Financial Audit of the Department of Hawaiian Home Lands

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

Report No. 02-13
September 2002

THE AUDITOR
STATE OF HAWAII

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.

7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.

8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.

9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

THE AUDITOR
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OVERVIEW

Financial Audit of the Department of Hawaiian Home Lands

Report No. 02-13, September 2002

Summary

The Office of the Auditor and the certified public accounting firm of Grant Thornton LLP conducted a financial audit of the Department of Hawaiian Home Lands, State of Hawaii, for the fiscal year July 1, 2000 to June 30, 2001. The audit examined the financial records and transactions of the department; reviewed the related systems of accounting and internal controls; and tested transactions, systems, and procedures for compliance with laws and regulations.

We found deficiencies in the financial accounting and internal control practices of the department. The deficiencies included material weaknesses, the worst possible type of reportable condition. In the first material weakness, we found that the department does not have documentation to support its methodology to determine the allowance for doubtful accounts for loans receivable. The department relied on its external auditors to recommend an allowance based on those auditors' professional judgment. Financial statements are the responsibility of management; however, the department is unable to compute its own allowance for doubtful accounts for loans receivable and is unable to provide the necessary details to support the balance presented in the financial statements.

We identified infrastructure improvements of $1.8 million recorded in the incorrect accounting period as another material weakness. This error resulted in the underreporting of liabilities and expenditures in FY1999-00 and the overreporting of expenditures in FY2000-01. Failure to report all expenditures and liabilities in the proper period provides an inaccurate picture of the department's financial condition.

We also found that management has failed to ensure that all departmental accounting policies and procedures are in place and enforced. This could cost the State and Hawaii's taxpayers millions of dollars; also, this could cost qualified, eligible beneficiaries the opportunity to receive assistance because loan moneys are tied up in delinquent loans that are unlikely to be repaid. The department does not enforce written collection policies for its outstanding loans, documentation for follow-up on delinquent loans is not maintained consistently, loan records contain invalid addresses, increasing financial assistance is being given to lessees, and interest is accrued on loans related to cancelled leases.

In addition, management does not require accurate and timely financial reporting, potentially resulting in non-compliance with bond covenants. Also, the department does not properly record ancillary charges related to fixed asset costs and to construction costs related to the inventory of homes for sale. Furthermore, the department is authorized to guarantee up to $50 million in loans originally made by other agencies; however, it has failed to maintain the details on the loans that it guarantees.

Finally, the department does not have written policies and procedures for the collection of lease and license receivables. Existing procedures to follow up on delinquent receivables are not formally documented nor consistently executed.

Recommendations and Response

We recommend that the department reevaluate its methodology for determining its allowance for doubtful accounts for loans, obtain enough documentation to support the methodology it uses, and ensure the allowance estimate is properly calculated. The department should also review its internal control policies and procedures and ensure that all expenditures and liabilities are properly recorded.

The department must review its loan collection policies and procedures for reasonableness and determine and document the steps necessary to enforce them. Also, the department should consider purchasing a software program similar to those used by commercial institutions for managing its outstanding loans. Current and accurate information on all guaranteed loans should be maintained.

In addition, financial accounting records should be properly maintained and financial reporting and audits should be completed on a timely basis. Written policies and procedures for the collection of lease and license receivables should be established and staff should be properly trained. The department should assume more responsibility for the proper recording of transactions under generally accepted accounting principles. Finally, the department should update its waiting lists to ensure they contain current and accurate information on all applicants.

The department disagreed with the majority of our findings and recommendations. It does not believe that a qualified opinion is warranted. Yet the department is unable to provide us with the documentation to support the methodology for determining the allowance for doubtful accounts for loans receivable because its external auditors, not its own staff, prepared the calculation.

The department also considers as immaterial to its financial statements the $1,816,100 of expenditures and $647,267 of home construction costs recorded in the incorrect period, and unrecorded infrastructure and ancillary costs for which it is unable to quantify. The department believes it is sufficient to identify the $1,816,100 prior period error in the footnotes to the financial statements. The department agrees, with caveats, with our recommendations for implementing and enforcing policies and procedures.

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Financial Audit of the Department of Hawaiian Home Lands

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

Conducted by

The Auditor
State of Hawaii
and
Grant Thornton LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 02-13
September 2002

Foreword

This is a report of the financial audit of the Department of Hawaiian Home Lands, State of Hawaii, for the fiscal year July 1, 2000 to June 30, 2001. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Grant Thornton LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Department of Hawaiian Home Lands.

Marion M. Higa
State Auditor

Table of Contents

List of Exhibits

List of Schedules

Chapter 1

Introduction

This is a report of our financial audit of the Department of Hawaiian Home Lands. The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of Grant Thornton LLP. The audit was undertaken pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawaii (State) and its political subdivisions.

Background

The Department of Hawaiian Home Lands originated from Section 101, Hawaiian Homes Commission Act of 1920, as amended, Act 349, Session Laws of Hawaii 1990, enacted by the U.S. Congress to protect and improve the lives of native Hawaiians. The act created a Hawaiian Homes Commission to administer certain public lands, called Hawaiian home lands, for homesteads. The purpose of the act was to:

> Enable native Hawaiians to return to their lands in order to fully support self-sufficiency. . . self-determination. . . and the preservation of the values, traditions, and culture of native Hawaiians.

The act was incorporated as a provision in the State Constitution in 1959 when Hawaii was granted statehood. Responsibility for the commission and the Hawaiian home lands was transferred to the State at that time. Under the Hawaii State Government Reorganization Act of 1959, the commission's powers were transferred to the newly created Department of Hawaiian Home Lands. Except for provisions that increase benefits to lessees or relate to administration of the act, the law can be amended only with the consent of Congress.

As of June 30, 2001, the department managed approximately 200,176 acres of land on the islands of Hawaii, Kauai, Maui, Molokai, and Oahu. In accordance with the act, the department leases homesteads to native Hawaiians who have at least 50 percent Hawaiian blood. Homestead leases may extend up to 199 years for an annual rental fee of $1. The department is also authorized to lease land and to issue revocable permits, licenses, and rights-of-entry for lands not in homestead use to any individual, public, or private entity.

As of June 30, 2001, the department has awarded 7,192 homestead leases. However, it has over 31,000 applications for such leases.

Organization of the Department of Hawaiian Home Lands

As shown in Exhibit 1.1, the department is headed by an executive board known as the Hawaiian Homes Commission. The commission was created under the Hawaiian Homes Commission Act of 1920 to administer the Hawaiian home lands. It is composed of nine members who are residents of the various counties, including three from Honolulu, two from Hawaii, two from Maui, and one from Kauai. The ninth member of the commission is the chairman. The Office of the Chairman directs and carries out the department's programs, projects, and activities in accordance with policies established by the commission.

Offices

Four offices provide support services to the department.

The Administrative Services Office provides personnel, budgeting, program evaluation, information and communication systems, risk management, facilities management, clerical, and other administrative services to the department. The office also provides support services in preparation of legislative proposals and testimonies, coordinates preparation of reports to the Legislature, and facilitates the administrative rule-making process.

The Fiscal Office plans, organizes, and carries out accounting and fiscal activities that support the department's programs.

The Planning Office conducts research and planning studies related to the development of policies, programs, and projects to benefit native Hawaiians.

The Information and Community Relations Office plans, organizes, and carries out public information and community relations programs and projects.

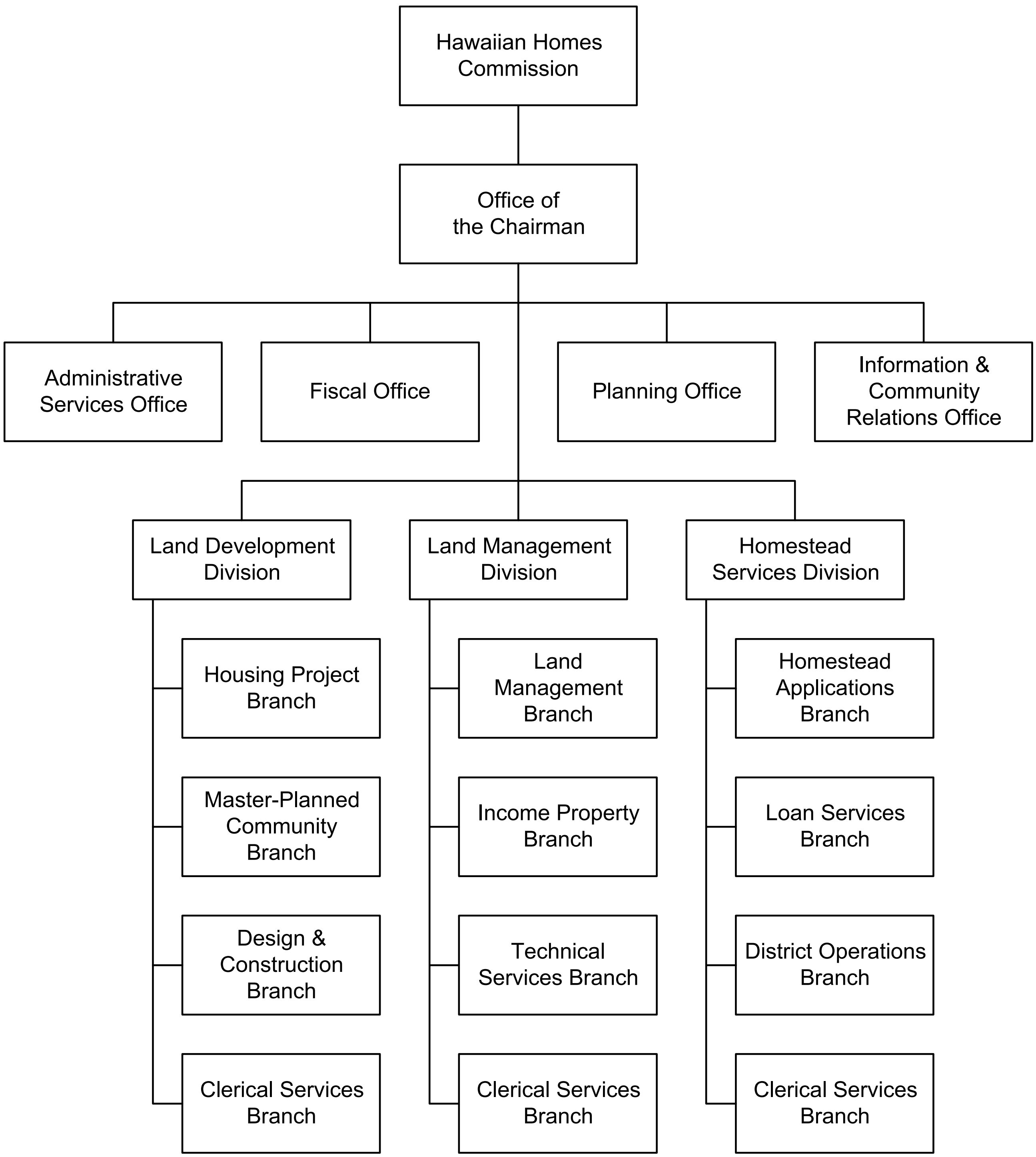
Operating divisions

The department's three operating divisions include the Land Development, Land Management, and Homestead Services divisions, which carry out the department's programs.

Land Development Division

The Land Development Division develops trust lands for homesteading and income-producing purposes by developing properties for residential, agricultural, pastoral, and economic use. The division carries out these responsibilities through its three operating branches.

Exhibit 1.1
Organization Chart of the Department of Hawaiian Home Lands



Source: Department of Hawaiian Home Lands.

The Housing Project Branch constructs units and awards leases for available, existing subdivided lots. The branch also assists lessees to arrange financing and select qualified contractors to build on their awarded lots.

The Master-Planned Community Branch arranges the planning, financing, design, and construction of master-planned communities. The branch works closely with the Temporary Development Assistance Group, which is tasked with the specific goal of expediting construction of beneficiary housing options through private sector partnerships and other housing opportunities.

The Design and Construction Branch plans, designs, and constructs both off- and on-site improvements to residential, agricultural, and pastoral subdivisions.

Land Management Division

The Land Management Division manages those Hawaiian home lands not used for homestead purposes, including residential, agricultural, and pastoral lands. It manages and disposes of unencumbered lands for both long- and short-term uses in order to generate revenues and keep the lands productive while minimizing the occurrence of vegetative overgrowth, squatting, and illegal dumping. The division has three branches that carry out its duties.

The Land Management Branch conducts studies on land acquisitions and exchanges and provides for the management and disposition of non-homestead lands and properties.

The Income Property Branch conducts feasibility studies on developing land for commercial, industrial, business, or mixed uses, and generates plans for developing revenue-producing sites.

The Technical Services Branch conducts and reviews appraisals, conducts studies, and develops and maintains records for both land and real property.

Homestead Services Division

The Homestead Services Division processes homestead lease applications; manages programs and activities in leasing homestead lots for residential, agricultural, and pastoral purposes; and provides homestead lessees loans and other financial assistance. The division has three branches that help meet its responsibilities.

The Homestead Applications Branch determines native Hawaiian qualifications, manages programs and activities in leasing homestead lots, and provides homestead lessees loans and other financial assistance. In addition, this branch maintains applicants' records and certifies their eligibility for residential, agricultural, and pastoral awards.

The Loan Services Branch administers the department's loan origination, servicing, and collection programs.

The District Operations Branch includes district offices on Kauai, Oahu, Molokai, Maui, and in West and East Hawaii. This branch facilitates and processes subdivision of homestead lots, home improvement permits, and lessee requests for lease conveyances through successorships or transfers. The branch also updates lessee files and successorship designations, the voluntary surrender of leases, and enforces compliance with lease terms.

Objectives of the Audit

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the Department of Hawaiian Home Lands; to recommend improvements to such systems, procedures, and reports; and to report on the financial statements of the department.

2. To ascertain whether expenses or deductions and other disbursements have been made and all revenues or additions and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

3. To make recommendations as appropriate.

Scope and Methodology

We audited the department's financial records and transactions and reviewed its related systems of accounting and internal controls for the fiscal year July 1, 2000 to June 30, 2001. We tested financial data to provide a basis from which to report on the fairness of the presentation of the financial statements. We also reviewed the department's transactions, systems, and procedures for compliance with applicable laws, regulations, and contracts.

We examined existing accounting, reporting, and internal control structures and identified deficiencies and weaknesses therein. We made recommendations for appropriate improvements including, but not limited to, the department's forms and records, management information system, and accounting and operating procedures.

In addition, we reviewed the extent to which recommendations made in the department's prior external financial audit and in Chapter 2 of the State Auditor's Report No. 93-22, *Management and Financial Audit of the Department of Hawaiian Home Lands*, have been implemented.

The independent auditors' opinion as to the fairness of the department's financial statements presented in Chapter 3 is that of Grant Thornton LLP. This audit was conducted from July 2001 through December 2001 in accordance with generally accepted government auditing standards.

Chapter 2

Internal Control Deficiencies

Internal controls are steps instituted by management to ensure that objectives are met and resources safeguarded. This chapter presents our findings and recommendations regarding the financial accounting and internal control practices and procedures of the Department of Hawaiian Home Lands.

Summary of Findings

Our findings are summarized as both reportable conditions as well as other significant areas of concern not considered reportable conditions.

Reportable conditions are significant deficiencies in the design or operation of the internal control over financial reporting which, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in its financial statements.

A material weakness is the worst possible type of reportable condition. A material weakness is a condition in which the design or operations of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material to the financial statements being audited may occur and not be detected within a timely period by the employees in the normal course of performing their assigned functions.

We found several reportable conditions and other significant areas of concern involving the department's internal control over financial reporting and operations. Similar deficiencies were communicated to the department in our Report No. 93-22, *Management and Financial Audit of the Department of Hawaiian Home Lands*, and by external auditors in prior financial audits concerning the department's management of loans, leases, and Hawaiian home lands.

The following matters are severe and considered material weaknesses:

1. The department does not have sufficient documentation to support its methodology for determining the allowance for doubtful accounts for loans receivable.

2. The department did not record expenditures for infrastructure improvements within the proper period.

Other reportable conditions are summarized as follows:

3. Management is ineffective. The department's policies and procedures are either not enforced or are non-existent. In addition, the department does not manage outstanding loans adequately, nor maintain current information on the status of loans originated by financial institutions or other lenders for which the department guarantees repayment. Futhermore, the department does not perform financial reporting accurately and timely.

4. Fixed assets are not properly recorded.

5. Construction costs are not properly capitalized as inventory of homes for sale.

We also identified other significant areas of concern not considered reportable conditions. Although these matters may not directly impact the financial statements, they are significant to the department's operations. We found that the department does not have written policies or procedures for the collection of lease and license receivables. We also found that the department does not have a current strategic plan to guide its programs in meeting its goals and objectives under the Hawaiian Homes Commission Act of 1920. In addition, the list of applicants for homestead awards has remained constant for the last five years, with thousands of beneficiaries waiting for the opportunity to be provided with land. Furthermore, information on applicants may not always be current, thus precluding the department from contacting beneficiaries about the availability of homestead leases.

The Methodology for Determining the Allowance for Doubtful Accounts for Loans Receivable Is Not Supported by Sufficient Documentation

The department's allowance for doubtful accounts for outstanding loans as of June 30, 2001 was $3.732 million. This amount represents management's best estimate of the outstanding loans that may not be collectible. Since management determines this amount based on subjective as well as objective factors, judgment is often required to estimate the amount shown in the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and assumptions about current conditions. The estimated amount for doubtful accounts must be reasonable and supported by relevant information and adequate documentation.

Support for the calculation of the doubtful accounts allowance is insufficient

In determining the allowance for doubtful accounts, the department's methodology is faulty. The department assumes that upon cancelling a loan it will repossess the real property, which serves as collateral for the loan, and sell it to another party. Under this methodology, the department's loss would be the difference between the outstanding loan plus interest balance and the sales price to the new buyer. The department's methodology for determining the allowance utilizes real property tax assessed values as the basis for determining the new buyer's sales price. The department could not provide us with sufficient documentation supporting the assumption that real property tax assessed values reflect the proper value to use in estimating the uncollectible receivables and that the value strongly correlates to the actual sales price for which the property can be sold.

Furthermore, the department's methodology includes applying certain percentages to various aged loan receivable balances. The department could not provide sufficient, reliable data supporting the use of these percentages in determining its allowance for doubtful accounts. The department's inability to provide a reliable basis for the computation of its allowance for doubtful accounts makes it impossible to determine whether the amount recognized by the department is reasonable.

Method used to calculate the allowance for doubtful accounts for agricultural loans is questionable

The department's use of the previously described methodology to compute the allowance for doubtful accounts for outstanding agricultural loans is also faulty. We found that agricultural loans are not collateralized by real property. Collateral is the property or asset pledged to secure a loan. If a loan is deemed uncollectible, the lending institution may seize the property or asset used as collateral. However, the department cannot recover uncollectible amounts through real property repossession because real property is not pledged as collateral for its agricultural loans. Applying this faulty methodology to determine uncollectible amounts for its agricultural loans is questionable. The department could not provide sufficient, reliable data supporting the use of this methodology for its agricultural loans. Outstanding agricultural loans and related interest receivable as of June 30, 2001 amounted to approximately $799,000. Of this balance, approximately $488,000, or 61.1 percent, of the loan payments due was outstanding for 60 days or more.

Historically, the department has not experienced significant losses due to uncollectible mortgage loans. This is due primarily to the resale values on foreclosed properties actually exceeding the outstanding loan and interest balances for the cancelled loans. The latter proves that there is limited correlation between the actual sales price of the properties and the methodology used to determine the department's allowance for doubtful loan accounts.

Without sufficient documentation, we were unable to determine the reasonableness of the estimates for uncollectible loan receivables and the accuracy of the financial statements. Management must base its estimate on relevant, sufficient, and reliable data. Failure to do so may result in improper financial reporting.

Recommendations

The Department of Hawaiian Home Lands should obtain sufficient documentation for determining its allowance for doubtful accounts for loans. The department should also reevaluate the methodology for determining its allowance for doubtful accounts for loans and ensure the uncollectible loans estimate is properly calculated.

Infrastructure Improvements Are Not Recorded in the Proper Accounting Period

The Department of Hawaiian Home Lands did not properly record its prior year liability for infrastructure improvements, thereby misstating its current and prior year financial statements. In the year ended June 30, 2000, the department received certain land parcels in Kealakehe, Hawaii. As part of the transaction, the department was supposed to reimburse the Department of Business, Economic Development and Tourism's Housing and Community Development Corporation of Hawaii a total of $1,816,100 for infrastructure improvements to the land. This reimbursement was to be made over a three-year period.

Instead, the department recorded the entire $1,816,100 as an expenditure in the year ended June 30, 2001. In accordance with accounting principles generally accepted in the United States of America (GAAP), expenditures should be recorded in the accounting period in which the fund liability is incurred. GAAP provides reporting standards by which financial statements should be prepared. Therefore, the $1,816,100 should have been recorded as a liability as of June 30, 2000 and as an expenditure for the year ended June 30, 2000. This error resulted in the underreporting of liabilities and expenditures in FY1999-00. Since the department did not correct this error in accordance with GAAP, its FY2000-01 expenditures were overstated by $1,816,100.

Failure to report all expenditures and liabilities in the proper period provides a misleading picture of an institution's financial condition. In addition, failure to properly correct the accounting error results in inaccurate financial statements. This accounting error may also cause the public, private businesses, and government officials to rely on misleading and inaccurate financial statements. Such reliance could also result in poor and misinformed decision-making.

Recommendation

The Department of Hawaiian Home Lands should review its internal control policies and procedures and ensure that all expenditures and liabilities are properly recorded.

Management Has Failed to Ensure That All Departmental Accounting Policies and Procedures Are in Place and Enforced

The Department of Hawaiian Home Land's management is ineffective and does not ensure that all necessary accounting policies and procedures are in place and enforced. Outstanding loans and guaranteed loans with outside lenders are improperly managed. Accurate and timely financial reporting is not required by management. Written collection policies and procedures for lease and license receivables are non-existent.

Management of outstanding loans is deficient

The department does not properly manage its outstanding loans. Its inability to effectively maintain, monitor, and collect outstanding loans could cost the State and Hawaii's taxpayers millions of dollars. In addition, qualified, eligible beneficiaries may not be able to receive assistance because loan moneys are tied up in delinquent loans which are unlikely to be repaid.

In FY2000-01, the department granted loans totaling $3,267,294; however, it could not provide the number of loans granted or the average time an applicant waited for loan approval or homestead land availability. There are currently 19,641 applicants on the waiting list for homestead lands.

As of June 30, 2001, the department also had about $47 million in existing outstanding loans. Of this balance, $4.5 million, or 9.7 percent, were outstanding for 60 days or more. The department considers a loan to be delinquent if no payments have been made for 60 days or more. As of June 30, 2001, the department had a total of 1,359 loans outstanding, of which 526 were delinquent, with loan payments totaling approximately $4.5 million. These figures equate to a delinquency rate of about 39 percent. Historically, the department's loan delinquency rate has been close to 40 percent. In comparison, the average delinquency rate for mortgage loans in Hawaii generally is 2.81 percent, according to the Mortgage Bankers Association of America's 2001 Second Quarter Report. It is imperative that the department make the collection of delinquent loans a high priority. The longer a loan remains delinquent, the less likely it will be collected.

High delinquency rates exist for a number of reasons. In addition to departmental inefficiencies, the loans themselves pose a high risk. Many current lessees cannot obtain loans from commercial institutions and rely on the department's assistance because its credit approval policies are much more relaxed than those of a commercial lending institution. The department approves many more "high risk" applicants than a commercial lender would. Therefore, the department runs a high risk of incurring a large number of delinquencies at the outset. As a consequence, the department needs to actively monitor loans and enforce collection policies to control the level of delinquent loans.

Furthermore, the department's loan system does not benefit from existing technology used by commercial institutions which could automate many of the tasks now performed manually. Currently, the department's system generates loan reports that must be manually sorted for distribution to the proper loan officers. Delinquency notification letters are also generated by hand. Loan officers physically review payment reports to determine which lessees should receive notices. Automating these tasks would free loan officers to spend more time performing their other duties.

Overall, we found that the department has numerous problems. It does not enforce written collection policies relating to outstanding loans, does not consistently maintain documentation on delinquent loans, does not ensure loan records contain valid addresses, is increasing financial assistance to lessees, and continues to accrue interest on loans related to cancelled leases.

Written collection policies are not enforced

The department does not follow its written delinquent loan policies, which prescribe the following actions to take when loan payments become outstanding for over 30 days:

- Over 30 days outstanding – Reminder notices are sent to lessees along with monthly statements.

- Over 60 days outstanding – A departmental representative contacts lessees by phone, personal visit, or a letter.

- Over 90 days outstanding – A departmental representative visits lessees to arrange payment plans or solicit promises to pay. If payments are not received by the agreed-upon date, a departmental representative and the lessee meet to rectify the delinquency.

- Over 120 days outstanding – After all collection efforts have failed, the delinquent borrower is referred to the Hawaiian Homes Commission for a citation hearing. Upon approval by the commission, a citation hearing is conducted, wherein the collection officer presents the account history and recommends action in the borrower's presence. The commission then renders its decision. If the commission cancels the lease, eviction proceedings commence.

Of ten delinquent loans we reviewed, none of the prescribed procedures were followed at the 30, 60, 90, or 120-day points of delinquency. Departmental loan specialists and the homestead services administration acknowledge that policies are not enforced, and the department's external auditors have reported this situation as a reportable condition since FY1998-99.

Documentation for follow-up on delinquent loans is not maintained on a consistent basis

The department does not document follow-up on delinquent loans consistently. Departmental policies require the recording of prior and current delinquent loan collection activity on a manually prepared follow-up collection card. Beginning in FY1999-00, a computerized system replaced the manual records. However, our review of ten additional delinquent loans indicated miniscule or non-existent compliance with collection policies, whether manual or computerized.

Loan records contain invalid addresses

Of 92 loans tested, we noted six lessees, or 6.5 percent, who had invalid addresses in the department's records. The inaccurate information limits the department's ability to contact lessees for loan collection matters and to enforce collection procedures. The department's external auditors have reported this problem since FY1999-00; however, the situation still exists.

Lessees receive increasing assistance

The department has provided increased financial assistance to certain lessees by repaying their delinquent debt to outside creditors for delinquent loans and delinquent property taxes. This practice has increased significantly over the years, with a 40 percent growth between June 30, 2000 and June 30, 2001. The outstanding balance at June 30, 2001 was $3,199,747, compared to $2,276,511 at June 30, 2000. Of the nearly $3.2 million balance outstanding, $2,826,797 represents advances for loans with outside lenders and more than $370,000 represents advances for delinquent property taxes.

The department guarantees loans to lessees made by agencies outside the department and advances the necessary funds to bring lessees to a current status with their outside lenders. Some of these lessees have delinquent loans outstanding; yet we found that advances made as of June 30, 2001 totaled over $2.8 million.

The department has also made payments to the various counties for delinquent real property taxes on behalf of many of its lessees. As of

June 30, 2001, outstanding advances for delinquent real property taxes amounted to $372,950. Some of these lessees also have delinquent loans with the department.

The department was unable to provide either the amount of advances outstanding for more than 60 days as of June 30, 2001 or the amount of advances provided to lessees with delinquent loans outstanding.

The department's Homestead Services Division is responsible for establishing payment plans with lessees for repayment of their loans and real property tax advances. However, these payment plans are not supported by formal written agreements with the lessees. Typically, lessees write and sign informal notes acknowledging their new repayment terms. Collecting these advances then becomes difficult to enforce in the absence of a binding written agreement. In addition, the fiscal office is not informed of the repayment terms for these advances. Because the fiscal office does not have repayment information, an aging report for these advances is not maintained which further results in inaccurate financial data.

Interest is accrued on loans related to cancelled leases

As of June 30, 2001, the department had a total of 92 cancelled leases. In our sample of ten of these leases with related loans, the department continued to accrue interest on all ten loans after the leases were cancelled. Although recording accrued interest on cancelled leases results in the overstatement of income, the department's accounting software continues to accrue interest on all loans regardless of the loan's status. Also, the probability of interest payments by lessees is questionable once the lease has been cancelled. The department's external auditors have identified this situation since FY1998-99.

At the Department of Hawaiian Home Lands, a "cancelled" lease might still be active. Although the commission may cancel a lease, the department may still grant the lessee a final chance to save the lease. The department provides the lessee with a letter explaining the lease cancellation, but gives the lessee an opportunity to salvage the lease by complying with specific provisions set forth by the department. Such letters also state that any noncompliance with revised provisions will cause the eviction process to take effect immediately. The Department of the Attorney General has approved this letter's form to ensure that the lessee has no legal grounds to challenge any cancellation proceedings. Due to the letter's terminology, the department classifies these leases as "cancelled." However, because of the continuing activity for some of the cancelled leases, the department has elected to accrue interest on all loans related to cancelled leases. At the department, a "cancelled" lease has three (unofficial) phases:

- The department is in the process of determining the specific provisions for the lessee.
- The department has reached an agreement with the lessee who is abiding by the terms of the agreement.
- The department has concluded that there is little hope for collection.

Loan guarantees are not properly monitored

The Hawaiian Homes Commission Act of 1920 authorizes the Department of Hawaiian Home Lands to guarantee loans to lessees originally made by other agencies. The act limits the aggregate amount of loan guarantees to $50 million. However, we found that the department does not maintain a current or accurate schedule of other agencies' loans for which it has guaranteed repayment. Furthermore, the department does not receive reports from other agencies regarding the number or balances of the guaranteed loans.

Since FY1998-99, external auditors have reported that the department does not track loan guarantees. Departmental officials admit that their only concern is to remain under the $50 million limit set by the act. Because these managers believe that the guarantee level at June 30, 2001 of $20.5 million is far below the limit, they are unconcerned with monitoring the loan guarantee details. We also found that although the Loan Services Branch handles the guarantees to financial institutions and other agencies and has certain information on guaranteed loans, it does not forward this information to the fiscal office.

In order to ensure that the department does not exceed its $50 million threshold, it must keep an accurate listing of the number of guaranteed loans and their current principal balances. If it does not monitor this data, the department cannot assure compliance with the act. Furthermore, the department does not track its loan exposure.

Financial reporting is not timely

Accurate and timely financial reporting is a key factor in management's decision making. Management must have accurate and timely financial information in order to measure an organization's performance, evaluate critical business opportunities, and strategically plan for the future. We found that the department's financial reporting is neither accurate nor timely. For the year ended June 30, 2001, the department did not have its audited financial statements completed until six months after the year end. Its internal financial statements also required numerous adjustments to comply with GAAP, which the external auditors assisted extensively in preparing. This was a major contributing factor to the delay in completing our financial audit.

At June 30, 2001, the Department of Hawaiian Home Lands also had revenue bond obligations of $14 million, payable in annual installments through the year 2012. The bond agreement terms require submittal of the department's audited financial statements to the director of finance within 150 days after the fiscal year-end. We found that the department has not complied with this requirement. Failure to comply with the bond covenants could be considered an event of default and result in the unpaid bond principal and interest amounts becoming due immediately. In such a case, the department would be required to remit these moneys to bondholders at once.

Because management is responsible for the data set forth in the department's financial statements, it should ensure that financial accounting records are accurate and complete. Management must also ensure the timely completion of financial statements for business decision-making as well as for meeting required deadlines. Management should meet these responsibilities.

Written collection policies and procedures do not exist for lease and license receivables

Written policies and procedures for the collection of lease and license receivables do not exist. While the department has procedures to follow-up on delinquent receivables, they are not formally documented nor consistently executed. Written documentation would support the consistent application of procedures.

As of June 30, 2001, the department had $2,105,626 in lease and license receivables outstanding. Of this amount, $1,878,145, or 89 percent, represents balances outstanding more than 60 days.

The allowance for doubtful accounts is used to record the balance of receivables outstanding which the department deems may not be collectible. At June 30, 2001, the balance of this doubtful accounts allowance for estimated uncollectible lease and license receivables was approximately $929,000, representing 44 percent of the total lease and license receivables outstanding.

Recommendations

1. The Department of Hawaiian Home Lands must review its loan collection policies and procedures for reasonableness and determine the necessary steps to enforce them. The following should also be considered:

    a. Monitor the loan delinquency rate and set benchmarks and time frames. This will provide the department with targeted goals and objectives for performance measurement.

   b. Reevaluate the credit approval process. A more stringent credit approval process may help reduce the delinquent loan level.

   c. Ensure the database for lessee information is current, reasonably accurate, and properly maintained.

   d. Obtain formal written agreements for advances on guaranteed loans and delinquent real property taxes.

   e. Provide the fiscal office with timely written documentation on repayment terms for advances on guaranteed loans and delinquent real property taxes.

   f. Cease accruing interest on loans related to cancelled leases considered uncollectible and modify the software program to ensure that this does not continue. Modify internal procedures to ensure the Loan Services Branch provides the fiscal office with the status of cancelled leases.

2. The department should consider purchasing a software program similar to those used by commercial institutions. This would reduce loan officers' manual labor by automatically generating delinquency notification letters at set intervals and preparing reports to facilitate loan monitoring.

3. The department should maintain current and accurate information on all guaranteed loans. Agencies that hold loans guaranteed by the department should provide it with quarterly reports identifying the number of loans guaranteed and the current principal balances outstanding. The Loan Services Branch should also inform the fiscal office of any new or cancelled guaranteed loans. The department should verify this information against the quarterly reports received from outside agencies to ensure accurate records.

4. The department should properly maintain its financial accounting records, thereby enhancing its financial reporting practices and fostering the timely completion of required financial audits.

5. The department should establish and implement written policies and procedures for the collection of lease and license receivables. Staff should receive proper training in the implementation of policies and procedures. The department should also set goals for reducing balances outstanding more than 60 days.

Fixed Assets Are Not Recorded Properly

Proper accounting requires that fixed assets be recorded at cost. Cost of a fixed asset includes not only its purchase price or construction costs, but also any ancillary charges. These charges include site preparation expenditures as well as professional fees directly attributable to the asset's acquisition and placement into its intended use. Although the department has incurred such ancillary charges, it has not recorded these amounts as fixed assets. We found that the department does not record its fixed assets properly, resulting in inaccurate fixed asset records.

As of June 30, 2001, the department recorded fixed assets of $26,542,329 and also identified unrecorded fixed asset costs of $27,895,183. Included in the latter figure are infrastructure costs as well as ancillary charges. Currently, capitalizing infrastructure costs as fixed assets is optional according to GAAP. However, effective July 1, 2001, the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, requires all governmental agencies to present financial statements similar to private businesses, including the computation of depreciation expense for its fixed assets. Therefore, the department must capitalize infrastructure costs at this time. If the department cannot comply with GASB Statement No. 34, its external auditor will not be able to issue an unqualified opinion on its financial statements and would have to qualify, disclaim, or issue an adverse opinion.

We also found that the department has not correctly recorded fixed asset costs related to its inventory of homes for sale. As of June 30, 2001, the department has recorded inventory of homes for sale of $7,578,282. It has also identified costs of $11,589,752, of which a portion should have been reflected as fixed assets; included in this figure are infrastructure costs as well as ancillary charges. Ancillary charges should have been recorded as fixed assets. The department could not provide information on the amount of ancillary charges that should be reflected as fixed assets.

Finally, fixed assets are understated on the department's financial records. Recording fixed assets improperly results in inaccurate financial reporting, which may mislead users of such information. Also, if the department does not properly record its fixed assets, it will not comply with the requirements of GASB Statement No. 34.

Recommendation

The Department of Hawaiian Home Lands needs to determine the amount of ancillary charges that should be recorded as additions to fixed assets and make the necessary adjustments to its accounting records. These adjustments are necessary for the preparation of financial statements in accordance with GAAP.

Construction Costs Are Not Properly Capitalized as Inventory of Homes for Sale

The Department of Hawaiian Home Lands did not properly capitalize costs in the amount of $647,267 for the prior year construction of homes. Instead, these amounts were recorded as expenditures. This error resulted in the understatement of the department's assets and overstatement of its expenditures in the prior year by $647,267. In the current financial year, expenditures are understated by the same amount because the prior year's error was not correctly accounted for in the current year in accordance with GAAP.

Recommendation

The Department of Hawaiian Home Lands should assume more responsibility for the proper recording of transactions under GAAP. External auditors have been heavily involved in preparing the necessary adjustments to conform the department's financial statements to GAAP. The department should not be so dependant on its auditors but should develop its own systems and procedures to ensure that financial statements are prepared in accordance with GAAP.

The Department Does Not Have a Current Strategic Plan in Place

The department does not have a current strategic plan to guide its programs. Since its 1976 *General Plan*, a strategic plan has not been prepared even though the original plan called for reevaluating the plan every five years. Despite this, the department has never reviewed or evaluated the plan and has been operating without the guidance of an updated strategic plan for many years.

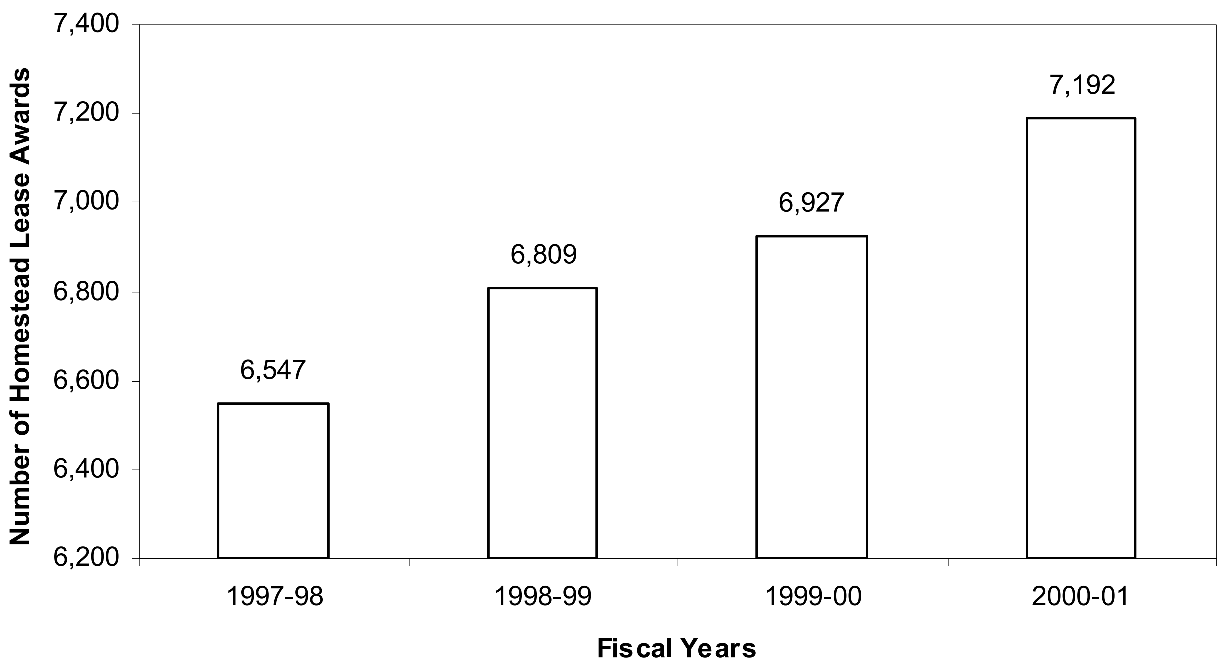
A strategic plan provides a framework from which to lead organizations to reach their goals and objectives. A current strategic plan would provide the department with the direction to achieve its mission. The absence of such a plan contributes to inefficiencies, abuse, and wasted resources.

At the time of our fieldwork, the department was actively updating its *General Plan*, which includes a strategic plan as a component, and had a draft prepared. With the update, it hopes to integrate a planning process that will tie all its different aspects into one all-encompassing system. Subsequent to our fieldwork, the department presented the final draft of its *General Plan* and overall planning system to the commission, which was adopted in March 2002.

Beneficiaries are still waiting for land to be provided to them

The Department of Hawaiian Home Lands' primary purpose is to administer land grants to native Hawaiians. As of June 30, 2001, the department had an inventory of approximately 42,034 acres of land for the explicit use of homesteads. Currently, the department has over 30,000 applications from more than 19,000 applicants on its waiting lists. This disparity is primarily due to the fact that applicants may submit two applications, one for a residential lot and the other for either agricultural or pastoral land. The cumulative leases awarded as of June 30, 2001 totaled 7,192; applications and cumulative leases awarded for FY2000-01 and the three years prior are shown in Exhibits 2.1 and 2.2.

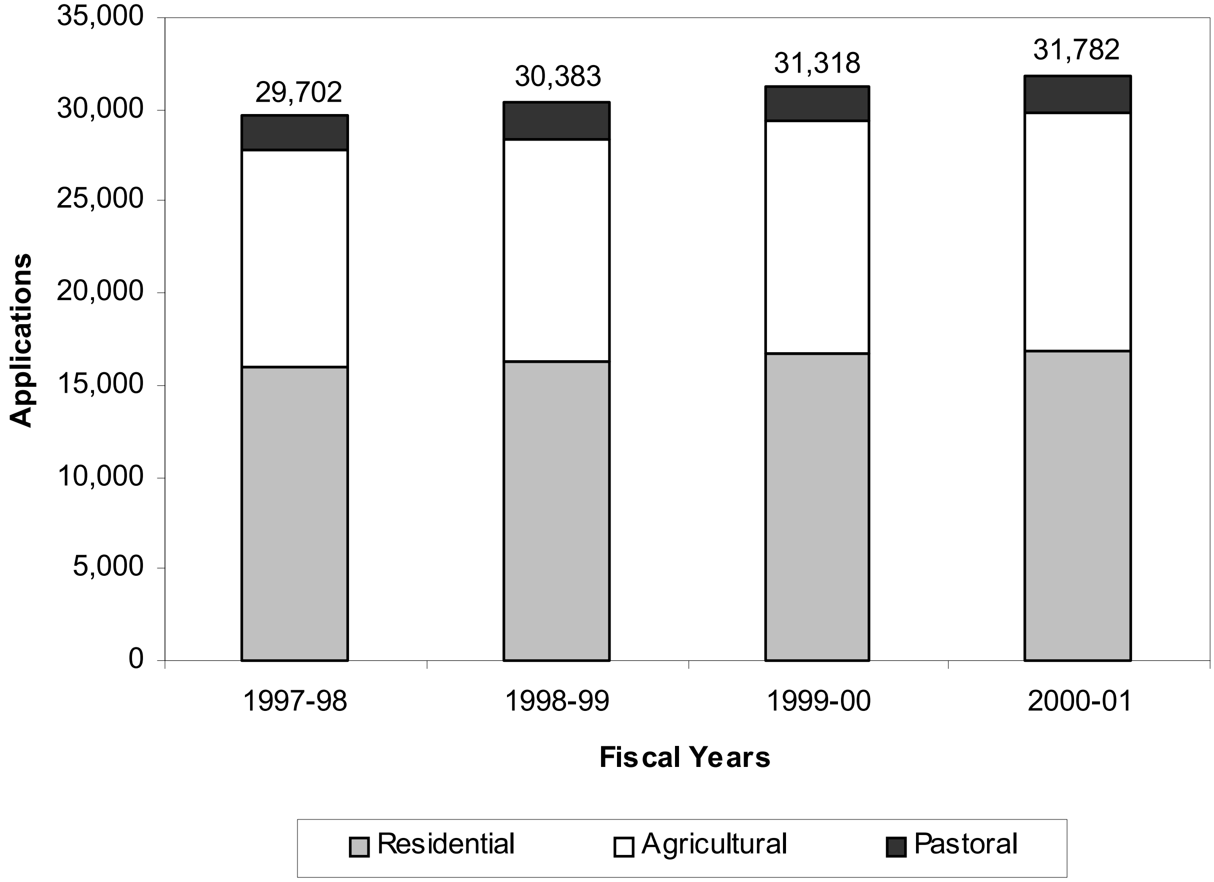
Exhibit 2.1
Homestead Lease Awards
Cumulative Totals FY1998-2001



Totals include residential, pastoral, and agricultural homestead leases.

Source FY1997-98 to FY1999-00: Department of Hawaiian Home Lands annual reports.
Source FY2000-01: Department of Hawaiian Home Lands, "Lease Report for the Month Ending June 30, 2001."

Exhibit 2.2
Homestead Applications
Cumulative Totals FY1998-2001



Source FY1997-98 to FY1999-00: Department of Hawaiian Home Lands annual reports.
Source FY2000-01: Department of Hawaiian Home Lands, "Homestead Area and Islandwide Applications Waiting List Monthly Report for the Month Ending June 30, 2001."

Increase in number of applications outpaces leases awarded

The number of applications for land grants continues to significantly exceed the leases awarded. Ten years ago in FY1990-91, the number of applications totaled 21,562, while leases awarded totaled 5,983 (21.7 percent). Although leases awarded have now increased 20 percent compared to ten years ago, the number of applications has also increased by 47 percent—far exceeding the award level. This data illustrates the thousands of beneficiaries who are still waiting to receive land.

Information on applications is not current or accurate

Applicants may have been on the waiting list for as many as 40 to 50 years, and the department may not have current information to reach these applicants. Thus, the department cannot contact these applicants to notify them of available lots.

Recommendations

The Department of Hawaiian Home Lands should expedite the implementation of its strategic plan. The plan should be reviewed and updated periodically.

The department should also update and maintain the data on its waiting lists to ensure they contain current and accurate information on all applicants.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the Department of Hawaiian Home Lands, State of Hawaii, as of and for the fiscal year ended June 30, 2001. This chapter includes the independent auditors' report and the report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* as they relate to the department. It also displays the combined financial statements of all fund types and account groups administered by the department together with explanatory notes and supplementary information.

Summary of Findings

In the opinion of Grant Thornton LLP, based on their audit, except for the effects of such adjustments, if any, as might have been determined to be necessary had they been able to obtain sufficient evidential matter supporting the amount of the allowance for loan losses as discussed in the third paragraph of their independent auditors' report and except for the effects of excluding ancillary costs for fixed assets as discussed in the fourth paragraph and not correcting for errors in prior year's financial statements for amounts related to infrastructure improvements expenditures and liabilities and home construction costs incurred in the year ended June 30, 2000, as discussed in the fifth and sixth paragraphs, respectively, of their independent auditors' report, the combined financial statements present fairly, in all material respects, the financial position of the department as of June 30, 2001, and the results of its operations for the year then ended in conformity with accounting principles generally accepted in the United States of America. Grant Thornton LLP noted certain matters involving the department's internal control over financial reporting and its operations that the firm considered to be reportable conditions, including material weaknesses as defined in the report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*. Grant Thornton LLP also noted that the results of its tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Independent Auditors' Report

The Auditor
State of Hawaii:

We have audited the accompanying combined financial statements of the Department of Hawaiian Home Lands, State of Hawaii, as of and for the year ended June 30, 2001. These combined financial statements are the responsibility of the department's management. Our responsibility is to express an opinion on these combined financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The department has loans receivable of $43,495,320, net of an allowance for losses of $3,732,000 as of June 30, 2001. The department was unable to provide sufficient evidential matter supporting the amount of the allowance for loan losses. It is not possible to form an opinion about the allowance for losses on loans receivable.

The department has not included in fixed assets ancillary costs necessary to place the assets into their intended condition for use. In our opinion, fixed assets should include ancillary costs necessary to place the assets into their intended condition for use in order to conform with accounting principles generally accepted in the United States of America. The effects of that departure on the combined financial statements have not been determined.

The department recorded expenditures in the amount of $1,816,100 for infrastructure improvements to land in the year ended June 30, 2001 that related to a fund liability incurred in the year ended June 30, 2000. In our opinion, these expenditures and liability should have been recognized in the year ended June 30, 2000 and the beginning fund balance as of July 1, 2000 should have been decreased by $1,816,100 and the expenditures for the year ended June 30, 2001 should have been decreased by $1,816,100 to conform to accounting principles generally accepted in the United States of America.

The department recorded expenditures in the amount of $647,267 in the year ended June 30, 2000 for home construction costs. In our opinion, the costs should have been capitalized as inventory of homes for sale in the year ended June 30, 2000 and the beginning fund balance as of July 1, 2000 and home construction/capital projects expenditures for the year ended June 30, 2001 should be increased by $647,267 to conform with accounting principles generally accepted in the United States of America.

As discussed in note A to the combined financial statements, the combined financial statements of the department are intended to present the financial position and results of operations of only that portion of the funds and account groups of the State of Hawaii that are attributable to the transactions of the department.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to obtain sufficient evidential matter supporting the amount of the allowance for loan losses as discussed in the third paragraph, and except for the effects of excluding ancillary costs for fixed assets as discussed in the fourth paragraph, and not correcting for errors in prior year's financial statements for amounts related to infrastructure improvements expenditures and liabilities and home construction costs incurred in the year ended June 30, 2000 as discussed in the fifth and sixth paragraphs, respectively, the combined financial statements referred to above present fairly, in all material respects, the financial position of the Department of Hawaiian Home Lands, State of Hawaii, as of June 30, 2001, and the results of its operations for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 4, 2002 on our consideration of the department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was performed for the purpose of forming an opinion on the combined financial statements taken as a whole of the department as of and for the year ended June 30, 2001. The supplementary information included in Schedules I and II is presented for purposes of additional analysis and is not a required part of the combined financial statements. Such information has been subjected to the auditing procedures applied in our audit of the combined financial statements and, in our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to obtain sufficient evidential matter supporting the amount of the allowance for loan losses as discussed in the third paragraph, and except for the effects of excluding ancillary costs for fixed assets as discussed in the fourth paragraph, and not correcting for errors in the prior year's financial statements for amounts related to infrastructure improvements expenditures and liabilities and home construction costs incurred in the year ended June 30, 2000 as discussed in the fifth and sixth paragraphs, respectively, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

/ s / Grant Thornton LLP

Honolulu, Hawaii
February 4, 2002

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Auditor
State of Hawaii:

We have audited the combined financial statements of the Department of Hawaiian Home Lands, State of Hawaii, except for the allowance for loan losses, as of and for the fiscal year ended June 30, 2001, and have issued our report thereon dated February 4, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the department's combined financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes) and procurement rules, directives, and circulars, noncompliance with which could have a direct and material effect on the determination of combined financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal control over financial reporting

In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the combined financial statements. Reportable conditions are described in Chapter 2 of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the combined financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described, we consider the items related to the documentation for the methodology for determining the allowance for doubtful accounts for loans receivables and the recording of infrastructure improvements expenditures and liabilities in the proper period to be material weaknesses as described in Chapter 2 of this report.

This report is intended solely for the information of the Auditor, State of Hawaii, and the management of the department and is not intended to be and should not be used by anyone other than these specified parties.

/ s / Grant Thornton LLP

Honolulu, Hawaii
February 4, 2002

Description of Combined Financial Statements and Supplementary Information

The following is a brief description of the combined financial statements and supplementary information audited by Grant Thornton LLP, which are located at the end of this chapter.

Combined financial statements

Combined Balance Sheet – All Fund Types and Account Groups (Exhibit 3.1). This statement presents the assets, liabilities, and fund equity of all fund types and account groups of the department at June 30, 2001.

Combined Statement of Revenues, Expenditures, and Changes in Fund Balances – All Governmental Fund Types and Expendable Trust Funds (Exhibit 3.2). This statement presents the revenues, expenditures, and changes in fund balances for all governmental fund types and expendable trust funds of the department for the fiscal year ended June 30, 2001.

Combined Statement of Revenues and Expenditures – Budget and Actual – General and Special Revenue Fund Types (Exhibit 3.3). This statement compares actual revenues and expenditures of the department's general and special revenue funds on a budgetary basis to the budget adopted by the State of Hawaii (State) Legislature for the fiscal year ended June 30, 2001.

Supplementary information

Combining Schedule of Balance Sheet Information – Special Revenue Funds (Schedule I). This schedule presents the assets, liabilities, and fund equity of the special revenue funds of the department at June 30, 2001.

Combining Schedule of Revenues, Expenditures, and Changes in Fund Balances – Special Revenue Funds (Schedule II). This schedule presents the revenues, expenditures, and changes in fund balances of the special revenue funds of the department for the fiscal year ended June 30, 2001.

Notes to Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the combined financial statements and financial condition of the Department of Hawaiian Home Lands, State of Hawaii, are discussed in this section.

Note A – Significant Accounting Policies

The Department of Hawaiian Home Lands is headed by the Hawaiian Homes Commission. The department was established by Section 24, Act 1 (the Hawaii State Government Reorganization Act of 1959), Second Special Session Laws of Hawaii 1959, and is responsible for the administration of the Hawaiian Homes Commission Act of 1920 enacted by the United States Congress. The Hawaiian Homes Commission Act of 1920 sets aside certain public lands as Hawaiian home lands to be utilized in the rehabilitation of native Hawaiians.

The following is a summary of significant accounting policies:

1. Reporting Entity – The department is part of the executive branch of the State. The department's combined financial statements are intended to present the financial position and results of operations of only that portion of the funds and account groups of the State that are attributable to the transactions of the department. The state comptroller maintains the central accounts for all State funds and publishes financial statements for the State annually, which includes the department's financial activities.

2. Fund Accounting – The accounts of the department are organized on the basis of funds and account groups, each of which is considered a separate accounting entity. The financial activities of each fund are accounted for with a separate set of self-balancing accounts which represent the funds' assets, liabilities, fund equity, revenues, and expenditures. Account groups are used to establish accounting control and accountability for the department's general fixed assets and general long-term obligations. Account groups are not funds as they do not reflect available resources.

Governmental Fund Types

General Fund – The general fund is used to account for all financial activities except those required to be accounted for in another fund. The annual operating budget, as authorized by the State Legislature, provides the basic framework within which the resources and obligations of the general fund are accounted.

Special Revenue Funds – Special revenue funds are used to account for the proceeds of specific revenue sources (other than expendable trusts) that are restricted to expenditures for specified purposes. Revenues are primarily from general leases, licenses, and permits granted for commercial, residential, agricultural, and pastoral uses; and interest and investment income.

Capital Projects Fund – The capital projects fund is used to account for financial resources to be used for the acquisition or construction of major capital facilities.

Debt Service Fund – The debt service fund accounts for the accumulation of resources for and payment of general long-term debt principal and interest. The principal sources of funds are transfers of funds from revenues from available lands and interest earned on investments in the debt service fund and from revenue bond proceeds.

Fiduciary Fund Types

Expendable Trust Fund – The expendable trust fund accounts for funds from the State to be expended by the department as provided by law upon approval by the Hawaiian Homes Commission and used for capital improvements and other purposes undertaken in furtherance of the Hawaiian Homes Commission Act of 1920.

Agency Fund – The agency fund accounts for security deposits held for the department's lessees as security for leased properties.

Account Groups

General Fixed Assets Account Group – General fixed assets acquired for use by the department in the conduct of its general governmental operations are accounted for in the general fixed assets account group at cost or estimated fair market value at date of donation. Accumulated depreciation is not recorded in the general fixed assets account group.

General Long-Term Debt Account Group – Revenue bonds, unmatured long-term general obligation bonds, and the obligation for the long-term portion of accrued vested vacation is recorded in the general long-term debt account group.

3. Basis of Accounting – All governmental funds and the expendable trust funds are accounted for using the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized when they become measurable and available. Expenditures are generally recognized when the related fund liability is incurred. An exception to this general rule includes accumulated unpaid vacation which is not payable from expendable available resources and is therefore included in the general long-term debt account group.

4. Appropriations – An authorization granted by the State Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are allotted quarterly. The allotted appropriations lapse if not expended by or encumbered at the end of the fiscal year, except for allotted appropriations related to capital projects.

5. Encumbrances – Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of moneys are recorded in order to reserve that portion of the applicable appropriation, is employed as an extension of formal budgetary integration in the governmental fund types. Encumbrances outstanding at fiscal year-end are reported as reservations of fund balances since they do not constitute expenditures or liabilities.

6. Cash and Short-term Investments – Cash reported in the combined balance sheet includes cash in the State Treasury, cash in various Hawaii banks, bank repurchase agreements, and time certificates of deposit.

   The State maintains a cash pool that is available for all funds. Each fund type's portion of this pool is displayed on the combined balance sheet within cash and short-term investments. Those funds are pooled with funds from other state agencies and departments and deposited in approved financial institutions by the state director of finance. Deposits not covered by federal deposit insurance are fully collateralized by government securities held in the name of the State by third party custodians. Interest income from this cash pool is allocated to the various departments and agencies based upon their average cash balance for the period.

   The Hawaii Revised Statutes (HRS) authorize the director of finance to invest in obligations of or guaranteed by the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

7. Accumulated Vacation and Sick Leave – Eligible employees are credited with vacation at a rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year end. Liabilities for vacation pay are inventoried at the end of each accounting period and adjusted to current salary levels. The liability is included in the general long-term debt account group since substantially all of the liability is not expected to be liquidated using expendable available financial resources.

   Eligible employees are credited with sick leave at a rate of one and three-quarter days per month of service. Unused sick leave may be accumulated without limit but can be taken only in the event of illness or other incapacitation and is not convertible to pay upon termination of employment. Accordingly, accumulated sick leave is not included in the department's combined balance sheet. However, an employee who retires or leaves government service in good standing with 60 days or more in unused sick leave is entitled to additional service credit in the Employees' Retirement System, State of Hawaii. Accumulated sick leave as of June 30, 2001 was approximately $2,952,000.

8. Intrafund and Interfund Transactions – Significant transfers of financial resources between activities and appropriations included within the same fund are eliminated. Transfers of revenues from funds authorized to receive them to funds authorized to expend them have been recorded as operating transfers in the combined financial statements.

9. Inventory – Inventory of materials and supplies is recorded as expenditures when purchased.

10. Inventory of Homes for Sale – The direct costs of homes constructed by the department are capitalized for the purpose of accumulating costs to match with sales revenues. Infrastructure costs, which includes the grading of land, roads, sidewalks, utility lines, and sewers, are not capitalized. Interest, real estate taxes, insurance, and overhead costs are also expensed when incurred by the department.

    The sales of homes are recorded, and profit or loss is recognized in full, at the time of closing. The apportionment of total cost and total profit is in the same ratio as to the sales price.

11. Fixed Assets – The department follows a policy of not capitalizing infrastructure such as streets, gutters, curbs, sidewalks, and draining and lighting systems. No depreciation has been provided on general fixed assets.

    All infrastructure and administrative costs are charged to the general, special revenue, trust, and capital projects funds as expenditures depending on where funding was obtained.

    The department also has land in various parts of the State, some of which was transferred to it at no cost or at nominal cost.

12. Office Space – Certain office space is provided to the department at no cost by the Department of Accounting and General Services, State of Hawaii. Other office space used by the department is located in buildings owned by the department.

13. General Leases and Licenses – General leases and licenses received in advance are recognized on a straight-line basis over the lease or license term. As of June 30, 2001, amounts received in advance approximated $306,000 and are recorded as deferred revenue.

14. Lease Rents and Interest Income – The department recognizes lease rent and mortgage interest on its governmental funds as revenues when they are measurable and available. Revenues are measurable when they are subject to reasonable estimation. The available criterion is satisfied when revenues are collectible during the period and the actual collection will occur either during the period or after the end of the period, but in time to pay fund liabilities. The department considers revenues available if they are expected to be collected within 60 days of the end of the year. Amounts not collected within this period approximated $3,758,000 as of June 30, 2001, and are recorded as deferred revenue.

15. Grants – Federal grants and assistance awards made on the basis of entitlement periods are recorded as intergovernmental receivables and revenues when entitlement occurs. All federal reimbursement type grants are recorded as intergovernmental receivables and revenue when the related expenditures are incurred.

16. Fund Balance Reserves – Portions of fund balance are reserved for the following:

    - Receivables – amounts owed to the department at fiscal year-end.
    - Inventories – inventory of homes for sale at fiscal year-end.
    - Loan commitments – loans funded after fiscal year-end.
    - Debt service – bond payments held by an agent.

- Guaranteed and insured loans – amounts designated to pay mortgage guarantees and insurance claims.

17. Memorandum Only – The total columns are captioned "memorandum only" to indicate that they are presented only to facilitate financial analysis. Data in those columns do not present financial position, results of operations, or changes in equity in conformity with accounting principles generally accepted in the United States of America (GAAP). Neither is such data comparable to a consolidation. Interfund eliminations have not been made in the aggregation of this data.

18. Use of Estimates – In preparing financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosures of contingent assets and liabilities at the date of the combined financial statements, and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

Note B – Budgeting and Budgetary Control

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated throughout the fiscal year. Amounts reflected as budgeted revenues in the combined statement of revenues and expenditures – budget and actual – general and special revenue funds, are those estimates as compiled by the state director of finance. Budgeted expenditures for the department's general fund and the Hawaiian homes administration account, a departmental special revenue fund, are provided to the state Department of Budget and Finance for accumulation with budgeted amounts of the other state agencies and included in the governor's executive budget that is subject to legislative approval. In addition, the budget for all expenditures of the department's funds are also presented annually to the Hawaiian Homes Commission for approval.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the fiscal year for which the appropriations were made. The State Legislature specifies the lapse date and any other particular conditions relating to terminating the authorization for other appropriations.

Summarization of the budgets adopted by the State Legislature for the "budgetary" general and special revenue funds is presented in the combined statement of revenues and expenditures – budget and actual – general and special revenue funds. For purposes of budgeting, the department's budgetary fund structure and accounting principles differ from those utilized to present the combined financial statements in conformity with GAAP. Under Section 78-13, Hawaii Revised Statutes (HRS), staff salaries and wages amounting to $51,220 and $214,598 in the general and special revenue funds, respectively, for the period from June 16, 2001 through June 30, 2001, are to be funded with moneys budgeted for fiscal year ending June 30, 2002. In addition, at June 30, 2001, the department accrued expenditures of $4,858 in the special revenue fund for certain salaries and wages for the period prior to June 16, 2001 and certain goods and services received through June 30, 2001, which the department will fund with moneys budgeted for fiscal year ending June 30, 2002. Accordingly, these amounts are excluded from the combined statement of revenues and expenditures – budget and actual – general and special revenue funds for the year ended June 30, 2001 for budgetary purposes. For accounting purposes these amounts are reflected in the combined balance sheet – all fund types and account groups at June 30, 2001, and combined statement of revenues, expenditures, and changes in fund balances – all governmental fund types and expendable trust funds for the year ended June 30, 2001, in accordance with GAAP.

In fiscal year ended June 30, 2000, under Section 78-13, HRS, salaries and wages for the period from June 16, 2000 to June 30, 2000, were funded with moneys budgeted for fiscal year ended June 30, 2001. In addition, at June 30, 2000, the department accrued certain salaries and wages for the period prior to June 16, 2000 and certain goods and services received through June 30, 2000, which the department funded with moneys budgeted for fiscal year ended June 30, 2001. Accordingly, these amounts are included in the combined statement of revenues and expenditures – budget and actual – general and special revenue fund types for the year ended June 30, 2001. These salaries, wages, goods, and services aggregated $50,255 and $256,792 for the general and special revenue funds, respectively.

The following schedule reconciles the budgetary amounts to the amounts presented in accordance with GAAP.

	General Fund	Special Revenue Funds
Excess of revenues over expenditures - actual on budgetary basis	$55,910	$3,508,948
Current year's appropriations included in reserved for encumbrances at June 30, 2001	3,581	3,893,870
Expenditures for liquidation of prior fiscal years' encumbrances	(1,595)	(2,775,730)
FY1999-00 salaries, wages, and other expenditures funded by FY2000-01 budget	50,255	256,792

FY2000-01 salaries and wages funded by FY2001-02 budget under Section 78-13, HRS	(51,220)	(214,598)
FY2000-01 expenditures funded by FY2001-02 budget	–	(4,858)
Current year's expenditures not funded by FY2000-01 budget:		
• Allowance for losses on receivables	–	(1,957,000)
• Deferred revenue	–	(254,000)
Other	2,836	–
Excess of revenue over expenditures – GAAP basis	$59,767	$2,453,424

Note C – Cash and Short-Term Investments

Cash includes moneys in the State Treasury and a Hawaii-based bank. The State Treasury maintains an investment pool for all state moneys. Hawaii Revised Statutes authorize the director of finance to invest any moneys of the State which in the director's judgment are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of or guaranteed by the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

Information relating to the bank balance, insurance, and collateral of cash deposits is determined on a statewide basis and not for individual departments or divisions.

As of June 30, 2001, the carrying amount, which approximates the bank balance, of the department's cash and short-term investments were $153,084,506.

Note D – Receivables

As of June 30, 2001, receivables consisted of the following:

	Special Revenue	Debt Service	Expendable Trust
Loans (see Note E)	$47,227,320	–	–
Allowance for losses	(3,732,000)	–	–
Accrued interest	3,888,042	$142,134	$1,248,603
General leases and licenses (see Note F)	2,105,626	–	–
Allowance for losses	(929,000)	–	–
Other (see Note G)	125,768	–	576,505
	$48,685,756	$142,134	$1,825,108

As of June 30, 2001, general leases and licenses receivable included installment agreements with eight lessees with an aggregate balance of approximately $405,000. The agreements provide for varying monthly or quarterly payments, accrued interest at 10 percent per annum, and varying terms extending through March 2009.

Note E – Loans Receivable

Loans receivable consist of approximately 1,600 loans made to native Hawaiian lessees for the purposes specified in the Hawaiian Homes Commission Act of 1920. Loans are for a maximum amount of approximately $126,000 and for a maximum term of 30 years. Interest rates on outstanding loans range from 2.5 percent to 10 percent. The department's loan portfolio consists of loans that the department has originated and that generally are collateralized by improvements on the leased properties located in the State. Loan commitments as of June 30, 2001 were $573,596. The department has provided an allowance for loan losses as of June 30, 2001. The allowance for loan losses is a valuation reserve, which has been provided through charges to operations. This charge to operations is the amount necessary, in the opinion of management, to maintain the balance in the allowance for loan losses at a level adequate to absorb potential losses for loans in the loan portfolio as of June 30, 2001.

Note F – Leases and Licenses

The department's general leasing operations (Section 204, Hawaiian Homes Commission Act of 1920, as amended) consist principally of the leasing of its Hawaiian home lands. The general leases have varying terms extending through 2059.

The future minimum lease income from general leases as of June 30, 2001 is as follows:

Year ending June 30,	
2002	$5,487,000
2003	5,347,000
2004	5,344,000
2005	5,383,000
2006	5,351,000
2007	5,296,000
2008	4,422,000
2009	4,109,000
2010	3,989,000
2011	3,590,000
Thereafter	139,150,000
	$187,468,000

In 1999 a Circuit Court judge invalidated the lease between a lessee and the department contending the commission erred when it approved the lease without requiring an environmental impact statement. The case is currently under appeal and the outcome is not determinable. As of June 30, 2000, management determined that approximately $2,465,000 of the related lease receivable was uncollectible. Accordingly, as of June 30, 2001, the $2,465,000 has been written off. The current year's revenues from general leases and the future minimum lease income above excludes revenue of approximately $1 million a year from this general lease.

As of June 30, 2001, approximately 60 percent of the department's land (based on acreage) was under homestead or general leases and license agreements.

Note G – Home Sales

The department plans to construct 111 homes for sale to native Hawaiians in the Village of Kapolei on the island of Oahu. During the year ended June 30, 2001, 40 homes had been sold and recognized as home sales. At June 30, 2001, home sales in escrow aggregated $496,824 and are reported as other receivables of the expendable trust fund. The department does not expect to incur any significant liability or warranties related to these sales. As a result of these sales, the department recognized revenues over capitalized costs of approximately $700,000 as of June 30, 2001.

Note H – General Fixed Assets Account Group

The changes in the general fixed assets were as follows:

	Land	Buildings and Improvements	Construction in-Progress	Vehicles and Equipment	Total
Balances at July 1, 2000	$17,505,000	$4,680,772	–	$2,056,725	$24,242,497
Additions	–	–	$2,209,854	157,385	2,367,239
Deletions	–	–	–	(67,407)	(67,407)
Balances at June 30, 2001	$17,505,000	$4,680,772	$2,209,854	$2,146,703	$26,542,329

Note I – General Long-Term Debt, Bonds Payable

The changes in general long-term debt were as follows:

	Accrued Vacation	Bonds	Total
Balances at July 1, 2000	$1,220,625	$16,883,473	$18,104,098
Principal payments	–	(966,766)	(966,766)
Net decrease in accrued vacation	(122,290)	–	(122,290)
Balances at June 30, 2001	$1,098,335	$15,916,707	$17,015,042

Revenue Bonds –

The State Legislature, by Act 316, Session Laws of Hawaii (SLH) 1989, as amended by Act 299, SLH 1990, and further amended by Act 296, SLH 1991, authorized the issuance of revenue bonds amounting to $43,768,000 to finance the cost of developing Hawaiian home lands. Of the total amount authorized, the department issued $18,000,000 of 1991 series revenue bonds in October 1991.

On January 15, 1999, the department issued $13,370,000 of 1999 series revenue bonds to advance refund $12,060,000 of outstanding 1991 series revenue bonds. The net proceeds of $13,055,195, after payment of the issuance cost and $207,950 of the department's funds, were used to purchase U.S. government securities. Those securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the 1991 series revenue bonds. As a result, the 1991 series revenue bonds are considered to be defeased and the liability for those bonds has been removed from the general long-term debt account group.

The revenue bonds are payable from and collateralized by the department's revenues from available lands and are due in annual installments through July 1, 2011. The balance of bonds payable as of June 30, 2001, are $800,000 and $13,370,000 for the unrefunded 1991 and 1999 series revenue bonds, respectively.

Interest on the unrefunded series 1991 bonds is at 7.1 percent and the bonds are payable on July 1, 2001. On June 30, 2001, the department deposited $828,400 with its fiscal agent for payment of revenue bond principal and interest on July 1, 2001. This is reflected in the debt service fund as cash held by agent.

Interest on the series 1999 bonds increases annually from 3.8 percent to 4.45 percent and is payable semi-annually on January 1 and July 1. Commencing on July 1, 2002, annual principal payments are required.

The annual requirements of the 1991 and 1999 series revenue bonds are as follows:

Year ending June 30,	Interest	Principal	Total
2002	$580,113	$800,000	$1,380,113
2003	530,528	1,115,000	1,645,528
2004	486,820	1,155,000	1,641,820
2005	440,298	1,200,000	1,640,298
2006	391,298	1,250,000	1,641,298
2007	339,973	1,300,000	1,639,973
2008	285,870	1,355,000	1,640,870

2009	228,835	1,410,000	1,638,835
2010	168,446	1,465,000	1,633,446
2011	104,146	1,525,000	1,629,146
2012	35,489	1,595,000	1,630,489
Total	$3,591,816	$14,170,000	$17,761,816

General Obligation Bonds –

The following are portions of the State general obligation bonds allocated to the department under acts of various Session Laws of Hawaii. These bonds are backed by the full faith, credit, and taxing power of the State. Repayments of allocated bond debts are made to the state general fund. Details of the allocated bonds as of June 30, 2001 are as follows:

$124,303 Series BZ bonds dated October 1, 1992; $7,769 was refunded on April 1, 1998; due in annual installments of $7,769 commencing October 1, 2000 through October 1, 2012; interest at 5.40% to 6.25% payable semi-annually	$93,228
$1,509,217 Series BU bonds dated November 1, 1991; $251,511 was refunded on April 1, 1998; due in annual installments of $83,837 on November 1, 1998, 2000, and 2001; interest at 5.85% to 7.25% payable semi-annually	83,837
$25,782 Series CJ bonds dated January 1, 1995; $8,594 was refunded on April 1, 1998; due in annual installments of $4,297 commencing July 1, 2002 through January 1, 2005; interest at 5.625% to 5.80% payable semi-annually	17,188
$86,517 Series CO bonds dated March 1, 1997; $11,940 was refunded on April 1, 1998; due in semi-annual installments of $2,735 to $4,477 commencing March 1, 2000 through March 1, 2011; interest at 4.625% to 6.00% payable semi-annually	65,333
$758,726 Series CI refunding bonds dated November 1, 1993; due in annual installments of $50,587 commencing through November 1, 2003 and $50,575 through November 1, 2010; interest at 4.20% to 4.90% payable semi-annually	505,789
$1,000,346 Series BW bonds dated March 1, 1992; due in annual installments of $55,569 through March 1, 2012; interest at 5.875% to 6.40% payable semi-annually	611,261
$1,062 Series CQ refunding bonds dated October 1, 1997; due in annual installments of $131 to $174 commencing October 1, 1998 through October 1, 2004; interest at 4.25% to 5.00% payable semi-annually	650

\$66,394 Series CH bonds dated November 1, 1993; \$55,335 was refunded on October 1, 1997; due in annual installments of \$3,689 commencing on November 1, 1999 through November 1, 2013; interest at 4.10% to 6.00% payable semi-annually	47,949
\$321,472 Series CS refunding bonds dated April 1, 1998; due in annual installments of \$39,227 on April 1, 2003; \$41,289 on April 1, 2004; \$43,457 on April 1, 2005; \$45,740 on April 1, 2006; \$48,137 on April 1, 2007; \$50,548 on April 1, 2008; and \$53,074 on April 1, 2009; interest at 5.00% to 5.25% payable semi-annually	321,472
	\$1,746,707

The annual requirements of the general obligation bonds are as follows:

Year ending June 30,	Interest	Principal	Total
2002	\$78,895	\$210,919	\$289,814
2003	69,812	166,588	236,400
2004	62,457	168,932	231,389
2005	54,778	171,407	226,185
2006	47,074	169,577	216,651
2007	39,319	172,352	211,671
2008	31,399	175,165	206,564
2009	23,348	178,119	201,467
2010	15,969	125,499	141,468
2011	9,270	125,979	135,249
2012	3,911	67,026	70,937
2013	263	11,456	11,719
2014	88	3,688	3,776
Total	\$436,583	\$1,746,707	\$2,183,290

Note J – Commitments and Contingencies

Litigation –

The department is involved in several lawsuits and complaints which management believes arose in the normal course of operations. Based on discussions with counsel, management has ascertained that lawsuits and complaints against the State are typically paid through an appropriation from the general fund of the State. Accordingly, management is of the opinion that the outcome of these lawsuits and complaints will not have a material adverse effect on the financial position of the department.

Insurance –

Insurance coverage is maintained at the state level. The State is substantially self-insured for all perils including workers' compensation. Effective July 1, 1997, all benefits paid for workers' compensation are reflected in the respective department or agency's financial statements. Benefits paid by the department for the year ended June 30, 2001, approximated $500 and are reflected as expenditures of the general fund. Expenditures for other insurance claims are made by the Department of Accounting and General Services, and are not reflected in the department's combined financial statements. Workers' compensation benefit claims reported, as well as incurred but not reported, were reviewed at year end. The estimated losses from these claims are not material.

Deferred Compensation Plan –

In 1983, the State established a deferred compensation plan which enables State employees to defer a portion of their compensation. The Department of Human Resources Development, State of Hawaii, has the fiduciary responsibility of administering the plan. The plan assets are protected from claims of the State's creditors and from diversion to any uses other than paying benefits to participants and beneficiaries. The deferred compensation is not available to employees until termination, retirement, death, or any unforeseeable emergency.

Guaranteed and Insured Loans –

As of June 30, 2001, the department was contingently liable for approximately $10,517,000 in loans originated primarily by the U.S. Department of Agriculture Rural Development for which the department has guaranteed repayment. A total of $1,506,000 of these loans has been reported delinquent as of June 30, 2001.

The department is also a party to a mortgage loan insurance agreement with the U.S. Department of Housing and Urban Development (HUD). The agreement provides that HUD will perform underwriting processing for the insurance of mortgages and will administer an insurance fund for mortgages originated and held by HUD-approved lenders. The department will maintain and provide the necessary and proper funds for payment of any mortgage insurance claims and expenditures incurred by HUD in connection with the lessee borrowers. The department has reserved cash of approximately $10,850,000 in the special revenue fund and has deposited $150,000 with HUD. As of June 30, 2001, loans outstanding totaled approximately $175,568,000 under this agreement, of which $6,081,000 has been reported as delinquent.

As of June 30, 2001, the department is also contingently liable for approximately $10,165,000 in loans originated by financial institutions and other lenders for which it has guaranteed repayment. A total of $2,728,000 of these loans has been reported delinquent as of June 30, 2001.

As of June 30, 2001, the department paid approximately $2,827,000 for delinquent mortgage loan payments of lessees. These payments are carried as loans receivable from lessees and bear similar terms as stipulated in the lessees' mortgage note with the lenders.

The department has certain loans for which the collateral for the loans is not covered by casualty insurance. The number of such loans is not known.

Other –

As of June 30, 2001, substantially all of the reserve for encumbrances in the capital projects fund relates to construction contracts.

Note K – Compensation for Past Use of Hawaiian Home Lands by the State of Hawaii

Pursuant to Act 14, Special SLH 1995, the Hawaiian Home Lands Trust Fund was established to account for funds to be paid by the State for the use or disposition of lands, which were alleged to have been Hawaiian home lands or covered by the Hawaiian Homes Commission Act of 1920 arising between August 21, 1959 and June 30, 1988.

Act 14, Special SLH 1995, requires the State to make 20 annual payments of $30 million in cash or such other consideration as agreed to between the State and the department. Interest is determined as provided in Act 14, Special SLH 1995, on the unpaid balance of any funds due, but not appropriated, by the end of each respective fiscal year. The State prepaid a portion of its June 30, 2001 obligation in the prior year. The department received the balance due of $13,853,155 in the current year as a transfer from the Department of Budget and Finance to the department's expendable trust fund.

Note L – Hawaiian Home Lands Trust Individual Claims

In 1991, the Legislature enacted Chapter 674, HRS, entitled "Individual Claims Resolution Under the Hawaiian Home Lands Trust," which establishes a process for individual beneficiaries of the Hawaiian Homes Commission Act of 1920 to file claims to recover actual economic damages they believed they suffered from a breach of trust that occurred between August 21, 1959, when Hawaii became a state, and June 30, 1988. The breach must have been caused by an act or omission of an employee or officer of the State in the management and disposition of trust resources.

A Hawaiian Home Lands Trust Individual Claims Review Panel (panel) was established under Chapter 674, HRS, to receive claims of individual beneficiaries. The panel is required to prepare a record of each claim, including the panel's non-binding findings and an advisory opinion concerning the probable merits of the claim. The panel's advisory findings and advisory opinions, which are issued after adversarial hearings, must be submitted to the Legislature. The Legislature may take such action upon the claims as it deems appropriate. If the Legislature's proffered resolution is not satisfactory to a claimant, a civil action for corrective action and the recovery of actual economic damages could be initiated after October 1, 1999, but no later than December 31, 1999.

The deadline to file a claim with the panel was August 31, 1995. A total of 4,327 claims were filed by 2,753 individuals. As of September 1999, claims from 1,376 claimants had not been reviewed by the panel and all but the claims of two claimants had not been acted upon by the Legislature. In 1997, the Legislature declared it to be its intent to postpone acting upon the panel's recommendations until all claims had been reviewed and forwarded to it.

Also arising from Chapter 674, HRS, in December 1999, three claimants filed a class action lawsuit in the state Circuit Court for declaratory and injunctive relief, and for damages under Chapter 673, HRS, for the panel's and Legislature's alleged failure to remedy their breach of trust claims under Chapter 674, HRS. In August 2000, the Circuit Court entered an order granting the plaintiffs' motion for summary judgment and declaratory relief as to Count I of the Complaint, and denied the State's motions on the pleadings. The plaintiff is appealing the judgment relating to the other Counts in the lawsuit with the State Supreme Court. Five other claimants filed similar individual claims actions for themselves. The plaintiffs in these other actions have stipulated to stay all proceedings in their actions pending the resolution of all questions of law in the class action lawsuit that are common to the questions of law presented in their suits. Outcome of these cases are pending.

Claims for actual damages under Chapter 674, HRS, are made against the State of Hawaii. Accordingly, counsel for the department does not believe that the final settlement of the claims will have an impact on the department's funds.

Note M – Assessments for Central Service and Administrative Expenses

The State has asserted that the department is liable for its pro rata share of central service and administrative expenses incurred by the State in accordance with Sections 36-27 and 36-30, HRS. Pursuant to Section 36-31, HRS, the department maintains that their funds are trust funds and are not subject to the special fund assessments. Accordingly, no provision for any liability has been made in the accompanying financial statements.

Effective July 1, 1998, Act 27, SLH 1998, amended Section 213 of the Hawaiian Homes Commission Act of 1920 and reclassified certain special funds as trust funds.

The department's estimate of the asserted assessments is as follows:

Year ending June 30,	
1994	$1,300,000
1995	2,200,000
1996	2,100,000
1997	1,900,000
1998	1,900,000
1999	377,000
2000	444,000
2001	383,000
	$10,604,000

Note N – Retirement Benefits

Almost all employees of the department are required by Chapter 88, HRS, to become members of the Employees' Retirement System, State of Hawaii (ERS), a cost sharing multiple employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. Prior to June 30, 1984, the ERS consisted only of a contributory plan. In 1984, legislation was enacted to create a new noncontributory plan for members of the ERS who are also covered under Social Security. Persons employed in positions not covered by Social Security are excluded from the noncontributory plan. The noncontributory plan provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory plan or to elect the new noncontributory plan and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory plans, respectively. Contributions for employees of the department are paid from the state general fund.

Actuarial valuations are prepared for the entire ERS and are not separately computed for each department or agency. Information on vested and nonvested benefits and other aspects of the ERS is also not available on a departmental or agency basis.

The State's policy is to fund its required contribution annually. The department's share of the retirement system expense for the year ended June 30, 2001 was included as an item to be expended by the Department of Budget and Finance, and is not reflected in the department's combined financial statements. Contributions expended from the special revenue funds for the year ended June 30, 2001, were approximately $2,300. The entire ERS' actuarial determination of the employer contribution requirements were met as of June 30, 2001.

The ERS issues a publicly available financial report that includes financial statements and required supplemental information. That report may be obtained from the ERS.

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to all departmental employees who retire from the State on or after attaining age 62 with at least ten years of service or age 55 with at least 30 years of service under the noncontributory option, and age 55 with at least five years of service under the contributory option. There are currently approximately 28,715 State retirees receiving such benefits. Retirees credited with at least ten years of service, excluding sick leave credit, qualify for free medical insurance premiums; however, retirees with fewer than ten years must assume a portion of the monthly premiums. All disabled retirees who retired after June 30, 1984 with fewer than ten years of service also qualify for free medical insurance premiums. Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive a reimbursement of the basic medical coverage premiums. Contributions are based upon negotiated collective bargaining agreements and are funded by the State as accrued.

Note O – Related Party

The department received approximately $2,300,000 from the Department of Education, State of Hawaii, in the fiscal year ended June 30, 1996. This amount represented a lump-sum payment for lease rent due for the continued State use of trust lands under Nanaikapono Elementary School between April 4, 1996 and October 27, 2002. Approximately $476,000 is included in deferred revenue as of June 30, 2001, and $357,000 has been recognized as license and permit income during the year ended June 30, 2001.

During the year ended June 30, 2000, certain parcels of land located in Kealakehe, Hawaii, were transferred from the Department of Land and Natural Resources, State of Hawaii, to the department. As part of this transfer, the department is to reimburse the Department of Business, Economic Development and Tourism, Housing and Community Development Corporation of Hawaii $1,816,000 for infrastructure improvements to the land. The reimbursement is to be made in annual payments of $454,025 in FY1999-00 and FY2000-01 and a final payment of $908,050 in FY2001-02. As of June 30, 2001, the department owed $908,050 to the Housing and Community Development Corporation of Hawaii.

Note P – Restatement of Beginning of Year Fund Balances

During the year ended June 30, 2001, management determined that in prior years, only lease rent receivable and mortgage interest receivable collected within 60 days of year end should have been recorded as revenue for the department to properly account for its governmental funds under the modified accrual basis of accounting. Accordingly, the June 30, 2000 fund balance of the special revenue fund has been restated to record only lease rents receivable and mortgage interest receivable collected within 60 days of year end as revenue. As a result of this restatement, the department's special revenue fund total deferred revenues at June 30, 2000 increased and total fund balance as of June 30, 2000 decreased by $3,504,000.

Note Q – Future Change in Accounting Principles

In June 1999, the Governmental Accounting Standards Board issued Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. This Statement establishes financial reporting standards for state and local governments and will change the current reporting standards. Among some of the changes will be: the inclusion of a section for management's discussion and analysis; the basic financial statements will be a set of government-wide financial statements; and a set of fund financial statements and budgetary comparison schedules will be presented as required supplementary information. The State of Hawaii plans to implement this Statement effective for fiscal year ending June 30, 2002. As a part of the implementation process, the department expects to record its previously unrecorded infrastructure assets and expects to depreciate its previously undepreciated depreciable assets.

Exhibit 3.1

Department of Hawaiian Home Lands
State of Hawaii
Combined Balance Sheet – All Fund Types and Account Groups
June 30, 2001

	Governmental Fund Types				Fiduciary Fund Types	Account Groups		
ASSETS	General	Special Revenue	Capital Projects	Debt Service	Trust and Agency	General Fixed Assets (Note H)	General Long-Term Debt (Note I)	Totals (Memorandum Only)
Cash:								
Cash and short-term investments held in State Treasury (Notes C and J)	$ 16,092	$ 66,684,154	$ 582,476	$27,640,709	$ 58,161,075	$ -	$ -	$ 153,084,506
Cash held by agent (Note I)	-	300	-	828,400	-	-	-	828,700
Receivables (Note D):								
Loans, net of allowance for losses of $3,732,000	-	43,495,320	-	-	-	-	-	43,495,320
Accrued interest	-	3,888,042	-	142,134	1,248,603	-	-	5,278,779
General leases and licenses, net of allowance for losses of $929,000	-	1,176,626	-	-	-	-	-	1,176,626
Other	-	125,768	-	-	576,505	-	-	702,273
Inventory of homes for sale	-	-	-	-	7,578,282	-	-	7,578,282
Fixed assets	-	-	-	-	-	26,542,329	-	26,542,329
Other assets (Note J)	-	475,579	-	-	-	-	-	475,579
Amount to be provided for the retirement of general long-term debt (Note I)	-	-	-	-	-	-	17,015,042	17,015,042
Total assets	$ 16,092	$115,845,789	$ 582,476	$28,611,243	$ 67,564,465	$ 26,542,329	$ 17,015,042	$ 256,177,436
LIABILITIES AND FUND EQUITY								
Liabilities:								
Vouchers and contracts payable (Note B)	$ 1,977	$ 438,945	$ 18,472	$ 1,000	$ 4,179,632	$ -	$ -	$ 4,640,026
Accrued wages and employee benefits payable (Notes B and I)	51,754	254,081	-	-	-	-	1,098,335	1,404,170
Due to State of Hawaii	10,000	-	-	-	908,050	-	-	918,050
Due to other government	-	1,402,381	-	-	-	-	-	1,402,381
Other liabilities	-	89,428	-	-	954,267	-	-	1,043,695
Bonds payable (Note I)	-	-	-	-	-	-	15,916,707	15,916,707
Deferred revenue (Notes O and P)	-	4,539,736	-	-	-	-	-	4,539,736
Total liabilities	63,731	6,724,571	18,472	1,000	6,041,949	-	17,015,042	29,864,765
Commitments and contingencies (Notes J, K, L, M, and N)	-	-	-	-	-	-	-	-

Fund equity:								
Investment in general fixed assets	-	-	-	-	-	26,542,329	-	26,542,329
Fund balances:								
Reserved for encumbrances	3,581	6,013,653	495,938	-	15,858,779	-	-	22,371,951
Reserved for receivables (Note D)	-	48,685,756	-	142,134	1,825,108	-	-	50,652,998
Reserved for inventories	-	-	-	-	7,578,282	-	-	7,578,282
Reserved for loan commitments (Note E)	-	573,596	-	-	-	-	-	573,596
Reserved for debt service (Note I)	-	-	-	828,400	-	-	-	828,400
Reserved for guaranteed and insured loans (Note J)	-	11,000,100	-	-	-	-	-	11,000,100
Unreserved (Note B)	(51,220)	42,848,113	68,066	27,639,709	36,260,347	-	-	106,765,015
Total fund equity	(47,639)	109,121,218	564,004	28,610,243	61,522,516	26,542,329	-	226,312,671
Total liabilities and fund equity	$ 16,092	$115,845,789	$ 582,476	$28,611,243	$ 67,564,465	$ 26,542,329	$ 17,015,042	$ 256,177,436

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

Exhibit 3.2

Department of Hawaiian Home Lands
State of Hawaii
Combined Statement of Revenues, Expenditures, and Changes in Fund Balances – All Governmental Fund Types and Expendable Trust Funds
For the Fiscal Year Ended June 30, 2001

	Governmental Fund Types				Fiduciary Fund Type	
	General	Special Revenue	Capital Projects	Debt Service	Expendable Trust	Totals (Memorandum Only)
Revenues:						
Appropriations	$1,359,546	$ -	$ -	$ -	$ -	$ 1,359,546
General leases	-	6,150,520	-	-	-	6,150,520
Licenses and permits	-	984,598	-	-	-	984,598
Interest and investment income	-	6,898,757	-	1,618,644	3,267,310	11,784,711
Intergovernmental revenues	-	69,000	-	-	428,122	497,122
Home sales (Note G)	-	246,253	-	-	6,306,807	6,553,060
Other	-	460,107	-	-	3,739,354	4,199,461
Total revenues	1,359,546	14,809,235	-	1,618,644	13,741,593	31,529,018
Expenditures:						
Cost of homes sold (Note G)	-	-	-	-	5,846,566	5,846,566
Operating	1,299,779	11,854,529	-	4,762	21,265	13,180,335
Home construction/capital projects	-	182,909	57,071	-	21,828,570	22,068,550
Principal on long-term debt	-	221,766	-	745,000	-	966,766
Interest on long-term debt	-	96,607	-	634,587	-	731,194
Total expenditures	1,299,779	12,355,811	57,071	1,384,349	27,696,401	42,793,411
Excess (deficiency) of revenues over expenditures	59,767	2,453,424	(57,071)	234,295	(13,954,808)	(11,264,393)
Other financing sources (uses):						
Operating transfers in	-	16,257,714	-	6,389,265	13,853,155	36,500,134
Operating transfers out	-	(15,146,979)	-	(7,500,000)	-	(22,646,979)
Total other financing sources (uses)	-	1,110,735	-	(1,110,735)	13,853,155	13,853,155
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses	59,767	3,564,159	(57,071)	(876,440)	(101,653)	2,588,762
Lapsed appropriations	(75,110)	-	(78,000)	-	-	(153,110)
Excess (deficiency) of revenues and other financing sources over expenditures, other financing uses, and lapsed appropriations	(15,343)	3,564,159	(135,071)	(876,440)	(101,653)	2,435,652

Exhibit 3.2 (continued)

Fund balances at July 1, 2000, as previously reported	(32,296)	109,061,059	699,075	29,486,683	61,624,169	200,838,690
Restatement (Note P)	-	(3,504,000)	-	-	-	(3,504,000)
Fund balances at July 1, 2000, as restated	(32,296)	105,557,059	699,075	29,486,683	61,624,169	197,334,690
Fund balances at June 30, 2001	$ (47,639)	$109,121,218	$ 564,004	$ 28,610,243	$ 61,522,516	$ 199,770,342

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

Exhibit 3.3

Department of Hawaiian Home Lands
State of Hawaii
Combined Statement of Revenues and Expenditures – Budget and Actual – General and Special Revenue Funds
For the Fiscal Year Ended June 30, 2001

	General Fund			Special Revenue Funds		
	Budget	Actual	Variance - Favorable (Unfavorable)	Budget	Actual	Variance - Favorable (Unfavorable)
Revenues:						
Appropriations	$1,359,546	$1,359,546	$ -	$ -	$ -	$ -
General leases	-	-	-	6,100,000	6,286,520	186,520
Licenses and permits	-	-	-	606,000	984,598	378,598
Interest and investment income	-	-	-	5,670,000	7,016,757	1,346,757
Intergovernmental revenues	-	-	-	-	69,000	69,000
Home sales	-	-	-	-	246,253	246,253
Other	-	-	-	301,000	460,107	159,107
Total revenues	1,359,546	1,359,546	-	12,677,000	15,063,235	2,386,235
Expenditures:						
Operating	1,359,546	1,303,636	55,910	14,461,652	10,911,484	3,550,168
Home construction/capital projects	-	-	-	-	324,430	(324,430)
Principal on long-term debt	-	-	-	-	221,766	(221,766)
Interest on long-term debt	-	-	-	-	96,607	(96,607)
Total expenditures	1,359,546	1,303,636	55,910	14,461,652	11,554,287	2,907,365
Excess (deficiency) of revenues over expenditures	-	55,910	55,910	(1,784,652)	3,508,948	5,293,600
Other financing sources (uses):						
Operating transfers in	-	-	-	-	16,257,714	16,257,714
Operating transfers out	-	-	-	-	(15,146,979)	(15,146,979)
Total other financing sources	-	-	-	-	1,110,735	1,110,735
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses	$ -	$ 55,910	$ 55,910	$ (1,784,652)	$ 4,619,683	$ 6,404,335

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

Schedule I

Department of Hawaiian Home Lands
State of Hawaii
Combining Schedule of Balance Sheet Information – Special Revenue Funds
June 30, 2001

ASSETS	Home Loan Fund	Operating Fund	General Loan Fund	Receipts Fund	Administration Account and Other	Native Hawaiian Rehabilitation Fund	Trust Fund	Total
Cash:								
Cash and short-term investments held in State Treasury	$ 695,792	$11,319,074	$22,237,020	$ -	$ 7,757,581	$ 13,824,587	$10,850,100	$ 66,684,154
Cash held by agent	-	-	300	-	-	-	-	300
Receivables:								
Loans, net of allowance for losses	4,070,057	-	39,420,372	-	-	4,891	-	43,495,320
Accrued interest	-	61,422	-	3,538,925	68,767	218,928	-	3,888,042
General leases and licenses, net of allowance for losses	-	210	-	-	1,176,416	-	-	1,176,626
Other	-	114,350	3,504	-	7,914	-	-	125,768
Other assets	166,979	-	308,600	-	-	-	-	475,579
Total assets	$4,932,828	$11,495,056	$61,969,796	$ 3,538,925	$ 9,010,678	$ 14,048,406	$10,850,100	$115,845,789
LIABILITIES AND FUND EQUITY								
Liabilities:								
Vouchers and contracts payable	$ 223	$ 228,834	$ 116,582	$ -	$ 93,306	$ -	$ -	$ 438,945
Accrued wages and employee benefits payable	-	121,595	-	-	132,486	-	-	254,081
Due to other government	-	1,148	1,315,350	85,883	-	-	-	1,402,381
Other liabilities	16,542	-	72,886	-	-	-	-	89,428
Deferred revenue	-	184,927	-	2,837,000	1,517,809	-	-	4,539,736
Total liabilities	16,765	536,504	1,504,818	2,922,883	1,743,601	-	-	6,724,571
Fund equity:								
Reserved for encumbrances	-	3,099,688	-	-	581,641	2,332,324	-	6,013,653
Reserved for receivables	4,070,057	175,982	39,423,876	3,538,925	1,253,097	223,819	-	48,685,756
Reserved for loan commitments	-	-	573,596	-	-	-	-	573,596
Reserved for guaranteed and insured loans	-	-	150,000	-	-	-	10,850,100	11,000,100
Unreserved	846,006	7,682,882	20,317,506	(2,922,883)	5,432,339	11,492,263	-	42,848,113
Total fund equity	4,916,063	10,958,552	60,464,978	616,042	7,267,077	14,048,406	10,850,100	109,121,218
Total liabilities and fund equity	$4,932,828	$11,495,056	$61,969,796	$ 3,538,925	$ 9,010,678	$ 14,048,406	$10,850,100	$115,845,789

Schedule II

Department of Hawaiian Home Lands
State of Hawaii
Combining Schedule of Revenues, Expenditures, and Changes in Fund Balances – Special Revenue Funds
For the Fiscal Year Ended June 30, 2001

	Home Loan Fund	Operating Fund	General Loan Fund	Receipts Fund	Administration Account and Other	Native Hawaiian Rehabilitation Fund	Trust Fund	Total
Revenues:								
General leases	$ -	$ -	$ -	$ -	$ 6,150,520	$ -	$ -	$ 6,150,520
Licenses and permits	-	-	-	-	736,192	248,406	-	984,598
Interest and investment income	-	33,147	-	5,719,649	337,568	808,393	-	6,898,757
Intergovernmental revenues	-	-	-	-	69,000	-	-	69,000
Homes sales	-	-	-	-	-	246,253	-	246,253
Other	-	432,052	-	-	27,929	126	-	460,107
Total revenues	-	465,199	-	5,719,649	7,321,209	1,303,178	-	14,809,235
Expenditures:								
Operating	244,000	4,862,741	1,722,121	(221)	4,396,561	629,327	-	11,854,529
Home construction/capital projects	-	96,435	-	-	67,771	18,703	-	182,909
Principal on long-term debt	-	221,766	-	-	-	-	-	221,766
Interest on long-term debt	-	96,607	-	-	-	-	-	96,607
Total expenditures	244,000	5,277,549	1,722,121	(221)	4,464,332	648,030	-	12,355,811
Excess (deficiency) of revenues over expenditures	(244,000)	(4,812,350)	(1,722,121)	5,719,870	2,856,877	655,148	-	2,453,424
Other financing sources (uses):								
Operating transfers in	-	4,596,290	-	-	11,661,424	-	-	16,257,714
Operating transfers out	-	-	-	(5,753,081)	(9,393,898)	-	-	(15,146,979)
Total other financing sources (uses)	-	4,596,290	-	(5,753,081)	2,267,526	-	-	1,110,735
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses	(244,000)	(216,060)	(1,722,121)	(33,211)	5,124,403	655,148	-	3,564,159
Fund balances at July 1, 2000, as previously stated	5,160,063	11,174,612	62,577,099	2,978,253	2,927,674	13,393,258	10,850,100	109,061,059
Restatement	-	-	(390,000)	(2,329,000)	(785,000)	-	-	(3,504,000)
Fund balances at July 1, 2000, as restated	5,160,063	11,174,612	62,187,099	649,253	2,142,674	13,393,258	10,850,100	105,557,059
Fund balances at June 30, 2001	$4,916,063	$10,958,552	$60,464,978	$ 616,042	$ 7,267,077	$ 14,048,406	$ 10,850,100	$109,121,218

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Hawaiian Home Lands (department) on August 20, 2002. A copy of the transmittal letter to the department is included as Attachment 1. The response of the department is included as Attachment 2.

The department generally disagrees with most of our findings. However, it incorrectly notes that five areas of concern were considered material weaknesses. In fact, we noted two areas of concern that are considered material weaknesses and three areas that were considered reportable conditions.

The department disagrees with our finding that it does not have sufficient documentation to support its methodology for determining the allowance for doubtful accounts for loans receivable. The department relied on its external auditors to estimate the allowance and adjusted its financial records to recognize the recommended amount. The department is unable to provide us with the documentation to support the methodolgy for determining the allowance.

We disagree with the department's conclusions. The financial statements are the responsibility of management. Management is responsible for establishing and maintaining effective internal controls over financial reporting. This includes developing a methodology for determining the allowance for doubtful accounts and ensuring that such methodology is adequately documented. The external auditors' responsibility is to express an opinion on the financial statements based on the audit procedures performed and not to develop the documentation to substantiate the amounts reported in the financial statements. Also, it is not the external auditor's responsibility to compute, for the department, any of the amounts reported in the financial statements. To do so compromises the independence of external auditing.

The department agrees that the $1.8 million for infrastructure improvements was improperly recorded. However, the department believes that sufficient corrective action was taken in FY2000-01 inasmuch as the transaction and error were disclosed in the footnotes. The department also believes that the impact of the error on the financial statements is immaterial both individually and in the aggregate to the financial statements taken as a whole. We disagree; immateriality is not an excuse for the incorrect application of accounting principles generally accepted in the United States of America (GAAP).

The department indicates that the finding that management is ineffective was not mentioned in Grant Thornton LLPs independent auditor's opinion. The issues discussed did not impact the FY2000-01 financial statements; however, the issues were considered to be reportable conditions because they are significant deficiencies in the design or operation of the internal controls over financial reporting and could adversely affect the department's financial statements. Also, the department generally concurred with the recommendations related to the finding, but included clarification to the findings in its response.

We agree with the department's clarification that its loans are intended to serve individuals without other financing options. We also agree that the department's loans are inherently riskier as it is a "lender of last resort." Nevertheless, the department is still responsible for these loans and must actively monitor them and develop and enforce its policies.

The department concurs with the recommendation that formal written agreements with lessees for advances for delinquent debt to outside creditors be executed. However, the department notes that collection proceedings can still proceed under the existing statutory authority, but agrees that formal agreements might assist the department in its collection efforts. We stand by our recommendation.

The department has provided background information explaining why lessees are given financial assistance for real property taxes. However, the department did not address its inability to provide either the amount of advances outstanding for more than 60 days or the amount of advances provided to lessees with delinquent loans outstanding.

The department believes that capitalizing infrastructure costs as fixed assets is optional. The department also states "There remains the question of whether ancillary costs, costs that are readily identifiable, are material to the financial statements individually or in the aggregate." Once again we note that management is responsible for establishing and maintaining effective internal controls over financial reporting. While we agree that currently the capitalization of infrastructure costs as fixed assets is optional according to GAAP, this will change effective FY2001-02. Also, management should ensure that controls are in place so that costs are captured and reported properly.

With regard to the finding that construction costs are not properly capitalized as inventory of homes for sale, the department feels that the error is immaterial. The department notes that it followed the recommendation of its external auditors. Once again, we note that the financial statements are the responsibility of the department's management, not the external auditors. Management is also responsible for establishing and maintaining effective internal controls over financial reporting.

The department recognized that it does not have written policies or procedures for the collection of lease and license receivables, but notes that it does follow the procedures stated in Section 171-20, Hawaii Revised Statutes. We continue to stand by our recommendation that the department should establish and implement written policies and procedures for the collection of lease and license receivables. The department should also consider the other recommendations made with regard to lease and license receivables.

The department indicates that it has improved the number of homestead leases awarded and continues to work at improving. While we commend the department for its efforts, we believe that it must still work at increasing the number of homestead awards given.

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

August 20, 2002

COPY

The Honorable Raynard C. Soon, Chairman
Department of Hawaiian Home Lands
Ali'i Place
1099 Alakea Street, 20th Floor
Honolulu, Hawaii 96813

Dear Mr. Soon:

Enclosed for your information are three copies, numbered 6 to 8 of our confidential draft report, *Financial Audit of the Department of Hawaiian Home Lands*. We ask that you telephone us by Thursday, August 22, 2002, 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 Wednesday, August 28, 2002.

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

BENJAMIN J. CAYETANO
GOVERNOR
STATE OF HAWAII

RAYNARD C. SOON
CHAIRMAN
HAWAIIAN HOMES COMMISSION

JOBIE M. K. M. YAMAGUC
DEPUTY TO THE CHAIRMAN

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

August 28, 2002

RE VED
Aug 28 3 11 PM '02
OFC. OF THE AUDITOR
STATE OF HAWAII

The Honorable Marion M. Higa
State Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to comment on the State Auditor's draft report, *Financial Audit of the Department of Hawaiian Home Lands*.

The Department of Hawaiian Home Lands (DHHL) believes that audits are a valuable tool to improve operational efficiency and program effectiveness. DHHL has engaged the Department of Accounting and General Services (DAGS) for the past thirteen years (13) to select independent certified public accounting firms to conduct annual financial audits on the department's accounting practices and records. Except for fiscal year 2000 (when all State of Hawaii executive departments received qualified opinions due to Y2K issues), DHHL has consecutively received unqualified or "clean" opinions for fiscal years 1988 to 2001.

We have included as part of this response a copy of the unqualified financial audit opinion rendered by Akamine, Oyadomari and Kosaki, Certified Public Accountants, relating to DHHL accounting records for fiscal year 2001. This financial audit opinion will assist in providing a frame of reference for our comments relating to the draft legislative audit report.

The draft Legislative audit report identifies five (5) areas of concern that were considered material weaknesses (pages 7 and 8). However, the independent certified public accounting firm of Grant Thornton LLP cited only three (3) areas of concern that were considered material enough to render a "qualified" audit opinion (page 25, paragraph 4). In addition, there were four (4) significant areas in the Draft Audit Report that were not considered reportable conditions (page 8, paragraph 2) but were mentioned. DHHL has commented on all areas of concern, both reportable and non-reportable conditions, in the "Attachment" to this letter.

Our review disclosed that all of the findings considered material by Grant Thornton LLP in its "qualified" audit opinion were also reviewed by Akamine, Oyadomari and Kosaki, Certified Public Accountants, and were determined to be immaterial. We find that these differences in professional judgement by both of these certified public accounting firms led to disparate financial audit opinions.

Again, we appreciate the opportunity to comment on the draft report. We would be pleased to meet with you or your staff if any of the comments need further clarification.

Aloha,

Raynard C. Soon, Chairman
Hawaiian Homes Commission

Attach

c: The Honorable Benjamin J. Cayetano, Governor of Hawaii
The Honorable Robert Bunda, President of the Senate
The Honorable Calvin K. Y. Say, Speaker of the House

Attachment

DHHL COMMENTS ON AUDITOR'S DRAFT REPORT OF AUGUST 20, 2002
As Recapped From the Summary of Findings (Page 7)

1. **"The department does not have sufficient documentation to support its methodology for determining the allowance for doubtful accounts for loan receivable."**

   In its audit opinion report (page 24), Grant Thornton LLP stated the following:

   "The department has loans receivable of $43,495,320, net of an allowance for losses of $3,732,000 as of June 30, 2001. The department was unable to provide sufficient evidential matter supporting the amount of the allowance for loan losses. It is not possible to form an opinion about the allowance for losses on loans receivable."

   This finding was considered material enough for Grant Thornton LLP to "qualify" its audit opinion.

   It is DHHL's position that an "Allowance for Losses" account for direct residential mortgage loans secured by homes and related improvements is not necessary. This position has been accepted in previous audits, including an audit performed by Coopers and Lybrand, Certified Public Accountants, for the Legislative Auditor in 1986 (Report No. 86-13, February 1986) where DHHL received an "unqualified" opinion. To support this position, during the past ten (10) years, DHHL has written off a total of $75,929 in loans receivables.

   During the course of the fiscal year 2001 financial audit, Akamine, Oyadomari and Kosaki, CPA's, recommended that the "Allowance for Losses" account be adjusted to $3,732,000 based on their professional judgement. The department relied on this recommendation based on the principle of conservatism in reporting its assets. Akamine, Oyadomari and Kosaki, CPA's, has asserted that the audit work papers used in formulating its "Allowance for Losses" account recommendation are proprietary. DHHL does not have any recourse in requiring the sharing of independent certified public accountant work papers between audit firms.

2. **"The department did not record expenditures infrastructure improvements within the proper period."**

In its audit opinion report (page 24), Grant Thornton stated the following:

"The department recorded expenditures in the amount of $1,816,100 for infrastructure improvements to land in the year ended June 30, 2001 that related to a fund liability incurred in the year June 30, 2000. In our opinion, these expenditures and liability should have been decreased by $1,816,100 and the expenditures for the year ended June 30, 2001 should have been decreased by $1,816,100 to conform to accounting principles generally accepted in the United States of America."

This finding was considered material enough for Grant Thornton LLP to "qualify" its audit opinion.

DHHL agrees that fiscal year 2000's liability in the amount of $1,816,000 for infrastructure improvements was not properly recorded. However, in the fiscal year 2001 financial statements, corrective action was taken by disclosing the transaction in question in DHHL's financial notes to the combined financial statements (Note O - Related Party). The financial statements footnote stated the following:

"During the year ended June 30, 2000, certain parcels located in Kealakehe, Hawaii were transferred from the Department of Land and Natural Resources, State of Hawaii, to the Department. As part of this transfer, the Department is to reimburse the Department of Business, Economic Development and Tourism, Housing and Community Development Corporation of Hawaii (HCDCH), State of Hawaii, $1,816,100 for infrastructure improvements to the land. The reimbursement is to be made in annual payments of $454,025 in fiscal years 2000 and 2001 and a final payment of $908,050 in fiscal year 2002. As of June 30, 2001, the Department owed $908,050 to the HCDCH."

DHHL considered the impact of the error on the fiscal year 2000 and 2001 financial statements. After analyzing the combined financial statements, DHHL believed the impact to be immaterial when compared both individually and in the aggregate to the financial statements as a whole.

Akamine, Oyadomari and Kosaki, CPA's, concurred that the impact of the error was immaterial to the financial statements as a whole and concurred that a financial footnote disclosure was the proper treatment in reporting the transactions. It is evident that the proper treatment taken in reporting these types of transactions is largely dependent on the professional judgement of the auditors.

3. **Loan Program:** "**Management is ineffective. The department's policies and procedures are either not enforced or are non-existent. In addition, the department does not manage outstanding loans adequately, nor maintain current information on the status of loans originated by financial institutions or other lenders for which the department guarantees repayment. Furthermore, the department does not perform financial reporting accurately and timely.**"

The findings above were not mentioned in the independent auditor's report (Grant Thornton LLP, pages 24 and 25), and were considered not to be material in rendering its "qualified" opinion.

DHHL generally concurs with the five recommendations outlined under this finding. However, we provide the following comments for clarification.

Lender of "Last Resort"

DHHL loans are, by design, intended to serve those with no other financing options. Section 10-3-46 subsection (5) of the DHHL's Administrative Rules indicates that "if the loan applicant is found by the department to have sufficient resources or credit to secure financing from non-departmental sources to undertake the purpose for which the loan is sought, no departmental loan shall be made." This is intended to preserve DHHL resources for those families most in need. While DHHL loans are therefore inherently riskier, in many cases the alternative of not extending the loan to the family is to deny the family the opportunity to reside on Hawaiian home lands or the opportunity to repair their existing home.

In the audit's discussion of the department's management of its loan portfolio, a comparison is drawn between the historical delinquency rate for DHHL and for mortgage loans in Hawaii, as reported in the Mortgage Bankers Association of America 2001 Second Quarter Report. The audit report also draws many comparisons between DHHL and a commercial lender. While the comparison appears reasonable on the surface, upon closer inspection the differences between the two entities render the comparison useless.

Commercial lenders, as private for-profit entities, are focused on generating assets (mortgages) that perform well. To achieve this outcome, they minimize their risk by lending to families with sufficient income and good credit. Lenders are judged based on how well their portfolio is performing, including maintaining a low delinquency rate.

DHHL, on the other hand, is judged not only on how well its loan portfolio is performing, but also on the number of families assisted by the department's programs. While the delinquency rate for commercial lenders may outperform DHHL's loan portfolio, DHHL's performance in terms of assisting families with no financial alternatives outperforms the record for the commercial lenders. Since denial of a loan application by a commercial lender is a criterion needed to qualify for a DHHL loan, the majority, if not all, of DHHL loans are given to families that did not qualify to receive assistance from a commercial lender. Although it may not be fair to base the performance of the commercial lenders on standards that are inconsistent with its core purpose as a for-profit entity, it is also not fair to judge DHHL's performance solely on standards that are established for the for-profit world.

In addition, the delinquency rate overstates the true delinquency situation for DHHL since many of the lessees that are delinquent are on a repayment plan and actually paying as required. These loans are not considered current until the Hawaiian Homes Commission (Commission) authorizes a refinancing of the entire loan, including the delinquent balances. This usually occurs after the lessee has demonstrated a consistent payment history on his or her payment plan for at least one year.

Planned Improvements

DHHL concurs with the audit's comments that it needs to actively monitor loans and enforce collection policies to control the level of delinquent loans given DHHL's higher risk portfolio. DHHL also concurs that technology could assist staff and that follow-up on delinquent loans and compliance to existing collection policies and procedures could be improved.

While DHHL concurs that much can be done to enhance DHHL's performance, we would like to note the following:

a. Improved Collection Efforts - Over the past seven years, DHHL has taken steps to improve its collection efforts. One measure of DHHL's progress is the number of contested case hearings being brought before the Commission. A contested case hearing before the Commission is the administrative due process afforded to a lessee when the department is recommending lease cancellation as a result of a loan delinquency. Prior to 1994, few contested case hearings were held for loan delinquencies. Today, the department retains five hearings officers on contract to hear cases and takes an average of five to ten cases a month to the Commission.

b. Partnerships - The Department is in the process of securing the services of a non-profit housing organization or a community development financial institution to assist DHHL in its collection and counseling efforts. In the past, DHHL has successfully partnered with non-profit organizations to assist lessees with meeting their lease obligation to build and occupy their homestead lot. DHHL would like to build upon this success and is now looking to partner with non-profit organizations versed in financial counseling to assist DHHL in its collection and counseling efforts with lessees who are currently delinquent.

c. Technology Enhancements - DHHL is currently in the middle of a multi-year, comprehensive upgrade to its management information system. Three phases of this project have been completed. Phase four, the next phase, includes addressing those information systems that deal with the client. Examples of these systems include the programs that manage the applicant waiting list and DHHL's loan portfolio.

Property Taxes and Advances

DHHL offers the following comments regarding the concerns raised in the audit about advances it has extended to pay for delinquent debt to outside creditors on behalf of certain lessee and to pay for delinquent property taxes:

The department concurs that formal written agreements with lessees should be executed. However, we note that Section 216 of the Hawaiian Homes Commission Act of 1920, as amended, (HHCA) provides DHHL with the statutory authority to have a first lien upon the lessee's interest in a lease for, among other things, payments that are made by DHHL on the lessee's behalf. Section 216 also provides DHHL with the authority to enforce this lien. While a formal agreement might assist this department in its collection efforts, DHHL can proceed with collections under existing statutory authority.

The HHCA clearly states that property taxes are an obligation of the lessee; however, section 208(7) of the HHCA explicitly provides that "the department may pay such taxes and have a lien therefor as provided by section 216 of this Act." Therefore, statutory authority exists for DHHL to make these payments, place a lien on the lessee's interest for these payments, and enforce this lien. Again, a formal agreement, while helpful, is not absolutely necessary.

DHHL has proceeded to resolve the delinquent property tax situation that exists on Hawaiian home lands for two important reasons: (1) to provide a service and benefit to our beneficiaries, and (2) to clarify, enhance and improve DHHL's working relationship with the counties.

Resolution of this issue has required that the counties forgive the late fees and penalties in exchange for an advance by DHHL, on behalf of its lessees, of the delinquent principal amounts. In the two cases in which advances have been made, the amounts advanced by DHHL on behalf of its lessees have equaled approximately half of the total bill originally outstanding.

DHHL has then proceeded to work with the lessees on repayment plans to DHHL for the amounts advanced on the lessee's behalf. In most cases, this program has resulted in a win-win situation. The lessees are given a fresh start with the county and a reduction in their delinquent property tax bill of approximately 50 percent; the counties are provided with substantial revenue.

4. **Fixed assets are not properly recorded.**

In its audit opinion report (page 24), Grant Thornton LLP stated the following:

"The department has not included in fixed assets ancillary costs necessary to place the assets into their intended condition for use. In our opinion, fixed assets should include ancillary costs necessary to place the assets into their intended condition for use in order to conform with accounting principles generally accepted in the United States of America. The effects of that departure on the combined financial statements have not been determined."

This finding was considered material enough for Grant Thornton LLP to "qualify" its audit opinion.

On page 18, paragraph 2 of the draft Legislative report it is stated that "As of June 30, 2001, the department recorded fixed assets of $26,542,329 and also identified unrecorded fixed asset costs of $27,895,183. Included in the latter figure are infrastructure costs as well as ancillary charges. <u>Currently, capitalizing infrastructure costs as fixed assets is optional according to GAAP (emphasis added)."</u> This finding raises several questions. If the capitalization of the infrastructure as fixed assets is <u>optional</u> according to GAAP and DHHL elected not to capitalize infrastructure costs as fixed assets, what is the purpose in mentioning these costs in the report? Were these costs included in rendering the "qualified" opinion?

There remains the question of whether ancillary costs, costs that are readily identifiable, are material to the financial statements individually or in the aggregate. In fiscal year 2003's audit, all of these costs will be restated and recorded (pursuant to GASB Statement No. 34) as fixed assets, leaving this discussion a moot point.

5. **"Construction costs are not properly capitalized as inventory or homes for sale**

In its audit opinion report (page 25), Grant Thornton LLP stated the following:

"The department recorded expenditures in the amount of $647,267 in the year ended June 30, 2000 for home construction costs. In our opinion the costs should have been capitalized as inventory of homes for sales in the year ended June 30, 2000 and the beginning fund balance as of July 1, 2000 and home construction/capital projects expenditures for the year ended June 30,2001 should be increased by $647,267 to conform with accounting principles generally accepted in the United States of America."

This finding was considered material enough for Grant Thornton LLP to "qualify" its audit opinion.

During the course of its fiscal year 2001 financial audit, Akamine, Oyadomari and Kosaki, CPA's, recognized this error and recommended that the capitalization be recorded in the "Inventory - Home for Sale" account in the fiscal year 2001 financial statements. They further recommended that the fiscal year 2000 financial statements not be restated due to the immateriality of the transaction. Based on their professional judgement, DHHL followed their recommendation and recorded an adjusting journal entry to reflect the capitalization of the home construction costs.

6. **"Other significant areas of concern not considered reportable conditions."**

   a. **"Department does not have written policies or procedures for the collection of lease and license receivables."**

      Although DHHL does not have written policies or procedures for the collection of lease and license receivables, it does follow the procedures outlined in Section 171-20, Hawaii Revised Statutes. The department issues written notices of the breach or default by certified mail to the parties in default after the accounts are 60 days past due. The Commission ratifies such action. If the defaults are not cured within sixty (60) days, DHHL then recommends that the Commission terminate the lease or license for failure to cure the default.

   b. **"Department does not have a current strategic plan to guide its programs in meeting its goals and objectives under the Hawaiian Homes Commission Act of 1920."**

The Commission adopted the final version of its General Plan on February 26, 2002. As noted in the Legislative report, the General Plan "includes a strategic plan as a component." The department is moving forward with implementation of the General Plan and will be updating its Administrative Rules for a planning system to guide the statewide development and use of Hawaiian home lands (page 19, paragraph 5).

c. **"The list of applicants for homestead awards has remained constant for the last five years, with thousands of beneficiaries waiting for the opportunity to be provided with land."**

The twenty percent increase in the number of homestead leases awarded during the past ten years is a significant achievement. DHHL has developed more homesteads in the past decade than at any time in the history of the program, including the construction of infrastructure improvements to more than 1,500 acceleration lots awarded between 1984 and 1987. DHHL's current level of funding will support the development of approximately 300-500 homesteads per year.

Total applications have risen by an average of 500 new applications per year. Interest in the Hawaiian home lands program is directly related to the increase in homestead production activity that has occurred during the last decade. While we acknowledge that there are applicants who "may have been on the waiting list for as many as 40 or 50 years," these applicants represent a very small percentage of the total applicants on the waiting list and all have been given the opportunity to receive an award. A review of the files of the first 100 residential applicants on each islandwide waiting list revealed that these applicants have received an average of seven to eight offering letters for homestead awards. For a variety of reasons, these applicants have not chosen to take advantage of the opportunity to obtain a homestead.

d. **"Information of applicants may not always be current, thus precluding the department from contacting beneficiaries about the availability of homestead leases."**

DHHL acknowledges the difficulty in maintaining current information on all applicants. Every effort is made to obtain current information on our beneficiaries. However, we must rely on our beneficiaries to inform us of any changes in their status. It is the applicant's responsibility to ensure that DHHL has their correct mailing address. When DHHL is notified by the Post Office of an address change, a letter is generated to the applicant at the new address requesting confirmation of the change. DHHL will continue to do the best it can with its limited resources.

Akamine, Oyadomari & Kosaki
CERTIFIED PUBLIC ACCOUNTANTS, INC.

Report of Independent Certified Public Accountants

Chairman
Hawaiian Home Lands Commission
State of Hawaii

We have audited the accompanying combined financial statements of the Department of Hawaiian Home Lands, State of Hawaii, as of and for the year ended June 30, 2001, as listed in the foregoing table of contents. These combined financial statements are the responsibility of the management of the Department of Hawaiian Home Lands, State of Hawaii. Our responsibility is to express an opinion on these combined financial statements based on our audit.

We also audited the adjustment described in Note P to the combined financial statements to correct the recording of lease and interest revenues to conform with the modified accrual basis of accounting, that was applied to restate the June 30, 2000 fund balance of the special revenue fund. In our opinion, such adjustment is appropriate and has been properly applied.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall combined financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A to the combined financial statements, the accounts of the Department of Hawaiian Home Lands, State of Hawaii, are intended to present the financial position and results of operations of only that portion of the financial reporting entity of the State of Hawaii that is attributable to the transactions of the Department of Hawaiian Home Lands, State of Hawaii.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of the Department of Hawaiian Home Lands, State of Hawaii, as of June 30, 2001, and the results of its operations for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

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In accordance with Government Auditing Standards, we have also issued our report dated October 19, 2001 on our consideration of the Department of Hawaiian Home Lands, State of Hawaii's, internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining information on the special revenue funds is presented for purposes of additional analysis of the combined financial statements rather than to present the financial position, results of operations and changes in fund balance of the individual funds, and is not a required part of the combined financial statements. Such information has been subjected to the auditing procedures applied in the audit of the combined financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the combined financial statements taken as a whole.

Akamine, Oyadomari & Kosaki CPAs, Inc.

Honolulu, Hawaii
October 19, 2001