Audit of the Office of Hawaiian Affairs

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

Report No. 97-7
February 1997

THE AUDITOR
STATE OF HAWAII

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Submitted by

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Foreword

This audit of the Office of Hawaiian Affairs responds to Section 10-14.55, Hawai'i Revised Statutes, which requires my office to conduct an audit of OHA at least once every four years. The purpose of the audit was to describe and assess OHA's management controls over its programs and its cash and investments.

We retained the firm of KPMG Peat Marwick LLP to assist us in reviewing OHA's management controls over its cash and investments. Chapter 3 of our report presents the results of the firm's review.

We wish to acknowledge the cooperation and assistance extended to us by officials and staff of OHA during the audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction and Background

The Office of Hawaiian Affairs (OHA) is a corporate body and public agency established by the State Constitution. Its mission is to better the conditions of all persons of Hawaiian ancestry. OHA carries out its mission through activities in such fields as education, economic development, and Hawaiian culture, and through advocacy. Principal fund sources include revenues from a public land trust, state general funds, and federal funds.

This is our first audit of OHA pursuant to Section 10-14.55, Hawai'i Revised Statutes (HRS), which requires the State Auditor to conduct an audit of the agency at least once every four years. Previously we issued audit reports on OHA in February 1990 and December 1993 pursuant to other legislative directives.

Background

Establishment of OHA

OHA was established by Article XII, Section 5 of the State Constitution, an amendment resulting from the 1978 Constitutional Convention. The constitution provides that OHA shall hold in trust for native Hawaiians and Hawaiians all real and personal property set aside or conveyed to it. "Native Hawaiians," as defined in the federal Hawaiian Homes Commission Act of 1920, must have at least 50 percent Hawaiian blood. The term "Hawaiians" includes *all* persons of Hawaiian descent.

Chapter 10, HRS, charges OHA with the task of serving as the principal public agency in the state responsible for the performance, development, and coordination of programs and activities relating to native Hawaiians and Hawaiians, except for programs administered by the Hawaiian Homes Commission. The statute also makes OHA a separate entity independent of the executive branch.

Board and administration

The State Constitution requires that OHA be governed by a Board of Trustees of at least nine members who are Hawaiian and elected by Hawaiians. Kaua'i, O'ahu, Moloka'i, Maui, and Hawai'i each must have at least one representative on the board. Trustees serve staggered four-year terms. Currently, the board has nine members, all of whom receive salaries and have personal staff to assist them in their work.

The board is OHA's policy-making body. As required by law, the board has appointed an administrator who serves as the agency's principal executive. The Office of the Administrator is responsible for executing board policies, carrying out OHA's goals and objectives, and managing agency operations. The administrator hires all staff, but the trustees' staff are selected by the trustees. Currently, OHA has a total of 99 employees (this number includes 8 part-time and 10 emergency hires—but does not include the trustees themselves). OHA also pays outside consultants and private providers to carry out many of its activities.

Offices and divisions

Those OHA staff who work under the administrator are organized into two main areas—programs and operations—each under a deputy administrator. The program areas include: economic development, education, health and human services, housing, land and natural resources, and volunteer services. The operations areas include personnel and the offices of administrative services, culture, government affairs, public information, and planning and research. Community resource coordinators operate on the islands of Kaua'i, Moloka'i, Maui, and Hawai'i (offices in Hilo and Kona). (See Exhibit 1.1.)

Revenues, investments, and expenditures

OHA has two principal sources of funds: (1) revenues generated by the public land trust (and the income earned on investing those revenues), and (2) funds appropriated by the State Legislature.

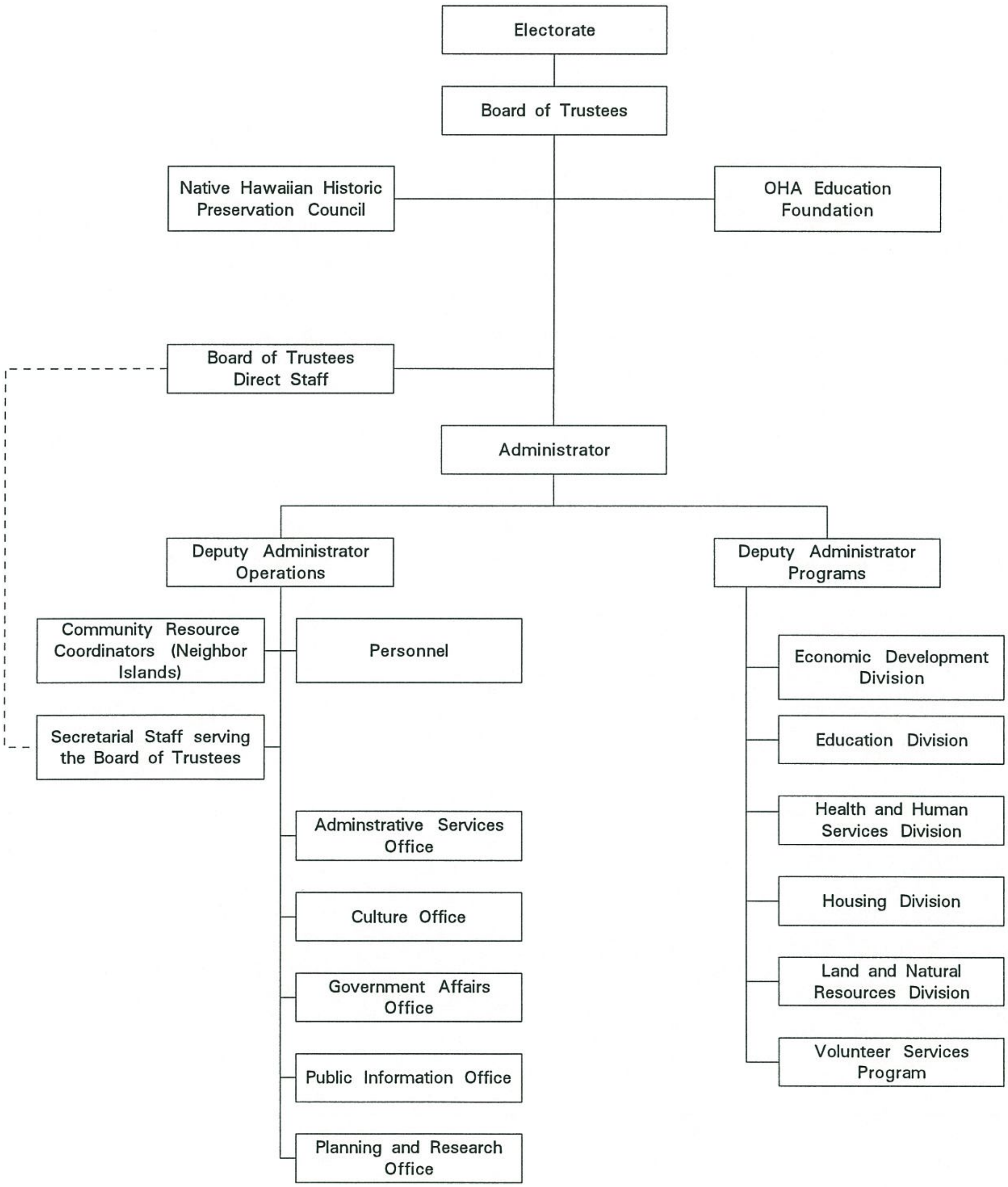
Certain lands ceded to the United States when Hawai'i was annexed as a territory in 1898 were returned to the State upon statehood in 1959. The Admission Act of 1959 mandated that these ceded lands and their proceeds and income be held in a public trust for several purposes, including the betterment of the conditions of native Hawaiians.

In 1978, by amendment to the State Constitution, a public trust that holds ceded lands (but excludes available land under the Hawaiian Homes Commission Act of 1920) was established for native Hawaiians and the general public.

Subsequently, Act 273 of 1980 designated 20 percent of the revenues of this public land trust as OHA's share. Act 304 of 1990 required that OHA use this share exclusively to better the conditions of native Hawaiians (not all Hawaiians). Thus, when serving Hawaiians who do not meet the "blood quantum" requirement for native Hawaiian status—50 percent or more Hawaiian blood—OHA is limited to using general fund appropriations or other sources of funding, such as federal funds.

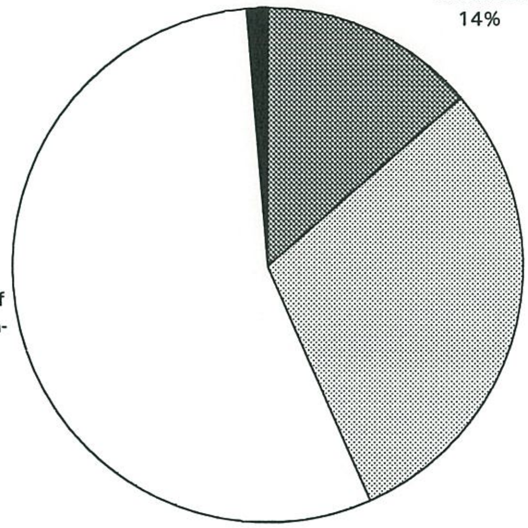
OHA received $5.4 million, $18.7 million, and $25.1 million as its share of annual trust revenues for the years ended June 30, 1993, 1994, and 1995, respectively. Exhibit 1.2 shows the sources of OHA's land-trust

Exhibit 1.1
Office of Hawaiian Affairs
Organization Chart
January 1996



Source: OHA

Exhibit 1.2
Sources of OHA's Public Land Trust Receipts, FY1994-95



*Approximately 68 percent of the revenues from Department of Transportation-Harbors were payments collected during FY1994-95 for prior years.
**"Other" includes revenues received from Department of Agriculture; Department of Business, Economic Development, and Tourism; Department of Accounting and General Services; and Department of Education. Approximately 23 percent of these revenues were payments collected during FY1994-95 for prior years.

Source: Internal financial documents provided by OHA.

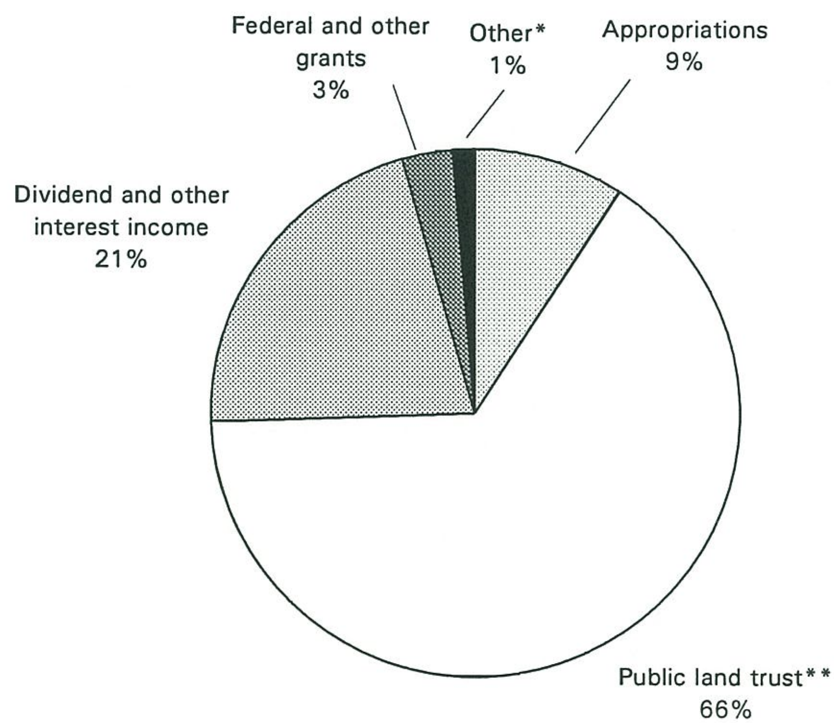
receipts for FY1994-95. Eighty-five percent of the trust revenues came from revenues generated by the state Department of Transportation.

For OHA's first year of existence, FY1980-81, the Legislature appropriated only general funds. From FY1981-82 through FY1986-87, the Legislature appropriated general funds and required that OHA match these one-to-one with funds from its land-trust revenues (which currently appear as "special fund" appropriations in the budget laws). General fund appropriations increased from $225,000 for FY1980-81 to $3,580,234 for FY1993-94. Special fund appropriations grew from $415,466 for FY1981-82 to $3,952,886 for FY1993-94.

Exhibit 1.3 shows the sources of OHA's $38.5 million in revenues for FY1994-95: the public land trust; dividend and other interest income; appropriations; federal and other grants; and revenues from other sources.

OHA has placed most of its land-trust revenues in long-term investments. During FY1992-93, these investments increased in value from approximately $10.6 million to $152 million. This increase was due primarily to a $134.6 million settlement between OHA and the State of Hawaii on amounts owed to OHA from its 20 percent share of the revenues of the public land trust going back well over a decade. As of March 31, 1996, OHA had nearly $188.8 million in long-term investments. OHA does not use its long-term investment funds for annual

Exhibit 1.3
Sources of OHA's Revenues, FY1994-95



*"Other" includes revenues from the Native Hawaiian Rights Fund, newspaper ads, donations, and non-imposed fringe benefits.
**Approximately 38 percent of the public land trust revenues includes payments collected during FY1994-95 for prior years.

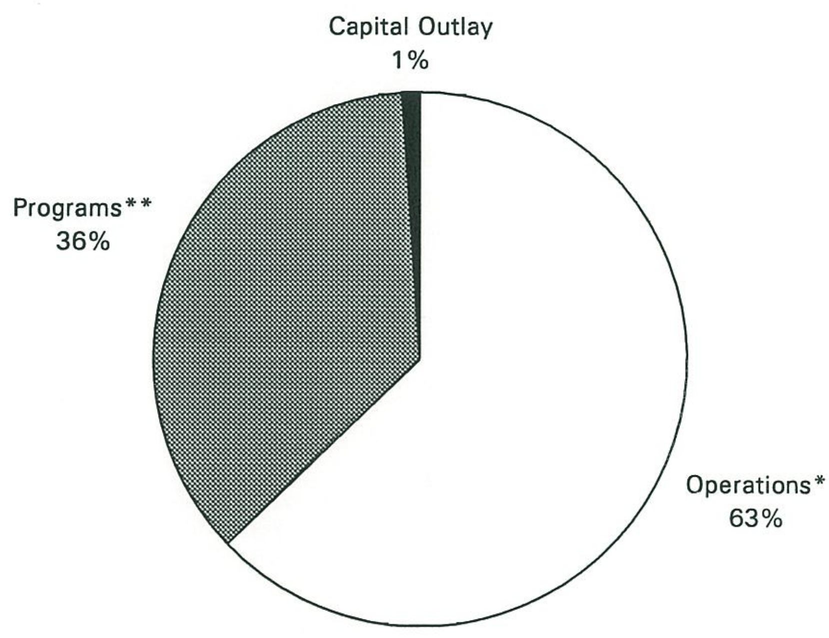
Source: OHA's audited financial statements for FY1994-95 and internal financial documents provided by OHA.

operating expenses. Instead, it uses its land-trust annual revenues, general fund appropriations, and federal funds. OHA maintains cash and short-term investment accounts for these funds.

OHA expends more than general funds and its legislatively appropriated special funds. OHA and the Legislature have generally followed the practice of matching general funds with special funds (land-trust revenues) for appropriations for OHA's operating budget. However, OHA has reported special fund expenditures above and beyond its legislatively appropriated special funds.

OHA's total expenditures increased from about $7.7 million for FY1991-92 to $15.6 million for FY1994-95. Exhibit 1.4 shows expenditures for FY1994-95 by type: operations, programs, and capital outlay.

Exhibit 1.4
OHA's Expenditures by Type, FY1994-95



*"Operations" includes policy/administration, administrative services, public information, planning/research, culture, and government affairs. Of these, 49 percent are for policy/administration.
**"Programs" includes health/human services, land/natural resources, economic development, education, and housing.

Source: OHA's audited financial statements for FY1994-95.

Programs and activities

OHA operates its own programs and projects serving native Hawaiians and Hawaiians, and also funds organizations serving these groups. The agency provides educational and community-based economic development grants to organizations; makes one-time donations to individuals experiencing hardship; supports Hawaiian culture, arts, and historic preservation; and advocates for Hawaiian entitlements.

Major activities of the various divisions include the following:

- The Economic Development Division makes low-interest loans to high-risk, Hawaiian-owned businesses; provides technical assistance and training; and researches venture proposals.

- The Education Division runs tutorial projects, works on Hawaiian culture and other educational programs such as the ʻAha Kupuna Project (traditions of Hawaiian elders) and ʻAha ʻOpio (youth leadership development), runs a scholarship program, and staffs the OHA Education Foundation.

- The Housing Division—the newest division—has developed a housing plan that includes self-help housing projects.

- The Land and Natural Resources Division concentrates on ensuring the receipt of land-trust revenues, running the Native Hawaiian Land Title Project, reviewing environmental assessments, and facilitating dialogue with Hawaiian sovereignty groups.

- The Health and Human Services Division is involved in the Waiʻanae Diet program and referral services of Alu Like Inc.

Public information and relations are handled by the Public Information Office. The Planning and Research Office runs the Grants, Subsidies, Purchase of Services, and Donations program. It also conducts evaluations, and compiles data on Hawaiians. The Culture Office handles Hawaiian culture and arts issues. The Government Affairs Office performs legislative monitoring, coordinates testimony, and drafts and tracks bills.

Prior Audits of OHA

We issued two prior audits of OHA: *Management and Financial Audit of the Office of Hawaiian Affairs*, Report No. 90-11 (February 1990); and *Management and Financial Audits of the Office of Hawaiian Affairs*, Report No. 93-28 (December 1993).

Our 1990 audit found that OHA needed a program management system to ensure that activities and projects are adequately planned, appropriately initiated, and consistently monitored, and that trustees and administrators are apprised of progress. We also found that OHA lacked a budget policy and adequate expenditure reports.

Our 1993 audit found that the board's relationship with the administrator and staff was sometimes blurred. We also found that OHA did not have up-to-date plans and complete policies and procedures. OHA also failed to follow its fiscal procedures and program evaluations were not being used productively.

Objectives of the Audit

The objectives of the present audit were to:

1. Describe and assess the Office of Hawaiian Affairs' management controls over its programs.
2. Describe and assess the Office of Hawaiian Affairs' management controls over its cash and short-term investments.
3. Describe and assess the Office of Hawaiian Affairs' management controls over its long-term investments.
4. Make recommendations as appropriate.

Scope and Methodology

We reviewed and evaluated OHA's management controls over its budgetary programs, services, projects, cash and short-term investments, and long-term investments.

Our examination of OHA's management controls over its programs focused on activities from 1994 to 1996 because OHA received the majority of its land-trust revenues in 1993 and we last audited OHA in that year.

Our work in the area of program controls included a review of planning, monitoring, evaluation, budgeting, and other management controls affecting working relationships at OHA. We focused in particular on the Education, Health and Human Services, Economic Development, and Housing divisions and on relationships among the Board of Trustees and the administration.

We examined program files, funding sources, internal correspondence, news articles, board and committee meeting minutes, planning documents, accounting documents, and budget documents. We met with all OHA trustees, the administrator, deputy administrators, division and office heads, and selected staff members. We observed a board meeting.

We engaged the services of KPMG Peat Marwick LLP to assist us in describing and assessing OHA's management controls over its cash and its short- and long-term investments. The firm's work focused on account balances and management controls existing as of March 31, 1996.

The firm assessed OHA's management controls over its cash and short-term investments derived from its annual trust revenues. This included examining whether cash and short-term investments are managed in a manner consistent with OHA's overall investment plans and annual operating cash needs.

The firm also assessed whether OHA has an overall plan for its long-term investments, whether the long-term investment strategies employed are consistent with its long-term investment policy, and the method by which OHA's investment managers and its money monitor, Merrill Lynch, were selected and their performance monitored and evaluated. The firm also considered the timeliness and understandability of investment reporting to OHA.

Our work was performed from December 1995 through December 1996 in accordance with generally accepted government auditing standards.

Chapter 2

OHA Needs Better Working Relationships and Clearer Direction for Its Programs

Successful organizations establish effective management controls. The term "management controls" refers to the organizational structure, methods, and procedures by which managers ensure that an organization meets its goals. Controls include the organization's processes for planning, organizing, directing, and controlling program operations. They also include the organization's systems for monitoring, measuring, and reporting program performance.[1]

This chapter describes and assesses the effectiveness of certain management controls established by the Office of Hawaiian Affairs (OHA) over its programs. We begin by examining controls affecting working relationships among the members of OHA's Board of Trustees and between the board and OHA's administrative staff. The chapter also focuses on OHA's program planning, monitoring, evaluation, and budgetary processes. In particular, we examine management controls that affect OHA's education, health and human services, economic development, and housing programs.

Our 1990 audit of OHA found that OHA lacked a program management system to ensure that activities and projects are adequately planned and consistently monitored. Our 1993 audit recognized that OHA had implemented a number of programs, but found that OHA lacked adequate management controls, such as proper planning and evaluation, to direct its operations. Relationships between trustees and staff were sometimes blurred and OHA failed to follow its fiscal procedures.

In the present audit, we found that OHA's management controls still need improvement.

Summary of Findings

1. Working relationships at OHA need improvement. Certain practices of individual trustees or the board as a whole contribute to discontent, suspicion, and discord. Also, the board's decisions are not easily accessible by trustees or staff.

2. OHA's program-planning process does not ensure clear direction. Key plans are outdated, there is no long-range plan for OHA's major financial resource, guidelines on the impact of blood quantum requirements are not clearly identified, and implementation of the plans is in question.

3. OHA's monitoring of the programs conducted by recipients of its funds in the four divisions that we focused on is limited and does not always yield useful information. More site visits are needed. Monitoring is sometimes loose and lacking in substance.

4. OHA's program evaluation efforts could be more productive. Better guidelines for deciding what programs to evaluate and earlier identification of evaluation criteria are needed. OHA itself is sometimes dissatisfied with the quality of the evaluations.

5. OHA's budgetary process does not ensure the effective and efficient use of resources. The process does not include the use of long-term investments, all trust-fund appropriations, adequate financial reports to trustees, and consistent procedures.

Certain Practices and Problems Weaken Working Relationships

OHA needs to attend to practices and problems that erode working relationships among trustees and staff. Tensions among certain members of the Board of Trustees have undermined the "feeling of social ease and rapport"[2] that is so important to effective governing boards. Relationships between some trustees and staff have also been strained.

Some trustees circumvent OHA's policy of requiring trustees to communicate with staff through the administrator. Indefinitely deferring committee recommendations limits trustees' participation in decision making and contributes to suspicion and distrust.

Furthermore, confusion over the control of trustees' expenditures and staff has created differential treatment of trustees' staff and increased conflict between trustees and the administrator. And the lack of an up-to-date, easily accessible compilation of board decisions also fosters misunderstandings.

Subsequent to the completion of our fieldwork on this audit, the recent OHA elections appeared to have resulted in significant turnover in board membership. However, the election results were being challenged in court. When the election is resolved, it would be a good time for the board to focus on improving its working relationships. Failure to do so will make it more difficult to meet the challenges in program management and investment management described later in this report.

Some trustees ignore proper channels of communication

Some trustees contribute to discord by circumventing the established channels of communication. Requests from trustees to staff are supposed to be made through OHA's administrator. Trustees who violate this policy and who generate large numbers of requests contribute to staff overload and office confusion.

A publication of the National Center for Nonprofit Boards discusses the relationship between the governing board and staff:

> To begin with, the executive should normally be the intermediary figure between the staff and the board. She must focus the work of the staff so that the mission of the institution can best be achieved....When lines of contact run directly between trustees and staff members without the knowledge or assent of the executive, the problems of communication and decision making can increase, matters can be seen out of proper perspective, the comments of individual trustees can be accepted as established policy or practice, special interests can be advanced, and the flow of smooth operations can be disrupted. This is not to say that the executive should try to choke off all contact between the board and the staff. Normal social relationships will always exist, but, on both sides, care should be taken to keep them from involving matters of institutional policy and practice. At the will of the executive, designated topics can be discussed between board and staff members. For example, a trustee committee on fund raising may need to work closely with staff members assigned to development. In all such cases, however, the executive authorizes such contacts and is entitled to know their results.[3]

OHA's administrator as its principal executive is responsible for managing its operations, conducting OHA's business according to board policies, and providing general supervision and direction of all employees.

Official OHA documents clearly establish the administrator as the staff person with whom trustees must deal. The bylaws require the board to adopt procedures for research referrals to staff through the administrator. The board operations guide states that when a matter is referred to a committee, the committee may request assistance (research, clerical, and so on) through the administrator.

The violation of this policy has been a continuing problem and OHA's administrators have had to officially remind board or staff members about the proper communication channel. Our 1993 audit report on OHA noted that some trustees' practice of dealing directly with staff can undermine the authority of the administrator.

Some trustees still deal directly with staff, apparently not grasping the impact of this practice. Their barrage of requests overwhelms staff, diverts their attention from their normal responsibilities, and leads to perceptions of micromanagement. In September 1995 alone, the administration recorded 42 requests for information from just two trustees. Eleven of those requests were made directly to staff.

The various ways that projects can be initiated aggravate the problem of trustees going directly to staff. Many projects are initiated from beneficiary requests, but at times the trustees may initiate projects and request research assistance from staff. Some requests require little effort and can be met quickly. Requests that require much effort and have short deadlines cause the most difficulty for staff.

Although some trustees complain that routing all their requests through the administrator causes weeks of delay, the administrator needs to be the focal point for requests. The administrator has general supervision over staff and should delegate the request to the appropriate staff member for the most efficient response. All trustees should follow official procedures, and the administrator should work with the trustees to develop a priority system so that all trustee requests are addressed fairly.

Deferrals and re-referrals of various matters raise questions

The indefinite deferral of OHA standing-committee recommendations can be counterproductive. OHA's beneficiaries can request grants and donations and propose joint ventures. Standing committees of the Board of Trustees review beneficiaries' requests and proposals, and make recommendations on them to the full board. The board chair may defer committee recommendations for indefinite periods of time, but this practice contributes to trustee dissatisfaction.

OHA's bylaws and its board operations guide require the chair to determine whether incoming requests meet OHA's mission, goals, and objectives, and, if so, refer them to appropriate subject-matter committees. Subject-matter committees must consider and report the facts and their recommendations back to the board no later than two board meetings after the matter was referred.

The chair of the board is responsible for scheduling board meetings at least monthly and preparing the agenda. However, no guidelines establish a timeframe within which the chair must then place committee recommendations on the full board's meeting agenda. Although the chair may orally inform the board when deferring recommendations for additional information, not all of the trustees are satisfied with this process.

We found instances where committee recommendations on grant requests still had not received a full board review after a year, during which their financing was being analyzed and additional information was being sought. The requests were deferred to allow for further work by the Planning and Research Office. The office hired a consultant to compare similar model projects and investigate whether the amounts requested were sufficient to accomplish stated objectives. The consultant submitted findings in November 1995, and staff of the Planning and Research Office asked for updated project status reports from the requesters. As of April 1996, the requesters had not submitted the updated information.

While there may have been good reasons for the deferrals, the length of the deferrals appears to contribute to discontent among some trustees. The practice prevents timely review of requests by the entire board and prevents individual trustees from raising their own questions and concerns. Some trustees view the chair's action as tantamount to a veto power, and speculate about the reasons for deferring requests.

Because the board as a whole is responsible for OHA, a formal mechanism is needed to ensure that all trustees are provided with a timely opportunity to review requests. As with the time limits within which subject-matter committees must make appropriate recommendations to the board on matters referred to them, the board chair should be required to place committee recommendations on the full board's meeting agenda no later than two board meetings after the chair receives the recommendations.

The board should also establish a formal process for re-referrals (referring matters to a committee for a second time) that requires written notice from the board chair to all board members containing the reasons for the re-referral, and establish time guidelines. Without adequate information concerning the status of a request, other board members may suspect the chair's actions.

Authority over board expenditures is blurred

Authority over board expenditures needs clarification. Trustees dispute the administrator's right to limit trustees' expenditures and supervise trustees' secretaries. For example, differential treatment of the board's direct staff has contributed to discord among some trustees and administration. Almost all trustees have an aide and a secretary to help with correspondence, minutes, filing, and other administrative duties. The issue of differential treatment arose when trustees promoted their secretaries, regardless of whether they met the minimum qualifications for the promotion, and declined to fund a 2 percent wage increase for all staff.

At the 1995 legislative session, the Legislature did not fund OHA's request for a wage increase for OHA's staff of 2 percent per year for fiscal biennium 1995-97, which led OHA's administration to ask the board for funding from land-trust funds to cover the increases. At its June 27, 1995, meeting, the board declined to fund the 2 percent adjustment, but did promote certain board secretaries to a higher level.

Thereafter, disputes arose between the trustees and OHA's administrator over whether the trustees could promote their secretaries without an explicit waiver of minimum qualifications. Eventually, the board officially waived the qualifications.

Conflict between the trustees and the administrator over the promotions is exacerbated by the way the Legislature appropriates funds and by some official OHA policies. The Legislature appropriates funds for the trustees and the administrator under one budget program ID—OHA 100. OHA 100 covers the salaries and expenses of the trustees, their aides and secretaries, the OHA administrator and deputy administrators, and the administrator's secretaries. Consistent with this appropriation scheme, OHA's *Administrative and Financial Manual of Guides* provides that both the administrator and the board chair are authorized to approve trustees' requests for travel.

In FY1993-94, expenditures from OHA 100 amounted to about $2.2 million, which was 19 percent of all of OHA's expenditures for that year. Expenditures for the trustees are included in the $2.2 million.

In OHA's personnel organization chart, most of the trustees' secretaries are positioned under the administrator. However, the administrator cannot actually supervise these secretaries. Trustees dispute the administrator's authority and cite OHA's bylaws, which prevent the administrator from supervising employees whose duties require supervision and direction by the board.

The situation can be clarified. First, the board could submit a budget request to the Legislature that separates OHA 100 into budget IDs for (1) trustees, their staff, and related expenditures, and (2) the administrator and her staff. This would enable trustees to monitor and be accountable for their own expenditures and relieve the administrator of the responsibility for trustees' expenditures. OHA already tracks the expenditures of trustees and the administrator separately. A separate budget ID for trustees would also enable the Legislature to more clearly identify and review OHA's budget requests for trustees.

The board could also amend the *Administrative and Financial Manual of Guides* to reflect that only the board chair approves or authorizes expenditures by trustees. The Board of Trustees should also revise OHA's personnel organization chart to reflect the trustees' exclusive control over their secretaries.

Implementing these measures would place pay raises, promotions, and other expenditures for trustees' secretaries and aides, and expenditures for trustees clearly under the purview and responsibility of the trustees. Allegations of disparate treatment and conflicts over supervision should diminish as trustees and their staff are clearly separated from the administrator and her staff.

Lack of easily accessible board policies contributes to confusion

Prevailing board policies are not readily available. Presently, the principal method of identifying them would be to search through the board's official meeting minutes, which are chronologically recorded and maintained by the board's secretary.

Most disagreements over policies have revolved around the hiring and firing of employees. At one time, the administrator's employment of officers and employees was subject to the approval of the board. However, Act 231, Session Laws of Hawai'i 1990, eliminated the requirement for board approval.

Some trustees repeatedly challenge the administrator's authority to hire and fire employees or contract for outside services. The administrator constantly responds to trustees' inquiries concerning her authority to act in certain circumstances. We found memos questioning the administrator's authority to fill a vacant deputy administrator's position, to contract for a financial auditor to do OHA's annual financial audit, to consult with an attorney, and to pay for services.

Other types of policies also are not clear. For example, the Economic Development Division assesses and evaluates venture proposals without adequate guidelines on how and what assessments are to be done. Lacking guidelines, staff find these assessments to be extremely difficult and time consuming.

In addition, it is not clear whether such proposals should currently be evaluated. The former chair of the board's Planning, Economic Development and Housing committee agreed not to evaluate further proposals until policies and protocols for investments are approved by the board. But it is uncertain whether the board ever established this moratorium as official policy. After considerable confusion over the moratorium, OHA administration reconfirmed the policy with the current committee chair.

Uncertainty about this moratorium and the administrator's authority to hire and fire employees might be reduced by clearly identifying board policies. Policies should be officially recorded in the board's meeting minutes and summarized in a separate compilation. The administrator should identify and compile policies established at board meetings and update this compilation as often as necessary. The compilation should be made easily available to both trustees and staff.

OHA's Agency-wide Plans Do Not Ensure Clear Direction

Effective planning is an ongoing process to meet changing circumstances. Goals provide a sense of direction, focus efforts, guide decisions, and help evaluate progress.[4]

OHA has a planning and budgeting system to guide its operations. However, OHA's goals need updating, and its long-term investments are not explicitly connected to goals. Furthermore, OHA has not clearly identified its guidelines for how blood quantum requirements affect access to programs. In addition, neither the Board of Trustees nor OHA's administrators regularly assess compliance with existing plans.

As a result, OHA appears to be reacting to the requests of beneficiaries or the interests of trustees without a strategic plan to carry out its mission to better the conditions of native Hawaiians and Hawaiians.

Description of OHA's master plan and functional plans

OHA's organization-wide plans consist of a master plan and functional plans (discussed here) and a budget (discussed later in this chapter).

Section 10-6, Hawai'i Revised Statutes, requires the Board of Trustees to develop, implement, and continually update a comprehensive master plan to include the establishment of immediate and long-range goals for programs and services for native Hawaiians and Hawaiians, and priorities for program implementation. OHA issued its first master plan in 1982 and revised it in 1988.

The master plan contains a mission statement, broadly stated prioritized goals, prioritized objectives, and a ten-year time frame. The plan provides certain performance measures such as, "To promote and assist fulfillment of basic physical and mental health needs of Hawaiians so that in 10 years, the percentage of Hawaiians who seek and do not receive health care is reduced from 18% to 10%..."[5]

OHA first published its functional plans (sometimes called "divisional" plans) in July 1991. These plans, which are supposed to have a four- or five-year time frame (according to the master plan) have short- and mid-range goals, objectives, and implementing actions to carry out the master plan. The functional plans, which actually extend beyond five years, are organized by division or subject area and relate to the master plan goals. Each plan includes a functional statement, goals, objectives, strategies, implementing actions, target groups, measures of effectiveness, and key progress dates.

Plans are outdated

The master plan and functional plans were intended to be updated periodically to reflect changing circumstances. However, our 1993 audit found that the plans were outdated. Lacking up-to-date plans, OHA was unable to ensure that its various activities were synchronized and relevant. We recommended in 1993 that OHA update the master and functional plans.

However, the plans still have not been updated. In response to our 1993 report, OHA agreed that the *master* plan should be updated. OHA said it intended to systematically review the plan and publish a revised version every six years beginning on July 1, 1994. Despite these assurances, OHA has not amended the master plan.

OHA disagreed with our 1993 audit finding that the *functional* plans issued in 1991 were outdated. OHA did not believe that updating the plans every two years was judicious. However, the master plan states that the functional plans should be updated every two years.

Furthermore, Section 10-6, HRS, requires a *continual* updating of a comprehensive master plan. Functional plans implement the master plan and thus, in effect, serve as updates to it. Seen in this light, functional plans should be frequently updated to comply with the law.

OHA's administrators and staff now generally agree that the master plan and functional plans need to be updated. Changing circumstances require certain revisions to the plans. For example, Operation Ohana was moved from the Education Division to the Planning and Research Office, the Native Hawaiian Genealogy Project was moved to the Culture Office, and the Education Division has not held planned seminars on School/Community Based Management (SCBM) because the Department of Education developed the Ke Au Hou project, which addresses SCBM. OHA's Economic Development Division does not address the issue of maximizing beneficiary and employer awareness of and access to employment training programs because another organization will receive money for this purpose.

The fact that the Board of Trustees has not supported certain aspects of the functional plans demonstrates the need to revise those plans. For example, the board has not supported the development of a program for job placements, insurance group plans, an emergency fund, and a safety net/income supplement program identified in the Health and Human Services Division's plan. In this division, funding for the organization Alu Like is purported to address many functional plan objectives, although currently Alu Like primarily provides referral services and may be providing case management services. Funding for Alu Like is mandated by the Legislature and constituted 68 percent of the division's entire budget for FY1995-96.

Finally, a recent major infusion of revenues to OHA has increased the importance of updating the master and functional plans. In 1993, OHA received a $134.6 million land-trust settlement for certain back revenues due, increasing OHA's long-term investments to $152 million (cost/ carrying value). Long-term investments are now valued at $188.8 million and OHA needs to review the master and functional plans with the use of this major resource in mind.

There is no long-range plan for OHA's major financial resource

OHA's only long-range plan is its master plan. Yet, its master plan does not constitute a strategic plan that includes the use of its financial assets. Moreover, the master plan was developed prior to the 1993 settlement which increased OHA's revenues substantially. Since the settlement was added to the long-term investments, these investments have amassed a total of $188.8 million. They may grow again, depending on the outcome of certain litigation pending between OHA and the State.

As mentioned earlier, this money is now OHA's major financial resource and must be accounted for in its long- and short-term plans. Without its inclusion, the planning process would be incomplete. Resources must be tied to planning goals and objectives.

The board has already designated the use of some of the long-term investment funds for the Education Foundation and OHA's Grants, Subsidies, Purchase of Services, and Donations program (grants and donations program).

The Education Foundation was established by OHA in 1992 and has its own board. It is funded with matching contributions from Bishop Estate. OHA's portion of the contributions is based on the annual earnings on $10 million of its long-term investments. The grants and donations program is funded through a formula that provides $500,000 from OHA's annual revenues and 15 percent of its annual long-term investment income, for a total not to exceed $3 million. In actual practice, the earmarked funds are not pulled out of the long-term investments and their earnings, but taken from unspent annual receipts of trust funds. However, this still amounts to an earmarking of long-term investments. If accumulated annual receipts are insufficient to fund the foundation and grants programs, the funds may have to be pulled out of the long-term investments.

In connection with its FY1993-94 financial audit of OHA, Deloitte & Touche LLP urged the agency to develop "long-term strategies concerning the goals and plans" for all land-trust moneys, and establish "levels of priorities to carry out the goals and plans."[6] Deloitte & Touche felt that with such significant funds, it was "imperative" for the trustees to develop long-term strategies for their expenditure. Our consultant on the present audit makes essentially the same recommendation for OHA's long-term investments. (See Chapter 3 of this report.)

Guidelines concerning beneficiaries should be more clearly identified

OHA's plans should more clearly identify its guidelines concerning beneficiaries. The master plan clearly explains that land-trust revenues are restricted to benefiting only one of two classes of beneficiaries: native Hawaiians. The master plan also explains that legislative appropriations have been the primary source of funding for those beneficiaries who do not meet the 50 percent Hawaiian blood requirement. However, the exact application of these two principles is subject to interpretation.

Making effective programming and funding decisions requires the agency to interpret its trust-revenue funding restriction in determining whether programs or services may serve Hawaiians as well as native Hawaiians. Court decisions and various legal opinions exist on this issue. Yet there are no compiled guidelines in OHA's master plan, functional plans, by-laws, board operations guide, or other written policies to clarify the funding restriction.

Blood quantum guidelines are said to be generally understood by trustees and staff. Generally speaking, when non-trust funds are involved (usually general fund appropriations or federal funds), both native Hawaiians and Hawaiians may receive services. But there seems to be uncertainty over whether a dollar for dollar match between trust funds and non-trust funds is required. And unemancipated Hawaiian minors may receive services if a parent or legal guardian is native Hawaiian. Moreover, trust funds may be used to fund the entire Culture Office and its activities because the benefits accrue to the Hawaiian culture as opposed to individuals.

Although guidelines may be generally understood, they should be put in writing and refined as necessary. Unwritten guidelines create a risk of inconsistent application and treatment of beneficiaries. Written guidelines would help new employees, new trustees, and beneficiaries understand how OHA applies the blood quantum restriction.

OHA's administrator should assign the task of drafting and updating the blood quantum guidelines to an appropriate division. The Board of Trustees should approve the guidelines and include them in the master plan, functional plans, or other official agency document, as appropriate.

Compliance with plans is not known

Plans that are not followed serve no useful purpose. OHA has not ensured that the master and functional plans are consistently followed. Neither the Board of Trustees nor OHA administration requires any regular assessment of whether and to what extent division programs, projects, and activities comply with the functional plans that implement the master plan.

Without such assessment, OHA cannot ensure compliance with functional and master plans and achievement of the goals and objectives of the master plan. The board needs to require the assessment.

Program Monitoring Should Be Tightened

Program monitoring is a key management control that helps ensure that an organization's plans are carried out as intended and its goals are achieved. The federal government imposes certain monitoring and evaluation requirements on OHA programs receiving federal funds.

Monitoring should include the routine, ongoing review of the performance of grantees, contract providers, and loan recipients. Currently, OHA's monitoring of these parties consists primarily of reviewing reports written by the party being monitored. Therefore, monitoring by the four divisions of OHA on which we focused is limited and does not always yield meaningful and useful information.

Site visits are limited

Conducting site visits is an excellent tool to meaningfully monitor the use of OHA's funds through a first-hand assessment of activities. Yet OHA divisions report difficulty in conducting site visits.

Participants in OHA's Grants, Subsidies, Purchase of Services, and Donations program must submit quarterly written reports to OHA and cannot receive funds without an approved report. OHA does not require any site visits to the grantee. While there is a standard monitoring form, the form allows the specific activities to be monitored to be set by the overseeing division and the grantee. The division that oversees a particular grant must review the completed monitoring form for content. The expenditure information required by the form must be approved by the Planning and Research Office before payment is made.

While the divisions consider site visits to be important, some report that they cannot conduct them frequently enough due to insufficient staffing or a lack of travel funds. The Education Division monitors tutorial grants entirely by reports, with no site visits, and does a cursory review for other grants. The Health and Human Services Division—which administers 11 grants, the Wai'anae Diet and Alu Like contracts, and other projects—performs a few site visits. The Housing Division reports that it makes site visits but does not document them unless there is a problem.

Monitoring is limited in content

Monitoring that is too limited in content does not assure that goals and objectives are being met. For example, in the Economic Development Division, loans from its Native Hawaiian Revolving Loan Fund are monitored for delinquency only. The division does not monitor the success of the businesses for which the loans are provided.

An example of the consequences of insufficient monitoring is the Housing Division's effort to monitor the Na Po'e Kokua self-help housing project. In 1994, the organization Na Po'e Kokua was awarded a $50,000 grant for a self-help housing project on Maui to construct eight homes. None of the houses were constructed and the grant money was used up. Only a standard grant monitoring form was used.

Because the grant money was used to administer and manage the project, the division claims that this grant was not a construction contract but an agreement for services, like a purchase of service contract. However, we believe that construction management principles are applicable. Had it followed these principles, OHA would more likely have been assured that the purpose of the grant award—the construction of homes—was achieved.

The division should have required by contract a detailed schedule of work and monitoring reports on whether the project was on schedule and whether it was within the budget. Another applicable principle—requiring that certain milestones be accomplished before payment is made—also was not followed.

Monitoring improvements are needed

Monitoring reports need to be meaningfully tailored to the particular program or project, and more opportunities for site visits are needed. OHA's administrator should work with the divisions to ensure that monitoring provides sufficient confidence that the terms and intended benefits of grants, contracts, and loans are being achieved. Where site visits are difficult for lack of staff or travel funds, the administrator should implement guidelines for the selection of which to target.

Evaluation Efforts Could Be More Productive

Program evaluation is another key management control. OHA's procedures define "program evaluation" as:

> The process by which the impact, effectiveness, degree of client satisfaction, and implementation of a program or project are studied for the purpose of determining program quality or for making adjustments or refinements in the program approach or methods. These elements are generally measured against the objectives of a program or project.[7]

"Programs" are defined as "on-going, major initiatives that usually have more than one component. Programs often include several projects."[8] "Projects" are defined as "efforts of limited scope and conducted over a specific time period."[9]

In our 1993 audit, we noted that OHA has a policy to evaluate all programs. However, we found in 1993 that evaluations were not integrated into the program development process, and were not used to decide whether to continue, modify, or terminate programs. We recommended that OHA develop a policy requiring an evaluation of its programs to ensure that they actually have a positive impact on beneficiaries.

Evaluations are the responsibility of OHA's Planning and Research Office. Some evaluations are conducted internally, and others by consultants using funds appropriated for this purpose by the Legislature. OHA's evaluation efforts have grown substantially since 1993.

In the present audit, we found that OHA does evaluate many programs and projects, at a considerable cost. However, we found that improvements can still be made. OHA needs a stronger evaluation *system.* We also found that evaluations are not always meaningful and useful. OHA recognizes some of the problems and is working on improving the evaluation program.

Evaluations incur costs

Evaluations incur costs. In 1993, the Legislature appropriated $120,000 in general funds to be matched by OHA, for evaluations of programs funded by the Legislature during fiscal biennium 1991-93. In 1994, the Legislature appropriated $60,000 in matching funds for FY1994-95 to conduct independent program evaluations for programs funded by the Legislature during FY1993-94. In its report to the Legislature at the 1995 session, OHA stated that it expected to spend a total of $333,521 on evaluations for those years.

OHA needs a system of evaluation

OHA performs evaluations, but not systematically enough. A fully developed system would include solid guidelines for selecting programs to evaluate, and criteria that are built into program planning.

Selection procedures need strengthening

Resources for program evaluation in local and state governments tend to be scarce.[10] Therefore, it is important to wisely select programs to evaluate so that the most timely and useful information will be produced.[11] OHA does not yet have adequate guidelines to achieve this objective.

According to OHA's procedures, at the beginning of each fiscal year the planning officer proposes to the administrator programs and projects to be evaluated during that year. The scope, size, timeframe, estimated costs, and needs of the trustees, administration, and division officers are taken into consideration. Also considered is the budget for evaluations, and programs that have not been evaluated or that need updated evaluations. Grants are not usually evaluated because they are one-time awards.

In light of the limited staff and resources of the Planning and Research Office, the office reports that it is working on a model for evaluations. OHA administration wants to develop criteria for: (1) programs needing a full-blown evaluation; (2) programs needing evaluations at the mid-range cost of $5,000; and (3) programs that can be evaluated in-house or at little cost. The development of such a model is a worthwhile effort and a step toward a true evaluation system.

Groundwork for evaluations should be established during program planning

OHA's evaluations could be more meaningful and useful if evaluation criteria were determined during the program planning process. Currently, evaluation criteria are determined much later, after programs and projects have been implemented.

In program evaluation, data collection probably consumes the most time and effort. Data must be (1) reasonably accurate, (2) reasonably complete, and (3) comparable.[12] Many problems can be avoided if the evaluation is planned before program implementation so that relevant data can be collected before and after implementation.[13]

Establishing evaluation criteria before program implementation also leads to a clearer understanding and agreement on the type of information the evaluation should provide to OHA's trustees and administration. This would help to ensure that appropriate data is collected for important questions.

The evaluation of the Wai'anae Diet program showed that the program could not conclusively determine the extent to which it made a direct long-term impact on health because the program could provide follow-up medical data on only 4 percent of its past participants. The new contract for the program requires that the program explore the long-term effectiveness of the program by obtaining data on 60 percent (100) of past participants.

Some evaluations are not useful

OHA itself is sometimes frustrated with the limitations of the evaluations. Some externally done evaluations reportedly were not useful to the affected division. In one evaluation, the division found the recommendations were superficial and concerned issues already known to OHA. In another, the division said the evaluation did not stay within the intended scope. In yet another, the division concluded that the evaluation did not make use of available data.

Budgetary Process Limits the Effective and Efficient Management of Resources

A budget is a plan of financial operation that estimates an organization's proposed expenditures for a certain time period and identifies the proposed means of financing. Through the budgetary process, the organization's various units propose plans and programs for executive consideration. The basic elements of the budgetary process in the public sector are budget formulation, legislative consideration and adoption, and budget execution.

Budgeting helps an organization set its goals and objectives, identify its weaknesses, and control the interaction and integration of all its activities. A sound budgeting process allows the organization to examine how its resources were used in the past, evaluate what was accomplished, identify costs, and chart a future course for allocating resources.

We found that OHA's budgetary process needs improvement. The process is incomplete, and controls to ensure the effective and efficient use of resources are weak. OHA does not plan and budget for all of its revenues. It does not plan for the use of funds in its long-term investments and does not budget for all appropriations made from annual trust-revenue receipts.

OHA's administrative staff do not provide sufficient financial reports on operating funds to help the Board of Trustees monitor the agency's compliance with its budget. OHA also lacks formal, consistent procedures to ensure adequate time for and input into the preparation of its budgets.

Not budgeting for all of the board's appropriations weakens expenditure control

OHA is not budgeting all appropriations the board makes from its annual land-trust receipts, resulting in commitments to spend on unplanned activities and in weakened control over expenditures.

There is no budget ceiling or limit for the unplanned board appropriations that some staff refer to as "parachutes." "Parachutes" have included, for example, board appropriations for legal fees, and a $2.1 million grant to Aha Punana Leo, Inc., to purchase the Henry Opukaha'ia School property on the Island of Hawai'i for a Hawaiian language immersion program.

"Parachute" appropriations have been substantial, about $22.8 million for FY1993-94 and about $8.7 million for FY1994-95. As of May 30, 1996, about $6.3 million had been expended for "parachutes" for FY1995-96.

As of March 31, 1996, because of unplanned board expenditures, OHA may be headed towards a $400,000 deficit in annual trust revenue receipts for FY1995-96, based upon projected annual receipts. While the deficit may be made up with unspent receipts from prior years, this reflects insufficient planning and control over spending.

Trustees do not receive adequate financial reports

OHA is a corporation with over $245 million in cash and investments, yet its trustees do not receive adequate financial reports on operating funds. Trustees need interim financial reports with adequate financial information to enable them to monitor revenues and expenditures.

Financial reports on operating funds that the trustees currently receive are not always useful—some trustees consider them confusing or insufficient. Each month, trustees receive an expenditure variance report and an administrator's report. They also receive special fund account balances reports on a quarterly basis for the receipts and expenditures of the Hawaiian Projects Fund and the Native Hawaiian Rights Fund.

Authoritative sources[14] indicate that to adequately monitor the budget, at a minimum the trustees should receive monthly or quarterly a balance sheet, an operating statement, and a report summarizing any variances from the budget. The balance sheet would provide a snapshot of OHA's financial position on a particular date by listing assets, liabilities, and fund balances. The operating statement would show OHA's financial transactions (revenues received, moneys expended, and outstanding encumbrances) over a period of time. The variance report would compare OHA's actual costs against its budget and summarize the reasons for any differences. The variance report would also notify the trustees of any anticipated deficits or surpluses.

OHA does not produce interim balance sheets or operating statements. The administrator's report includes the land-trust receipts less trust-fund appropriations, trust-revenue projections, and appropriations of trust funds for the year to date. But the financial information provided in the administrator's report is not necessarily relevant or helpful unless presented with other financial information. For example, it currently is not presented so that the trustees can get a snapshot view of OHA's financial position at a particular date. Also, the administrator's report does not show what OHA's financial transactions are over a period of time.

Several trustees indicate that OHA's expenditure variance report is neither understandable nor relevant. It is not a true variance report communicating the information they need to monitor OHA's compliance with the budget. It only tells the trustee what the expenditures were for the month, what the expenditures were for the year to date, encumbrances, what was appropriated for the year, how much of the appropriations are left, and the percentage of the appropriations used. The report does not tell the trustee how much of the appropriations were budgeted for the month, whether the divisions are within their budgeted amounts, what the variances are, and what caused the variances.

The information in any financial report should be understandable, relevant, and useful. OHA's financial reports should be expanded and improved to enable the trustees to adequately monitor expenditures.

Consistent budget preparation procedures are needed

OHA lacks formal, consistent budget preparation procedures. Such procedures would ensure adequate time for and input into budget preparation.

OHA has a process for developing budget requests to the Legislature for appropriations of general funds and land-trust funds. The Board of Trustees also approves supplemental budgets funded entirely by OHA's trust revenues. However, procedures for developing legislative budgets and trust-funded budgets are not consistent from year to year. These procedures are not guided by a budgeting manual to ensure that trustees and staff have sufficient information and involvement to formulate good budgets.

We found that the procedures for preparing the biennium budget request to the Legislature for fiscal bienniums 1993-95 and 1995-97 could not be determined with certainty and appeared to differ between bienniums. Also, the degree to which the subject matter committees were involved could not be determined clearly.

OHA has also prepared its own trust-funded supplemental budgets each year since 1993. The preparation of this budget is not part of the preparation process for the legislative budget. This supplemental budget consists entirely of trust-fund moneys, is approved solely by the Board of Trustees, and is approved after the close of the Legislature.

The trust-funded supplemental budgets were initially prepared to make up for personnel funds that were not provided by the Legislature. This was the case when the trustees approved a trust-funded supplemental request on July 2, 1993. On January 12, 1995, the trustees approved another trust-funded supplemental request to afford OHA employees the same collective bargaining increases approved by the 1994 Legislature for other state employees for FY1994-95.

But following the close of the 1995 legislative session, there were changes in the form and substance of the trust-funded budgets. Instead of one budget request, OHA administration issued instructions to prepare what were referred to as the "A" and "B" trust-funded budgets. The "A" budget would request trust funds for the personnel costs not funded by the Legislature. The "B" budget was a request for new programs.

The creation of the "B" budget marks the first time that OHA prepared a budget, funded entirely by trust funds, to expand its programs and services. It appears to be a step toward budgeting for trust-fund appropriations in a more comprehensive manner.

While the "B" budget fosters more systematic budgeting, OHA's budgeting procedures would be clearer and more consistent if a manual of formal procedures were developed and implemented. Such clarity and consistency would help to ensure adequate input and involvement in both legislative and trust-funded budgets by trustees and staff.

Conclusion

The Office of Hawaiian Affairs now has over $245 million in cash and investments and conducts programs to improve the conditions of persons of Hawaiian ancestry. Meeting the challenge of producing successful programs will require the development of better working relationships among OHA's trustees and staff. The trustees and staff need to rise above internal discontent and discord that could compromise OHA's mission and move ahead to solve the problems in program planning, monitoring, evaluation, and budgeting that we described in this chapter.

Recommendations

1. The Board of Trustees of the Office of Hawaiian Affairs should:

    a. Enforce its policy that all trustee requests for staff assistance be channeled through the administrator;

    b. Adopt time limits within which the chair must place a committee's recommendations to the board on the full board's meeting agenda (no later than two board meetings after the chair receives the recommendations); and adopt a formal re-referral process that includes written notice to all trustees of the re-referral and its reasons, and time guidelines;

    c. In its budget request to the Legislature, create separate budget program IDs for (1) trustees, their staff, and related expenses, and (2) the administrator and her staff; amend the personnel organization chart to reflect the trustees' exclusive control over their secretaries; and amend the *Administrative and Financial Manual of Guides* to reflect that only the board chair approves or authorizes expenditures by trustees;

d. Ensure that all board policies are compiled and easily accessible by trustees and staff;

e. Adopt a comprehensive, ongoing planning process that includes updating master and functional plans; preparing a long-range strategic plan connecting all financial assets (especially the funds in long-term investments) to OHA's goals and objectives; and approving clear written guidelines on the application of the blood quantum requirement;

f. Require a regular assessment of all programs, projects, and activities to ensure that they comply with planning goals and objectives; and

g. Strengthen the budgetary process by budgeting for all resources and expenditures.

2. OHA's administrator should:

a. Work with trustees to establish a system to prioritize trustees' requests in order to treat all requests fairly;

b. Compile and update an official set of board policy decisions for the easy reference of trustees and staff;

c. Assign the task of drafting and updating blood quantum guidelines to an appropriate division;

d. Work with the divisions to ensure that the monitoring of contracts, grants, and loans provides sufficient confidence that their terms and intended benefits are being achieved. Opportunities for site visits should be increased, and where they are difficult for lack of staff or travel funds, the administrator should develop guidelines for a systematic selection of those to target;

e. Develop a system for evaluating programs and projects that ensures useful results and includes (1) strengthened procedures for selecting what activities to evaluate and (2) the establishment of evaluation criteria as a part of the planning process for a program or project;

f. Provide all trustees with improved interim financial reports, such as a balance sheet, an operating statement, and a more useful variance report; and

g. Develop a formal budgeting procedures manual that incorporates all aspects of budget management such as planning, budget preparation, and financial reporting.

Chapter 3

OHA Should Build on Its Investments

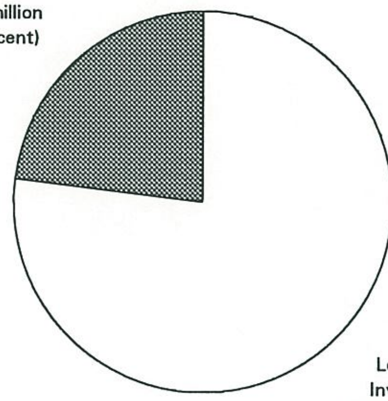
As consultants on this audit, we reviewed management controls established by the Office of Hawaiian Affairs (OHA) over its cash and investments. This chapter presents the results of our review. - KPMG Peat Marwick LLP.

As of March 31, 1996, OHA had about $245.6 million in cash and investments. (See Exhibit 3.1.) About $56.8 million (23 percent) of this amount was in cash and short-term investment accounts (based on an unaudited summation of bank balances), which included cash held in the state treasury of $22.9 million. With the exception of cash held in the state treasury, these are considered "liquid" assets—that is, cash or other investments that can readily be converted to cash—and are used to finance OHA's programs and operations. The remaining $188.8 million (77 percent) was in long-term investments, which included equity and fixed income securities. Equity securities are investments which represent an ownership interest possessed by OHA (for example, common and preferred stocks). Fixed income securities are debt instruments that produce interest income (for example, corporate and government bonds). Currently, OHA is allowing its long-term investments to grow and earn interest and dividend income and, accordingly, long-term investments are not used to finance OHA's programs and operations.

We found that OHA has made progress in managing its long-term investments. Its long-term investment policy is basically sound, at least for the present. OHA has taken steps to implement the policy effectively, such as retaining professional investment consultants. However, OHA could make improvements in the management of its long-term investments, cash, and short-term investments.

With OHA's assets increasing substantially, strong management controls over its investments are more important than ever. Key elements of management control include the following: strategic planning; investment strategy; adequate monitoring and reporting of investment performance; selection, monitoring, and evaluation of investment consultants; sufficient communications between the Board of Trustees, investment consultants, and OHA personnel; and assurance that members of the board have access to and understand investment information.

Exhibit 3.1
OHA's Cash and Investments
March 31, 1996



Summary of Findings

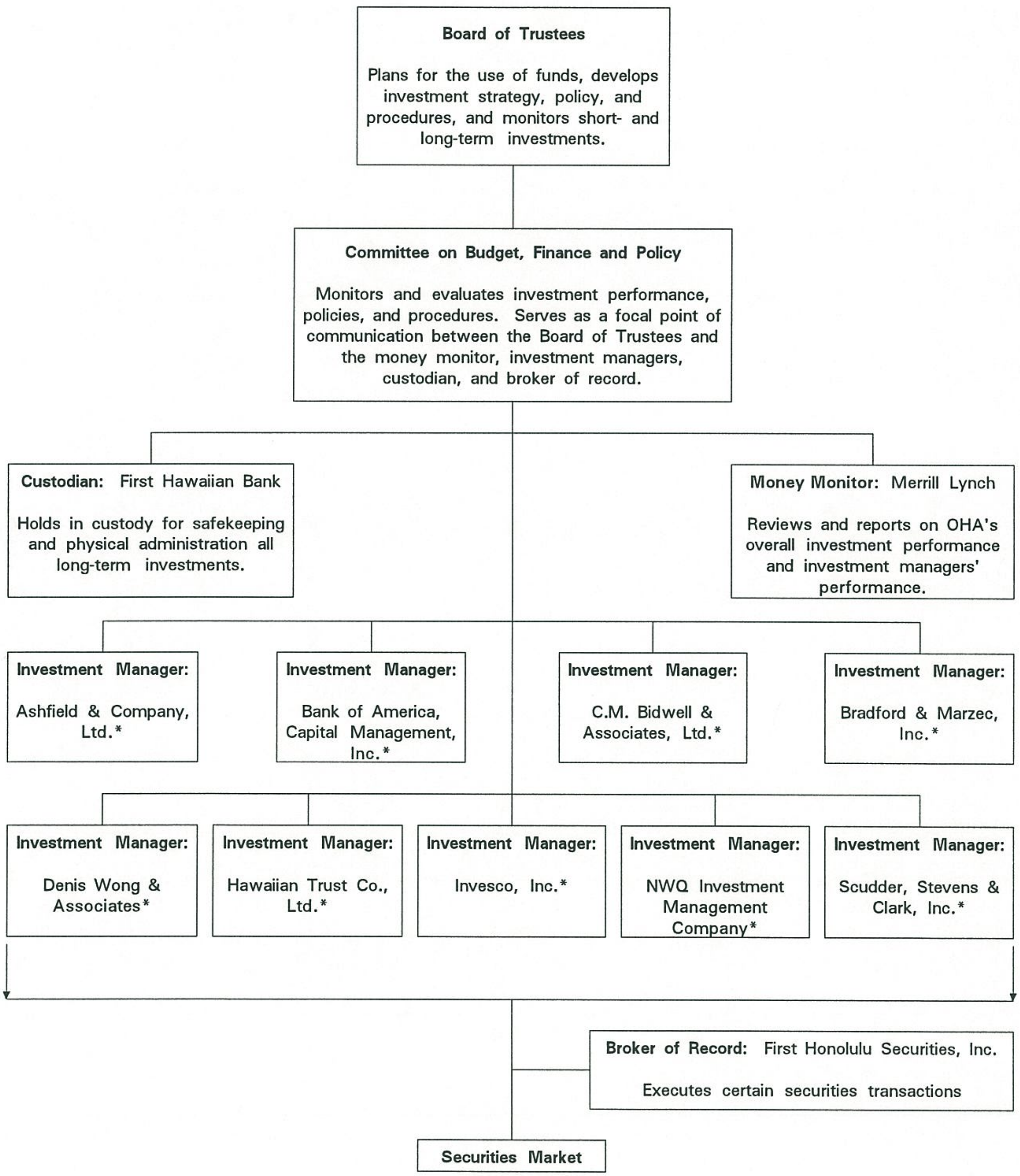
1. OHA's approach to its long-term investments has many strengths. However, improvements are needed in strategic planning for the use of these investments, arrangements with OHA's broker of record, and communications to and from members of the Board of Trustees.

2. OHA's management of its cash and short-term investments needs improvement to maximize investment earnings.

Approach to Long-term Investments Has Significant Strengths and Weaknesses

Management of OHA's long-term investments is based on a written investment policy and involves several key players. OHA's Board of Trustees (the board) sets the investment policy and its Committee on Budget, Finance and Policy (the budget committee) plays a central role. OHA has also retained professional investment assistance in the form of nine investment managers, each responsible for a portion of OHA's long-term investment portfolio; a custodian (First Hawaiian Bank) to hold the investment portfolio; a money monitor (Merrill Lynch) responsible for monitoring OHA's overall investment performance and its investment managers; and a broker of record (First Honolulu Securities) to execute certain securities transactions. Exhibit 3.2 shows the key players involved with OHA's long-term investments.

Exhibit 3.2
Key Players Involved in OHA's Long-term Investments



*Each of the investment managers makes investment decisions for a portion of OHA's long-term investment portfolio within guidelines established by the Board of Trustees.

We found that OHA's management controls over its $188.8 million in long-term investments have many strengths, including improved investment policy and monitoring of the investment managers and the money monitor.

However, additional improvements are needed. OHA lacks a comprehensive strategic plan for the use of its long-term investments. Furthermore, OHA's contract with its broker of record is poorly constructed and the broker's reports are not adequately reviewed. Also, communications concerning long-term investments could be improved.

Board of trustees has basic investment policy and monitoring responsibilities

The board has the fiduciary responsibility of defining policies and procedures for short- and long-term investments and developing a strategic plan for the use of those funds. OHA's policy and procedures manual (January 1991) states that "...the Board of Trustees shall act according to the highest fiduciary standards applicable to private trusts..."

Although the board has the overall fiduciary responsibility of defining policies and procedures and monitoring investments, the budget committee has been delegated the responsibility of dealing with the attendant issues on a day-to-day basis.

The budget committee consists of five trustees, one of whom serves as the chair. The committee recommends actions or decisions pertaining to budgetary, financial, policy, and procedural matters to the board for approval. The committee's responsibilities include evaluating and monitoring the long-term investment portfolio and the nine investment managers with the assistance of the money monitor, and developing policies and procedures for the portfolio. The chairperson of the committee serves as the primary contact point for communication between OHA and the investment managers, the custodian of the portfolio, the money monitor, and others.

OHA must move from accumulating wealth to deciding on its use

Board's long-term investment policy document has significantly improved

To fulfill its fiduciary responsibility of monitoring the investment performance of OHA's funds, the board has documented its philosophy, objectives, and policies for the investment of assets in an investment policy. This document specifies that "the Trustees may make strategic or tactical adjustments in the existing overall fund asset allocation whenever deemed appropriate."

Titled *Investment Policy For Office of Hawaiian Affairs Native Hawaiian Trust Fund* (the investment policy), this document, as amended in December 1995, is a significant improvement by OHA over its previous policy document.

The current policy identifies an asset allocation and permitted investments, and provides guidelines and objectives for the portfolio and for the investment managers. The revised investment policy is reasonably consistent in nature with policies that we have observed being used by other public and private sector pensions and trusts.

OHA does not have a comprehensive strategic plan for the use of its long-term investments

OHA does not currently have a comprehensive strategic plan for the use of its long-term investments, although a couple of uses have been earmarked (for example, the Grants, Subsidies, Purchase of Services, and Donations program and the Education Foundation). OHA should take the next step of developing a comprehensive strategic plan for the overall use of the long-term investments. The comprehensive strategic plan could include specific strategies for implementing OHA's stated objective of assisting native Hawaiians and decisions on which long-term programs will be supported.

While there is no strategic plan, it is important to note that all of the trustees have individually and collectively articulated the desire to see the moneys invested in a manner that will provide funding for programs to assist native Hawaiians in perpetuity rather than just for the foreseeable future. Some of the programs that the trustees are committed to providing for native Hawaiians include the improvement and expansion of educational opportunities and providing assistance for purchasing decent housing.

OHA's long-term investment strategy is reasonable for the time being

OHA's overall goal for its long-term investments as defined in its investment policy is:

> ...to provide superior investment returns to sustain the beneficiaries of the Office of Hawaiian Affairs and to uphold the mission of the Office of Hawaiian Affairs. Every effort shall be made to insure that the purchasing power of the assets is maintained over the investment horizon and that the assets are protected from excess volatility in market value from year to year. In investment terminology, the primary goal shall be to achieve long-term growth with appropriate diversification among asset classes.

In order to have the ability to provide perpetual funding for OHA's programs, OHA must invest its funds in a manner that will both protect the purchasing power (that is, the ability to purchase goods and services taking into account the effects of inflation) of the principal and generate enough income to fund programs and projects approved by the trustees. OHA has delayed adopting a formal strategy for investing its long-term portfolio in a manner that will meet these dual objectives because it believes that it has not yet received all of the funds it is owed by the State under the ceded lands statutes. OHA currently is involved in litigation with the State over an additional settlement amount OHA believes it is owed for the years 1981 through 1991.

Since its receipt in 1993 of the settlement of back trust revenues due from the State, OHA has not needed to use either investment earnings from its long-term investments or any part of the principal thereof to pay for existing programs and operating expenses. OHA's annual operating budget of just over $20 million has been and is currently being funded by a combination of state appropriations and annual trust revenues from ceded lands.

In the absence of an immediate need for revenues from the long-term investment portfolio, OHA has adopted a formal investment strategy for managing the assets in that portfolio which is directed at increasing the value of its principal balance. OHA is currently pursuing a strategy of investing its long-term assets in a diversified combination of equity and fixed income securities and reinvesting the dividends and interest payments received from those investments. Withdrawals from the long-term investment portfolio have been limited to those amounts needed to pay the various investment managers and certain expenses associated with the portfolio's operation. The objective of OHA's diversified investment strategy is to increase the principal amount of the portfolio without incurring undue risk to the existing principal.

The diversified investment strategy currently employed by OHA is consistent with generally accepted modern portfolio management theory. The theory maintains (and is generally supported by historical performance measures) that a portfolio of assets consisting of both equity and fixed income securities will, over time, produce reasonably attractive long-term results with less volatility than a portfolio of assets consisting solely of equity securities. OHA's current investment strategy is conservative in that it allocates approximately 50 percent of the assets to equities, 35 percent to fixed income securities, and the remaining 15 percent to a combination of real estate and cash. Currently, most asset allocation models are calling for a higher weighting in equities. Obviously, portfolio sector and asset class allocations are changed over time depending upon the owner's (or portfolio manager's) view of the relative opportunities and risks associated with each asset class at that particular point in the economic cycle. In actuality, OHA's current portfolio is divided almost evenly between equities and fixed income because OHA does not own any real estate as an investment vehicle and the entire 15 percent allocated to real estate and cash is invested in short-term securities at the custodian bank.

Given OHA's current operating budget and revenue sources, the trustees' focus on securing all of the funds that they believe OHA is legally due, and the relatively short time that OHA has had substantial funds available to invest in the long-term assets, the existing investment strategy is, for the time being, not unreasonable.

However, OHA should begin to explore a wide variety of specific strategies for implementing its stated objective of assisting native Hawaiians. Only by doing so and deciding on just what long-term programs are to be supported, can the proper investment strategy, asset mix, and approach be formulated. In other words, the sooner various programs are identified, the sooner the types of investment strategies that will be required to support the funding of those programs can be developed, while simultaneously protecting the principal balance of the portfolio.

"Inflation proofing" should be considered. One method of protecting the long-term portfolio's purchasing power would be to attempt to "inflation proof" it. Inflation proofing attempts to preserve the purchasing power of a portfolio's assets by adding a percentage of investment earnings equal to the rate of inflation to the principal on an annual basis.

The rate of inflation can be measured by an index such as the Commodity Research Bureau's index or the Consumer Price Index. Investment earnings equal to this percentage can then be added back to the principal amount of the portfolio. For example, if the principal amount is $1,000 and the inflation rate is 3 percent, then $30 ($1,000 multiplied by 3 percent) of the interest earned would be added back to the principal amount. The adjusted principal amount of the portfolio would then equal $1,030.

This procedure does not protect the portfolio against changes in value due to market fluctuations, but does provide some degree of protection against increases in the prices of goods and services. In fact, inflation proofing is used by some other state funds, such as the Alaska Permanent Fund.

The issue of "inflation proofing" has been considered informally in the past by certain trustees. The budget committee should reconsider inflation proofing the portfolio by formally studying the concept when developing a comprehensive strategic plan for the use of its long-term investments.

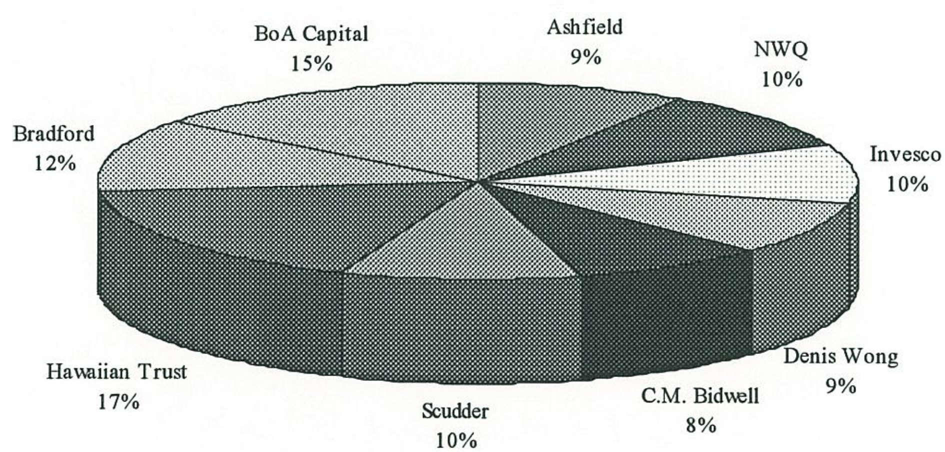
OHA shows real strength in the areas of investment managers, custodian, and money monitor

Selection and monitoring of investment managers appear sound

OHA has contracted with nine investment managers: four core equities managers, two small capitalization equities managers, and three fixed income managers. An investment manager is responsible for all investment purchase and sale decisions for its allocated portions of OHA's long-term investment portfolio. As delineated in the investment manager contract and OHA's investment policy, each investment manager has specific performance goals to achieve and must adhere to the stated investment guidelines, philosophy, and style. Exhibit 3.3 shows the investment manager portfolio allocation as of March 31, 1996.

It appears that the selection process for investment managers was conducted in an appropriate manner. We also found that their reports are useful and timely and that their work is being monitored appropriately.

Exhibit 3.3
Investment Manager Allocation as of March 31, 1996



	Market Value
Ashfield & Company, Ltd.	$ 17,026,000
NWQ Investment Management Company	18,309,000
Invesco, Inc.	18,324,000
Denis Wong & Associates	16,348,000
C.M. Bidwell & Associates, Ltd.	16,100,000
Scudder, Stevens & Clark, Inc.	19,337,000
Hawaiian Trust Co., Ltd.	33,011,000
Bradford & Marzec, Inc.	22,777,000
Bank of America Capital Management, Inc.	27,545,000
Total Long-term Investments	**$ 188,777,000**

Selection of investment managers appears appropriate. To assess the selection of the investment managers, we used OHA's current search for a short-term investment manager as a proxy for the overall process and procedures for this type of activity. We took this approach because the search process for a short-term manager was ongoing during the time of our review while the selection process for the nine current investment managers occurred almost two years ago.

The search process for OHA's short-term investment manager is described later in this chapter. If a similar process was used in selecting the investment managers, then it appears that the selection was conducted in an appropriate manner.

Reporting by investment managers is sufficient and timely. Investment managers must comply with OHA guidelines and meet objectives delineated in the Individual Investment Manager Guidelines in OHA's investment policy.

Each investment manager is required to prepare and deliver quarterly reports to the trustees recapping the prior quarter's activities and performance. We examined copies of selected quarterly reports from each of the investment managers. The reports were written in language and presented in a form that we believe could be understood by individuals who are not formally trained in the investment management business. These reports resembled reports of other public and private sector pension and trust accounts that we have reviewed. We did not note any significant deficiencies in the nature, volume, and/or types of information contained in the reports we examined. It also appears that the investment managers are reporting to OHA in a timely fashion.

Investment managers are adequately monitored. OHA's oversight of the investment managers consists of the budget committee reviewing both the individual investment managers' self-policing activities and the money monitor's reports concerning compliance with OHA's investment policy. The money monitor's reports are described later in this chapter.

Compliance with the investment policy is monitored at the individual manager level in two ways. First, each individual manager is required to provide OHA with a description of its methodology and process for ensuring compliance with relevant asset guidelines at the time of an individual asset's purchase. Second, compliance with the investment policy is monitored at the portfolio level on an ongoing basis. During our review, we examined several investment managers' protocols and methodologies and found them to be similar in nature to those of other investment managers we have observed.

The budget committee meets with representatives of each of the investment managers on a quarterly basis and more frequently if this is felt to be warranted. The frequency of the meetings in addition to the regularly scheduled quarterly meetings, depends on an individual investment manager's performance against established performance benchmarks over a variety of time periods, as well as other issues that might arise, such as changes in investment manager personnel, alterations to investment style or approach, and adherence to stated investment guidelines and restrictions.

Custodian's reports are sufficient

First Hawaiian Bank serves as the custodian of OHA's long-term investment portfolio. The bank was selected on September 29, 1993, to hold in custody for safekeeping and physical administration all funds, securities, and other investments subject to management by the investment managers. Each investment manager's account is maintained separately and distinctly from the other investment managers' accounts, and each investment manager's investment authority extends only to the individual account established for that manager.

Each month, the custodian provides two transaction reports to OHA: a summarized version for the entire portfolio and a detailed version by individual investment managers. The custodian also provides annual transaction reports.

We did not note any significant deficiencies in the nature, volume, or types of information contained in the custody reports we examined.

Money monitor's work is sound

In July 1994, OHA selected Merrill Lynch to serve as the money monitor for its long-term investment portfolio. The money monitor is OHA's primary mechanism for independently reviewing the activities of its nine investment managers.

The scope of services provided by Merrill Lynch is defined by contract to include:

1. Keeping accurate and detailed records of all transactions enacted by the nine investment managers;

2. Providing quarterly evaluations of the performance of the various investment managers;

3. Reporting the quarterly evaluations of the investment managers, including an overview of the performance of each investment manager;

4. Providing a concise executive summary written in plain language and supported with facts in the quarterly reports;

5. Comparing the investment managers' performance against standards delineated in the contracts;

6. Providing due diligence for each investment manager;

7. Evaluating securities selection, investment strategy, and risk management;

8. Monitoring how the investment managers' performances adhere to their contracts; and

9. Responding to ad hoc requests.

Based upon documents provided to us by OHA, it appears that a formal request for proposal (RFP) process was used in the procurement of the money monitor. The prior money monitor, Bishop Trust Company, resigned due to a conflict created by its acquisition by Bank of Hawaii, the parent company of one of the investment managers, Hawaiian Trust Company, Ltd. Bishop Trust advised OHA of the conflict during the RFP selection process. We were not provided any documentation concerning the final selection process, but it appears that Merrill Lynch was selected based upon a combination of an extremely low fee quotation and its prior experience with other public bodies in Hawai'i and other locations.

Monitor's reports meet or exceed standards. We examined several quarterly reports prepared by Merrill Lynch as money monitor for OHA. The type and nature of the reports are consistent with those prepared by investment consultants for other large pension funds and portfolios that we have observed. The money monitor's reports also met and in some areas exceeded the contractual requirements with regard to content and form. The reports are written in language and presented in a form that we believe can be understood by individuals not formally trained in the investment management business. Based upon the dates of the quarterly presentations provided to us by OHA and meeting minutes of the budget committee, it also appears that the money monitor is providing the information required in its contract in a timely manner.

Quarterly meetings are useful. In addition to preparing quarterly reports, the money monitor meets quarterly with the budget committee to review the performance of OHA's portfolio from an overall perspective and from the individual investment managers' perspectives. While this information is presented to the trustees on a quarterly basis, the money monitor compiles it internally on a monthly basis using the custodian's report and other supporting documentation.

The report package presented by the money monitor to the budget committee contains an overview of the portfolio's composition and performance as a whole and detailed analysis of each individual manager's performance against his or her cycle and interim benchmarks. The cycle and interim benchmarks are based upon indices (for example, Standard and Poor's 500, Consumer Price Index, Russell 2000) chosen by OHA based on discussions with each individual investment manager and with the advice of the money monitor. Each manager's cycle benchmark performance index is contained in OHA's investment policy and the individual investment manager's agreements and appended investment guidelines (as formally amended in March 1996). The indices that we observed being used as both interim and cycle benchmarks are widely accepted, and used as such, in the investment management industry.

Compliance work is hard to assess. Another responsibility of the money monitor is to scrutinize the individual investment managers' compliance with their respective sets of investment guidelines for permitted investments. Merrill Lynch contracts with the Aspen Performance Group for the compilation of portfolio analysis and monitoring of guideline compliance.

We requested copies of any guideline compliance reports produced by this vendor, but we were informed that Aspen Performance Group does not produce any permanent reports detailing its compliance routines, but reports to the money monitor on an exception basis only. Since we were unable to independently verify the tests and routines that Merrill Lynch represents are performed by Aspen Performance Group, we are unable to comment on their efficacy. We would note, however, that since Merrill Lynch is contractually obligated to monitor investment manager compliance with the guidelines established by OHA and report any deviation from those guidelines, any loss resulting from the purchase of a non-conforming asset by one of the nine investment managers might be recoverable from Merrill Lynch.

Arrangements with OHA's broker of record could be improved

The broker of record is a preferred but not exclusive executor of securities transactions for OHA's investment portfolio. Investment managers are encouraged to use the broker of record if the securities transaction will result in the best execution and lower commission rates.

On August 1, 1991, OHA solicited proposals for a broker of record. On August 16, 1991, First Honolulu Securities, Inc. responded, stating its fees based upon the number of shares traded. In a report of OHA's budget committee dated September 16, 1991, the committee determined that First Honolulu Securities was capable and qualified to execute transactions for OHA's investment portfolio. At a meeting on September 19, 1991, OHA's board unanimously approved First Honolulu Securities as OHA's securities broker of record.

There is no formal contract between OHA and First Honolulu Securities. However, terms were agreed upon through a written offer letter dated August 16, 1991 sent to OHA from First Honolulu Securities, and written acceptance by OHA of the terms specified. A *de facto* contract was thus created.

We were not provided sufficient documentation to determine the process through which First Honolulu Securities was selected as OHA's broker of record. Therefore, we can make no observations about the origins of this relationship.

We found that OHA's agreement with the broker of record is poorly constructed and does not specifically address contractual responsibilities expected of First Honolulu Securities. We also found that OHA does not adequately review reports received from the broker of record to permit OHA to monitor the broker's activities.

Contract with broker of record is poorly constructed

The agreement between the two parties, while apparently legal and binding, bears little resemblance to the contracts OHA has with its money monitor or any of the nine investment managers. The agreement does not specify the frequency and format of reports that First Honolulu Securities will prepare and present to OHA.

Review of broker's activities is inadequate

During our review, we observed that First Honolulu Securities' monthly reports to OHA consisted of a plain white (not on letterhead), manually typed page providing only limited monthly information, including the name of and commissions paid to each investment manager, and the total commissions paid to First Honolulu Securities during the month. Those reports did not list individual security transactions (for example, type of security, number of shares, and the commission rate and amount). As a result, OHA was unable to monitor adequately the broker of record's activities and determine whether OHA was receiving the best execution at the agreed-upon commission rate. OHA could not compare and confirm the security transactions reported by First Honolulu Securities to the monthly custodial reports. OHA also could not determine whether commissions charged by First Honolulu Securities were proper and in accordance with the stipulated fee schedule. OHA should reconcile security transactions contained in the monthly reports from First Honolulu Securities to the custodial reports and ascertain the reasonableness of First Honolulu Securities commissions on a timely basis.

Subsequent to our fieldwork, we were provided First Honolulu Securities statements for later periods. Those statements were on First Honolulu Securities letterhead and did list individual security transactions and the other type of information described above. We were informed that OHA intends to reconcile security transactions contained in the monthly reports from First Honolulu Securities to the custodial reports and ascertain the reasonableness of First Honolulu Securities commissions.

Agreement should be revised

OHA's agreement with First Honolulu Securities compares poorly with OHA's other contractual relationships by its numerous deficiencies and omissions. In order to clearly define the broker of record's responsibilities and to ensure that the broker has a thorough understanding of OHA's expectations, OHA should draft and execute a formal, written contract with the broker similar to those OHA has with its investment managers, the custodian, and the money monitor. Establishing a formal contract that contains defined responsibilities and other pertinent terms (such as qualifications, compensation, and the nature, detail, and frequency of reports) would serve OHA's interests both in the short and long run.

Communication to and from the board could be improved

Communication to and from OHA's Board of Trustees could be improved through a focused educational program familiarizing the trustees with the concepts and techniques of long-term investing, increased access to investment information, and improved information dissemination and retrieval processes.

Every trustee should remain informed about OHA's investments (among other issues and topics) to fulfill his or her individual fiduciary responsibilities to OHA's beneficiaries. Through our interviews, we believe that certain individual trustees are not as familiar with the concepts and techniques of long-term investing as they may wish to be. Communication among trustees, staff, and investment consultants could be improved.

Educational program for trustees is needed

A lack of understanding about the precepts, concepts, approaches to, and variability of results from long-term investing can lead to misunderstanding and confusion about the process. The field of investment management is complex and constantly evolving. A focused and ongoing program of educational lectures or workshops will provide trustees with a working knowledge of investment management and enhance their ability to fulfill their fiduciary responsibilities. These presentations by different investment professionals would be directed towards discussing the fundamental concepts, techniques, and issues involved in investment management.

Dedicated meetings would help

OHA's trustees should consider dedicating one meeting each quarter to discuss OHA's investment performance, policies, procedures, and strategic plan. All of the trustees should be invited to attend these quarterly meetings to be held with the money monitor. Sufficient time should be set aside for trustees to address investment-related questions to the money monitor and the budget committee. In addition, the trustees should be provided copies of the money monitor's quarterly report at least one week before the quarterly meeting at which it will be discussed.

Information dissemination and retrieval could be enhanced

We were informed by several trustees and vendors that there were complaints and expressions of less than complete satisfaction with the current information dissemination and retrieval processes. We also observed that proper protocols for requesting information from staff and vendors are sometimes bypassed, producing disharmonious relationships between the trustees, staff, and vendors. To facilitate effective and efficient working relationships, communication protocols need to be established and followed. The establishment of a single point of contact in administration would be a start.

During our review, we were informed OHA is upgrading its administrative services officer position to that of a chief financial officer. We agree with this change. The chief financial officer should be the administrative contact point for information and data requests about OHA's investment activities. Giving the chief financial officer the responsibility for handling trustee requests for information and reports would provide a central control point for those requests and also identify a senior, knowledgeable employee as being responsible for them. This would ensure accountability and focus on the part of OHA's staff and give the trustees additional confidence in the information dissemination process. It would also make communication with vendors and managers more efficient.

Better Management of Cash and Short-term Investments Could Enhance Their Value

We found that OHA could improve the management of its $56.8 million in cash and short-term investments. OHA does not have formal polices and procedures for its short-term investments, nor are there policies and procedures for reviewing the amount of funds kept in its short-term investment accounts. Transferring and redeploying short-term investments to its long-term investment portfolio when appropriate could maximize investment earnings. In addition, OHA did not transfer excess funds kept in the state treasury to its First Hawaiian Bank short-term investment fund (STIF) account for the quarter ending March 31, 1996, which would have increased investment earnings. However, OHA's anticipated procurement of a short-term investment manager is a step in the right direction toward resolving these problems.

Background: Cash and short-term investments are in several appropriation and bank accounts

OHA's primary sources of funds are land-trust revenues and state appropriations. OHA receives quarterly trust revenues from the various state departments through the Department of Accounting and General Services (DAGS). This amount is posted to OHA's Public Land Trust Proceeds revolving appropriation account.

Other revenue sources include: Native Hawaiian Revolving Loan Fund loan repayments, revenues from newspaper advertisements, donations, interest and dividend income, and miscellaneous revenues.

Interest and dividend income earned on OHA's long-term investment portfolio remains in the long-term accounts and is not transferred to the STIF accounts.

Cash disbursements are for operations or programs and occur in three forms: (1) checks issued by DAGS as a result of a request for payment in the form of a summary warrant voucher, (2) checks issued by OHA from its petty cash bank account, and (3) transfers between the cash or STIF accounts held outside the state treasury. To date, there have been no transfers between short- and long-term investment accounts.

Description of accounts held outside the state treasury

As of March 31, 1996, OHA held nine cash and short-term investment accounts outside the state treasury with balances totaling approximately $33.9 million. OHA has cash and short-term investment accounts with three financial institutions: five are with First Hawaiian Bank, three with Bank of Hawaii, and one with American Savings Bank.

OHA's primary STIF account is held with First Hawaiian Bank. A related cash account is used as a clearing account for transfers in and out of this STIF account in order to minimize disruptions due to the timing of investments.

OHA also has established separate accounts for each of the following loan programs: Home Improvement Loan Program, Downpayment Loan Program, Federal Home Loan Bank Grant Program (Waimanalo Kupuna Housing Project), and the Native Hawaiian Revolving Loan Fund. OHA also has established an account to receive loan program repayments for both the home improvement and downpayment loans issued to beneficiaries and a related short-term investment account to the Native Hawaiian Revolving Loan Fund account. OHA also maintains a petty cash fund account.

The Appendix to this report contains brief descriptions of OHA's nine cash and short-term investment accounts.

Description of process for transferring funds

Funds are deposited into and withdrawn from the First Hawaiian Bank STIF account through its related cash account, as previously mentioned. Transfers into the First Hawaiian Bank STIF account are from the state treasury. There are two types of transfers out of the First Hawaiian Bank STIF account. The first is the transfer of funds from the First Hawaiian Bank STIF account to the state treasury for operating expenditures. The second is to the home improvement and downpayment loan program accounts. The process for transferring funds into and out of the First Hawaiian Bank STIF account is described below.

Process for transferring funds into the First Hawaiian Bank STIF account from the state treasury. Each quarter, the excess of revenues over OHA's operational requirements is withdrawn from the state treasury via a check from DAGS and deposited into OHA's First Hawaiian Bank STIF account to earn a higher rate of return. To determine the amount to be transferred, OHA calculates matching fund requirements for state appropriations and additional amounts required for payroll, contract, and purchase order encumbrances, trust-funded projects not yet encumbered, and large board appropriations for the upcoming quarter.

Process for transferring funds out of the First Hawaiian Bank STIF account into the state treasury. Funds may also be transferred out of the First Hawaiian Bank STIF account into accounts within the state treasury on an as-needed basis to cover operating expenditures. OHA initiates the fund transfer process by generating an internal memorandum to the OHA administrator specifying the amount and justification of the transfer. The administrator reviews the requested transfer and, upon approval, prepares a memorandum to First Hawaiian Bank, the custodian of the STIF account. The memorandum authorizes the transfer and requires two signatures from approved signatories (usually one person from administration and one trustee). A transaction receipt is then sent to the fiscal office of OHA.

Process for transferring funds out of the First Hawaiian Bank STIF account into the loan accounts. For both the home improvement and downpayment loan programs accounts, the First Hawaiian Bank residential loan manager has the authority to transfer funds from the First Hawaiian Bank STIF account as loans are closed. The loan manager notifies OHA via a letter to the board chair indicating the amount and reason for the transfer.

In addition to transferring funds into and out of the First Hawaiian Bank STIF account, OHA also transfers funds from its Native Hawaiian Revolving Loan Fund money market account to the state treasury's Native Hawaiian Revolving Loan Fund account as approved Native Hawaiian Revolving Loan Fund loans are closed. Until those funds (that is, loan proceeds) are needed for disbursement, OHA keeps the funds in its interest bearing account (as opposed to allowing the funds to remain in the state treasury, where they would not earn interest for OHA's benefit). OHA's Native Hawaiian Revolving Loan Fund manager calculates the amount to be transferred. Once the funds are deposited into the state treasury, DAGS will disburse a check to the loan recipient.

Potential earnings were lost when funds were not transferred promptly

We found an instance where OHA did not transfer its excess funds held in the state treasury to its interest-bearing First Hawaiian Bank STIF account in a timely manner. As a result, OHA did not maximize potential earnings from these moneys.

As of March 31, 1996, OHA had cash balances totaling approximately $22.9 million in its special appropriation accounts in the state treasury. This large amount resulted from OHA's failure to transfer its excess funds for the quarter ending March 31, 1996 to the First Hawaiian Bank STIF account in a timely manner. On June 4, 1996, we were again informed that OHA had not determined the amount to be transferred, so the transfer was not made.

To ensure maximum interest earnings, the OHA administrator should enforce procedures requiring that excess funds held in the state treasury be transferred to the First Hawaiian Bank STIF account in a timely manner.

Redeployment of funds may provide additional earnings

We also found that OHA lacks formal policies and procedures for its short-term investments. There are no policies and procedures for reviewing the amount of funds kept in the First Hawaiian Bank STIF account to determine whether part of these funds should be redeployed to OHA's long-term investment portfolio to maximize earnings.

OHA has not defined a ceiling above which the funds can be redeployed. A ceiling would define the maximum balance to be retained in the First Hawaiian Bank STIF account. To determine the First Hawaiian Bank STIF account ceiling, OHA's board should consider what the First Hawaiian Bank STIF account funds are going to be used for and when the funds will be expended. Once the board has done this, a ceiling can be established for OHA's First Hawaiian Bank STIF account.

When the balance of the First Hawaiian Bank STIF account exceeds the ceiling, the excess amount should be transferred into the long-term investment portfolio in order to yield a higher rate of return. OHA's board should establish this ceiling and establish procedures for transfers of funds between the short-term and long-term investments.

Procurement of a manager for short-term investments should help

At the time of our review, OHA was in the process of procuring an investment manager to determine how to invest the short-term funds.

The search process for a short-term investment manager was being coordinated by OHA's budget committee with the assistance of Merrill Lynch, which also serves as the money monitor for OHA's long-term investments. The additional duty of search coordinator, for which Merrill Lynch receives no supplemental compensation, is permitted under Merrill Lynch's contract to serve as money monitor.

OHA gave us copies of the RFP for a short-term investment manager (developed by the money monitor), the advertisements soliciting requests for the RFP, responses to the advertisements, and a matrix summarizing the respondents' qualifications based upon responses from the three firms that submitted proposals. We were informed that each of the three candidates would be requested to make a formal presentation to the entire board, after which the budget committee would make a recommendation to the board. The board will then formally select the short-term investment manager.

We were not provided the benchmarks for how the budget committee would evaluate the three proposals, but were told that objective criteria would be used. We did not observe any violations of OHA's policies and procedures during our review and noted that according to state statutes, OHA is not required to conduct a competitive bidding process for investment services. However, we believe that whenever possible and practical, a competitive bidding process that provides access to all qualified applicants, and that results in a decision based upon objective criteria, is in the best interests of all involved. We recommend that OHA continue its policy of soliciting competitive proposals for all of its investment services providers.

Conclusion

The Office of Hawaiian Affairs has much to be proud of in its handling of long-term investments. OHA has established a foundation of sound investment policy and investment management, largely by hiring outside expertise to assist in this complex area. Now OHA needs to build on this foundation by planning strategically to link investments to programs. OHA also needs to improve communications to and from the Board of

Trustees concerning investments, manage cash and short-term investments to enhance their value, and attend to the other details discussed in this chapter.

Recommendations

1. We recommend that the Board of Trustees of the Office of Hawaiian Affairs:

    a. Take pride in significant improvements made through its revised investment policy and continue to improve documentation and guidelines related to investment objectives and goals;

    b. Develop a comprehensive strategic plan for the use of its long-term investments, including strategies for implementing its stated objective of assisting native Hawaiians and decisions on which long-term programs are to be supported. Then OHA's Committee on Budget, Finance and Policy should formulate an appropriate investment strategy, asset mix, and approach to meet the needs of the strategic plan. The committee should also reconsider inflation-proofing OHA's long-term investment portfolio in connection with the development of a strategic plan;

    c. Execute a formal, written contract with OHA's broker of record that clearly defines the terms of the contractual agreement, including qualifications, compensation, and reporting requirements;

    d. Consider dedicating one meeting each quarter to discuss OHA's investment performance, policies, procedures, and strategic plan. The chair of the budget committee should provide trustees with copies of the money monitor's reports at least one week before this quarterly meeting. When calling the meeting, the board's chair should set aside sufficient time for trustees to pose investment-related questions to the money monitor or the committee. In addition, the board should consider conducting ongoing educational sessions to provide trustees with a better understanding of the concepts, techniques, and management activities of long-term investing;

    e. Establish and adhere to communication protocols. The chief financial officer should be the single contact person for trustee-initiated requests for information and data requests about OHA's investment activities (all these communications should be sent to the chief financial officer through the administrator); and

f. Establish policies and procedures for reviewing the amount of funds kept in OHA's short-term investment accounts to determine whether part of those funds should be redeployed to the long-term investment portfolio.

2. OHA's administrator should enforce procedures requiring that the transfer of excess funds from the state treasury to OHA's interest-bearing First Hawaiian Bank STIF account be accomplished on a timely basis.

Appendix

The following provides a brief description of accounts OHA holds outside the state treasury:

Bank Account	Account Description
Short-term Investment Fund (STIF) Account, First Hawaiian Bank	This interest-bearing holding account is used to fund operations and programs such as: the Education Foundation, the Grants, Subsidies, Purchase of Services, and Donations (GSPD) program, the Native Hawaiian Revolving Loan Fund (NHRLF), and home improvement and downpayment loans. This account is also used to accumulate excess reserves. For the fiscal year ended June 30, 1995, the average rate of return for this account was 5.4 percent. The STIF account balance as of March 31, 1996 approximated $30,045,000, which included $5,400,000 earmarked for specific uses ($3,000,000 earmarked for the GPSD program and $2,400,000 earmarked for the Education Foundation).
Cash Account, First Hawaiian Bank	This account is a related account to the STIF account held at First Hawaiian Bank and serves as a clearing account for transfers in and out of that STIF account. As of March 31, 1996, there was a zero balance in this account.
Loan Program Repayments Account, First Hawaiian Bank	This maximizer savings account is used as a repository for the repayments of home improvement and downpayment loans issued to beneficiaries. OHA does not transfer any funds into this account. As of March 31, 1996, the bank balance of this account was approximately $165,000.
Home Improvement Loan Program Account, First Hawaiian Bank	This maximizer savings account is used to issue loans to beneficiaries for the purpose of improving their homes. First Hawaiian Bank serves as the Residential Loan Administrator for the home improvement and downpayment loan programs. Money is transferred into this account as needed from the First Hawaiian Bank STIF account through the First Hawaiian Bank cash clearing account as home improvement loans are closed by First Hawaiian Bank. As of March 31, 1996, the bank balance in this account was approximately $43,000.

Bank Account	Account Description
Downpayment Loan Program Account, First Hawaiian Bank	This maximizer savings account is used to issue loans to beneficiaries to be used as downpayments for a new home. This account was established in a similar fashion to the home improvement loan account. As of March 31, 1996, the bank balance of this account was approximately $1,000.
Public Land Trust and Federal Home Loan Bank Grant Account, Bank of Hawaii	This money market account holds funds received from an award from the Federal Home Loan Bank of Seattle to develop the Waimanalo Kupuna Housing Project. OHA does not regularly transfer any funds into this account. As of March 31, 1996, the bank balance in this account was approximately $99,000.
Native Hawaiian Revolving Loan Fund (NHRLF) Account, Bank of Hawaii	This money market account is used to issue loans to beneficiaries unable to secure conventional financing from lending institutions. This account is jointly funded by OHA and the Administration for Native Americans (ANA). Because this program is jointly funded, OHA transfers matching funds from the First Hawaiian Bank STIF account when funds are received from ANA. As of March 31, 1996, the bank balance in this account was approximately $363,000.
NHRLF Short-term Investments, Bank of Hawaii	This STIF account is a related account to the NHRLF money market account. Funds are transferred into this account from its related account in order to earn a higher rate of interest. Funds in this account are invested in Treasury Bills and other short-term investments. As of March 31, 1996, the bank balance in this account was approximately $3,146,000.
Petty Cash Account, American Savings Bank	The petty cash fund is maintained under an imprest system whereby the total of petty cash on hand plus the amount of petty cash vouchers at any one time must equal the original amount of the petty cash fund of $10,000. This account is replenished on a quarterly basis, or as often as may be necessary within a quarter. As of March 31, 1996, the bank balance of this account was approximately $5,000.

Notes

Chapter 2

1. U.S. General Accounting Office, *Government Auditing Standards*, 1994 Revision, pp. 77-78.

2. Cyril O. Houle, *Governing Boards—Their Nature and Nurture*, San Francisco, Jossey-Bass, and Washington D.C., National Center for Nonprofit Boards, 1989, p. 204.

3. Ibid., p. 112.

4. James A.F. Stoner and R. Edward Freeman, *Mary Coulter, Annotated Instructor's Edition, Management*, 5th ed., Englewood Cliffs, New Jersey, Prentice Hall, p. 186.

5. Hawaii, Office of Hawaiian Affairs, *Master Plan*, Honolulu, 1988, p. 29.

6. Letter to Board of Trustees, Office of Hawaiian Affairs, from Deloitte & Touche LLP, December 23, 1994.

7. Hawaii, Office of Hawaiian Affairs, *Procedures for the Evaluation of OHA Programs and Projects*, Honolulu, p. 1.

8. Ibid.

9. Ibid.

10. Harry P. Hatry, Richard E. Winnie, and Donald M. Fisk, *Practical Program Evaluation for State and Local Governments*, 2d ed., Washington D.C., The Urban Institute Press, 1981, p. 84.

11. Ibid.

12. Ibid., p. 57.

13. Ibid.

14. Felix Pomeranz, Alfred J. Cancelliari, Joseph B. Stevens, and James L. Savage, *Auditing in the Public Sector: Efficiency, Economy and Program Results*, Boston, Warren, Gorham & Lamont, 1976, pp. 6-14.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the chair of the Board of Trustees of the Office of Hawaiian Affairs on February 12, 1997. A copy of the transmittal letter to the chair is included as Attachment 1. The response from the chair is included as Attachment 2.

The chair of the Board of Trustees responded that our report provides OHA with useful recommendations and that actions are under way to address most of them.

The chair also says that Recommendation No. 1.e on page 50 of our report contradicts some of our Chapter 2 recommendations. His concern may be that Recommendation No. 1.e proposes making OHA's chief financial officer the single contact person for trustee-initiated requests for information and data requests about OHA's investment activities, while Recommendation No. 1.a on page 29 proposes that the Board of Trustees enforce its policy that all trustee requests for staff assistance be channeled through the OHA administrator. While the two recommendations are not necessarily inconsistent, we clarified Recommendation 1.e in our final report to address the chair's concern.

The chair also raises questions about our finding (detailed on page 48 of our report) that OHA lost potential earnings when it did not transfer excess funds held in the state treasury to its interest-bearing First Hawaiian Bank STIF account in a timely manner. The chair acknowledges that OHA could have monitored the cash more closely. However, he claims that we are erroneous in saying that the $22.9 million cash balance held in the state treasury resulted from OHA's failure to transfer its excess funds for the quarter ending March 31, 1996. The chair observes that a lesser amount was actually excess, available to be withdrawn and invested. However, our report is not erroneous. We believe the report is sufficiently clear in pointing out that OHA failed to determine and transfer an appropriate portion of the $22.9 million. We simply pointed out that if the transfer had been made, the balance in the state treasury accounts would have been less than $22.9 million. While we disagree with the chair's comments on this matter, we did clarify in our final report that the $22.9 million was held in OHA's special appropriation accounts in the state treasury, not in general and special appropriation accounts as stated in the draft report.

The chair also questions our report's approach of adhering strictly to OHA's organizational chart when classifying budgetary items as falling under "operations" or "programs." He indicates that the "operations" and "programs" categories in the chart reflect reporting lines at OHA but do not dictate OHA's "divisional functions or operational areas of concentration." His concern is that the approach taken in our report attributes budget commitments disproportionately to administrative costs. However, we believe that we acted reasonably in following OHA's own organizational chart as a framework for classifying its expenditures.

In addition, the chair suggests that our report distorts OHA's revenue picture by including in its land-trust revenues for particular fiscal years, back payments received in that year but earned in prior years. However, we based our figures on OHA's own audited financial statements or other OHA financial documents, again a reasonable approach. Also, our report notes in several places that land-trust revenue figures for particular years include payments collected for prior years.

We made some additional editorial changes in the final report, some in response to the chair's comments.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

February 12, 1997

COPY

The Honorable Clayton H.W. Hee, Chair
Board of Trustees
Office of Hawaiian Affairs
711 Kapi'olani Boulevard, Suite 500
Honolulu, Hawai'i 96813

Dear Mr. Hee:

Enclosed for your information are 10 copies, numbered 6 to 15 of our draft report, *Audit of the Office of Hawaiian Affairs*. Please distribute the copies to the members of the Board and the Administrator. We ask that you telephone us by Friday, February 14, 1997, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Monday, February 24, 1997.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

ATTACHMENT 2

PHONE (808) 594-1888

FAX (808) 594-1865

STATE OF HAWAI'I
OFFICE OF HAWAIIAN AFFAIRS
711 KAPI'OLANI BOULEVARD, SUITE 500
HONOLULU, HAWAI'I 96813

February 27, 1997

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OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa, State Auditor
Office of the Auditor
465 S. King St., Room 500
Honolulu, HI 96813-2917

Dear Ms. Higa:

We would like to take this opportunity to thank you for your conclusion as the State Auditor, that "**the Office of Hawaiian Affairs has much to be proud of in its handling of long-term investments and has established a foundation of sound investment policy and investment management**." We take seriously our commitment to strengthening this financial competence and soundness as these are critical prerequisites for achieving future goals and objectives.

Our most important duty is to protect the Trust. We find the auditor's report to be most helpful and validating, but it could be improved and made even more relevant if the following were to be either incorporated into the report, or appropriately noted:

Page 1 Fourth paragraph, last sentence should read: The statute makes OHA a self-governing entity separate from the executive branch.

Page 2 Offices and divisions paragraph:
Clarification needs to be provided regarding some budgetary items that are classified under operations. These "offices" offer program services to beneficiaries even though they report to the Deputy Administrator of Operations per our organizational chart. The report throughout appears to attribute services to beneficiaries along strictly organizational lines, i.e., program or operations. However, these reporting lines do not necessarily dictate divisional functions or operational areas of concentration. All "offices" perform services which serve the entire agency as well as provide support services, activities and programs for beneficiaries. The organization chart merely relegates assignment of offices (which provide agency support as well as beneficiary services) to "operations." Divisions which operate programs and are subject-matter specific are organized under a program deputy. Accordingly, administrative costs should not attribute "office" budget

commitments disproportionately to administrative costs solely on organizational chart lines.

Page 2 Revenues, investments and expenditures heading, first paragraph, last phrase: the phrase infers that the State legislature appropriates federal funds. OHA's sources of funding include federal funds received through awards of federal grants based on independent application efforts by OHA which are not affected by the State legislature.

Page 2 Last paragraph: The annual trust revenues depicted include back payments of revenue earned in prior year(s) and due OHA for some time. Using cash receipts as the prime modulus of account, instead of periodic revenue earned during a given year grossly distorts our economic position. Our annualized average revenue received is substantially less than the amounts referenced here.

Page 3 We are currently in the process of amending our organization chart to reflect the assignment of Community Resource Coordinators (Neighbor Islands) staff to Deputy Administrator of Programs (which occurred after the State auditors were here last year).

Page 3 The organizational chart assigns divisions and offices into one of two clusters, operations or programs. Clarification is, again, warranted as items that are classified as operations/offices actually function as programs by providing beneficiary services. For example, our Planning and Research office runs our Grants & Donations and Operation Ohana projects which involve heavy beneficiary interaction; the Culture office directly interacts with beneficiaries via the provision of workshops, council formations and advisory functions. The Government Affairs office acts as an advocate for all beneficiaries in the legislature. The Public Information office publishes the Ka Wai Ola, a monthly newspaper for 60,000+ readers/OHA beneficiaries. Though labeled "operations," beneficiary-directed services and programs are also managed and delivered by these "offices."

Page 4 Exhibit 1.2 shows that DOT harbors is OHA's main revenue source. This graphic includes a $9.5MM catch-up payment from previous years. In a normal year, the percent coming from DOT -Airport and -Harbors is less than the 85% stated. This depiction exaggerates the amount of revenue from these sources. Clarification is needed to show that the annual trust revenues sometimes include back payments of revenue earned in a previous period and due OHA for some time. Our annualized revenue is substantially less than these aberration years which include sizable make-up payments.

Page 5 Stating that OHA's revenues were $38.5MM in FY94-95 grossly misrepresents and overstates our revenues. Once again the Auditor should differentiate Cash Receipts from Revenues. Your footnote acknowledges that "approximately 38% of the public land trust revenues includes payments collected during FY1994-95 for prior years." We believe that discussion regarding revenues should also be analyzed with respect to the year the revenue is earned, vis-a-vis the year when the cash is received. Exhibit 1.3 on this page should depict both scenarios and discussion of these two views warrants more than a footnote. The graphic is misleading because of the under emphasis on back payments.

Page 6 The last sentence of the second paragraph refers to additional expenditures in the amount of $26 million. This number seems to be materially higher than our records indicate. We are unable to reproduce this number using either our audited financial statements or internal accounting record.

Page 6 Again, clarification to Exhibit 1.4 is warranted as items that are classified as operations/offices actually function as programs by providing beneficiary services. Our Planning and Research office runs our Grants & Donations and Operation Ohana projects which involve heavy beneficiary interaction; and, the Culture office directly interacts with beneficiaries via the provision of workshops, council formations and advisory functions. The Government Affairs office acts as an advocate for all beneficiaries in the legislature. The Public Information office publishes the Ka Wai Ola, a monthly newspaper for 60,000+ readers/OHA beneficiaries. Though labeled "operations," beneficiary-directed services and programs are also managed by these "offices." Further, expenses that should be allocated to programs, such as a program's fair share of rental expense are being considered wholly under operations. This further adds to the distortion. We have computed, and reported previously, an administration cost equating to 22.3% We feel this number is fair and accurate. It would be even smaller if we were to include un-budgeted trust appropriations approved by trustees in the course of a fiscal period in our calculations as these affect workload of the various divisions.

Page 14 Deferrals are sometimes made because one or more trustees request additional information. On occasion, key informants are unavailable to respond to trustee queries. We acknowledge the prudence of gathering the additional information as a more fully informed board is more likely to make better decisions.

Page 14 Last paragraph. In summary, the facts as brought out in this paragraph are generally consistent with what occurred for three grant proposals cited in FY 1995-1996. However, it should be noted that these specific grant projects were substantial agriculture and land projects requiring detailed preparation and data collection. The Board's requirement for thorough analysis is a legitimate basis for lengthening the deliberation process. Processing of these types of grants represents a small part of the entire grants program volume and is atypical of the overall grants process or the Board review of such grant proposals.

Page 16 First paragraph. We agree that program ID, OHA100, should be segregated into at least two separate cost centers--BOT and Administration. We have assigned this task to the Chief Financial Officer, who will effectuate this recommendation effective July 1, 1997.

In reference to the administrator and board chair authorizing trustees' request for travel, we note that in practice the administrator verifies availability of funds and the extent that the request comports to policy leaving the actual authorization decision to the board chair.

Page 17 First paragraph. While recognizing the continuing need to maintain and improve communication between the Board, as the originator of policy, and those tasked with implementing them, the notion that the Administrator could simply compile the policies established by the Board oversimplifies the unique organizational structure of OHA and its related governance mechanisms. The context in which policies are created are as important as the substance of a statement of policy. For OHA, there are many dimensions to an expression of policy. Some of the factors include cultural context and tradition, federal and state legal conformance requirements, and consistency with OHA plans. We contend that policies affected by so many contextual influences should more appropriately be assembled, reduced to a manual, guidebook, or procedures and distributed to those who must implement and comply.

To address this issue, the Administrator has initiated an assessment and review of the entire OHA planning and governance process. This review effort is founded on a well established principle that policy and procedure development is a natural outcome of organizational and strategic planning activities. The resulting administration proposals to the Board will be in the form of action items. In addition to addressing tasks for administration, it is recommended that a policy analyst position be created or reconfigured to assist the Board with legislative history, legal and external conformance issues, drafting of motions, and other tasks related to policy creation and dissolution.

Pages 18, 19 and 20. We cannot disagree with the factual findings concerning the lack of planning activities. To address this need and as mentioned above, the Administrator has tasked the Planning and Research Office with assessing and reviewing the planning process and governance practices of OHA. The Administrator has established a deadline for the written assessment and a time line for action on identified deficiencies. The written assessment report is due no later than June 30, 1997. In consideration of present budgetary constraints, the Administrator will be utilizing in-house resources for this assessment and to the extent practicable, using agency expertise for the planning activities as well. This is a departure from past practices and the extensive use of more costly outside consultants. The practice of using outside consultants for planning will also be reviewed.

Pages 22, 23, and 24. We also cannot disagree with the factual findings that more monitoring and evaluation must be done. We concur in the fundamental premise that OHA projects and programs need to be regularly monitored not only for contract compliance but also to determine if the project or program is consistent and supportive of OHA's goals and the needs of our beneficiaries.

At present, granting activities occur under the Grants, Subsidies, Purchase of Services, and Donations Program (GSPD), tutorial grants through the Education Division, community based economic development grants through the Economic Development Division and through "parachutes." Additionally, the Native Hawaiian Revolving Loan Fund makes loans for small business start-up and expansion activities. These various grants and loans for our beneficiaries create hundreds of opportunities for monitoring and evaluation. We concur in the view that every OHA grant and loan, at the minimum, must be monitored for compliance with grant award contracts and loan agreements.

Limited staffing and resources constraints, however, limited our ability to conduct site visits and monitoring at the desired frequencies. Each grant agreement now requires grantees to submit quarterly progress reports. Subsequent installment payments for grant awards are not made until the quarterly report has been received and approved by the grants staff.

Monitoring and evaluation are closely related activities within the purview of grant specialist, loan specialists, and program managers. Past practices were such that many of the larger evaluations were performed by outside consultants. In view of budgetary constraints, internal resources are being assessed to determine the extent to which monitoring and evaluation activities can be accomplished internally by OHA personnel. Toward this end, the OHA evaluation specialist has prepared a *Technical Manual of Evaluation Services in OHA* and a *Monitoring Plan and Procedures of the OHA Functional Plans.*

Additionally, the evaluation specialist has developed a level of effort and cost containment matrix to assist in asserting the costs of an internal monitoring & evaluation plan.

Both manuals mentioned above are being refined with the ultimate objective of securing a Board approved system for project and program monitoring and evaluation in OHA.

Earlier incorporation of monitoring and evaluation requirements into grant proposals and business plans is an important ingredient in an effective monitoring and evaluation process. Accordingly, we will devise criteria which will require that monitoring and evaluation plans and timelines be made part of an applicant's grants proposal or borrower's business plan as appropriate. After a grant is awarded, reference to a monitoring and evaluation process shall be made part of grant agreements signed by the parties.

Staffing and resources at present levels are insufficient to perform the ideal numbers and the scope of evaluation desired . Site visits and meetings with grantees and borrowers necessitated by growing caseload, although necessary, have been curtailed by budget constraints. These constraints have been exacerbated by the 1996 legislature's elimination of intrastate travel general funds appropriations and more recently complicated by Governor Cayetano's decision to withhold $7.5 million in ceded land revenues (50% of our anticipated receipts).

Page 21 The issue of blood quantum requirements for various OHA programs and benefits was raised many times throughout the report. The need for establishing agreed upon uniform criteria for our programs and benefits is recognized. The Administrator has tasked the Planning and Research Office with preparing a staff paper in support of an action item for consideration/adoption by the Board. The staff paper will present analysis of matters relating to the blood quantum requirement, the application of the quantum requirement by OHA and other agencies, implications of changing/maintaining the quantum requirement, necessary policy determinations, and the legal and operational impact of these matters. The Administrator has directed that the staff paper be completed by September 30, 1997 for submission to the OHA Trustees. Trustee policy decisions relating to these matters will be codified in the appropriate governance/operations documents.

Page 26 The OHA budget process is an evolving one due to substantial changes in a variety of influences which directly affect budget formulation: 1) the uncertainties associated with ceded land payments received vs. those owed makes revenue forecasting problematic, 2) the governor has made clear his intentions to withhold up to 7.5 million in ceded land airport revenues based on a draft inspector general opinion which questions the propriety of the State paying OHA from proceeds of the airport special fund. This represents about a 50% reduction in our anticipated ceded land revenues for the year; and, 3) the legislature contributes a reduced share of general fund appropriations to our annual budget each year. We share the view that a more consistent budgetary process would be beneficial to the organization and its beneficiaries. However, these reduced alterations of revenue receipts and shifting legislative and increasingly hostile priorities adversely affect OHA's budget process.

Page 27 Page 27, second paragraph. OHA's staff is currently working on further improvements in the area of financial reporting to the Board. Although annually a complete set of financial statements are prepared which has always received a "clean" independent auditors opinion, and detailed reports are generated throughout the year that enable the program officers to monitor their division budgets, we do recognize the need to provide timely summarized and comprehensive financial reports throughout the year to the Board. In the past two years, the sudden and untimely departure of key staff have hindered the ability of the remaining staff to work on improvements, much less to keep up with the day-to-day requirements of the office. Now that certain key staff positions have been filled, we expect to be able to devote meaningful amounts of time to making improvements in the area of financial reporting per Auditor's suggestions.

Page 29 In light of your comments that the "B" budget "appears to be a step toward budgeting for trust fund appropriations in a more comprehensive manner," we will continue developing a more systematic protocol for future refinement of same.

Page 32 Summary of Findings #2. The findings regarding cash and investment management are inconsistent with information we have furnished. Our unsuccessful attempts to clarify and rectify these disparities with the authors of the report leave us at an impasse on this point.

Page 35 Second paragraph. OHA has proceeded with care and diligence to establish a sound foundation for managing and tracking our long-term investments. We acknowledge that the next step is to develop "a comprehensive strategic plan for the overall use of long-term investments." We must chart a course which will transcend the exigencies of our increasingly unpredictable revenue stream, steadily mounting demand for assistance by beneficiaries and erosion of core social service and related assistance previously born by the State government. We must proceed in a manner which strikes an appropriate balance between perceived urgency to have "the plan" and taking care to develop a strategy that can withstand these convergent influences.

Page 37 Third paragraph. Your recommendation to "inflation proof" the portfolio may be premature given the fact that the corpus has never been touched, and interest and dividends currently accumulate in the portfolio. Inflation proofing would be a more relevant strategy when, during a period of inflation, the purchasing power of a portfolio's assets could become diminished. However, given the aforementioned circumstances, inflation proofing may be more critical to address once dividends and interest are actually expended.

Page 42 Third paragraph. We will explore this area of concern with our money monitor. We would benefit from clarification of your point regarding recoverability of losses arising from "the purchase of a non-conforming asset by one of the nine investment managers."

Page 44 Second paragraph. These recommendations for strengthening our agreements with our broker will be considered for inclusion in the next iteration of our agreement with First Honolulu Securities and/or any other future broker selected to serve in this capacity.

Page 44 Last paragraph. The Board of Trustees has been responsive to previous educational efforts associated with investment matters. Our new Chief Financial Officer has been directed to formulate recommendations for future ongoing training opportunities in this area.

Page 45 Last paragraph and page 46 first paragraph. We believe this entire account is factually incorrect.

Page 48 Second, third, and fourth paragraphs. Your report states that as of 3/31/96, "OHA had cash balances totaling approximately $22.9 million in its general and special appropriation accounts in the state treasury. This large amount resulted from OHA's failure to transfer its excess funds for the quarter...to the First Hawaiian Bank STIF account in a timely manner." There are several points of clarification that need to be made.

Firstly, OHA is not able to withdraw general fund appropriations from the state treasury; general funds are appropriations to OHA and not cash. OHA staff made repeated attempts to determine how the $22.9 million amount was obtained; your office responded by instructing us to address it in this response. Therefore, although we wish we could make an informed response, we are limited to "guessing" at how this amount was derived and formulate our response accordingly. The only amount that seems close to this would be what the state's Financial Accounting and Management Information System (FAMIS) report calls "Unencumbered cash balance" on the Fund Total level - this would be a sum of the <u>cumulative</u> cash in <u>all</u> of OHA's special fund accounts. This amount is <u>before</u> expenditures, transfers and encumbrances for the fiscal year up to that point in time. From this total $22.9 million amount (and reported in that same FAMIS report), OHA had used approximately $12.5 million in expenditures and transfers, and needed $2.4 million to cover outstanding contract and purchase order encumbrances. Also included in this amount is cash of $2.25 million that <u>was</u> actually invested outside of state treasury in the STIF and other accounts - the report total includes an account called "Public Land Trust Proceeds (not in state treasury)".

Moreover, this $22.9 million (assuming it is derived from "Unencumbered cash balance" of all of OHA's special revenue funds combined) includes cash that is designated or obligated for other projects (i.e. $1.5 million before loan disbursements for the year, for the Native Hawaiian Revolving Loan Fund) which is not available to be deposited into OHA's STIF account.

Finally, because of the timing of the interdepartmental transfers of ceded land revenues and the state accounting cutoff, $2.9 million was actually transferred to OHA in April and would not have been available for withdrawal on March 31, 1997.

We agree that under ideal circumstances we could have monitored the cash more closely for that period; it is important to note however, that we had to deal with staff shortages and the extra demands associated with the legislative session requirements during that time.

We believe your report is erroneous in stating that the large $22.9 million amount "resulted from OHA's failure to transfer its excess funds for the quarter"; in fact, an amount much less than that was actually excess available to be withdrawn and invested. In the absence of other clarifying information from your staff, we conclude that this large amount is the combined cumulative total of all cash in all of OHA's special fund accounts before expenditures, encumbrances, and other obligations; and not the result from OHA's failure to transfer excess funds.

The Auditors report provided OHA useful recommendations. Our comments are as follows:

Chapter 2 Recommendations

1.a These are insightful observations and consistent with ongoing discussions that have occurred at the administration and board levels.

1.b. This board operations matter will be addressed as part of our ongoing clarification of overall agency policies and procedures.

1.c Part (1) The new Chief Financial Officer has already been advised by administration to separate program ID's for Trustee related expenses and administrative related expenses for internal reporting as well as legislative budget requests effective 7/1/97.
Part (2) Proper organizational placement of secretaries and clarifying reporting relationships are shared concerns and appropriate changes will be made in the organization chart, job descriptions, and other appropriate documents to reflect decisions in this area once approved by the Board of Trustees.

We will work with the Budget, Finance and Policy Committee to insure that the *Administrative and Financial Manual of Guides* accurately reflects the actual current practice wherein the board chair approves and authorizes expenditures of trustees. The administrator currently reviews requests to verify the availability of funds and to verify that the requests comport to the purposes for which the funds were allocated.

1.d We agree with this recommendation and will consider merits of designating this task to an existing position, new or reconfigured position. In the interim, Administration will coordinate appropriate staff to begin the process of compiling board policies.

1.e,f,g We are in support of the recommendations made in these sections and have already begun to take steps responsive to these suggestions.

2.a We will bring this matter before the Budget, Finance and Policy Committee for appropriate analysis, review and action in order to improve practices to prioritize trustee's requests.

2.b Administration will coordinate staff efforts to begin consolidation of board policy decisions. Additionally, we propose to explore the viability of reassigning an existing position or reconfigure a position to consolidate policy analyst functions in a more focused manner.

2.c The issue of blood quantum requirements for various OHA programs and benefits was raised many times throughout the report. Work in that regard has already been initiated by the Administrator. OHA's Planning and Research Office has been tasked with preparing a staff paper as a precursor to an action item for the Board. The staff paper will analyze the legal basis of the blood quantum requirement, the application of quantum requirements by OHA and other agencies, issues associated with any change in the quantum requirement, necessary policy determinations, and the legal and operational impact of any policy changes. The assignment is scheduled for completion by September 30, 1997.

2.d,e To address this issue, the Administrator is working with OHA Planning staff to continue their assessment and review of the entire OHA planning and governance process. This review effort is founded on the principle that that policy and procedure development is a natural outcome of organizational and strategic planning activities. The resulting administration proposals to the Board will be in the form of action items. In addition to addressing tasks for administration, it is recommended that a policy analyst position be created or reconfigured to assist the Board with legislative history, legal and external conformance issues, drafting of motions, and other tasks related to policy creation and dissolution.

conformance issues, drafting of motions, and other tasks related to policy creation and dissolution.

#2.f Administration has tasked the new Chief Financial Officer with the responsibility of further refining existing documents with the goal of producing a complete set of financial reports per the Auditor's recommendations effective October 1, 1997.

#2.g As soon as the board is formally reorganized, we will work with the relevant committee chairs to develop a formal budgeting procedures manual.

Chapter 3 Recommendations

1.a We appreciate the acknowledgment, by the State Auditor, of our financial competence and soundness.

1.b Long range strategic plans have the potential of being affected by change every 2 years because of OHA's Trustee election process. This dynamic which added to those mentioned in our response to comments on page 35, speaks to the necessity to proceed incrementally and deliberately.

Your recommendation to "inflation proof" the portfolio may be premature given the fact that the corpus has never been touched, and interest and dividends currently accumulate in the portfolio. Inflation proofing would be a more relevant strategy when, during a period of inflation, the purchasing power of a portfolio's assets could become diminished. However, given the aforementioned circumstances, inflation proofing may be more critical to address once dividends and interest are actually expended.

1.c These recommendations for strengthening our agreements with our broker will be considered for inclusion in the next iteration of our agreement with First Honolulu Securities and/or any other future broker selected to serve in this capacity.

1.d Currently, one meeting per quarter is already devoted to OHA's investment portfolio performance. Policies, procedures and strategic planning issues are most often imbedded in other routine subject matter or BF&P meetings. We will coordinate efforts to address the subjects more directly as part of our Planning division's overall assessment and review of OHA's planning and governance process.

1.e This recommendation contradicts some of your Chapter 2 recommendations. We recommend that all communications be sent to the Chief Financial Officer via the Administrator.

1.f This fund level is now routinely monitored to insure that the short term investment fund balances comport to our guidelines.

2. Cash transfers have been made on a timely basis.

If anyone from the auditors office would like to discuss or elaborate on any of the recommendations with us, we would more than welcome their contribution to making OHA a better, more efficient organization.

Sincerely,

Clayton Hee

Clayton Hee
Chairman, Board of Trustees