of those listed are deceased, cannot be located, or are not interested in obtaining a lease any longer.

Lack of adequate lease and loan qualification criteria. The department lacks sufficient quantitative criteria to guide their decisions on lease and loan qualification. We believe that this has led to the department's questionable approval of some leases and loans. The department lacks adequate criteria in the following areas.

1. Net worth. Part V, section 5.01, of the department's regulations requires the department to consider the applicant's net worth (applicant's assets minus liabilities) in determining his qualification and need for financial assistance. However, the regulations do not specify the amount of net worth which is acceptable. We should point out that the previous regulations of the department limited the applicant's net worth to $15,000. Without a specified limit of acceptable net worth, the determination of whether the applicant's net worth is acceptable becomes a matter of subjective judgment on the part of the staff.

*2. **Income.*** The department has no limitation on the income of an applicant although it must be considered for lease and loan qualification. Previous regulations of the department limited the applicant's income to $800 per month. Thus, whether an applicant's income is acceptable is also left to the judgment of the department's staff.

In our review of a sample of loan folders, we found cases where the income of the applicants appeared to be high, and thus questionable as to whether the individuals required financial assistance from the department. In one case the individual's monthly income exceeded $1400 per month and in another it exceeded $1200.

3. Ratio of gross income to monthly payment. The department has no set ratio to utilize in this area. We were informed that, generally, the applicant's monthly gross income should be four times the amount of the monthly loan payment. However, this ratio is flexible, and what is an acceptable ratio is again left to the discretion of the department. In some cases, we were informed that a ratio of 3 to 1 is used.

The department does not have a definition of "gross income" in its regulations. This has resulted in staff members' using their own judgment as to the items which are to be included or excluded from an applicant's gross income. We noted some cases where different staff members used different definitions in determining loan qualifications.

4. Resultant questionable loans. The lack of quantitative criteria has resulted, in our opinion, in some questionable loans. Earlier, we noted loans being made to applicants whose income appeared "high." We should point out that, in these cases, there was no indication that the applicant attempted to secure financing from nondepartmental sources as required by part XI, section 11.04,b.5., of the department's regulations.

We questioned the department about the reason for approving loans made to individuals who appeared to have high incomes. According to department personnel, a high income level will not automatically cause disqualification since the department believes that an important element contributing to rehabilitation is a mix of successful and poor people in a homestead area. We believe, however, that such loans to individuals in high income levels may be contrary to the intent of the Hawaiian Homes Commission Act and the general provisions of the department's regulations which require applicants to show a need for financial assistance. We also believe that such loans are unfair to applicants on the waiting list with greater need of assistance from the department.

Recommendations. *We recommend that:*

1. The department review its files and determine which individuals do not have a notarized statement and other evidence or documentation on file indicating that they are at least 50 percent Hawaiian. These individuals should be requested to complete Form HH2, presently being used to determine whether an individual is at least 50 percent Hawaiian. If these individuals cannot submit adequate documentation to support their claim of Hawaiian ancestry, they should at least be required to submit an affidavit or notarized statement.

2. The department document its determinations in regards to delinquent taxes and property ownership.

3. The department correct and update its waiting list by:

a. Amending its rules and regulations to provide for the removal from the waiting list those applicants who continually fail to respond to the department's requests for information.

b. Documenting all attempts to contact applicants so that there would be some evidence that applicants are being contacted every two years as required by the regulations and contacted when a lease is available.

c. Taking the steps necessary to encourage applicants to immediately inform the department of changes in their address and other changes which may affect their status on the waiting list.

4. The department adopt quantitative criteria to aid it in determining lease and loan qualification. Such criteria should set limits on allowable net worth and income and, if applicants exceed the limits set, all reasons for granting the loans should be fully documented.

Deficiencies in Monitoring and Collecting Delinquent Accounts

Delinquent loan payments have been a chronic problem with the department. In our audit report of the department for the fiscal year ended June 30, 1967,[1] we reported that 85 loans or approximately 10 percent of the total number of loans outstanding of the Hawaiian home loan fund were delinquent. Payments on these accounts, totaling over $20,000, were delinquent for periods ranging from three months to over one year. The state comptroller in a subsequent audit of the department reported the same conditions as in our earlier audit report. He noted that as of June 30, 1971, delinquent accounts of all loan funds administered by the department totaled $31,206, of which $24,206 were over 90 days past due.[2]

In February 1974, the department hired a collections officer in an effort to reduce delinquencies, but the rate still remained high. A

[1]Legislative Auditor, *Financial Audit of the Department of Hawaiian Home Lands,* Audit Report No. 68–4, February 1968.

[2]KeNam Kim, State Comptroller, State of Hawaii, *Department of Hawaiian Home Lands,* audit report for the period July 1, 1962 to June 30, 1972, p. 13.

delinquency report filed by the collections officer for the month of June 1975 disclosed that, of the total number of loans outstanding (1285), 406 or 31.6 percent were delinquent. These delinquencies represented installment payments in arrears totaling $224,531.[3]

The collections officer left the department sometime in February 1977 and the position was vacant for about 16 months until June 1978 when a new collections officer was hired. In its delinquency report for June 1978, the department reported that, of 1717 loans outstanding, 750 or 43.7 percent were delinquent. This delinquency represented $384,008 (73.3 percent) of total loan installments due of $523,822. The prolonged vacancy apparently contributed to the increase in delinquencies.

The major cause of the high rate of delinquencies has been the failure of the department to pursue delinquent accounts as prescribed in the department's manual.

In summary, the prescribed procedures require the department to maintain timely contact with all delinquent lessees via telephone calls, personal visits, and form letters. There are five types of form letters. Form HH33, a friendly reminder, is supposed to be sent out from 20 to 30 days after the due date of a payment. If payment is not received, a delinquent notice on the past due amount, Form HH34 (two months' reminder) is to be mailed. If partial payment is received, a combination collection and thank you letter, Form HH35, is to be used. A firm repayment plan with the delinquent lessees is expected to be negotiated by the 90th day of delinquency. Collection Form HH36 is to be used if there is no response or payment and verbal contact is not established after 90 days. This is a notification that legal action might be taken. If no payment is received or special payment plan negotiated after 90 to 100 days, Form HH37 is to be sent, informing the lessee that the matter has been referred to the state attorney general's office for legal action. The Form HH37 is supposed to be sent to the lessee after the Hawaiian homes commission decides that a citation hearing is required.

The present collections officer appears to be monitoring and pursuing delinquent accounts more aggressively, and there appears to be more personal contact with borrowers now than in the past.

The department's high delinquency rate can also be attributed to the department's inaccurate and incomplete delinquent records and report.

Incorrect and incomplete recordkeeping and reporting on accounts. The department utilizes a lessee ledger trial balance and age analysis report and delinquency ledger cards to monitor and review delinquent accounts. However, the reports and records are incomplete and incorrectly maintained.

1. Lessee ledger trial balance and age analysis report. This report, issued monthly, lists the amounts receivable from each lessee as of the 19th of each month. The receivable balances include insurance advances, pasture fees, water charges, lease rents, and loan principal and interest charges. The report also notes the delinquencies. It lists the lessees who are delinquent by loan fund, project, and island, and displays the delinquent amounts by length of delinquency. The report is used by the department to analyze delinquent accounts and to determine the appropriate collection action to be taken.

The problem with this report is that it shows some accounts to be delinquent when they may not in fact be delinquent. This occurs because the cutoff date for the report is the 19th of each month, and the report notes as delinquent for the month reported those loan payments falling due between the 20th and the end of the month, which have not been paid by

[3]Memorandum, dated July 17, 1975, from the department's collection officer to the chairman of the department.

the 19th. It makes no allowance for payments which become due and are paid between the 20th and the end of the month. Also with respect to farm loans which are repayable on a yearly (rather than on a monthly) basis, the report treats as delinquent the interests that have accrued, although not yet payable, as of the 19th of the reported month.

Thus, the report is inaccurate. The danger with such an inaccurate report is that inappropriate collection procedures may be initiated against borrowers who are not delinquent on their payments.

*2. **Delinquency ledger cards.*** The delinquency ledger card is a card on which a delinquent borrower's loan and collection information is recorded by the department. One side of the card provides information such as the delinquent borrower's name, address, telephone number, employer, income, pay dates, and the amount of delinquency at the end of each month. The department records collection information on the reverse side of the card.

The department requires a delinquency ledger card to be set up by a project manager as soon as a borrower is 20 days delinquent on his payment. Any delinquency and collection activity such as contact with the borrower, delinquency letters, special payment plans, and collections received, are recorded on the card. Copies of the ledgers are sent to the department's collections officer who reviews the information on the delinquency ledger to determine whether appropriate collection efforts have been made and makes recommendations for any further action which may be necessary. These cards are also used as a basis for compiling the delinquency and collection activity reports on the borrower for review by the commission.

In most instances, a delinquency ledger card is not prepared by project managers on Oahu as soon as an account is 20 days delinquent, as required by the department. In many instances a ledger card is not prepared until a loan is 120 days past due. As a result, the collections officer is not in a position properly to control and monitor collection efforts.

In addition, the delinquency ledger cards are not properly maintained. We noted that required information is frequently not recorded on the cards. This missing information includes items such as the borrower's work telephone number and supervisor's name. In almost all instances, information regarding the loan balance, the number of days delinquent, and the amount delinquent is not current. Without full and up-to-date information posted on the delinquency cards, the usefulness of the cards is limited.

***Recommendations.** We recommend that:*

1. The department continue its efforts to closely monitor and pursue delinquent accounts. Further, we recommend that the department adhere strictly to its prescribed collection procedures.

2. The department consider changing its cutoff date to the end of the month rather than the 19th of the month in its monthly reporting of delinquent accounts and discontinue its practice of listing accrued but not yet due interest charges as being delinquent on farm loans which are payable in yearly installments.

3. The department take the steps necessary to ensure that project managers prepare delinquency ledger cards on a timely basis.

4. The department ensure that project managers record complete information on the delinquent ledger cards.

Other Administrative Deficiencies

Described below are other deficiencies in the administration of the loan programs.

Inadequate physical security over documents and records. The department's vital lease and loan documents and fiscal records are not adequately protected from possible loss or damage from vandalism, fire, or theft.

A copy of each lease and loan document is kept at the main office in Honolulu. The documents include homestead applications, homestead lease agreements, loan contracts, and other records which account for the transactions between the homesteaders and the department. The documents are kept in filing cabinets in a room adjacent to the general office area. The filing cabinets are not fireproof and are generally left unlocked at the end of the workday. While the door to the room where the files are located has a lock, the door can easily be forced open. In addition, a window to the room provides another convenient point of entry. Fire, of course, is an ever-present danger, especially so since the filing cabinets are not fireproof and there is no fire sprinkler system. The fiscal records are exposed to the same dangers as the lease and loan documents.

Should the documents and records be destroyed by fire or stolen, it would be extremely difficult to reconstruct all of the information relating to the leases and loans. In fact, any serious loss would probably force the department's operations to come to a standstill until the files can be reconstructed.

Bids from contractors. One of the responsibilities of the department's planning office is to provide assistance and advice to lessees in planning the construction of new homes or improvements to existing homes and in negotiating with contractors to provide the lessees with the opportunity to receive maximum value and benefit from the funds borrowed from the department. The planning office must also review and approve plans for home construction and improvement.

The files of homesteaders we selected for review disclosed the cost estimates or bids from more than one contractor are not required in planning and in constructing improvements. The securing of several bids provides the homesteader with the opportunity to choose from different home construction or improvement plans and benefit from design and construction suggestions that contractors may make and take advantage of bid pricing. The department's personnel have stated that, while the securing of several bids is recommended to the homesteaders, there is no requirement that they do so. Consequently, homesteaders are not receiving the full benefit of the expertise of the planning office in choosing the most appropriate construction or improvement plan from a number of different plans and having the work done at the lowest possible cost consistent with the quality and service required.

Method of payment of real property tax and insurance premium. At the present time, the lessees pay their real property tax and fire insurance premium directly to the state department of taxation and to the insurance companies. The department should consider, however, adopting the method used by commercial lending institutions. The lending institutions require homeowners to pay to a trust account an amount equal to 1/12 of the annual cost of real property taxes and fire insurance. These amounts are then disbursed by the lending institutions on behalf of the homeowners.

If the department adopts this method, there would be greater assurance that the real property tax and fire insurance premiums will be paid when they become due. This method would also allow the department to monitor the adequacy of the insurance coverage. It would also make it easier for lessees, financially, to make payments in monthly installments rather than in large sums at certain times of the year.

Recommendations. *We recommend that:*

1. The department take immediate action to assure adequate security over documents and records, such as the locking of filing cabinets at the end of a workday, the acquisition of fireproof filing cabinets, and the installation of an adequate lock to the door of the records room.

2. The department require homesteaders to secure several bids from contractors. Further, we recommend that the planning office review all bids received and recommend to the homesteader the most advantageous bid.

3. The department consider adopting a policy requiring lessees to make monthly payments to the department on their real property tax and fire insurance premiums.

Chapter 5

FINANCIAL STATEMENTS AND ACCOUNTANTS' OPINION

This chapter contains the report made by Main Lafrentz & Co. on its examination of the financial statements of the loan funds of the department of Hawaiian home lands for the fiscal year July 1, 1977 to June 30, 1978. This chapter also displays the financial statements of the loan funds with explanatory notes to the financial statements.

Accountants' Opinion

Main Lafrentz & Co. was contracted by the office of the legislative auditor, among other things, to conduct an examination of the financial statements of the loan funds of the department for the purpose of determining and reporting on the accuracy of the financial statements. The audit examination for that purpose was discontinued after some initial audit work was performed.

Main Lafrentz & Co. reported that the records of the department were not in an auditable condition. Substantial differences were noted in the internal records of the department and between the records of the department and those of DAGS. (See chapter 3, *supra.*) In addition, Main Lafrentz & Co. noted that possible losses, due to loans being uncollectible, had not been taken into account in the department's statement of loans receivable. Thus, the loan receivable amounts shown on the department's financial statements appeared to be overstated. The CPA firm stated that, under the circumstances, it could not render any audit opinion on the financial statements. The financial statements displayed in this chapter are, therefore, unaudited statements of the department.

Main Lafrentz & Co.'s report to us is as follows:

"To the Auditor
State of Hawaii

The accompanying combined balance sheet of the Department of Hawaiian Home Lands Loan Funds as of June 30, 1978, and the related statements of revenues and expenses and changes in fund balances for the year then ended were not audited by us and we express no opinion on them.

The Department has informed us that an allowance for doubtful accounts was not made on the financial statements. The affects of this departure from generally accepted accounting principles on the accompanying financial statements have not been determined.

There were differences at June 30, 1978 between certain general ledger control accounts and the related subsidiary ledger accounts and the amounts appearing on records independently maintained by the Department of Accounting and General Services. The combined total of the general ledger accounts for loans receivable were $312,044 less than their related subsidiary ledger accounts. These general ledger accounts for loans receivable were also $111,778 greater than the amounts appearing in the records maintained by the Department of Accounting and General Services.

/s/ Main Lafrentz & Co.
Main Lafrentz & Co.
Certified Public Accountants

Honolulu, Hawaii
January 17, 1979"

Descriptions and Definitions

Description of financial statements. The unaudited financial statements of the loan funds administered by the department and presented in this chapter are identified and described briefly below.

1. The combined balance sheet (exhibit A) discloses the assets, liabilities, and fund balances of the various loan funds at the end of the fiscal year.

2. The combined statement of changes in fund balances (exhibit B) presents the balances of the loan funds at the beginning of the fiscal year, summarizes the additions to and deductions from the beginning balances, and the resulting fund balances at the end of the fiscal year.

3. The combined statement of revenues and expenses (exhibit C) shows the revenues, by source, and the expenses for the fiscal year.

Definition of terms. Technical terms are used in the financial statements and in the explanations of the statements. The more common terms and their definitions are as follows:

*1. **Appropriation*** – An authorization granted by the state legislature permitting a state agency within established fiscal and budgetary controls to incur obligations and to make expenditures.

*2. **Fund*** – A sum of money or other resources segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with statutes and special regulations and constituting an independent fiscal and accounting entity. A separate group of accounts must be maintained for each fund to show its assets, liabilities, and reserves as well as its revenues and expenditures.

*3. **Fund balance*** – The excess of a fund's assets over its liabilities and reserves which is available for future use unless restricted for a specific purpose.

*4. **Transfer*** – Transfer of amounts from one fund to another.

Notes to Financial Statements

Explanatory notes which are pertinent to an understanding of the various financial statements of the department's loan funds are as follows.

General notes. Here we note matters that are of general applicability–that is, they apply to more than one financial statement.

*1. **Accounting principles.*** The accounts of the loan funds of the department are maintained and the accompanying financial statements have been prepared on a modified accrual basis of accounting. Under this method of accounting, revenues are recorded when earned and expenditures are recorded when invoices are transmitted to DAGS for processing for payment. However, unpaid interest on borrowed funds is accrued and recorded as an expense at the end of the fiscal year.

*2. **Pending litigation.*** The office of the attorney general reported that the department was involved in the following matters of litigation:

a. A suit has been filed on behalf of various air carriers challenging the authority of the department to charge the state department of transportation rental for the use of 92 acres of Hawaiian home lands as part of General Lyman Airfield. The department has filed a counterclaim seeking rental for retroactive as well as prospective use. The present rental per annum claimed by the department is $633,000.

b. General damages of $25,000 and special damages of $50,000 are being sought, in an action alleging trespass, by a plaintiff against the United States Department of Defense, the department of Hawaiian home lands, and others.

c. A civil rights action has been brought against the department in which general damages of $50,000, punitive damages of $25,000, and special damages in a sum not less than $25,000 are being sought.

The office of the attorney general is unable to provide an assessment of the probable success of the plaintiffs in the above two cases (b and c) or the monetary range of losses, if any.

d. A claim has been threatened against the department which, if pursued and proved, could result in losses ranging from $30,000 to $40,000.

Certain other claims and complaints arising in the ordinary course of program administration have been filed or are pending against the department. In the opinion of the office of the attorney general, such actions are of a kind, or involve amounts that would not have significant adverse effect on the accompanying financial statements.

Specific Notes

Noted here are matters which pertain to specific entries in the financial statements.

1. Improvements purchased. This item on the balance sheet represents purchases made by the Hawaiian homes commission of dwellings and other improvements placed upon Hawaiian home lands by lessees who died leaving no qualified heir, or whose leases were cancelled, or who surrendered their leases. Section 209 of the Hawaiian Homes Commission Act provides for these purchases. The improvements purchased are valued at the purchase price and are sold to successor tenants at the same price.

Improvements purchased and insurance receivable accounts of $72,374 were written off from the following loan funds during the fiscal year with the attorney general's approval: Hawaiian home farm loan fund for $15,230 and Hawaiian home loan fund for $57,144.

2. Notes payable. The department's notes payable consisted of the following at June 30, 1978.

Employees retirement system ...	$ 166,667
Model cities housing development corporation...	31,625
Hawaii housing authority	5,942,424
Total	$6,140,716

a. Employees' retirement system. Notes payable to the employees' retirement system of the State of Hawaii and secured by a pledge of two thirds of the additional receipts – loan fund portion revenues were paid in full in August 1978.

b. Model cities housing development corporation. The note payable to the model cities housing development corporation is unsecured and is due on or before October 31, 1991 with interest payable at 2½ percent per annum.

c. Hawaii housing authority. The notes payable to the Hawaii housing authority are unsecured, bear interest at 7½ percent per annum, and the principal amounts are due in monthly installments with various maturity dates from 1990 through 1995.

3. Capital improvement project funds for mortgage loans. During 1976, the department received approval for allotments to be made from existing capital improvement project appropriations to provide funds for loans in various housing projects. In December 1977 the department was granted approval to use $6,925,000 of such allotments for long-term mortgage loans as well as for interim loan financing. As of June 30, 1978, $5,711,000 in mortgage loans that had been made had not been transferred from the bond fund to the loan fund. Accordingly, the $5,711,000 in loans are not reflected on the balance sheet of the Hawaiian home general loan fund. Loans that had been transferred to the loan fund, and cash received by the department for loans assumed by the farmers' home administration were recorded in the Hawaiian home general loan fund as transfers from the bond fund.

EXHIBIT A

State of Hawaii
Department of Hawaiian Home Lands
Loan Funds

Combined Balance Sheets
(Unaudited)

June 30, 1978

	Hawaiian home loan fund	*Additional receipts— loan fund portion*	*Hawaiian home farm loan fund*	*Anahola-Kekaha loan fund*	*Act 239 loan fund*	*Model cities loan fund*	*Hawaiian home repair loan fund*	*Papakolea home replace-ment loan fund*	*Keaukaha-Waiakea home replace-ment loan fund*	*Hawaiian home com-mercial loan fund*	*Hawaiian loan guarantee fund*	*Statewide replace-ment loan fund*	*Hawaiian home general home loan fund*	*Total*
Assets														
Cash in state treasury														
Unrestricted	$ 163,848	$ 96,783	$240,031	$ 5,022	$ 100,389	$ 5,861	$ 40,471	$ 11,961	$ 4,152			$ 62,527	$2,926,931	$ 3,657,976
Restricted	16,224	48,522	48,404				24,443				$500,000	$ 166,690	1,648,733	2,453,016
Investments — time certificates of deposit		150,000		20,000		30,000	250,000	15,000	20,000					485,000
Receivables														
Accrued interest, insurance and sundry	3,787	5,641	1,615		188,401	295	285					284	254	200,562
Loans	3,182,075	534,879	444,500	96,478	5,776,534	34,745	434,897	173,039	175,848			5,020,499	840,582	16,714,076
Due from other funds	397,407													397,407
Construction in progress		113,436											63,500	176,936
Improvements purchased	18,888		220		22,265									41,373
Other assets	4,675				18,954									23,629
	$3,786,904	$949,261	$734,770	$121,500	$6,106,543	$70,901	$750,096	$200,000	$200,000	—0—	$500,000	$5,250,000	$5,480,000	$24,149,975
Liabilities and Fund Balances														
Notes payable		$166,667			$5,942,424	$31,625								$ 6,140,716
Due to other funds					365,782	31,625								397,407
Others							$ 96							96
	--	166,667	--	--	6,308,206	63,250	96	--	--	--	--	--	--	6,538,219
Fund balances	3,786,904	782,594	734,770	121,500	(201,663)	7,651	750,000	200,000	200,000	—0—	500,000	5,250,000	5,480,000	17,611,756
	$3,786,904	$949,261	$734,770	$121,500	$6,106,543	$70,901	$750,096	$200,000	$200,000	—0—	$500,000	$5,250,000	$5,480,000	$24,149,975

These financial statements and accompanying notes are subject to the accountants' disclaimer of opinion.

EXHIBIT B

State of Hawaii
Department of Hawaiian Home Lands
Loan Funds

Combined Statement of Changes in Fund Balance
(Unaudited)

Year Ended June 30, 1978

	Hawaiian home loan fund	*Additional receipts– loan fund portion*	*Hawaiian home farm loan fund*	*Anahola-Kekaha loan fund*	*Act 239 loan fund*	*Model cities loan fund*	*Hawaiian home repair loan fund*	*Papakolea home replace-ment loan fund*	*Keaukaha-Waiakea home replace-ment loan fund*	*Hawaiian home com-mercial loan fund*	*Hawaiian loan guarantee fund*	*Statewide replace-ment loan fund*	*Hawaiian home general home loan fund*	*Total*
Balance, July 1, 1977	$3,844,048	$757,656	$750,000	$121,500	$ (201,393)	$6,803	$750,000	$200,000	$200,000	–0–	$500,000	$5,250,000	$ 782,000	$12,960,614
Add														
Excess of revenues over expenses for the year		24,838				848								25,686
Transfer from bond fund													4,698,000	4,698,000
Reinstatement of unaccountable difference erroneously written off		100												100
	3,844,048	782,594	750,000	121,500	(201,393)	7,651	750,000	200,000	200,000	–0–	500,000	5,250,000	5,480,000	17,684,400
Deduct														
Excess of expenses over revenues for the year					270									270
Improvements purchased and insurance receivables written off	57,144		15,230											72,374
	57,144	--	15,230	--	270	--	--	--	--	--	--	--	--	72,644
Balance, June 30, 1978	$3,786,904	$782,594	$734,770	$121,500	$(201,663)	$7,651	$750,000	$200,000	$200,000	–0–	$500,000	$5,250,000	$5,480,000	$17,611,756

These financial statements and accompanying notes are subject to the accountants' disclaimer of opinion.

EXHIBIT C

State of Hawaii
Department of Hawaiian Home Lands
Loan Funds

Combined Statement of Revenues and Expenses
(Unaudited)

Year Ended June 30, 1978

	Hawaiian home loan fund	*Additional receipts– loan fund portion*	*Hawaiian home farm loan fund*	*Anahola-Kekaha loan fund*	*Act 239 loan fund*	*Model cities loan fund*	*Hawaiian home repair loan fund*	*Papakolea home replace-ment loan fund*	*Keaukaha-Waiakea home replace-ment loan fund*	*Hawaii home com-mercial loan fund*	*Hawaiian loan guarantee fund*	*Statewide replace-ment loan fund*	*Hawaiian home general home loan fund*	*Total*
Revenues														
Interest on loans to lessees		$39,367			$416,297	$848								$456,512
Expenses														
Interest		14,529			416,567									431,096
Excess (deficiency) of revenues over expenses	--	$24,838	--	--	$ (270)	$848	--	--	--	--	--	--	--	$ 25,416

These financial statements and accompanying notes are subject to the accountants' disclaimer of opinion.

PART III

THE RESPONSE OF THE AFFECTED AGENCY

COMMENTS ON AGENCY RESPONSE

A preliminary draft of this report was transmitted on September 17, 1979 to the governor, the presiding officers of the legislature, and the chairperson of the Hawaiian homes commission. We asked the chairperson to comment on the recommendations contained in the report, including the actions that have been taken or will be taken on the recommendations.

A copy of the transmittal letter to the chairperson is included in this part as attachment 1. The response received from the chairperson is included as attachment 2.

Comments on the Response

The chairperson of the Hawaiian homes commission has responded to each of the audit recommendations. The commission concurs with the recommendations and has indicated that the department has taken or will be taking steps to correct the deficiencies. While it is encouraging that the department has already initiated action, the commission reports that the department will take approximately nine months to reconcile its accounting records. Since some of the other deficiencies to be corrected must first await the reconciliation of the accounting records, the department should strive to accomplish the reconciliation as quickly as possible.

ATTACHMENT 1

THE OFFICE OF THE AUDITOR
STATE OF HAWAII
465 S. KING STREET, RM. 500
HONOLULU, HAWAII 96813

CLINTON T. TANIMURA
AUDITOR
RALPH W. KONDO
DEPUTY AUDITOR

September 17, 1979

Miss Georgiana K. Padeken
Chairperson, Hawaiian Homes Commission
Department of Hawaiian Home Lands
State of Hawaii
Honolulu, Hawaii

COPY

Dear Miss Padeken:

Enclosed are 14 copies of our preliminary report, numbered 9 to 22, of the *Financial Audit of the Loan Funds of the Department of Hawaiian Home Lands.* This preliminary report has also been transmitted to the Governor and the presiding officers of the Legislature.

The report contains a number of recommendations relating to your department. We would appreciate receiving your comments on these recommendations, including the actions that have been taken or will be taken with respect to the recommendations. Please have your written comments submitted to us by October 5, 1979. Your comments will be included as part of the final report.

Since the report is not in final form and changes may possibly be made to it, access to this report should be restricted solely to those officials of your organization whom you might wish to call upon to assist you in your response. We request that you exercise controls over access to the report and ensure that the report will not be reproduced. Should you require additional copies, please contact our office. Public release of the report will be made solely by our office and only after the report is published in its final form.

If you wish to discuss the report with us, we will be pleased to meet with you, at our office, on or before September 21, 1979. Please call our office for an appointment. If we do not hear from you, we will assume that a meeting is not necessary.

We appreciate the assistance and cooperation extended to us during the examination.

Sincerely,

Clinton T. Tanimura

Clinton T. Tanimura
Legislative Auditor

Enclosures

GEORGE R. ARIYOSHI
GOVERNOR OF HAWAII

PROJECT OFFICES

WAIMEA OFFICE
P. O. BOX 125
KAMUELA, HAWAII 96743

KEAUKAHA OFFICE
P. O. BOX 833
HILO, HAWAII 96720

STATE OF HAWAII
DEPARTMENT OF HAWAIIAN HOME LANDS
P. O. BOX 1879
HONOLULU, HAWAII 96805

PROJECT OFFICES

MAUI OFFICE
P. O. BOX 22
KAHULUI, MAUI 96732

MOLOKAI OFFICE
P. O. BOX 198
HOOLEHUA, MOLOKAI 96729

KAUAI OFFICE
P. O. BOX 332
LIHUE, KAUAI 96766

October 5, 1979

RECEIVED
OCT 5 4 15 PM '79
OFC. OF THE AUDITOR
STATE OF HAWAII

MEMORANDUM

TO: Clinton T. Tanimura, Legislative Auditor
The Office of the Auditor

SUBJECT: Financial Audit of the Loan Funds of the Department of Hawaiian Home Lands

Transmitted herewith is the Department of Hawaiian Home Lands' comments on the recommendations made in your preliminary report of the "Financial Audit of the Loan Funds of the Department of Hawaiian Home Lands."

We have reviewed the report, and as you will note, we have already taken steps to correct many of the past practices noted in the report. We will also give serious consideration to those recommendations on which no action has been taken.

We thank you for affording us this opportunity to review and to respond to the contents of your report before it is released in final form.

Georgiana K. Padeken

Georgiana K. Padeken
Chairman

GKP:MM:mr
Enclosure

Inaccurate and Unverifiable Records

Page 3-8

Recommendations

1. The department make a concerted effort to identify and correct all of the errors in its accounting records. In this regard, we recommend that the department proceed immediately with its plans to hire accountants on a temporary basis to assist it in reconciling the accounting records.

2. After the records are corrected, the department reconcile its accounting records with those of DAGS at least quarterly, and it reconcile its internal accounting records, such as the general ledger and subsidiary ledgers, on a monthly basis.

3. In the future, whenever discrepancies in the accounting records are disclosed, the Commission, through its chairman, take action to ensure that the discrepancies are investigated immediately and appropriate corrections are made to the accounting records. The Commission should direct the fiscal officer to report periodically to the Commission on the reconciliations performed of the accounting records and on the condition of the accounting records.

Auditee's Response

1. Since April, 1979, the department has had two CETA employees working full time on the reconciliation of the accounting records. It is estimated that it will take these employees approximately 9 months to complete the reconciliation.

2. The department is currently in the process of correcting its fiscal records for the period July 1972 through March 1977. Reconciliations of the internal records from April 1977 to the present have been made on a monthly basis using the March 1977 unreconciled difference figure as a reconciling item. In addition, monthly reconciliations of the loans and accounts receivable for the period, April 1977 to the present have been made with DAGS records, again using the March 1977 unreconciled difference figure as a reconciling item.

3. The fiscal officer has been directed to report all future discrepancies in the accounting records and the remedial action taken to the chairman.

4. The Commission monitor the activities of the fiscal staff to ensure that the staff does not, as in the past, divert its efforts to matters which are of a non-accounting nature.

4. At the time of the initial audit examination in 1975, the job description of the Fiscal Officer read as follows:

"This position serves as the head of the Administrative Services Office and is responsible to the Director of the Department of Hawaiian Home Lands. This position directs and coordinates staff and line activities in fiscal, applications and loans for houselots, general leases for commercial and industrial lots, internal management, printing supply, and certain statistical reporting."

Since the completion of the audit fieldwork, the following organizational changes have been effected.

a. The responsibility for lease and loan applications has been assumed by the Loan Services Office of the District Management Branch of the Land Management Division.

b. The responsibility for the general leases for commercial and industrial lots has been assumed by the Income and Maintenance Branch of the Land Management Division.

Thus, as a result of the aforementioned organizational changes, much of the non-accounting activities that had heretofore been assigned to the Fiscal Officer have been assumed by other departmental personnel. Henceforth, the fiscal office's activities will be predominantly accounting-related.

Unnecessary & Inefficient Maintenance of Accounting Records Page 3-11

Recommendations

1. The accounting machine be programmed to produce a cash receipts journal, and the department eliminate the manually posted cash journal.

1. After the accounting records have been reconciled and more of the approximately 1,230 loan accounts which we currently maintain on the accounting machine have been transferred to the bank, we will proceed with the programming of the accounting machine to produce the cash receipts journal and other departmental accounting records. However, it is anticipated that such a conversion will not be implemented for at least one year.

2. The department obtain the computer services of the bank for all its loan funds as soon as possible. In this regard, the department should reconcile its records as soon as possible.

2. Once the accounting records have been reconciled, the department plans to obtain the bank's computer services for more of its loan funds. However, because we have encountered certain problems as a result of the terms of the current contract, we intend to study this matter thoroughly before such a transfer is made.

Noncompliance With & Inadequate Controls Over Expenditures Page 3-12

Recommendations

1. The supply of purchase order forms be kept under lock and key.

1. Henceforth, the unused supply of purchase orders will be kept under lock and key.

2. The department take the steps necessary to ensure that invoices are properly approved to prevent unauthorized payments from being made.

2. The department's current vouchering process requires that both the purchasing clerk and the person approving the summary warrant voucher--the fiscal officer or the Accountant IV--verify that the necessary approvals have been obtained before the vouchers are processed for payment.

Incorrect Computation of Interest Charges Page 3-14

Recommendation

1. We recommend that the department compute interest charges on all future loans from the date of the first disbursement of the loan.

1. The loan agreement currently in use for home construction loans states that "interest shall commence to accrue on the twentieth (20th) day of the month in which the Borrower acknowledges receipt of possession or takes possession or control of said home." Thus, the practice of accruing interest "from, on or about the date when the last or final disbursement of the loan amount is made" is, at present, consistent with the intent of Section 215 of the Hawaiian Homes Commission Act of 1920 and the loan agreement.

While we recognize that good business practice would dictate that interest charges be computed from the date of the first disbursement of the loan, to do so would create a financial burden on the lessee if interest payments to the Department and rental payments to a landlord must be made concurrently.

The Department will be studying the propriety of accruing interest on home construction loans within a given period (e.g., 4-6 months) from the loan approval date.

<u>Lease and Loan Application Deficiencies</u>
<u>Page 4-9</u>
<u>Recommendations</u>

1. The department review its files and determine which individuals do not have a notarized statement and other evidence or documentation on file indicating that they are at least 50 percent Hawaiian. These individuals should be requested to complete Form HH2, presently being used to determine whether an individual is at lease 50 percent Hawaiian. If these individuals cannot submit adequate documentation to support their claim of Hawaiian ancestry, they should at least be required to submit an affidavit or notarized statement.

2. The department document its determinations in regards to delinquent taxes and property ownership.

1. The Department is currently in the process of computerizing its homestead lessee files. Upon the completion of this computerization process, quarterly updates of the status of each lease will be generated. Those lessee records which do not include a record of native Hawaiian verification or are found to be incomplete in any way will be updated through contacts with the lessee.

2. Under the current screening process, new award applicants for leases and loans are required to submit a notarized affidavit--Form HH94 (2-12-76)--to the Department stating, among other things, that: (1) they are not in arrears in the payment of taxes; and (2) they have no interest in land. Departmental personnel confirm the delinquent tax information by calling the Delinquent Enforcement Section of the Department of Taxation for verification that the applicant has no tax delinquencies. The result of this verification process is recorded on the applicant's "DHHL Credit Check", Form HH22 (2-1-72).

Project office personnel on each island confirm that new award applicants have no interest in real property by examining the real property records maintained by the various district offices of the Department of Taxation and by completing the "Property Ownership Clearance" list initiated by the Applications and Loans Division. As this list includes the names of many applicants, it is filed in the Applications and Loans Division's award screening master file. Henceforth, we will number each "Property Ownership Clearance" list and make reference to the lists on which the applicant is listed on the "DHHL Credit Check" form.

In those instances in which Hawaiian Homes lessees apply for replacement, repair or farm loans, a tax delinquency verification with the Delinquent Enforcement Section of the Department of Taxation is made and documented on the applicant's "DHHL Credit Check" form. A real property ownership check is not performed since lessees may be landowners.

3. The department correct and update its waiting list by:

a. Amending their rules and regulations to provide for the removal from the waiting list those applicants who continually fail to respond to the department's requests for information.

3a. While the Department recognizes that some practical problems have been created by our inability to remove an applicant from the waiting list as a result of non-response, we will request that the Attorney General's Office research the legal ramifications of such an amendment to the Rules and Regulations before a change is made.

b. Documenting all attempts to contact applicants so that there would be some evidence that applicants are being contacted every two years as required by the regulations and contacted when a lease is available.

3b. Copies of our correspondence to applicants for homestead lease award screenings are available in our files.

As had been noted in your report, the applicant waiting list was computerized subsequent to the completion of the audit fieldwork. In the 1978 biennial contact, a computer-generated notice was mailed to each applicant on the waiting list. We believe that the computer company's list of applicants to whom update forms were sent should be sufficient documentation that attempts were made to contact the applicants.

c. Taking the steps necessary to encourage applicants to immediately inform the department of changes in their address and other changes which may affect their status on the waiting list.

3c. As your report indicates, Part IV, Section 4.09 of the Department's Rules and Regulations requires that the applicant "notify the Department, in writing, of any change in address within fifteen (15) calendar days of such change." In the spring of 1978, copies of the Rules and Regulations were mailed to each applicant.

The Department's Homestead Applicant Packet, which is distributed to each applicant, stresses the importance of maintaining current mailing addresses. We are including this same message in our biennial contacts and interim applicant notices and correspondence.

Periodically, the Department includes in the "Ka Nuhou", its bimonthly newsletter to all applicants and lessees, an article emphasizing the importance of notifying the Department of any address changes. The September 1979 issue contains such an article.

4. The department adopt quantitative criteria to aid it in determining lease and loan qualifications. Such criteria should set limits on allowable net worth and income and, if applicants exceed the limits set, all reasons for granting the loans should be fully documented.

4. We concur with the recommendation that quantitative criteria be adopted to aid departmental personnel in determining lease and loan qualifications. The Applications and Loan Division staff has been instructed to develop the income and net worth criteria to be used in guiding their lease and loan qualification decisions.

With the exception of farm loans and loans to recipients of Department of Social Services and Housing financial assistance, departmental staff currently use the standard 4 to 1 gross income to monthly payment ratio for all loan qualification decisions. Currently, this ratio is not lowered under any other circumstances.

Once the aforementioned quantitative criteria have been established, loans will generally be made to those applicants whose income, net worth and gross income to monthly payment ratio fall within the prescribed limits. Exceptions to the prescribed guidelines will be fully documented.

Deficiencies in Monitoring & Collecting Delinquent Accounts Page 4-14

Recommendations

1. The department continue its efforts to closely monitor and pursue delinquent accounts. Further, we recommend that the department adhere strictly to its prescribed collection procedures.

3. The department take the steps necessary to ensure that project managers prepare delinquency ledger cards on a timely basis.

4. The department ensure that project managers record complete information on the delinquent ledger cards.

2. The department consider changing its cutoff date to the end of the month rather than the 19th of the month in its monthly reporting of delinquent accounts and discontinue its practice of listing accrued but not yet due interest charges as being delinquent on farm loans which are payable in yearly installment.

1,3, &4. With the promulgation of the department's delinquent account follow-up procedures in April, 1979, definite procedures have been delineated for all departmental staff involved in the collection process. These employees have been instructed to adhere to the established guidelines.

The delinquency ledger card HH30 was revised in April, 1979, to delete the information that was not pertinent to the collector or duplicated information which was already available on the department's Lessee Ledger Trial Balance and Age Analysis Report. Henceforth, the department's Delinquent Loan Collection Officer will monitor closely the staff's compliance with the departmental collection procedures.

2. In November, 1975, the due dates of all outstanding loans due after the 19th day of the month were converted to the 1st day of the following month. Thus, the current aging analyses include only those accounts which are delinquent at the cutoff date.

At present, there are 40 farm loans outstanding which are payable in annual installments. Although the monthly interest charges for these loans are accrued and aged on the Lessee Ledger Trial Balance and Age Analysis Report, these accruals have been deleted manually by the accounting machine operator. However, to alleviate the accounting machine operator of the task of manually deducting the accrued, but not yet due interest charges from the delinquent amounts, interest accruals on loans which are payable in annual installments will not be computed until the installments become due.

Other Administrative Deficiencies
Page 4-16

Recommendations

1. The department take immediate action to assure adequate security over documents and records, such as the locking of filing cabinets at the end of a workday, the acquisition of fireproof filing cabinets, and the installation of an adequate lock to the door of the records room.

1. The staff of the Applications and Loan Division have been instructed to lock the filing cabinets at the end of each day, and a new lock to the door of the file room will be installed. To further strengthen the security over the ground floor offices, a silent alarm system was installed in the fiscal and applications and loan offices in 1976.

The Department's limited financial resources have prevented it from purchasing fireproof filing cabinets. However, this matter will be pursued as soon as funds become available.

2. The department require homesteaders to secure several bids from contractors. Further, we recommend that the planning office review all bids received and recommend to the homesteader the most advantageous bid.

2. The Department currently encourages its homesteaders to secure more than one bid and review more than one house plan. However, we feel that a requirement that the homesteader secure more than one bid and house plan may not be in the best interest of the homesteader for the following reasons.

a. It is difficult and expensive to secure house plans which the homesteader can use to obtain bids since contractors will not release house plans without a definite commitment from the homesteader.

b. Many homesteaders have definite ideas of what they want constructed and whom they want to do the constructing. In these instances the bidding requirement is merely a formality since the homesteader has already made a decision.

The planning office currently reviews each house plan selected by the homesteader to insure that the construction cost is commensurate with the quality of the structure to be built. If the plan is found to be consistent with the construction cost, it is approved. Otherwise the homesteader is advised to seek other proposals. Further, each homesteader is apprised of the fact that the planning office staff is always available for consultation at any time during the planning or construction stages.

3. The department consider adopting a policy requiring lessees to make monthly payments to the department on their real property tax and fire insurance premiums.

3. While we agree that the recommendation that lessees be required to make monthly payments to the Department for real property taxes and fire insurance premiums has some merit, cost factors and the limited personnel currently preclude our considering the adoption of such a policy. However, once our accounting records have been reconciled and our loans have been transferred to the bank, we will give this recommendation more serious consideration.