REPORT NO. 84-7
JANUARY 1984

FINANCIAL AUDIT OF THE DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

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.

Hawaii's laws provide the legislative auditor with broad powers to examine and inspect all books, records, statements, documents, and all financial affairs of every state and local agency. However, the office exercises no control functions and is restricted to reviewing, evaluating, and reporting its findings and recommendations to the legislature and the governor. The independent, objective, and impartial manner in which the legislative auditor is required to conduct his examinations provides the basis for placing reliance on his findings and recommendations.

LEGISLATIVE AUDITOR

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

FINANCIAL AUDIT OF THE DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

Conducted by the

Office of the Legislative Auditor
State of Hawaii
and
Coopers & Lybrand
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

Report No. 84—7
January 1984

FOREWORD

This financial audit report is the result of an examination of the financial statements and records of the Department of Planning and Economic Development for the fiscal year ended June 30, 1983. The audit was conducted by the Office of the Legislative Auditor and the certified public accounting firm of Coopers & Lybrand.

This report is divided into three parts. Part I contains an introduction and some background information on the Department of Planning and Economic Development. Part II presents our findings and recommendations regarding the department's financial and accounting practices and displays the department's financial statements, including the audit opinion of the CPA firm on the fairness and accuracy of the department's financial statements. We have followed our customary practice of requesting the agency affected by the audit to comment on the findings and recommendations. Part III contains the Department of Planning and Economic Development's response to this report and our comments on the department's response.

We wish to express our sincere appreciation for the cooperation and assistance extended by the staff of the Department of Planning and Economic Development.

Clinton T. Tanimura
Legislative Auditor
State of Hawaii

January 1984

TABLE OF CONTENTS

PART III
RESPONSE OF THE AFFECTED AGENCY

LIST OF EXHIBITS

LIST OF SCHEDULES

PART I

INTRODUCTION AND BACKGROUND

Chapter 1

INTRODUCTION

This is a report of our financial audit of the Department of Planning and Economic Development (DPED).

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the state auditor to conduct post-audits of all transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Objectives of the Audit

The objectives of the audit were:

1. To determine the reasonable accuracy of the financial statements of the department.

2. To ascertain whether or not expenditures and other disbursements were made and all revenues and other receipts to which the State is entitled have been collected and accounted for in accordance with state laws, rules and regulations, and policies and procedures.

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

Scope of the Audit

This audit examined the financial statements of DPED for the period July 1, 1982 to June 30, 1983. The audit opinion as to the reasonable accuracy of the financial statements is that of the independent certified public accounting firm of Coopers & Lybrand.

Organization of the Report

This report is organized as follows:

Part I (Chapters 1 and 2) presents this introduction and some background information on the department.

Part II (Chapters 3 and 4) presents our audit findings and recommendations on the financial and accounting practices and procedures of the department. It also includes the department's financial statements and the accountants' opinion on such statements.

Part III contains the response of DPED to our recommendations, together with our comments on the department's response.

Chapter 2

BACKGROUND

In 1963, the Legislature established the Department of Planning and Economic Development (DPED). Planning and research functions formerly carried out by the Department of Planning and Research and the Department of Economic Development were consolidated into a single agency known as the Department of Planning and Economic Development "... in order to eliminate overlapping functions of two relatively small departments and to give recognition to their mutually complementary areas."[1]

By statute, DPED is responsible for encouraging the promotion of locally manufactured products, developing and promoting industry and tourism, offering expert consultative services, planning fairs, and administering business credit programs and other programs established by law.

Organization and Activities[2]

The department is comprised of the office of the director, the operating divisions, and the staff offices. Outside the formal organization of the department are the Board of Planning and Economic Development and the Hawaii State Plan Policy Council. In addition, the Land Use Commission, Hawaii Community Development Authority, Natural Energy Laboratory of Hawaii (NELH), Commission on Population and the Hawaiian Future, and the Aloha Tower Development Corporation are attached to the department for administrative purposes.

Office of the Director. This office includes the Director of DPED who has overall responsibility for planning, directing, and coordinating the various programs of the department.

Operating divisions. Seven operating divisions carry out the programs of the department. These operating divisions and their activities are as follows:

1. ***Research and Economic Analysis Division.*** This division provides the department with statistical data and basic research studies on the State's economy. This division also provides the analysis, plans, and recommendations on various economic issues which assist the director and others responsible for policy decisions.

2. ***Planning Division.*** This division assists in the development of state policies and strategies to meet economic, social, and environmental concerns. It is responsible for implementation of the Hawaii State Plan and Hawaii Coastal Zone Management Program. The division also serves as the state clearinghouse for federal grants and administers the comprehensive planning assistance grant from the U.S. Department of Housing and Urban Development.

3. ***Land Use Division.*** This division assists the director in resolving issues relating to land use in Hawaii. It represents DPED in all proceedings before the Land Use Commission and reports proposed boundary changes requested by petitioners.

1. House Standing Committee Report 200 on H.B. No. 49, General Session, 1963.

2. Department of Planning and Economic Development, *1982 Annual Report.*

4. ***Economic Development Division.*** This division develops and implements economic development programs to encourage investment in new or existing industries. It also administers the department's various credit and management assistance programs.

5. ***Foreign-Trade Zone Division.*** This division operates and maintains the Foreign-Trade Zone. In addition, it is responsible for promoting Hawaii as a center for international trade activities.

6. ***Hawaii International Services Agency (HISA).*** This agency, as a division of DPED, is responsible for locating and developing new overseas markets and business opportunities to enhance Hawaii's role in international trade. HISA promotes and participates in international conferences, trade shows, seminars, and trade missions.

7. ***Energy Division.*** This division is responsible for energy management and conservation programs and the development of Hawaii's alternate energy resources.

Staff offices. Six staff offices also provide advice and assistance to the director:

1. ***Ocean Resources Office.*** This office was established to manage the former Marine Affairs Coordinator functions transferred to the department by Act 281, SLH 1982, and the ocean-related activities of DPED.

2. ***Office of Tourism.*** This office provides advice and assistance to the director, state and county agencies, and the visitor industry on tourism planning, development, and promotion. It administers the department's contract with the Hawaii Visitors Bureau.

3. ***Hawaii Film Office.*** This office promotes Hawaii as a production site for films and television.

4. ***Economic Planning Information System.*** This division provides support to the economic analysis and planning process in Hawaii by establishing an economic data base; providing the capabilities for analysis, forecasting, and modeling.

5. ***Information Office.*** This office provides informational services on DPED activities to the public. It also maintains the department's library.

6. ***Administrative Services Office.*** This office provides general internal management, fiscal, budgetary, and personnel assistance to the director.

Advisory board and council and units assigned for administrative purposes. In addition to the operating divisions and offices of DPED, there are two advisory units and five units which have been assigned to the department for administrative purposes only. The two advisory units are:

1. ***Board of Planning and Economic Development.*** This board sits in an advisory capacity to the director. It is comprised of nine members appointed by the Governor.

2. ***Hawaii State Plan Policy Council.*** This council, established in 1978, advises the Legislature on the Hawaii State Plan. The council is composed of 13 state agency heads, four county planning directors, and nine public members. The Director of DPED serves as chairman of the council and provides technical assistance and staff services to the council as needed.

The five units assigned to DPED for administrative purposes are:

1. ***Land Use Commission.*** This commission established boundaries for the districting of all lands in the State. The commission also acts on boundary change petitions, special permit petitions, boundary interpretation requests, and requests for public information. The commission consists of nine members appointed by the Governor.

2. ***Hawaii Community Development Authority.*** This authority is involved in coordinating public and private sector efforts to implement community development plans and programs in areas designated as "underdeveloped or blighted" by the Legislature. The authority is composed of 11 members. The executive director, who serves as chief executive officer, is appointed by the authority.

3. ***Natural Energy Laboratory of Hawaii.*** The NELH was established for the research, development, and demonstration of natural energy resources. Present studies primarily involve ocean thermal energy conversion and cold water aquaculture. The NELH is directed by a managing board consisting of seven ex-officio members, including the Director of DPED.

4. ***Commission on Population and the Hawaiian Future.*** The commission consists of 11 members appointed by the Governor. Among its concerns is population growth and its effects on the quality of life of Hawaii's people.

5. ***Aloha Tower Development Corporation.*** This corporation is responsible for the redevelopment of the Aloha Tower complex in downtown Honolulu. The Director of DPED is chairman of the corporation's board of directors.

PART II

FINDINGS AND RECOMMENDATIONS

Chapter 3

LOANS

To encourage the development and growth of commerce in the State, the Legislature established five loan programs which are administered by the Department of Planning and Economic Development (DPED). These programs are designed to assist companies and individuals in securing needed credit either through direct loans or in participation with other lenders. In addition, under Chapter 211, Hawaii Revised Statutes, the department is empowered to guarantee commercial loans made by private lending institutions.

This chapter assesses DPED's financial management and accounting practices as they relate to the various loan programs administered by the department.

Summary of Findings

Our findings are as follows:

1. The rules and regulations relating to the loan programs are not being adhered to.

2. The evaluation of the ability of loan applicants to repay loans is inadequate.

3. Loan disbursement practices vary and often do not provide assurance that loan proceeds are being spent as intended.

4. The department's loan management practices are deficient. Specifically, the financial status of borrowers is not adequately monitored, business counseling and training to borrowers are not provided, and the practices followed by the department are insufficiently documented.

5. Idle funds are not being invested by the department.

6. The accounting and billing systems for the loan programs are inefficient and should be automated.

Description of Loan Programs

This section briefly describes the various loan programs administered by DPED and their purposes. The loan programs are administered by the financial and management assistance branch of the economic development division. Loan activities are handled by two loan officers and a branch chief.

Hawaii Capital Loan Program (Chapter 210, HRS). Under this program, DPED is authorized to make two types of loans: direct loans and local development company loans.

Direct loans provide funds for plant construction, conversion or expansion; acquisition of land for expansion; acquisition of equipment or machinery; or working capital. Loans of up to $100,000 are available and may be made in participation with other lenders. Loans bear interest at 7.5 percent (5.5 percent for loans made prior to 1976) and terms cannot exceed 20 years. DPED may require that the loan be collateralized, and it can defer payment of the first principal installment for up to five years.

Local development company loans are available to companies approved by the Small Business Administration (SBA) as qualifying for loans under Section 502 of the

Small Business Investment Act of 1958, as amended. Funds are provided for the financing of construction, acquisition of land or acquisition of equipment and machinery. Loans cannot amount to more than 20 percent of the total cost of the project and the original term of the loan cannot exceed 25 years. However, an extension of up to 10 years may be granted. In addition, interest rates on loans cannot be less than that charged on SBA loans, and payment of the first principal installment may be deferred.

As of June 30, 1983, DPED had 142 loans outstanding under the Hawaii Capital Loan Program which represented a statewide total of $4,136,614.

Hawaii Large Fishing Vessel Loan Program (Chapter 189, HRS). The purpose of this program is to assist in the development of commercial fishing in the State by providing funds for the purchase, construction, renovation or repair of large (at least five tons) fishing vessels. Loans for purchasing or constructing a vessel cannot exceed 80 percent of the vessel's cost and are limited to terms of not more than 20 years. Loans for renovating or repairing a vessel are limited to $50,000 and terms of not more than 10 years. All loans bear interest at 7.5 percent, and payment of the first principal installment can be deferred for up to two years, if deemed appropriate by the department. In addition, while all loans must be collateralized, DPED's secured position may be subordinated, if required, to induce a private lender to participate in the loan.

As of June 30, 1983, DPED had 39 loans outstanding in the aggregate amount of $3,385,090.

Hawaii Small Fishing Vessel Loan Program (Chapter 189, HRS). The purpose of this program and its loan conditions are similar to the Hawaii Large Fishing Vessel Loan Program except that all loans are limited to a maximum of $50,000 and terms of not more than 10 years.

As of June 30, 1983, DPED had 38 loans outstanding totaling $681,376.

Disaster Commercial and Personal Loan Program (Chapter 209, HRS). The purpose of this program is to provide disaster relief and rehabilitation loans. Commercial borrowers are eligible only if they are unable to obtain financial assistance under the SBA Disaster Loan Program.

As of June 30, 1983, there was one loan outstanding with a balance of $22,127.

Economic Redevelopment Program for Depressed Areas (Chapter 208, HRS). Under this program, DPED is empowered to provide loans for the redevelopment of depressed areas, as designated by the department's director.

As of June 30, 1983, there was one loan outstanding with a balance of $69,700.

Noncompliance with Rules and Regulations

Since the procedures involved in the processing and monitoring of loans are complex and detailed, rules and regulations are needed to assure complete and uniform application of loan procedures. While DPED has established rules and regulations for its loans, we found instances where the rules were not being observed.

Information provided by applicant is generally not verified. Section 15-3-5(c) of the rules and regulations of the Fishing Vessel Loan Programs states that "in the review of the applicant's eligibility, all information supplied by the applicant shall be subject to verification by the department."

The information referred to in this section is contained in the loan application form and consists of such data as cash in banks, personal and real property owned, investments, sources of income, bank and other borrowings, etc., all of which play an important role in the evaluation of an applicant's financial position and ability to repay the loan.

It is standard practice for lending institutions to confirm the applicant's representations. Cash balances and loans with financial institutions are verified. The real property tax assessment notice showing the valuation of real property is obtained. Proof of investments owned may also be required.

Despite the importance of verifying the financial status of potential borrowers, we found that in the majority of the loans we reviewed, the department had not verified the information provided by applicants.

Borrower's financial data is not kept current. Sections 15-2-11 and 15-3-9(9) of the rules and regulations of the Hawaii Capital Loan and Fishing Vessel Loan Programs, respectively, require borrowers to submit annual financial reports within four months following the close of their tax year. These annual financial reports enable the lender to analyze and evaluate the borrower's current performance and financial condition from industrywide and historical perspectives. Such analysis could identify potential problems or undesirable trends that might be corrected before they impair the collectibility of the loan. However, we found that the department has not enforced this requirement, and as a result, many borrowers have not submitted the required financial reports.

Hull insurance not obtained. While the foreclosure and subsequent resale of collateral is not intended to be the primary source of loan repayment, the existence of collateral does protect the lender by: (a) encouraging the borrower to repay the loan since a default would result in loss of ownership of the property used as collateral, and (b) preventing or at least minimizing the amount of loss by the lender in the event of default. The protection of the collateral through insurance is therefore a major concern to all lenders.

Section 15-3-9(7) of the rules and regulations for the Fishing Vessel Loan Programs states: ". . . the insurance policy shall provide, as a minimum, for hull insurance and shall name the department as an additional insured." This type of requirement is common to all lenders since it provides protection against serious damage or total loss of the collateral due to an accident or fire. Despite this requirement, during our examination we noted that the proceeds of a loan for $30,400 granted under the Hawaii Small Fishing Vessel Loan Program in September 1982 was disbursed in full prior to the department receiving evidence that the borrower's boat had been insured.

Recommendation. *We recommend that the department comply with its rules and regulations concerning verification of loan applicant information, annual financial reports from borrowers, and insurance of collateral.*

Inadequate Evaluation of Loan Applicants

A loan is meant to be repaid. Thus, the prospective ability of the loan applicant to repay the loan is a material factor in granting or refusing a loan. Section 15-2-7(c) DPED rules and regulations of the

Hawaii Capital Loan Program states: "The department shall not approve a loan unless the applicant provides reasonable assurance that the loan can and will be repaid pursuant to its terms. *Reasonable assurance of repayment shall be based upon consideration of the applicant's record of past earnings or projections of future earnings which indicate that the applicant will be able to repay the loan from the income of the business.*" [Emphasis added.] Similarly, with regard to the Fishing Vessel Loan Programs, Section 15-3-3 DPED rules and regulations states, "No applicant for a fishing vessel loan shall be approved by the director unless . . . (4) The applicant possesses the ability to repay the money borrowed. . . ."

Despite the department's requirement that loan applicants possess the ability to repay the money borrowed, DPED does not adequately evaluate the loan applicant's ability to repay. The department's rules and regulations require that the data submitted by the applicant be carefully reviewed and analyzed to determine the applicant's earning potential and repayment capacity. The analysis performed by the department is inadequate.

The department has made loans under the Hawaii Capital Loan Program based on income projections which, if not specious, can only be described as overly optimistic. Further, it has made loans under the Fishing Vessel Loan Programs without regard to earnings projections. Instead, it has concentrated its evaluation on the ratio of the loan amount to the value of collateral pledged.

Inflated projections. As part of the loan application process, all applicants are required to submit the projected income and expenses for their enterprise. Since these projections serve as a basis for determining whether or not the applicant has the earning power to repay the proposed loan, one would expect the projections to be carefully scrutinized by DPED to ensure that predicted income is based on realistic unit prices and volume amounts and that planned expenditures are derived from a realistic budget.

The projections are not given such careful scrutiny. On the contrary, the projections as submitted by loan applicants are readily accepted, even though they often appear inflated. The following two loans are examples.

Our review of a working capital loan for $40,000, granted in October 1981, revealed that the applicant's projected income statements for 1982 and 1983 reflected extremely large increases in sales (expected to triple by 1983) with no explanation as to what changes in operations were to occur. With such a large increase in sales being projected, the likelihood is that the borrower was overly optimistic. Accordingly, good credit practices would have routinely required that additional information supporting the increased sales projections be obtained. However, the department failed to obtain such additional information.

Since the time the loan was granted, no financial statements have been received so we were not able to establish how close actual sales were to the projected sales. However, no payments have been made on this loan since August 1982. The principal balance outstanding is $37,400.

Similarly, our review of a loan for $75,000, granted in March 1981, to provide working capital and for the purchase of equipment and leasehold improvements revealed that the applicant's projected income statements reflected extremely large increases in sales. The applicant expected sales of $9,000 for the last three months of 1980 (or $36,000 if annualized),

$183,000 in 1981, and $850,000 in 1982, with no explanation as to what changes in operations were to occur. As discussed in the previous example, such a large increase in sales should have been supported by additional information. However, the department did not obtain such additional information.

Again, in this case, no financial statements have been received. No payment on this loan has been received since May 1982, and the loan has a principal balance of $56,000. The case has been turned over to the Attorney General's office for possible legal action.

If projections are to serve as a meaningful basis for loan decisions, they need to be more critically evaluated than they are now.

Reliance on collateral. The fishing vessel loans are supposed to be repaid from net earnings from fishing. We found, however, that the emphasis of the loan officer's review is on the ratio of loan amount to the underlying collateral pledged as security for the loan.

While it is important for loans to be adequately collaterized, collateral value alone does not determine whether a loan will be repaid. Lenders look to the sale of collateral to satisfy loan obligations only as a last resort. The primary focus of an evaluation of loan repayment ability should be a review of earnings projections to determine whether the applicant can generate sufficient income to service the debt. Review of the adequacy of collateral should not take the place of the review of an applicant's ability to repay a loan.

In the previous examples, loans were made under the Hawaii Capital Loan Program without careful review of income projections. Loans under the Fishing Vessel Loan Programs have also apparently been made without regard to income projections. For example, a loan of $240,000 was granted even though the applicant's projected net income was barely enough to service the debt on the loan. Another loan of $172,000 was granted without income projections or other financial data to indicate an ability to repay the loan.

The loan officers apparently feel that the department would get its money back because the boats are worth more than the amount owed. This presupposes that in the event of default, there are buyers willing to pay what the boats are said to be worth. In addition, foreclosing on a loan and disposing of the collateral are time-consuming and costly, and should normally be avoided.

At June 30, 1983, 44 percent of the loans made under the Hawaii Large Fishing Vessel Loan Program and 53 percent of the loans made under the Hawaii Small Fishing Vessel Loan Program were delinquent. At the same time, 32 percent of the loans made under the Hawaii Capital Loan Program were delinquent. We believe that better loans could be made and the delinquency rate improved if emphasis were placed on the applicant's ability to repay a loan through the earnings of the business.

Recommendations. *We recommend that the department require detailed income projections from loan applicants and that such projections be analyzed for reasonableness and adequacy. In addition, we recommend that the department use the earnings of a business as the primary criterion in determining an applicant's ability to repay a loan.*

Loan Disbursement Practices Are Deficient

Adequate procedures and controls for the disbursement of loan funds are an essential part of any loan program since they help to ensure that the moneys provided to the borrower are utilized only for the purposes for which the loan was granted. For loans that are collateralized by property, equipment or other assets of the borrower, the procedures and controls should also help to ensure that the State's lien on the collateral has been properly executed and recorded prior to the disbursement of the loan.

Certain basic procedures should be followed in connection with disbursements. Before disbursements of construction loans are made, loan officers should evaluate the contractor's performance to ascertain that the progress payments being requested correspond with the stage of completion of the project. In all cases, payments should be made directly to the contractor or supplier based on invoices received and approved by the borrower.

In DPED, disbursing practices vary from loan-to-loan as determined by the loan officer. Loan proceeds have been disbursed directly to the borrowers without adequate substantiation of costs incurred or sufficient evaluation to determine that the payments approximate the stage of construction completion.

In one instance, construction loan funds for a fishing vessel were disbursed in full even though construction was not complete. An additional loan had to be made to complete construction. In this case, funds under the first loan were disbursed directly to the borrower, albeit stricter disbursement procedures were established for the second loan.

Several other loans were disbursed directly to the borrower or to others at the borrower's direction without supporting invoices. These practices were not limited to fishing vessel loans but applied to capital loans also.

Recommendations. *We recommend that loan disbursements be made on the basis of invoices approved by the borrower and that payments be made directly to the suppliers or contractors. We further recommend that the progress payments for construction loans be made in relation to the stage of completion of construction.*

Loan Management Practices Are Inadequate

Loan management consists of monitoring the financial status of borrowers, providing business counseling, enforcing the terms and conditions of the loan, and maintaining adequate documentation of the loan management procedures followed. Because the purpose of the various loan programs is to provide loans to businesses that are unable to obtain financing from conventional sources, there exists a greater risk that the loans might become uncollectible. Accordingly, a properly functioning loan management program is essential not only to protect the assets of the State, but also to assist in the survival of new businesses, which is an important economic development objective. Our examination indicated that, despite its importance, the department has failed to institute an adequate loan management program.

Lack of business counseling. While it is always good credit practice for lenders to take an active interest in its borrower's business, it is especially important when dealing with a new business. Accordingly, since many of the borrowers that the department deals with are either new businesses or those in the process of expanding, business counseling should be a key consideration in loan management. The position descriptions of the various loan officers require that they spend, on the average, 15 percent of their time either consulting with or training borrowers. The loan officers have not done this, and therefore, there is a general lack of business counseling.

Inadequate documentation in loan folders. Good loan management practices also require that the various actions taken in connection with a loan are fully documented to provide a historical record of the loan and to protect the interest of the State. In our review of DPED's loan files, we noted that the department has failed to adequately document its performance of certain loan procedures.

Fishing vessel title searches. Section 15-3-5(g) of the rules and regulations of the Fishing Vessel Loan Programs states, "If the approved loan application is for a loan for an existing fishing vessel, the department shall cause the title to that fishing vessel to be examined." This requirement is also mandated by good credit practices since it serves to verify that the borrower does own the vessel and provides the lender with an opportunity to uncover any undisclosed liens that could affect the lender's ability to secure the vessel as collateral. Although the department contends that they do examine the title of all fishing vessels, the performance of these searches was rarely documented.

On-site visits. While not required under the department's rules and regulations, it is good credit practice to observe the physical facilities or vessel of the loan applicant. These visits not only confirm the existence of the collateral but also provide the loan officer with information as to the applicant's ability and willingness to maintain the facilities and equipment in good working order. Although the department contends that such visits are generally made, these visits were rarely documented.

Net earnings clause not consistently enforced. While the objective of the department's loan programs is to assist new or growing businesses, once these businesses become established and profitable, continued assistance from the department should not be expected. Accordingly, the department has initiated a policy requiring the prepayment of loans based upon a percentage of the borrower's net earnings. This policy, if properly enforced, should accelerate the collection of loans and increase the amount of funds available for new loans. However, because the department has failed to enforce the requirement that all borrowers submit financial reports in which data on net earnings would be presented or derived, the prepayment requirement is not being enforced since it would be impossible to do so without knowing the borrower's net earnings.

In the one instance where we noted that there was sufficient information to apply the prepayment requirement, the requirement was waived despite the fact that the company had been profitable. The waiver of the prepayment requirement was ostensibly to provide working capital for the company to fund its rapid growth. However, at the same time the loan prepayment was waived, the department allowed the company to repay advances from stockholders so that the stockholders could make some home improvements.

Recommendations. *We recommend that the department make appropriate changes to strengthen its loan management practices. Specifically, we recommend the following:*

1. Loan officers should become more actively involved in counseling and training borrowers. At a minimum, DPED should establish guidelines as to the frequency of field visits and counseling sessions and the type of training that should be provided to borrowers.

2. Performance of all significant loan activities should be documented in the borrower's loan folder to provide a historical record of the loan and to enable subsequent analysis and verification.

3. The requirement for prepayment of loans based upon a percentage of the borrower's net earnings should be enforced.

Idle Funds Are Not Invested for the Benefit of the Loan Programs

The Department of Budget and Finance invests idle cash (moneys not immediately required for program operations) of the special funds of a department when instructed to do so by the department. The interest earned on such investments are then credited to the special funds. The Department of Budget and Finance also invests, at its own discretion, the moneys in the special funds which have not specifically been designated to be invested by the departments. The interest earned on these investments are credited to the state general fund.

Our audit revealed that the department has failed to issue the necessary instructions to the Department of Budget and Finance to invest its special fund moneys. As a result, assuming an average interest rate of 9 percent, we estimate that for the year ended June 30, 1983, the various loan programs administered by the department have failed to realize interest revenues totaling approximately $300,000. If this interest had been received, the various loan programs would have had more funds available for loans.

Recommendation. *We recommend that the department instruct the Department of Budget and Finance to invest all idle cash for the benefit of the respective loan programs.*

Accounting for Loans Should Be Automated

As administrator of the various loan programs, the department is responsible not only for processing and managing loans, but also for maintaining the financial records of the programs. Our review of the department's activities revealed that efficiency can be increased through the use of the department's in-house computer. The following are three examples that illustrate our point:

1. The department's fiscal office must manually prepare approximately 125 loan billings each month;

2. Individual ledgers for all of the department's loans must be manually posted and maintained; and

3. Information required for preparation of the department's monthly loan delinquency reports must be manually compiled and summarized.

Recommendation. *We recommend that the department use the in-house computer to reduce the manual operations and increase the efficiency of its loan operations.*

Chapter 4

FINANCIAL STATEMENTS AND ACCOUNTANTS' OPINION

This chapter presents the results of the examination of the financial statements of the Department of Planning and Economic Development (DPED) for the fiscal year ended June 30, 1983. It contains the opinion of Coopers & Lybrand regarding the fairness and accuracy of the department's financial statements. It also displays various financial statements of the general fund accounts, special revenue funds, and trust fund administered by the department, together with explanatory notes, and supplemental information presented for analysis purposes only.

Summary of Finding

In the opinion of Coopers & Lybrand, the department's financial statements present fairly the financial position of the department's special revenue and trust funds at June 30, 1983 and the results of operations of the department's general fund accounts, special revenue funds, and trust fund for the fiscal year then ended.

Accountants' Opinion

Coopers & Lybrand's statement filed with the Legislative Auditor is as follows:

"To the Legislative Auditor
State of Hawaii
Honolulu, Hawaii

We have examined the following financial statements of the Department of Planning and Economic Development, as of June 30, 1983 and for the year then ended:

Combined balance sheet — special revenue and trust funds (Exhibit A)

Combined statement of revenues, expenditures and changes in fund balance — all fund types and general fund accounts (Exhibit B)

Combined statement of revenues and expenditures - budget and actual — general fund accounts and special revenue funds (Exhibit C)

As explained in the notes to the financial statements, the general fund accounts of the Department of Planning and Economic Development are a part of the State of Hawaii general fund and our opinion expressed herein, insofar as it relates to the amounts included for the general fund, is limited to the transactions of the Department of Planning and Economic Development only. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the combined financial statements referred to above present fairly the financial position of the special revenue and trust funds of the Department of Planning and Economic Development at June 30, 1983, and the results of operations of the department's general fund accounts, special revenue funds and trust fund for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the combined financial statements referred to in the first paragraph, taken as a whole. The combining financial statements and Schedules I and II are not necessary for a fair presentation of the combined financial statements, but are presented as additional analytical data. This information has been subjected to the tests and other auditing procedures applied in the examination of the combined financial statements and in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ Coopers & Lybrand

COOPERS & LYBRAND
Certified Public Accountants

Honolulu, Hawaii
September 16, 1983"

Descriptions and Definitions

Descriptions of financial statements and schedules. The following is a brief description of the financial statements and schedules examined by Coopers & Lybrand. The financial statements and schedules are attached at the end of this chapter as Exhibits A to E and Schedules I and II.

1. ***Combined balance sheet—special revenue and trust funds (Exhibit A).*** This statement presents the assets and fund balances of the special revenue and trust funds used by the DPED on an aggregate basis.

2. ***Combined statement of revenues, expenditures, and changes in fund balance—all fund types and account groups (Exhibit B).*** This statement presents revenues and expenditures for each type of fund and account group used by the DPED on an aggregate basis. It also presents changes in fund balance for the department's combined special revenue and trust funds.

3. ***Combined statement of revenues and expenditures—budget and actual—general fund accounts and special revenue funds (Exhibit C).*** This statement presents a comparison of budgeted and actual revenues and expenditures for the general fund accounts and special revenue funds used by the DPED.

4. ***Special revenue funds—combining balance sheet (Exhibit D).*** This statement presents the balance sheets for all of the individual special revenue funds maintained by the DPED.

5. ***Special revenue funds—combining statement of revenues, expenditures, and changes in fund balances (Exhibit E).*** This statement presents the revenues, expenditures, and changes in fund balances for all of the individual special revenue funds maintained by the DPED.

6. ***General fund accounts—schedule of expenditures—budget and actual (Schedule I).*** This schedule presents a comparison of the budgeted and actual expenditures for the general fund accounts, classified by function, within the DPED.

7. ***Special revenue funds—schedule of expenditures—budget and actual (Schedule II).*** This schedule presents a comparison of the budgeted and actual expenditures for the special revenue funds, classified by function, within the DPED.

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

1. ***Allotment.*** Authorization by the Director of Finance to a state agency to incur obligations and to make expenditures pursuant to the appropriation made by the Legislature.

2. ***Appropriation.*** An authorization granted by the Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are of two types: (a) funds which are available for use until completely expended, and (b) funds which lapse if not expended by or encumbered at the end of the fiscal year.

3. ***Appropriated receipts.*** Funds received by the State for designated purposes and specifically authorized by the Legislature to be expended by the state agency. Depending upon the designated purposes of the receipts, the funds may lapse at the end of the fiscal year or be carried over until completely expended.

4. ***Encumbrance.*** An obligation in the form of a purchase order or contract which is chargeable to an appropriation, the incurring of which sets aside the appropriation for the amount of the obligation.

5. ***Expenditure.*** The actual disbursement of funds for the payment of goods delivered or services rendered, the obligation to pay for such goods or services having been incurred against authorized funds.

6. ***Lapse of appropriated balance.*** The balance of funds authorized, which is unexpended and uncommitted at the end of the prescribed time period. The balance reverts to the designated fund and is available for appropriation by the Legislature in the ensuing fiscal year.

7. ***Reserve.*** An account used to earmark a portion of the fund balance to indicate that it is not available for expenditure.

8. ***Transfers.*** The transactions between funds, departments and/or programs which are approved by the appropriate authority.

9. ***Unallotted appropriation.*** An appropriation balance that is available for allotment.

10. ***Unencumbered allotment.*** The portion of an allotment that is not yet expended or encumbered.

11. ***Unliquidated encumbrances.*** Encumbrances that are outstanding and are to be liquidated.

General Notes to the Financial Statements

Explanatory notes which are pertinent to an understanding of the financial statements and financial condition of the funds administered by the DPED are discussed below.

Basis of accounting. The accounts of the funds maintained by the DPED and the accompanying financial statements have been prepared on a modified accrual basis of accounting. Under this method, revenues are generally recognized in the period in which they become available and measurable and expenditures are recorded when liabilities are incurred.

The accounting procedures generally provide for the recording of commitments at the time contracts are awarded and orders for equipment, construction, services, and supplies are placed. These commitments are represented as encumbrances in the accompanying financial statements and are necessary to reflect obligations against appropriations. General fund appropriations that are not expended or encumbered by the end of the fiscal year generally lapse. Appropriations for special revenue funds generally do not lapse until completely expended.

Capital assets constructed for or purchased by the DPED are recorded as expenditures in the year in which the cost is incurred. These assets are not reflected as assets in the accompanying financial statements, but are reflected in the general fixed assets account group of the State of Hawaii. Depreciation of these assets is not recorded by the State. Costs for pension, health, and Social Security benefits of state employees are reported as expenditures in the general fund. Required contributions to the Employees Retirement System are based upon actuarial valuation and include amortization of accrued unfunded liability over a period of 50 years from July 1, 1964. The State's policy is to fund its required contribution annually.

Fund categories and description. Moneys to finance the DPED's programs are accounted for in several different funds. These funds have been established by legislative actions, and each fund has a specific purpose or objective to fulfill. Each fund is an independent fiscal and accounting entity and a separate group of accounts is maintained for each to show its revenues and expenditures. There are three categories of these funds. The categories and the funds within each are described briefly below.

1. ***General fund.*** The general fund accounts for all resources not otherwise accounted for in other funds. Any activity not financed through another fund is financed through this fund. The budget as adopted by the Legislature provides the basic framework within which the resources and obligations of the general fund are accounted. The general fund accounts of the DPED are a part of the State of Hawaii's general fund and the accompanying general fund financial statement is limited to and reflects only the appropriations, expenditures, and obligations of the general fund accounts used by the DPED, and the general fund revenues collected by the Department of Planning and Economic Development.

2. ***Special revenue funds.*** Special revenue funds are operated to account for revenue and expenditures designated for particular purposes. There are 21 of these special revenue funds.

a. *Statewide Economic Development Planning.* This fund was established to account for federal grant moneys received from the U.S. Department of Commerce, Economic Development Administration, for the purpose of studying the coordination of statewide economic development planning and research.

b. *State Mandatory Petroleum Allocation Program.* This fund was established to account for federal grant moneys received from the former Federal Energy Administration for the purpose of administering the State Mandatory Petroleum Allocation Program.

c. *Waimanu Valley Estuarine.* This fund was established to account for federal grant moneys received from the U.S. Department of Commerce, National Oceanic and Atmospheric Administration, for the purpose of developing, administering, and maintaining an estuarine sanctuary program.

d. *Appropriate Energy Technology and Western Solar Utilization Network.* This fund was established to account for federal grant moneys received from:

(1) The U.S. Department of Energy for the purpose of soliciting, reviewing, and administering grants under the Appropriate Energy Technology Program.

(2) The Western Solar Utilization Network for the purpose of solar energy planning related to the commercialization of solar technologies and conservation of solar energy.

e. *Energy Development and Management.* This fund was established to account for federal grant moneys received from the U.S. Department of Energy for the implementation of energy conservation programs including activities for building efficiencies, transportation, energy recovery, solar water heating, and consumer awareness.

f. *National Science Foundation—State Science, Engineering and Technology Program.* This fund was established to account for federal grant moneys received from the National Science Foundation for the purpose of improving capabilities of the State to use science, engineering, and technology in planning and policy formulation.

g. *Foreign-Trade Zone Services.* This special fund was established in accordance with Section 212-9, Hawaii Revised Statutes, to account for the revenues and expenditures for the operation of the Foreign-Trade Zone.

h. *Hawaii Capitol Loan Revolving Fund.* This revolving fund was established in accordance with Section 210-3, Hawaii Revised Statues, to account for all moneys of the Hawaii Capital Loan Program, whose purpose is to provide loans to small businesses for the financing of plant construction, the acquisition of land, equipment, and supplies, and for the supplying of working capital.

i. *Aloha Tower Fund.* This special fund was established in accordance with Section 206J-17, Hawaii Revised Statutes, to account for the revenues and expenditures of the Aloha Tower Development Corporation, a public corporation established to undertake the redevelopment of the Aloha Tower Complex.

j. *New Vessel Construction Loan Revolving Fund.* This revolving fund was established in accordance with Section 189-23, Hawaii Revised Statutes, to account for all moneys for the Hawaii Large Fishing Vessel Loan Program, whose purpose is to provide loans for the purchase, construction, renovation, maintenance, and repair of commercial fishing vessels five net tons and over.

k. *Financial Assistance Commercial Fishing Vessel Revolving Fund.* This revolving fund was established in accordance with Section 189-43, Hawaii Revised Statutes, to account for all moneys for the Hawaii Small Fishing Vessel Loan Program, whose purpose is to provide loans for the purchase, construction, renovation, maintenance, and repair of commercial fishing vessels under five net tons.

l. *Hawaii Community Development Revolving Fund.* This revolving fund was established in accordance with Section 206E-16, Hawaii Revised Statutes, to account for all receipts and revenues of the Hawaii Community Development Authority.

m. *State Disaster Revolving Loan Fund.* This revolving fund was established in accordance with Section 209-34, Hawaii Revised Statutes, to account for all moneys of the State Disaster Loan Program, whose purpose is to provide commercial and personal loans for the rehabilitation of businesses and relief for victims of a disaster.

n. *Hawaii Invention Development Revolving Fund.* This revolving fund was established in accordance with Section 211E-2, Hawaii Revised Statutes, to account for all moneys for the Hawaii Invention Development Program, whose purpose is to promote the development of new products or inventions that have direct benefits for Hawaii.

o. *Contributions for Manganese Nodule Program.* This fund was established to account for moneys contributed by the Ocean Minerals Company and the County of Hawaii for the purpose of conducting research in developing a manganese nodule industry.

p. *Contributions from State Agencies for Product Promotion.* This fund was established to account for moneys contributed by the Governor's Agricultural Coordinating Committee for the promotion of agricultural products.

q. *Contributions for Energy Projects.* This fund was established to account for moneys received from oil companies and the U.S. Department of Energy resulting from settlements between the U.S. Department of Energy and oil companies charged with violation of pricing regulations. Funds received are to be used for the purpose of approved energy programs.

r. *Contributions for Solar Energy Projects.* This fund was established to account for moneys contributed by the Western Solar Utilization Network for the printing of publications relating to solar energy.

s. *Contributions for Marine Projects.* This fund was established to account for moneys contributed by the County of Hawaii to support a conference on marine mining.

t. *Land Use and Physical Planning—Section 701.* This fund was established to account for federal grant moneys received from the U.S. Department of Housing and Urban Development for the purpose of conducting comprehensive planning including the conservation and improvement of existing communities and expansion of housing and employment opportunities.

u. *Coastal Zone Management Program.* This fund was established to account for federal grant moneys received from the U.S. Department of Commerce, National Oceanic and Atmospheric Administration, for the purpose of planning and implementing the Coastal Zone Management Program in Hawaii, involving the management, beneficial use, protection, and development of the land and water resources of Hawaii's coastal zones.

3. ***Trust fund.*** The trust fund consists of a temporary deposit fund established by the department principally to account for security deposits collected on rental space at the Foreign-Trade Zone and moneys collected for department sponsored workshops and seminars.

Notes to the Financial Statements of the General Fund Accounts (Exhibits B and C) and the Special Revenue Funds (Exhibits A, B, C, D, and E)

Budgeting and budgetary control. Amounts reflected as budgeted revenues in the combined statement of revenues and expenditures—budget and actual—are those estimates as compiled by the Director of Finance. Budgeted expenditures are derived primarily from the General Appropriations Act of 1982 (Act 264, Session Laws of Hawaii 1982) and from other authorizations contained in the Hawaii Constitution, the Hawaii Revised Statutes, other specific appropriations acts in various Session Laws of Hawaii, and transfers instituted by the Department of Budget and Finance. To provide for comparability, actual expenditures in this statement have been adjusted to include encumbrances and continuing appropriations at year end and exclude current year expenditures for liquidation of prior year encumbrances and continuing appropriations.

Notes to the Financial Statements of the General Fund Accounts (Exhibits B and C)

Commitments and contingencies. In accordance with the general practice followed by other state agencies, the DPED does not reflect accrued and potential liability for earned vacation and sick leave credits for other than federally-funded project employees.

At June 30, 1983, earned vacation and sick leave for other than federally-funded project employees amounted to approximately $712,000 and $1,847,000, respectively.

Within certain limitations, the employees are entitled to receive cash payments for accrued vacation upon the termination of their employment. Sick leave can accumulate at the rate of one and three-quarters working days for each month of service without limit, but can be taken only in the event of illness and is not convertible to pay upon the termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the retirement system.

All full-time employees of the department are required by Chapter 88 of the Hawaii Revised Statutes to become members of the Employees Retirement system of the State of Hawaii, a contributory retirement system. The system consists of a Pension Accumulation Fund which provides basic pension benefits and a Post Retirement Fund which provides annual increases to individuals receiving pensions.

Actuarial valuations are made for the entire system and are not separately computed for the State and each county. The department's and other state agencies' share of the retirement expense for the fiscal year ended June 30, 1983, was included in the general appropriation bill as an item to be expended by the Department of Budget and Finance and is not reflected in the DPED's financial statements.

The State is self-insured for substantially all perils including workers' compensation. Expenditures for workers' compensation are appropriated annually and are not considered material.

Presently, there are two cases of pending litigation, claims or assessments. Losses, if any, arising from these matters are not expected to have a significant effect on the accompanying financial statements. Any losses would be included in the general appropriations bill as an item to be expended by the Department of Budget and Finance and accordingly would not be reflected in the DPED's financial statements.

Notes to the Financial Statements of the Special Revenue Funds (Exhibits A, B, C, D, and E)

Notes receivable. At June 30, 1983, notes receivable consisted of the following:

Hawaii Capital Loan Revolving Fund, with interest at 5–1/2 percent and 7–1/2 percent and maturing at various dates through March 1997.	$4,136,614
New Vessel Construction Loan Revolving Fund, with interest at 5–1/2 percent and 7–1/2 percent and maturing at various dates through March 2003.	3,385,090
Financial Assistance Commercial Fishing Vessel Revolving Fund, with interest at 5–1/2 percent and 7–1/2 percent and maturing at various dates through September 1993.	681,376
State Disaster Revolving Loan Fund, with interest at 5 percent and maturing in June 1990.	22,128
	$8,225,208

All notes are collateralized by interests in fishing vessels, commercial and residential property, and business assets. In addition, the DPED has received the personal guarantee of certain borrowers and assignment of certain life insurance policies.

Notes to the Financial Statements of the Special Revenue Funds (Exhibits A, B, C, D, and E)

Notes receivable. At June 30, 1983, notes receivable consisted of the following:

Hawaii Capital Loan Revolving Fund, with interest at 5–1/2 percent and 7–1/2 percent and maturing at various dates through March 1997.	$4,136,614
New Vessel Construction Loan Revolving Fund, with interest at 5–1/2 percent and 7–1/2 percent and maturing at various dates through March 2003.	3,385,090
Financial Assistance Commercial Fishing Vessel Revolving Fund, with interest at 5–1/2 percent and 7–1/2 percent and maturing at various dates through September 1993.	681,376
State Disaster Revolving Loan Fund, with interest at 5 percent and maturing in June 1990.	22,128
	$8,225,208

All notes are collateralized by interests in fishing vessels, commercial and residential property, and business assets. In addition, the DPED has received the personal guarantee of certain borrowers and assignment of certain life insurance policies.

Exhibit A

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

Combined balance sheet- special revenue and trust funds
June 30, 1983

	Special Revenue (Exhibit D)	Trust	Totals (Memorandum Only)
ASSETS			
Cash with treasury	$ 6,912,150	$85,936	$ 6,998,086
Notes receivable	8,225,208	-	8,225,208
Total assets	$15,137,358	$85,936	$15,223,294
FUND BALANCES			
Reserved for continuing appropriations:			
Unallotted appropriations	$ 2,995,414	$ -	$ 2,995,414
Unencumbered allotments	3,692,438	-	3,692,438
Unliquidated encumbrances	224,298	-	224,298
	6,912,150	-	6,912,150
Reserved for notes receivable	8,225,208	-	8,225,208
Reserved for amounts held in trust	-	85,936	85,936
Total fund balances	$15,137,358	$85,936	$15,223,294

The accompanying notes are an integral part of the financial statements.

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

Combined statement of revenues, expenditures and changes in fund balance - All fund types and account groups for the year ended June 30, 1983

	General	Special Revenue (Exhibit E)	Trust	Totals (Memorandum Only)
REVENUES:				
Licenses and permits	$ -	$ 1,000	$ -	$ 1,000
Interest earned	99	628,565	-	628,664
Federal grants in aid	20,147	1,500,778	-	1,520,925
Revenue from private sources	-	1,380,400	-	1,380,400
Charges for current services	267,421	794,823	-	1,062,244
Repayment of loans and advances	1,687	976,408	-	978,095
Deposits	-	-	95,487	95,487
Total revenues	289,354	5,281,974	95,487	5,666,815
EXPENDITURES:				
General government	1,801,610	1,090,806	-	2,892,416
Conservation of natural resources	-	1,505,995	-	1,505,995
Economic development and assistance	7,751,900	3,045,148	-	10,797,048
Urban redevelopment and housing	58,140	-	-	58,140
Miscellaneous	-	-	72,472	72,472
Total expenditures	9,611,650	5,641,949	72,472	15,326,071
Excess of revenues over (under) expenditures	(9,322,296)	(359,975)	23,015	(9,659,256)
OTHER FINANCING SOURCES (USES):				
Operating transfers in	425,775	695,000	-	1,120,775
Operating transfers out	(961,083)	(9,224)	-	(970,307)
Total other financing sources (uses)	(535,308)	685,776	-	150,468
EXCESS OF REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	$(9,857,604)	325,801	23,015	$(9,508,788)
FUND BALANCES, beginning of year		13,805,886	62,921	
INCREASE IN RESERVE FOR NOTES RECEIVABLE		1,005,671	-	
FUND BALANCES, end of year		$15,137,358	$85,936	

The accompanying notes are an integral part of the financial statements.

Exhibit C

STATE OF HAWAII

DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

Combined statement of revenues and expenditures - budget and actual
General fund accounts and special revenue funds
for the year ended June 30, 1983

	General Fund Accounts			Special Revenue Funds		
	Budget	Actual On A Budgetary Basis	Variance-Favorable (Unfavorable)	Budget	Actual On A Budgetary Basis	Variance-Favorable (Unfavorable)
REVENUES:						
Licenses and permits	$ -	$ -	$ -	$ -	$ 1,000	$ 1,000
Interest earned	100	99	(1)	461,000	628,565	167,565
Federal grants in aid	-	20,147	20,147	1,179,819	1,500,778	320,959
Revenue from private sources	-	-	-	-	1,380,400	1,380,400
Charges for current services	23,245	267,421	244,176	596,700	794,823	198,123
Repayment of loans and advances	2,000	1,687	(313)	811,000	976,408	165,408
Total revenues	25,345	289,354	264,009	3,048,519	5,281,974	2,233,455
EXPENDITURES:						
General government	1,677,872	1,842,562	(164,690)	448,000	832,988	(384,988)
Economic development and assistance	11,007,352	7,889,926	3,117,426	2,909,515	2,143,964	765,551
Total expenditures	12,685,224	9,732,488	2,952,736	3,357,515	2,976,952	380,563
Excess of revenues over (under) expenditures	(12,659,879)	(9,443,134)	3,216,745	(308,996)	2,305,022	2,614,018
OTHER FINANCING SOURCES (USES):						
Operating transfers in	-	425,775	425,775	2,100,000	695,000	(1,405,000)
Operating transfers out	-	(961,083)	(961,083)	-	(9,224)	(9,224)
Total other financing sources (uses)	-	(535,308)	(535,308)	2,100,000	685,776	(1,414,224)
EXCESS OF REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	$(12,659,879)	$(9,978,442)	$2,681,437	$1,791,004	$ 2,990,798	$ 1,199,794

The accompanying notes are an integral part of the financial statements.

Exhibit D

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT
SPECIAL REVENUE FUNDS
Combining balance sheet
June 30, 1983

	Statewide Economic Development Planning	State Mandatory Petroleum Allocation Program	Waimanu Valley Estuarine	Appropriate Energy Technology And Western S.U.N.	Energy Development And Management	N.S.F.-State Science, Engineering And Technology Program	Foreign-Trade Zone Services	Hawaii Capital Loan Revolving Fund	Aloha Tower Fund	New Vessel Construction Loan Revolving Fund	Financial Assistance Commercial Fishing Vessel Revolving Fund
ASSETS											
Cash with treasury	$49,910	$ -	$2,235	$5,522	$47,793	$3,327	$778,491	$1,610,386	$211,039	$1,420,074	$127,523
Notes receivable	-	-	-	-	-	-	-	4,136,614	-	3,385,090	681,376
Total assets	$49,910	$ -	$2,235	$5,522	$47,793	$3,327	$778,491	$5,747,000	$211,039	$4,805,164	$808,899
FUND BALANCES											
Reserved for continuing appropriations:											
Unallotted appropriations	$49,323	$ -	$2,235	$5,522	$47,793	$3,327	$675,576	$ 59,829	$139,579	$ 80,546	$ 15,838
Unencumbered allotments	-	-	-	-	-	-	-	1,550,557	-	1,339,528	111,685
Unliquidated encumbrances	587	-	-	-	-	-	102,915	-	71,460	-	-
	49,910	-	2,235	5,522	47,793	3,327	778,491	1,610,386	211,039	1,420,074	127,523
Reserved for notes receivable	-	-	-	-	-	-	-	4,136,614	-	3,385,090	681,376
Total fund balances	$49,910	$ -	$2,235	$5,522	$47,793	$3,327	$778,491	$5,747,000	$211,039	$4,805,164	$808,899

The accompanying notes are an integral part of the financial statements.

Exhibit D
(Cont'd)

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

SPECIAL REVENUE FUNDS

Combining balance sheet
June 30, 1983

	Hawaii Community Development Revolving Fund	State Disaster Revolving Loan Fund	Hawaii Invention Development Revolving Loan Fund	Contributions For Manganese Nodule Program	Contributions From State Agencies For Product Promotion	Contributions For Energy Projects	Contributions For Solar Energy Projects	Contributions For Marine Projects	Land Use And Physical Planning-Section 701	Coastal Zone Management Program	Total
ASSETS											
Cash with treasury	$184,232	$481,380	$140,000	$ -	$ -	$1,750,989	$ -	$7,890	$ -	$91,359	$ 6,912,150
Notes receivable	-	22,128	-	-	-	-	-	-	-	-	8,225,208
Total assets	$184,232	$503,508	$140,000	$ -	$ -	$1,750,989	$ -	$7,890	$ -	$91,359	$15,137,358
FUND BALANCES											
Reserved for continuing appropriations:											
Unallotted appropriations	$161,000	$ 303	$ 45,000	$ -	$ -	$1,701,653	$ -	$7,890	$ -	$ -	$ 2,995,414
Unencumbered allotments	23,232	481,077	95,000	-	-	-	-	-	-	91,359	3,692,438
Unliquidated encumbrances	-	-	-	-	-	49,336	-	-	-	-	224,298
	184,232	481,380	140,000	-	-	1,750,989	-	7,890	-	91,359	6,912,150
Reserved for notes receivable	-	22,128	-	-	-	-	-	-	-	-	8,225,208
Total fund balances	$184,232	$503,508	$140,000	$ -	$ -	$1,750,989	$ -	$7,890	$ -	$91,359	$15,137,358

The accompanying notes are an integral part of the financial statements.

STATE OF HAWAII

DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

Exhibit E

SPECIAL REVENUE FUNDS

Combining statement of revenues, expenditures and changes in fund balances
for the year ended June 30, 1983

	Statewide Economic Development Planning	State Mandatory Petroleum Allocation Program	Waimanu Valley Estuarine	Appropriate Energy Technology And Western S.U.N.	Energy Development And Management	N.S.F.-State Science, Engineering And Technology Program	Foreign-Trade Zone Services	Hawaii Capital Loan Revolving Fund	Aloha Tower Fund	New Vessel Construction Loan Revolving Fund	Financial Assistance Commercial Fishing Vessel Revolving Fund
REVENUES:											
Licenses and permits	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Interest earned	-	-	-	-	-	-	85,061	256,751	15,521	186,853	44,387
Federal grants in aid	52,650	-	140,655	8,625	435,848	-	-	-	-	-	-
Revenue from private sources	-	-	-	-	-	-	-	-	-	-	-
Charges for current services	-	-	-	-	1,253	-	793,570	-	-	-	-
Repayment of loans and advances	-	-	-	-	-	-	-	722,837	-	198,114	54,454
Total revenues	52,650	-	140,655	8,625	437,101	-	878,631	979,588	15,521	384,967	98,841
EXPENDITURES:											
General government	-	46,891	-	-	-	-	-	-	-	-	-
Conservation of natural resources	-	-	141,807	-	-	-	-	-	-	1,197,563	166,625
Economic development and assistance	19,033	-	-	10,053	454,975	-	936,727	752,262	304,482	-	-
Total expenditures	19,033	46,891	141,807	10,053	454,975	-	936,727	752,262	304,482	1,197,563	166,625
Excess of revenues over (under) expenditures	33,617	(46,891)	(1,152)	(1,428)	(17,874)	-	(58,096)	227,326	(288,961)	(812,596)	(67,784)
OTHER FINANCING SOURCES (USES):											
Operating transfers in	-	-	-	-	-	-	-	-	500,000	-	100,000
Operating transfers out	-	-	-	-	-	-	-	-	-	-	-
Total other financing sources (uses)	-	-	-	-	-	-	-	-	500,000	-	100,000
Excess of revenues and other sources over (under) expenditures and other uses	33,617	(46,891)	(1,152)	(1,428)	(17,874)	-	(58,096)	227,326	211,039	(812,596)	32,216
FUND BALANCES, beginning of year	16,293	46,891	3,387	6,950	65,667	3,327	836,587	5,609,893	-	4,618,311	679,239
INCREASE (DECREASE) IN RESERVE FOR NOTES RECEIVABLE	-	-	-	-	-	-	-	(90,219)	-	999,449	97,444
FUND BALANCES, end of year	$49,910	$ -	$ 2,235	$ 5,522	$ 47,793	$3,327	$778,491	$5,747,000	$ 211,039	$4,805,164	$808,899

The accompanying notes are an integral part of the financial statements.

Exhibit E
(Cont'd)

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

SPECIAL REVENUE FUNDS

Combining statement of revenues, expenditures and changes in fund balances
for the year ended June 30, 1983

	Hawaii Community Development Revolving Fund	State Disaster Revolving Loan Fund	Hawaii Invention Development Revolving Loan Fund	Contributions For Manganese Nodule Program	Contributions From State Agencies For Product Promotion	Contributions For Energy Projects	Contributions For Solar Energy Projects	Contributions For Marine Projects	Land Use And Physical Planning-Section 701	Coastal Zone Management Program	Total
REVENUES:											
Licenses and permits	$ 1,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 1,000
Interest earned	-	1,133	-	-	-	38,859	-	-	-	-	628,565
Federal grants in aid	-	-	-	-	-	-	-	-	-	863,000	1,500,778
Revenue from private sources	-	-	-	-	-	1,380,400	-	-	-	-	1,380,400
Charges for current services	-	-	-	-	-	-	-	-	-	-	794,823
Repayment of loans and advances	-	1,003	-	-	-	-	-	-	-	-	976,408
Total revenues	1,000	2,136	-	-	-	1,419,259	-	-	-	863,000	5,281,974
EXPENDITURES:											
General government	-	-	-	-	-	-	-	-	210,927	832,988	1,090,806
Conservation of natural resources	-	-	-	-	-	-	-	-	-	-	1,505,995
Economic development and assistance	-	-	-	26,000	-	535,026	4,480	2,110	-	-	3,045,148
Total expenditures	-	-	-	26,000	-	535,026	4,480	2,110	210,927	832,988	5,641,949
Excess of revenues over (under) expenditures	1,000	2,136	-	(26,000)	-	884,233	(4,480)	(2,110)	(210,927)	30,012	(359,975)
OTHER FINANCING SOURCES (USES):											
Operating transfers in	-	-	95,000	-	-	-	-	-	-	-	695,000
Operating transfers out	-	-	-	-	(9,224)	-	-	-	-	-	(9,224)
Total other financing sources (uses)	-	-	95,000	-	(9,224)	-	-	-	-	-	685,776
Excess of revenues and other sources over (under) expenditures and other uses	1,000	2,136	95,000	(26,000)	(9,224)	884,233	(4,480)	(2,110)	(210,927)	30,012	325,801
FUND BALANCES, beginning of year	183,232	502,375	45,000	26,000	9,224	866,756	4,480	10,000	210,927	61,347	13,805,886
INCREASE (DECREASE) IN RESERVE FOR NOTES RECEIVABLE	-	(1,003)	-	-	-	-	-	-	-	-	1,005,671
FUND BALANCES, end of year	$184,232	$503,508	$140,000	$ -	$ -	$1,750,989	$ -	$ 7,890	$ -	$ 91,359	$15,137,358

The accompanying notes are an integral part of the financial statements.

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

General Fund Accounts
Schedule of expenditures - budget and actual
for the year ended June 30, 1983

Functions	Actual Expenditures	Carryover Appropriations June 30, 1982	Carryover Appropriations June 30, 1983	Lapses Of Prior Appropriations	Expenditures Adjusted For Carryover Appropriations	Budgeted Appropriations	Variance- Favorable (Unfavorable)	Transfers And Other Credits	Lapses Of Current Appropriations
General government	$1,801,610	$ 179,081	$ 218,076	$ 1,957	$1,842,562	$ 1,677,872	$ (164,690)	$ 245,959	$ 81,269
Economic development and assistance	7,751,900	1,519,745	1,617,099	40,672	7,889,926	11,007,352	3,117,426	(781,267)	2,336,159
Urban redevelopment and housing	58,140	87,467	29,327	-	-	-	-	-	-
	$9,611,650	$1,786,293	$1,864,502	$42,629	$9,732,488	$12,685,224	$2,952,736	$(535,308)	$2,417,428

Schedule II

STATE OF HAWAII
DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

Special Revenue Funds
Schedule of expenditures - budget and actual
for the year ended June 30, 1983

Functions	Actual Expenditures	Nonbudgeted Expenditures (Actual)	Budgeted Expenditures (Actual)	Encumbrances	Expenditures Adjusted for Encumbrances	Budgeted Expenditures	Variance-Favorable (Unfavorable)
General government	$1,090,806	$ 257,818	$ 832,988	$ -	$ 832,988	$ 448,000	$(384,988)
Conservation of natural resources	1,505,995	1,505,995	-	-	-	-	-
Economic development and assistance	3,045,148	901,184	2,143,964	-	2,143,964	2,909,515	765,551
	$5,641,949	$2,664,997	$2,976,952	$ -	$2,976,952	$3,357,515	$ 380,563

PART III

RESPONSE OF THE AFFECTED AGENCY

COMMENTS ON AGENCY RESPONSES

On December 29, 1983, copies of a preliminary draft report of this financial audit were transmitted to the Governor, the presiding officers of the Legislature and to the Department of Planning and Economic Development (DPED). A copy of the transmittal letter to the department is included here as Attachment 1. As is our practice, we invited the department to comment on the recommendations made in the report. The department's response is included here as Attachment 2.

In his response dated January 19, 1984, the director of DPED submitted additional information and statistics on the loan programs administered by the department and additional background information on some of the examples cited in our report. The director also presents the view that because the department's loan programs assist higher-risk operations, the department does not expect loan delinquency rates to be comparable to commercial banks and feels that the record on delinquency is "very good." Our view, expressed in the report, is that better loans could be made and the delinquency rates improved. At June 30, 1983, 44 percent of the loans made under the Hawaii Large Fishing Vessel Loan Program, 53 percent of the loans under the Hawaii Small Fishing Loan Program, and 32 percent of the loans under the Hawaii Capital Loan Program were delinquent. These loan delinquency rates are high by almost any standard and indicate a need for further improvements in loan practices and loan management.

As to the specifics of the report, the director has expressed general agreement with all but two of the findings and recommendations in the report. One disagreement is over our finding that the department emphasizes collateral as a basis for making fishing vessel loans, rather than a review of future earnings to determine whether applicants can generate sufficient income to repay the loans. The director states that the department does not rely on the value of collateral as the primary consideration for the granting of loans but takes other factors into consideration. We continue to believe that earnings projections should be the primary basis for determining whether to grant a loan and that the department has not given this key factor sufficient attention.

The second disagreement is about our finding that there is a lack of business counseling in the loan programs. The director states that the loan officers spend 18 percent of their time on some form of counseling on the telephone alone in addition to counseling during initial interviews and at loan closings. We believe that there should be a more structured and systematic counseling program and that the department should develop some guidelines as to what activities constitute business counseling and when they should be provided.

One other point should be clarified. In our report, we stated that the department failed to realize interest revenues totaling approximately $300,000 in FY 1982-83, because it failed to issue the necessary instructions for investing moneys available in the various loan funds. The department believes our figure to be an overestimate. Our estimate was based on the average amount of funds available for loans in FY 1982-83 ($3.3 million), which was not invested on behalf of the respective loan funds, multiplied by an assumed 9 percent interest rate.

ATTACHMENT 1

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

CLINTON T. TANIMURA
AUDITOR

December 29, 1983

COPY

Mr. Kent M. Keith, Director
Department of Planning and
Economic Development
250 South King Street
Honolulu, HI 96813

Dear Mr. Keith:

Enclosed are two preliminary copies, Nos. 4 and 5, of our *Financial Audit of the Department of Planning and Economic Development.* We call your attention to the recommendations affecting your department which are made in Chapter 3 of the report. If you have any comments on the recommendations, we ask that you submit them in writing to our office by January 12, 1984, for inclusion in the final report.

The Governor and the presiding officers of the Legislature have been provided with copies of this preliminary report.

Since the report is not in final form and there may be changes to it, access to this report should be restricted to those officials whom you might wish to call upon to assist you in the review of the report. Public release of the report will be made solely by our office and only after the report is published in its final form and submitted to the Legislature.

We appreciate the assistance and cooperation extended to us.

Sincerely,

Clinton T. Tanimura

Clinton T. Tanimura
Legislative Auditor

Enclosures

ATTACHMENT 2

DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT

KAMAMALU BUILDING, 250 SOUTH KING ST., HONOLULU, HAWAII
MAILING ADDRESS: P.O. BOX 2359, HONOLULU, HAWAII 96804

GEORGE R. ARIYOSHI
GOVERNOR
KENT M. KEITH
DIRECTOR
JOHN R. PINGREE
DEPUTY DIRECTOR
MURRAY E. TOWILL
DEPUTY DIRECTOR

DIVISIONS
ECONOMIC DEVELOPMENT DIVISION
ENERGY DIVISION
335 Merchant St., Room 110, Honolulu, Hawaii 96813
FOREIGN-TRADE ZONE DIVISION
Pier 2, Honolulu, Hawaii 96813
HAWAII INTERNATIONAL SERVICES AGENCY
335 Merchant St., Room 248, Honolulu, Hawaii 96813
LAND USE DIVISION
PLANNING DIVISION
RESEARCH AND ECONOMIC ANALYSIS DIVISION

OFFICES
ADMINISTRATIVE SERVICES OFFICE
HAWAII FILM OFFICE
INFORMATION OFFICE
OCEAN RESOURCES OFFICE
TOURISM OFFICE

January 19, 1984

MEMORANDUM

RECEIVED
JAN 19 3 57 PM '84
OFC. OF THE AUDITOR
STATE OF HAWAII

TO: Mr. Clinton T. Tanimura
Legislative Auditor

FROM: Kent M. Keith Kent M. Keith

SUBJECT: Financial Audit of the Department of Planning and Economic Development (December 1983)

The Department of Planning and Economic Development appreciates the opportunity to respond to the preliminary audit report for our Department. We are pleased to note that our financial records and accounting are in good order and have received a good report from Coopers and Lybrand, especially considering the complexity of our accounts. These accounts include special and federal funds, projects like the Aloha Tower Development, revolving funds for loans and development programs, contributions for energy and marine projects and a number of others. We note that you have some criticisms and recommendations in the area of managing loans for small businesses and fishing vessels. Since no issues have been raised regarding our numerous other programs and accounts, our response addresses in detail your observations relating to the Hawaii Capital Loan Program and the Large Fishing Vessel and Small Fishing Vessel Loan Programs, which are part of our economic development efforts. In some cases, we are able to clarify the auditor's examples with further information; in others we can benefit from suggestions made in the report.

The following are our comments regarding DPED's economic development loan programs and the findings and recommendations of your audit.

The Department believes that not all standard banking practices and criteria can be applied to our programs. The original intent of legislators for these programs was to have DPED, as a lender of last resort, provide loans to businesses (fishing vessel loan applicants included) that are unable to obtain the necessary financing through conventional sources. This means that they cannot meet standard banking criteria, and are therefore "risky" by banking standards. It is the State's policy, however, to take these risks. This policy has resulted in tremendous benefits. The most important fact about our loan programs is that they are exceptionally successful. They are among the few State programs which generate far more tax dollars than they cost.

Mr. Clinton T. Tanimura
Page 2
January 19, 1984

The value of these loan programs may be demonstrated by considering the impacts of the Hawaii Capital Loan Program (HCLP) in comparison to its costs. A 1983 survey of 220 current and former HCLP clients showed that about 1,350 jobs were directly created by the program and another 1,200 indirectly generated through secondary effects. It was also shown that the greater production caused by this one loan program alone generates in the neighborhood of $4 million annually in added State taxes. This compares quite favorably with the 1983 costs of servicing the HCLP, as well as the Large and Small Fishing Vessel Loan Programs and the Disaster Loan Program, which were about $145,000 ($95,000 for personnel; $15,000 for supplies, equipment, rental, postage, etc.; and $35,000 in defaults). Considering both the $3.8 million revolving fund appropriation and the approximately $1.2 million in other expenses over the life of HCLP, it has aided in the creation of one job for each $2,000 spent.

The last State appropriation to the HCLP revolving fund available for loans was in 1980 and the fund is now self-renewing through interest payments and payments on principal. Interest payments of $300,000 in 1983 were, by themselves, double the administrative costs of the whole program. The write-off rate for the whole program is 2.4 percent, which is comparable to that expected by commercial institutions in spite of the greater risk involved.

In the survey, 49 percent of the respondents in the Hawaii Capital Loan Program (the most active of five DPED loan programs) reported that the program's financial assistance "helped our business to survive."

Here is a summary of the survey findings:

Date of Survey: November 1983
220 Firms Surveyed
110 Firms Responded

Summary of Businesses Surveyed

Total employment		5,300
Current annual payroll		$ 60,000,000
Gross annual revenue		$340,000,000
Taxes:	Gross Excise	$ 7,000,000
	State Income	$ 650,000
	Real Property	$ 500,000

Estimated Direct Impact of Hawaii Capital Loan Program

Employees added by loan effect	1,350
Current annual payroll	$ 15,000,000
Gross annual revenue	$ 85,000,000
Local taxes	$ 2,000,000

In the above table, "Estimated Direct Impact of HCLP," the number-of-workers figure (added employment) was derived from the survey responses. Since this added employment makes up about 25 percent of total employment, payroll, revenue and taxes were estimated using this ratio.

The five loan programs are managed by a branch chief, two loan officers and a clerk-steno. Whereas commercial banks have many departments to handle different loan functions, our staff must handle all responsibilities, including interviewing prospective applicants, analyzing and presenting credit requests, preparing all documentation, and servicing and following up on loans for all islands. Our loan officers process about twenty-five new loans a year, and service about 225 additional ongoing loans. (In addition, they have other duties, like serving on department-wide task forces and committees.)

It should also be noted that the loan presentations (for loans in the period covered by the audit) were scrutinized by a loan review committee consisting of DPED Advisory Board members who reviewed all loan presentations. (The 1983 Session of the State Legislature abolished the Board.) The loan officers made their presentations to the loan review committee members who in turn made their recommendations to the Director.

The Department agrees that loan management practices can and should be improved. To "become more actively involved in counseling and training borrowers," however, would require at least two additional loan officers and two loan assistants. Our present staff members are spread too thinly to meet the needs of all of our programs.

The audit review also points out the delinquent rates of the various programs and indicates that "better loans could be made and the delinquency rate improved if emphasis were placed on the applicants' ability to repay a loan through the earnings of the business." We believe that the legislated intent for the programs allows for delinquent rates higher than in normal banking practice. As a lender of last resort, we do not expect our rates to be comparable to commercial banks. The intent of the State program is to assist higher-risk operations not considered bankable, and to supplement loans when private sector funding is not sufficient.

The Department is satisfied with the progress made in the decline in the Large Fishing Vessel Loan Program's delinquency rate. When the program was transferred from DLNR to DPED in 1976, 100 percent of the loans on the books were considered delinquent. As of June 30, 1983, and as reported by the auditor, the delinquency rate had dropped to 44 percent. This improvement--a decline in the delinquency rate of 56% over seven years--should be an indication that our loan management has made remarkable progress in the right direction.

We feel that the record on delinquency is very good considering our mandate and the substantial benefit derived from our programs. Since the inception of the loan programs in 1963, 28 loans totaling $326,795 have been considered uncollectible and written off. This represents only two percent of the total State financing of $19,558,603, and only 1.4 loans per year.

Following are our responses to specific areas of concern:

I. Compliance with Rules and Regulations.

A. Although the Auditor found instances where the rules were not being observed, we feel the examples in the preliminary report merit more detailed discussion.

Verification of Information by the Applicant.

The rules and regulations governing the loan programs were established as guidelines to administer these programs. As such, Section 15-3-5(c) of the Rules and Regulations of the Fishing Vessel Loan Program has been interpreted by the Department to mean that verification of all information provided by the borrower is an option of the Department and not a mandate. The rule stating "all information supplied by the applicant shall be subject to verification" [emphasis added] serves as a notice to the applicant rather than a requirement to check all information in every case.

Information currently requested by the loan applicants generally includes a completed loan application; current financial statements; copies of income tax returns; personal financial statements; background of the business; history of its management; fish catch reports; type of fishing; insurance coverage; etc. In essence, the information requested from the loan applicant is voluminous. It would appear that verification of all information provided would be very costly (loan applicants must bear all costs) and would cause excessive delay for loan approval.

Current practice is that a review of the loan package is made by the Department and additional information is usually requested and verified when valuations of assets appear out of line. Our loan officers all have had experience in bank loan departments and do not deviate from good banking practices except to the extent our mandate demands (discussed above).

Additionally, information provided in the loan application is verified through the following services:

1. Dun and Bradstreet.
2. Chilton Credit Reporting-Honolulu.
3. Applicant's bank of account.

Loans under these programs are made either in participation with other financial institutions or directly from DPED. Under the Hawaii Capital Loan Program, participating banks are charged with the responsibility of verifying information provided by the loan applicant. Since 1981, participating loans made under the Hawaii Capital Loan Program comprised more than 61 percent of the total loan portfolio. Hence, a majority of the loans are verified by the participating banks.

Of the direct loans, 16 percent were loans made to new businesses with little or no account relationships established with banks. In most instances where loans are made to existing businesses, oral contact is made with bank loan officers to assess the applicant's overall credit and loan needs. Although undocumented, these confidential conversations also assess the account relationship with the bank. In the future, DPED will pay closer attention to the possibility of documenting these conversations.

Although actual real estate appraisals are currently provided in some instances, the Department will, as a result of your audit, require that all loan applicants provide notices of real property tax assessments for valuation of real property.

B. Borrower's financial data reports.

The Department agrees that the requirement of obtaining and reviewing annual financial statements subsequent to loan approval is an important function. However, due to staff constraints, DPED's efforts have been concentrated on the obtaining and reviewing of annual statements on delinquent loan accounts. Henceforth, DPED will increase its efforts to obtain annual financial statements on both non-delinquent and delinquent loan accounts.

C. Hull insurance.

DPED concurs with the report that hull insurance is an important fishing vessel loan condition and, as such, has actively pursued its placement on all boats secured as collateral in our loan program. As a general rule, DPED has not required hull insurance on the vessel until either the title has passed, or the vessel is operational in the water.

The example cited in the report was a $30,400 loan made for the construction of a fishing vessel. In this instance, hull insurance was placed on the vessel by the borrower on August 5, 1982. The title to the vessel was turned over to the borrower on August 2, 1982. However, the boat builder was still doing finishing work on the vessel at his place of business and did not turn over physical possession of the vessel until after August 10, 1982. During the construction period and up to the time of physical transfer of the vessel, any damage to the vessel was covered under the boat builder's insurance policy. Requiring double insurance coverage in this instance would have been costly ($1,340 annually) and excessive for the borrower. Hull and other insurance coverage are a major fixed cost for fishermen. The vessel was adequately insured either by the boat builder's insurance policy or by hull insurance.

II. Evaluation of Loan Applicants.

A. Projections of income and expenses.

DPED concurs with the audit report that projections from loan applicants should be carefully scrutinized and supplemented with additional data where necessary.

In the example cited where a working capital loan of $40,000 was granted to a small business firm, data substantiating the projections were provided as part of a 17-page, in-depth financial analysis and financing proposal prepared by the Hawaii Economic Development Corporation (HEDCO). At that time, HEDCO had a contract with the U.S. Department of Commerce, Minority Business Development Agency, to provide minority businesses in Hawaii with financial, management, marketing and technical assistance. Due to limited staff and other resources, DPED often refers potential loan applicants to loan packaging agencies such as HEDCO, U.S. Small Business Administration, the Chamber of Commerce of Hawaii, and others listed in the Yellow Pages.

In the past year, the subject firm's gross revenues experienced an increase of more than five times, from $29,582 to $185,413, due to growth in all of its current product lines. With the addition of five new products to its current lines and the addition of two additional employees to its current staff of three, the firm felt confident in tripling its sales within the next two years. In its report, HEDCO provided detailed sales projections for each product on a monthly basis for 1982 and 1983. In its cover letter of the report, HEDCO stated that "Projections of future business activity have been developed by us (HEDCO) in conjunction with (the principal of the firm) and represent, in our opinion, a conservative estimate of future operations based on information available to date."

The approval of the loan was also based on the following factors:

1. Historic track record. The business and its principal have been in business since 1975 and the firm has been profitable since its inception.

2. Adequate ability to repay loan. The firm's net income of $20,296 before interest and depreciation expense for the fiscal year 1981 showed adequate ability to service this additional debt of $9,618 per annum including interest expense.

3. Management experience. The principal of the firm, born and raised in Hawaii, has been in this line of business since 1975. Additionally, he has been in various managerial positions with other firms since 1969.

4. Satisfactory credit rating. Credit reports received from Dun and Bradstreet, Inc. and the Chilton Credit Reporting-Honolulu indicated satisfactory ratings.

5. Adequate collateral. In addition, a blanket security interest on all assets of the firm valued at about $66,600, plus personal guarantees, were taken on the principals of the firm--including a mortgage on their residence with an equity of about $27,300.

In the second example cited, DPED's loan analysis did establish the fact that the revenue projections of the loan applicant were overly optimistic and listed this as a negative factor. However, the loan was granted based on the following positive economic factors:

1. The firm assembled electronic parts in the high-technology industry which has a high priority under the Hawaii State Plan and the Governor's economic development strategies. The firm employed 16 persons and had anticipated hiring an additional four employees after the loan approval.

2. The principal stockholders injected more than $288,000 cash equity into the firm as compared to DPED's loan investment of $75,000 (current balance, $57,000).

3. The firm had started production and had met initial quality specifications and service requirements under its contract.

4. Management appeared to have adequate technical knowledge and managerial ability to run the firm.

5. One of the stockholders had substantial net worth for possible additional financial resources in the future.

As noted in the foregoing, DPED does not place heavy reliance on projections as a major criteria on loan approvals. Decisions are also based on other factors such as the firm's existing track record, adequate repayment ability, credit rating, management experience, marketing plan, collateral, etc.

B. Reliance on collateral.

DPED does not rely on the value of the collateral as the primary consideration for granting a loan. In all of the loan presentations, other factors were taken into consideration.

In the example of the large fishing vessel loan for $240,000, we concur that the projections were barely sufficient to service the debt on the loan. However, there were other considerations for granting this loan.

1. The principal is an experienced commercial fisherman and he has assisted in and enhanced the development of the commercial fishing industry in the State of Hawaii.
2. If the vessel were not sold to the applicant, it would have been removed from Hawaiian waters and returned to the West Coast.
3. The principal had a satisfactory credit rating.

The loan was assumed in June 1983 by a new limited partnership which is now engaged in successful shrimping operations. The loan repayments are current.

In the example of the large fishing vessel loan for $172,000, satisfactory financial data were provided by the applicant. The applicant's ability to repay the loan was based primarily on his past commercial fishing experience and his track record with DPED. The applicant provided the following documents for our review.

1. Tax returns for calendar years 1980 and 1981.
2. Gross sales reports from his wholesaler for calendar year 1982.

Therefore, we feel that a detailed review of the loans cited in the draft audit indicates there was substantial and sufficient evaluation of loan applicants.

III. Loan Disbursement Practices.

A. Disbursements on construction loans.

We concur that payments for construction loans should be made progressively and in relation to the state of completion of construction.

In the example cited, the applicant served as the owner/general contractor to construct the vessel. The initial loan amount to construct a 63-foot steel hull commercial fishing vessel was very low considering market values of similar size vessels. However, because of the borrower's background, DPED initially expected that the loan requested by the borrower was adequate to complete the vessel. During construction, the borrower became aware that the loan amount was inadequate due to the following:

1. Construction took longer than expected.

2. Increases in prices of supplies and equipment.

3. Items not included in the original estimate.

With additional funding, the vessel was completed in February 1983.

B. Disbursement without invoices.

The majority of loan disbursements are made on approved invoices provided by the borrowers. The payments are made directly to suppliers or contractors and the borrower.

Payments may have been made directly to the borrower under the following circumstances:

1. Reimbursement for items purchased by the borrower or for payment made for work completed. The borrower provides either cancelled checks or paid receipts or invoices.

2. The borrower provides an estimated listing of items to be purchased or work to be completed. After payment is made, the borrower will submit confirming copies of cancelled checks, paid receipts or invoices. This procedure is utilized to expedite the transaction. Otherwise, the borrower would have to obtain individual invoices from numerous vendors causing considerable delay.

3. The loan proceeds were to be utilized for the purchase of inventory, for working capital and for accounts payable.

IV. Loan Management Practices.

A. Business counseling.

The Department does not agree with the audit statement regarding lack of business counseling. The report indicates that the position description of the loan officers requires that 15 percent of their time be spent on either consulting or training borrowers, but that the loan officers have not done this. The consultation or training given may be in various forms (telephone conversations, field visits, etc.) which are often undocumented. For example, the loan officers have tallied the telephone servicing during the past five months with the following results:

	Telephone Calls: Loan Inquiries	Telephone Calls: Servicing the Loans
Hawaii Capital Loan Program	309	969
Large & Small Fishing Vessel Loan Program	161	371
	470	1,340

It is estimated that more than 18 percent of each loan officer's time was spent on some form of counseling on the telephone alone. This is based on an average of 15 minutes per phone call and does not include field trips, office visitations, etc.

Because of staff constraints, the loan officers have been unable to make as many field trips as desired. In all instances, however, prior to loan approvals or loan disbursements, site visits are made. Counseling is also given at loan closings as well as during initial interviews.

B. Documentation in loan folders.

We concur that various actions taken in connection with a loan must be fully documented to provide a historical record of the loan and to protect the interest of the State.

Loan accounts are being serviced by on-site visitations, meetings with borrowers and/or participating lenders and phone calls, with some actions recorded in the loan files. Despite the shortage of staff, we will work harder to document additional significant actions taken relative to the respective loan accounts.

C. Fishing vessel title searches.

Fishing vessel abstracts of title for existing large fishing vessels registered with the U.S. Coast Guard are verified by the Department but not necessarily documented. The loan officers either personally examine the abstract of title or contact the personnel at the U.S. Coast Guard to verify ownership and lien holders. Likewise, the existing small fishing vessels' ownership and lien holders are verified with the Department of Transportation. Henceforth, the Department will note the title searches in the loan file.

D. On-Site Visits.

On-site visits to both Hawaii Capital Loan and Fishing Vessel Loan applicants and borrowers are conducted by the Department but often are not documented in the loan files. The Department will henceforth note these visits in the files.

E. Enforcement of net earnings clause.

The net earnings clause is a relatively new tool used by this program to induce firms to repay their outstanding loan balances at an accelerated rate should they achieve successful years earlier than anticipated.

The Department has established a "tickler" system on loans that have a net earnings clause and has attempted to obtain financial data to enforce this loan condition. In the future, the Department will seek to better enforce this loan condition.

However, there will be instances where this loan condition should be waived due to extenuating circumstances. The rules and regulations that govern the loan programs are only guidelines. They give the Director of the Department flexibility to administer these loans so as to allow for any unique or extenuating circumstances that may occur for each loan account.

The example cited was a participation loan made in 1978 together with a local bank and the U.S. Small Business Administration (SBA). As it was the firm's first profitable year, it requested a waiver of the net earnings clause for the 1981 fiscal year because working capital was needed to fund its rapid growth. It was recently awarded a substantial contract and needed these funds to purchase additional inventory.

During the period in which the request for the waiver of the net earning clause was made, the firm also requested release of advances from stockholders. The justification for this request was that the principal stockholders have been reinvesting most of their earnings into the business since its inception. During hard times when cash was insufficient, they withheld their own salaries to meet the firm's bills and keep the firm afloat. In 1975, the principals had to refinance their existing residential mortgage to inject needed working capital into the business. Additional advances were made by the principals in subsequent years. During this time, they did not make some needed improvements as most of their earnings had to be invested into the business. A major roof leak at the residence of the principals was attended to by drilling a hole in the floor so that the water could be drained whenever it rained. Hence, when the firm established its first profitable year in 1981, the principals requested the release of their advances to the firm in order to undertake the critically needed home improvements. As their residence was also hypothecated as collateral, any home improvements would increase the value of this loan's security position. Concurrently, additional funds have been injected into the firm through the sale of capital stock to key employees. As the net effect of these transactions did not dilute the equity base of the firm, the bank, SBA and this Department did not feel that the request was unreasonable.

V. Investment of Funds for Benefit of Loan Programs.

We agree that idle funds should be invested for the benefit of the respective loan programs. The loan staff previously inquired as to the possibility of investing idle funds but were informed by fiscal staff, who are no longer with us, that this could not be done. Since September 1983, however, we have been instructing the Department of Budget and Finance to invest funds which are not immediately required for disbursements.

We cannot comment specifically on the report that $300,000 might have been realized in revenue by investing idle funds without knowing how the auditor estimated this figure. We have reviewed our fund records and believe this figure to be an over-estimate.

VI. Automation of Accounting for Loans.

We agree that automating the accounting for loan programs would increase the efficiency of operations, and in the past we have studied the feasibility of automating with the equipment we have available. We have determined that DPED's in-house mini-computer cannot handle the special accounting requirements of the loan revolving funds. For example, we compute interest rates for each individual loan based on date of receipt (and not on the same date for all accounts each month).

We plan to review alternatives for automating the accounting for loan funds with the Department of Budget and Finance and the Department of Accounting and General Services. Our word processing equipment does not provide the capability for computing and we do not expect to be able to purchase data processing equipment in the near future. We have consulted with other departments which manage loan funds and none has as yet devised any better system.

DPED will take steps to implement appropriate recommendations as stated in the foregoing, and will take the auditor's recommendations as an opportunity for improvement in our management. Some steps may be hampered by the limited number of staff. In spite of limitations, the loan programs have been generally well-managed, and have made a vital contribution to the development of small business and the fishing industry in Hawaii.

For the Department as a whole, we appreciate the efforts of the Office of the Auditor and are satisfied that the review shows we are very close to meeting our Departmental mandates with good financial records and appropriate management practices.