SUPPLEMENTAL REPORT OF THE 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

Supplement to Audit Report No. 79—4
November 29, 1979

Background

On November 6, 1979, we submitted to the Governor and the Legislature of the State of Hawaii our report of the Financial Audit of the Loan Funds of the Department of Hawaiian Home Lands (Audit Report No. 79–4). The audit, conducted by the firm of Main Lafrentz & Co., Certified Public Accountants (now Main Hurdman & Cranstoun), examined the financial statements of the loan funds of the department for the fiscal year ended June 30, 1978 and the department's systems and procedures of accounting and internal controls.

The audit was originally initiated in July 1975. After a number of tests were conducted of the department's financial operations and after discussion with the auditors of their preliminary findings, we directed that the audit be suspended and resumed at some later time. We had two basic reasons for deferring the audit: *first*, the accounting records were inadequate, and it did not appear that the auditors would be able to determine the accuracy of the department's financial statements; and, *second*, the department had just begun to embark on a program of reconciliation and correction of its accounting records and of developing new systems and procedures for accounting and internal control. We concluded that deferring the audit until some later period would enable a fairer test to be made of the department's financial operations.

The audit was resumed in the latter part of 1978, and tests in accordance with generally accepted auditing standards were conducted. On September 17, 1979, we transmitted to the chairman of the Hawaiian Homes Commission a preliminary report of our audit and asked for a response to our recommendations. We received the department's comments on October 5, 1979 and incorporated the response into the final report submitted to the Governor and the Legislature.

Subsequent to the submission of the report, we were contacted by the department's former director, Billie Beamer, who raised a number of objections to our report. Mrs. Beamer had been the director of the department and chairman of the Hawaiian Homes Commission from January 1975 to July 1978. While it is clearly the responsibility of the present director to submit the official response to our recommendations, we believed that fairness required us to consider the objections of the former director, since the period covered by our audit coincided in part with the period of her tenure with the department. Therefore, we invited her to a meeting with the auditors and our staff on November 16, 1979, when she elaborated on her concerns and objections, and again with our staff on November 26, 1979. We informed Mrs. Beamer that we would consider and review the points that she had raised and submit a supplemental report.

This report constitutes our supplemental report. Its purpose is to discuss the points raised by the former director and, where possible, to resolve the points of contention.

Points of Contention

In summary, the former director's contentions relate to the following:

- That the overall report describes the financial conditions of the department as she herself found them in 1975 but did not relate to conditions as they existed when she left the department in 1978.

- That, while two of the loan funds of the department still required reconciliation and correction in 1978, other loan funds were in a condition to be audited, and that the auditors erred in not proceeding to render an opinion on the accuracy of the financial statements of these other funds. Further, that the funds reported in the audit to be out of balance should be placed in the perspective of the total capitalization of all of the loan funds and the total number of loan funds comprising the loan program.

- That legislative appropriations capitalized the Hawaiian Home Farm Loan Fund and the Hawaiian Home Repair Loan Fund at $750,000 for each fund, and not $500,000, as reported in the background chapter of the audit report.

- That the department did not treat the accounting function as an item of low priority but considered it of the highest priority and that a former fiscal officer did not spend any time on nonaccounting matters.

- That in 1975, the department began reporting to the commission on financial matters and discrepancies.

- That, rather than there being inadequate control over expenditures, she herself had tightened controls beginning in 1976.

- That computation of interest charges on loans was correct and proper.

- That loan program administration had been strengthened during her tenure and that, specifically, loans could not be approved without complete documentation and that the applicant waiting list, far from being inaccurate and obsolete as reported by the audit, had never been more current in the history of the department by the time her service ended with the department. Further, that our recommendation to remove from the waiting list those applicants who continually fail to respond to the department's requests for information would be an ill-advised and arbitrary action and contrary to legal advice received in discussions with a deputy attorney general.

- That the loan delinquency data in the audit report present a distorted picture and that the delinquency rate should not be attributed to the vacancy of the collection officer's position, inasmuch as loan collection efforts by the department continued in spite of the vacancy.
- That the audit report's recommendation that criteria be established for an applicant's income to aid in determining loan qualification is a recommendation contrary to the policy of the commission, which has not taken the position that an applicant had to be poor to qualify for a loan. Further, that no fixed and specific income standards should be imposed.
- That the department had previously changed its cutoff date in its monthly reporting of delinquent accounts.
- That security measures over documents and records had been strengthened during her tenure, including the securing of a window through which entry and access to the documents room might otherwise be obtained, the installation of an alarm system to detect surreptitious entry, and the purchase of fire-resistant cabinets for the storage of critical files.
- That, as the programs grew and additional responsibilities were assigned to the department, there has been inadequate attention given to the increased administrative requirements and to the personnel and other resources required to discharge administrative functions.

We discuss in the remainder of this section of the report the foregoing points raised by the former director of the department.

Applicability of the Audit Report. One of the underlying objections of the former director to the audit report is her contention that the audit describes conditions as she herself found them in 1975 but that these conditions no longer existed by the time she left the department in 1978. The perspective of the auditors is that, while significant improvements were made in accounting and internal control during the period 1975 to 1978 (and for having initiated the audit in 1975 and resumed it in late 1978, they were able to observe the changed conditions), discrepancies did exist nonetheless in 1978.

On the basic issue of the accuracy of accounting records, the audit report acknowledges the efforts which were made to correct the records during the former director's tenure. Thus, on page 12, the report states:

> "... 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."

It is understandable that the former director should believe that for all the efforts which were made under her leadership and for all the new systems and procedures which she had installed to improve financial administration, discrepancies could not persist. However, it should also be understandable that, given the magnitude of the department's accounting problems, which had grown appreciably worse by 1975, certain discrepancies continued to exist in 1978.

Opinion on Financial Statements. One of the objectives of the audit was to provide a basis for an opinion as to the reasonable accuracy of the financial statements of the loan funds administered by the department. However, the auditors were unable to issue an opinion on the department's loan fund statements. Among other reasons, the auditors could not certify to the accuracy of the financial statements because three of the loan funds, including two of the larger funds, were out of balance at June 30, 1978. While we understand that the smaller fund, the Hawaiian Home Repair Loan Fund, has since been reconciled, the two larger funds, the Hawaiian Home Loan Fund and the Act 239 Loan Fund, are still out of balance and reconciliation efforts by the department are continuing.

It is the former director's contention that the auditors should have audited the individual loan funds other than those which were out of balance for the purpose of rendering an opinion on the individual funds. We acknowledge that this could have been done, although it would not have solved the problem of the unreconciled funds which were out of balance.

More recently, we discussed with department officials whether an audit of the individual funds, other than those which are still being reconciled, would be helpful to the department.

It is our understanding that the department's preference is that when another audit is conducted it should examine and render an opinion on all of the department's funds, and not just on those funds which are believed to be in balance, but that such an audit should await the reconciliation of the two funds known to be out of balance.

We offer one further observation on this matter. There will come a time when the department will have exhausted reasonable efforts at reconciliation, but it might still find the funds out of balance. At that point, if it is determined that further reconciliation efforts would be marginal or futile, the department should reach agreement with the State Comptroller as to what adjusted figures should henceforth be used as the basis for maintenance of the accounting records.

As to placing the three funds which were out of balance at June 30, 1978 in some perspective, as the former director contends they should, the loan receivable balances of the department's general ledger were not in agreement with the subsidiary ledger accounts in the aggregate amount of $312,044. At that time, the fund balances for the department's 13 loan funds were reported to total $17,611,756.

Capitalization of Funds. On pages 5 and 6, the audit report, by way of background information, states that legislative appropriations to the Hawaiian Home Farm Loan Fund have totaled $500,000 and that through Act 155, SLH 1969, the Legislature appropriated $500,000 for the Hawaiian Home Repair Loan Fund.

The former director pointed out to us that subsequent legislative appropriations capitalized the two funds in the amount of $750,000 each. She is correct. The financial statements presented in the audit report on pages 32 and 33 show the higher capitalization, but through an oversight on our part the text relating to capitalization in the background chapter was not amended to conform to the data presented in the statements. However, we point out as a matter of fact and not as an excuse that the error in background information does not affect any of the findings and recommendations.

Priority of Accounting. On page 15, the report states: "We believe the department has erred *in the past* by treating the accounting function as an item of low priority." [Emphasis added.] Also, on page 15, the report states: "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." [Emphasis added.]

The former director states that during her tenure the accounting function received the highest priority and that the fiscal staff, including the fiscal officer, concentrated their efforts on accounting matters. We agree.

Our observations, qualified as they are by the phrase, "in the past," refer to the time period prior to 1975, in the context of identifying the reasons for the poor condition of the accounting records as recognized by the department's 1975 annual report. We would clearly be inconsistent if we had intended our observations to apply to the former director's period of tenure, since elsewhere in the report we note the extraordinary efforts to reconcile the accounting records which were undertaken during her term of office.

Reports to the Commission on Financial Discrepancies. On page 15 of the audit report, we made the following recommendation:

> "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 reconciliations performed of the accounting records and on the condition of the accounting records."

The former director believes that the recommendation is irrelevant because since 1975 the department began reporting to the commission on financial matters and discrepancies.

The auditors agree that during the former director's tenure the commission was being apprised of the financial condition of the department. However, it is our contention that the recommendation is relevant as a cautionary recommendation. We do not want the department to lapse into the conditions which prevailed prior to 1975. Apparently, the current director accepts the recommendation in the cautionary vein in which it was offered as reflected in her response: "The fiscal officer has been directed to report all future discrepancies in the accounting records and the remedial action taken to the chairman."

Noncompliance with and Inadequate Controls over Expenditures. The former director states that rather than there being inadequate controls over expenditures, she herself had tightened controls beginning in 1976. We have no reason to doubt that controls over expenditures, as were controls over other areas of financial administration, were strengthened by the former director. Nonetheless, our findings are that controls should be further improved in two specific areas: (1) that security be exercised over purchase order forms and (2) that the department ensure that invoices are properly approved to prevent unauthorized payments from being made.

These specific recommendations, which were made to further strengthen expenditure controls in the department, have been acknowledged by the present director: "1. Henceforth, the unused supply of purchase orders will be kept under lock and key. 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."

Computation of Interest Charges. At one time, the department's contract of loan executed with lessees provided that "interest (on the loan) shall commence when the loan is first used in whole, or in part . . . ." Thus, it appeared that the department had determined that interest would be computed from the time a loan is first disbursed, whether in total or in installments. We believe that this is the practice intended by the Hawaiian Homes Commission Act. We noted, however, that the department actually computed interest on the loan from on or about the last or final disbursement of the loan amount made.

The former director contends that the department's practice is correct and proper. The current director has also informed us that: "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.' "

In our opinion, the date on which interest payments commence is a policy matter, with obvious financial implications to both the department and the lessee. The point that the department should pursue with the Department of the Attorney General is whether it has the authority under the Hawaiian Homes Commission Act or state statutes to commence interest from the time the borrower takes possession of the home, rather than from the time loan disbursements are made.

Loan Program Administration. The former director contends that loan program administration has been strengthened during her tenure and that, specifically, loans could not be approved without complete documentation; and that the applicant waiting list, far from being inaccurate and obsolete as reported in the audit, had never been more current in the history of the department by the time she ended her service with the department. Furthermore, she contends that our recommendation to remove from the waiting list those applicants who continually fail to respond to the department's requests for updated information would be an ill-advised and arbitrary action and contrary to legal advice received in discussions with a deputy attorney general.

Again, as with other areas of the department's financial administration, we have no reason to doubt that loan program administration was strengthened by the director during her tenure. Nonetheless, the auditors in applying tests conducted in accordance with generally accepted auditing standards, did find instances where loans were approved without full documentation. The discrepancies reflect departures from required departmental procedures which need to be monitored to ensure compliance.

As to the waiting list, the report fully describes the considerable efforts made by the department to bring the list up-to-date. It probably is, as the former director contends, the best list that has yet been prepared, but the fact remains that it still needs further updating. Department officials have told the auditors that there could be as many as 1000 to 1500 deceased persons on the waiting list, or persons who cannot be located or who are no longer interested in obtaining a lease. We suggest that the department attempt to further update the list by enlisting the assistance of the vital records section of the Department of Health and to pursue formally with the Department of the Attorney General, as the current director reports it will, whether it can legally remove from the waiting list those applicants who fail to respond to repeated requests for information.

Loan Delinquencies. The former director contends that the loan delinquency data in the audit report presents a distorted picture. On page 24, the audit report stated that some 750 loans, or 43.7 percent of 1717 outstanding loans, were delinquent and that this delinquency represented $384,008 (73.3 percent) of total loan installments due in the amount of $523,822.

It is true that the loan delinquencies were presented only in the aggregate, but we do not believe that the data represents a distortion, inasmuch as a disaggregation of the data by how long a period loans were then delinquent points to a problem which was serious. This is displayed in the following table, which identifies 56.1 percent of the delinquent amount to have been more than 120 days delinquent and shows that the number of these older delinquencies represented 36 percent of the delinquent loans.

Delinquency Status – June 1978

Delinquency Period	*Delinquent Amount*	*%*	*No. of Accounts*	*%*
30 days	$ 82,067	21.4	280	37.3
60 days	52,599	13.7	143	19.0
90 days	33,953	8.8	58	7.7
120 days	215,389	56.1	270	36.0
Total	$384,008	100.0	751	100.0

The former director also disputes our observation on page 24 of the report that the prolonged vacancy of the collections officer position apparently contributed to the delinquencies. She informed us that collection efforts by the department continued in spite of the vacancy. We do not doubt that such efforts were exerted. While the issue is now moot because the position has since been filled, we do continue to believe that the presence of a collections officer then would have helped the department in its control of delinquencies.

Criteria on Loans. On page 23, the audit report recommends that the department adopt criteria to aid it in determining lease and loan qualification. This recommendation was the result of cases where the auditors found that the income of applicants appeared to be high, and thus questionable whether they required financial assistance from the department.

The former director contends that no specific criteria should be established to determine loan qualification and, furthermore, the commission has not taken the position that an applicant had to be poor in order to qualify for a loan.

It is our view that, because the resources of the department are limited, loans cannot be granted to all persons who want them but should be provided first to those qualified applicants who most need them. We believe that some criteria need to be established to guide those officials who recommend or make loans.

In any event, this is a matter for the department's current administration to consider, and the current director has informed us:

> "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."

Cutoff Date in the Reporting of Delinquencies. On page 25, the audit report recommends that the department change its cutoff date to the end of the month rather than the 19th of the month in its monthly reporting of delinquent accounts. The former director has informed us that reporting procedures for delinquencies were changed during her tenure. The current director, in her written response to our report, has also stated that procedures had previously been changed to require that the due dates of all outstanding loans due after the 19th day of the month be converted to the first day of the following month. We acknowledge that this change did take place and, therefore, we withdraw our recommendation.

Security Measures over Documents. On pages 25–26, the audit report states that 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.

The former director contends that far from the security measures being inadequate, she had during her tenure strengthened security, including the barring of entry to the documents room which might have been obtained through a window, the installation of an alarm system to detect unauthorized entry, and the purchase of fire-resistant file cabinets.

We acknowledge that during the former director's term of office she strengthened security by having a heavy file cabinet positioned to bar access through a window and by installing a silent alarm system for the department's facility. However, the auditors have determined from the distributor that the file cabinets which were purchased and are being used for the storage of critical records (Astromatics Model 84184M) are not fire-resistant.

Inadequate Attention to Increased Administrative Requirements. The former director points out that, with the expansion of programs and new program responsibilities, administrative requirements have increased in the department, but that at the same time there has been inadequate attention to the personnel resources and other resources required to discharge the enlarged administrative functions.

We agree that in the last decade the programs of the department have grown significantly and new programs have been added, with the result that the department has had to cope with enlarged administrative responsibilities. Budget officials in the executive branch should review the department's personnel resources and other resources and ensure that the department can adequately discharge its functions.

Conclusion

We have reviewed in this supplemental report the points of contention raised by the former director. Unquestionably, the former director was faced with a large problem in financial administration when she took office in 1975. Unquestionably also, improvements in financial administration were made during her term of office. Nonetheless, we believe our report is valid in its basic findings and recommendations. Of those discrepancies which remain and in those areas where the accounting and internal control systems can be further strengthened, there is every indication from the department's official response to our audit that the current director intends to correct those discrepancies and pursue those improvements. We believe that the department, under both the former director and the present director, has been approaching the task of making financial improvements in the spirit that such improvements will enable it to better serve the Hawaiian people. Our audit report and this supplemental report are rendered in the same spirit.