

## OFFICE OF COUNCIL SERVICES

CITY AND COUNTY OF HONOLULU  
530 SOUTH KING STREET  
HONOLULU, HAWAII 96813/TELEPHONE (808) 523-4911

DIANE E. HOSAKA, ESQ.  
DIRECTOR

October 22, 1997

To the Chair and Members of the Honolulu City Council:

We are pleased to present this report, "Review of the Housing Development Special Fund," prepared by KPMG Peat Marwick LLP under contract administered by the Audit Section of the Office of Council Services. This review was authorized by an amendment to the Council's annual financial audit contract with KPMG in response to Council concerns regarding whether the Special Fund could reimburse the general fund for the debt service associated with the City's housing projects. These concerns initially arose because of delays in obtaining financial information from the City Administration about the fund and about two of the ongoing housing projects financed from the fund: the Ewa Villages Revitalization Project and the Pawaaw Redevelopment Project.<sup>1</sup>

### Controlling Project Costs

Among the findings of this study is the recurring observation that project forecasts did not include all costs, and that projects were not checked to see if they kept to their initial or updated budgets. It should be noted that improved controls on project budgets and periodic updates of project financial forecasts for City construction projects were recommended four years ago in the Council's 1993 audit report, "Performance Audit of the Police Department Headquarters Project". Had such controls and reporting systems been in place for the projects reviewed in this report, it is

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<sup>1</sup>These delays were experienced by both the Council Committee on Budget and by KPMG, in its capacity as the City's financial auditor, which provides information necessary for the Council's financial audit report and the Finance Director's annual financial report.

The delay resulted in our issuance of the City's 1996 financial audit reports over a month late. The delay also required the Department of Finance to request an extension of the deadline to apply for a national award for financial audit reports.

In the case of the Council Committee on Budget, the Budget Chair felt that the problems in obtaining information from the City Administration about the fund were serious enough to introduce a resolution (Resolution 97-196) authorizing a Council investigation of the Special Fund using subpoena powers.

possible that the losses now reported herein could have been identified at an earlier date and corrective action taken.

For example, in the case of Ewa Villages, early identification of financial difficulty could have led to a reevaluation of the scope and approach taken to achieve the project's historic preservation goals, or of the feasibility of house-by-house reconstruction and rehabilitation rather than undertaking redevelopment of a whole block or area. In the case of the Kekaulike project, early identification of the project's minimal net operating income could have alerted the Administration that the project would not be self-financing, and that a substantial City subsidy and equity contribution was needed.

### **Recommendations**

Based on the findings of this report, we wish to suggest some recommendations for Council to consider. These recommendations are separate from and in addition to those made by KPMG:

- (1) Request the housing department to reevaluate the goals for the Ewa Villages project and amend them as needed.

As noted in this report, two of the project goals, namely providing homeownership opportunities to Village residents and preserving the historic character of the Village, have not been achieved and there is no prospect that they will be achieved in the foreseeable future. The remaining goal of the project, mitigating flooding by development of the golf course, would seem also to have been unmet in view of the severe flooding that occurred this past winter. Finally, as clearly shown in the report, it does not appear that the self-financing intent of the project's funding source will be met.

- (2) Request the housing department to redirect the Manager's Drive project away from the development of market housing.

Both the Council and the City Administration have voiced their support of redirecting the City's housing role away from developing market housing. If this is indeed current City policy, then the Manager's Drive project, which contemplates development of a 40-acre parcel for a school and a market-priced subdivision, is contrary to that policy and should be reconsidered.

- (3) Request the housing department to reassess the continued need for the Housing Development Special Fund in light of the City's present policy to discontinue development of market-priced housing.

As indicated in this report, the fund was established to facilitate development of self-financing housing projects. To be self-financing, housing projects require at

least a portion of the units to be developed to be market-priced. If it is City policy to discontinue development of such units, it would appear that housing projects will not be expected to be self-supporting, and therefore, the fund would no longer be necessary. Projects that are not expected to be self-supporting should utilize a fund other than the Special Fund. However, the future of the fund should be considered carefully before taking any action. Termination of the fund would have implications for the City's financial audit report, the accounting of and fiscal staffing for the fund, the computation of the City's debt burden, as well as for the City's bond rating.

## **Recent Developments**

We are aware that on October 6, 1997, the City Administration announced its selection of proposals from four nonprofit agencies and one commercial firm to acquire and develop portions of Ewa Villages. At this writing, written details of the proposals had been released to the media but not to the Council. We did obtain a copy of those details. While it was beyond the scope of the auditor's contract to review and comment on these proposals and certain proposal details remain unclear, we note the following for the Council:

- (1) There is a large discrepancy between the number of unsold homes and lots in Ewa Villages as reported to the auditors (as of March 1997) and as reported to the media (as of April 1997). As shown in this report, the number of unsold homes and lots as of March 1997 is 604. In the material provided to the media, the number of unsold homes and lots as of April 1997 is 322.
- (2) The proposals received for parcels A and B meet the upset prices set by the City Administration of about \$95,000 per lot. As pointed out in this report, this valuation exceeds the housing department's own appraisals for the lots by 26 to 36 percent.
- (3) The proposal for parcel A contemplates the development, in part, of market homes. This is contrary to the Mayor's and Council's stated redirection of the City's housing program.
- (4) The proposals for parcels A, B, H, and I contemplate obtaining nearly \$12 million of the City's community development block grant (CDBG) funds, over one-third of the cost, to enable those nonprofit agencies to buy and develop those City lands. It is unclear how the CDBG funds are intended to be used.
  - (a) Are the funds intended as a grant to support the proposed housing construction, so that the proposed \$34 million bids to purchase parcels A, B, H, and I really represent bids of just \$22 million to buy the lands, bundled with a grant request of \$12 million to develop the houses? If so,

the actual purchase price would be in accordance with the housing department's appraisal for the land. However, the amount of revenue that should be counted towards retirement of the \$63.5 million Ewa Villages bond due in October 1998 should be \$22 million, not \$34 million.

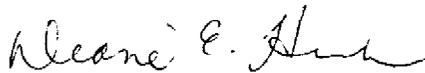
- (b) Alternatively, are the City's \$12 million CDBG funds requested by the proposers to be used to help retire the \$63.5 million Ewa Villages bond? If so, this represents a transfer of CDBG funds to retire debt attributable to the Housing Development Special Fund. As such, the Council may wish to request the housing department to obtain approval from the U.S. Department of Housing and Urban Development prior to the commitment of CDBG funds to this use.

We hope this report proves helpful in informing the Council of the status of the Housing Development Special Fund and the ongoing housing and redevelopment projects that the fund finances. We further hope this report helps to promote discussion of the larger issues raised in this report, such as those described above.



IVAN KAISAN  
Legislative Auditor

FORWARDED BY:



DIANE E. HOSAKA, Esq.  
Director

## **I. EXECUTIVE SUMMARY**

We reviewed the Housing Development Special Fund (Special Fund) to assist the City Council in assessing whether the Special Fund is operating in conformance with its purpose of funding self-financing housing projects and to report on the financial status of the Ewa Villages Revitalization and Pawaā Redevelopment housing projects.

We reviewed the forecasted revenues and expenditures for all ongoing housing projects with special focus placed on the Ewa Villages Revitalization and Pawaā Redevelopment housing projects. All forecast information was provided to us by the Department of Housing and Community Development of the City and County of Honolulu (DHCD). We were not engaged to prepare or revise any financial forecasts of the Special Fund.

Our review was limited to a report on the *financial performance* of the Special Fund only. Many of the projects which utilize the Special Fund also have broader project goals which are not necessarily financial in nature. These include the development of affordable housing for special target groups, community revitalization and historic preservation, community-based, economic development and development of needed community services and facilities. However, the evaluation of these “non-financial” goals were not covered as part of this study and our report considers only the financial outcome of the selected projects.

### ***Housing Development Special Fund***

DHCD’s own financial forecasts indicate that the five ongoing housing development projects are expected to lose approximately \$26.6 million (before consideration of rental revenues, redesignation of expenditures to other funds and proceeds from the sale of the Manager’s Drive Development and West Loch Commercial projects). However, even if the estimated rental revenues, redesignation of expenditures and sales proceeds were considered, they are not expected to cover the estimated deficit.

Overall, we found DHCD’s revenue forecasts for the Ewa Villages Revitalization Project to be aggressive and expenditure forecasts for the five ongoing housing projects to be significantly understated. Our findings and observations relating to forecasted revenues and expenditures of the Special Fund would only serve to increase the expected \$26.6 million deficit, casting considerable doubt over the Special Fund’s ability to fund self-financing housing projects.

It should also be noted that in addition to the salable or income generating properties which were considered in this review, the City still retains an inventory of vacant or improved properties which are currently “land banked” and could potentially be sold in the future. These 18 properties include ag-designated parcels at Ewa Villages, leased sites and community facilities (i.e. churches, schools, rentals, etc.) and excess land at the Pawaā

Project. To the extent that these parcels can be offered for sale, they could serve to reduce the projected \$26.6 million deficit which is expected to be incurred for the Special Fund.

### ***Ewa Villages Revitalization Project***

The Ewa Villages Revitalization Project (Ewa Villages) is projected to lose \$9.6 million. The results of the review of DHCD's financial forecast for Ewa Villages indicates that forecasted revenues are optimistic and forecasted expenditures are significantly understated. More importantly, the concerns raised over the financial forecast also shed considerable doubt over the Special Fund's ability to provide adequate funding for the upcoming debt repayment scheduled for October 1998.

Ewa Villages is plagued by weak market conditions in the Ewa Region. The residential resale market in the Ewa Region has been comparatively weaker than the rest of Oahu. Ewa Villages has had limited appeal to buyers and developers due to a number of factors including low aesthetic appeal, non-urban design standards, inclusion of a high number affordable homes, numerous affordable guidelines and buy-back provisions, recent flooding problems, crime, etc.

The City's involvement in Ewa Villages has enabled about one-half of its former residents to remain within the community in rentals. However, minimal benefit has been attained towards providing affordable *home ownership* opportunities for existing Ewa Villages residents and for other low and moderate income households. The rehabilitation of former plantation homes has also achieved minimal success as most buyers opt for new homes within Ewa Villages itself, but to a greater extent, at other communities that are more homogeneous in their offering, design and master plan.

Sales at Ewa Villages have slowed considerably, evidenced by declining sales absorption rates and virtually no buyers remaining on waitlists. Sell-out of the remaining inventory of 896 units consisting of single-family homes, vacant lots, multifamily parcel and other unimproved parcels within the next fourteen months is highly unlikely.

We found that forecasted revenues for Ewa Villages are extremely optimistic. Sale prices and absorption rates appear unrealistically high given weak current market conditions. No liquidation discounts were considered in estimating projected sales prices despite the accelerated disposition timetable. Further, preliminary appraisals indicate that DHCD's estimated sales prices could be overstated by up to about \$11.8 million. The City's cash flow projection also does not consider the concept of present value used by most real estate developers, which would have resulted in a lower present value of the future cash flows and further increase losses from the project. It appears unlikely that the Ewa Villages Revitalization Project will be able to meet its \$63.5 million debt due October 1998 with Special Fund proceeds.

Ewa Villages site development costs are significantly higher than other similar projects due to the complexity of working within a historic community and due to the difficult site. We also found that certain potential project expenditures were not included in the DHCD's financial forecast, including environmental remediation costs, flood control costs, selling, disposition and other holding costs, and additional contract expenditures. In addition, there was no objective basis to quantify relocation costs and interest charges included in forecasted expenditures. Also, project revenues and expenditures are not reconciled to the City's financial reporting system on a timely basis.

Even excluding consideration of our findings and observations relative to forecasted revenues and expenditures, DHCD's financial forecast indicates that, at completion, project expenditures are expected to exceed revenues by approximately \$9.6 million.

### ***Pawaa Redevelopment Project***

The City will receive revenues from the Pawaa Redevelopment Project through the receipt of development payments amounting to \$8 million. The City has already received \$4 million to date and the remaining amount will be received by the end of 1998, provided that Low Income Housing Tax Credit and tax exempt bond financing becomes available. If not, the remaining payment will occur in mid-1999.

The forecasted expenditures did not include certain potential project expenditures which could amount to at least \$2.2 million. It did not include:

1. Interest costs at approximately \$676,000 as of March 31, 1997 nor any interest costs to be incurred subsequent to March 31, 1997;
2. Direct on-site and other project costs amounting to approximately \$1.5 million; and
3. Selling, disposition and other holding costs for services provided by other City agencies.

We also found that the budget was not updated after the project was substantially changed and that budget variance analysis was not performed on a timely basis.

Without consideration of our findings and observations relative to forecasted expenditures, DHCD's financial forecast indicates that, at completion, project expenditures are expected to exceed revenues by approximately \$900,000.

### ***Kekaulike Courtyards Project***

Unlike the other projects where the City expects to recover its investment through the eventual sale of those projects, Kekaulike Courtyards was developed as a rental project.

Accordingly, if the City is to recover its investment, it must do so over time from the cash flow it generates from operations. Based upon DHCD's estimate of net operating income of \$47,000 per year and total forecasted project expenditures of \$13.1 million, the expected pay back period is estimated to be 278 years.

The forecasted expenditures did not include certain potential project expenditures which could amount to at least \$737,000. It did not include:

1. Interest costs at approximately \$611,000 as of March 31, 1997 nor any interest costs to be incurred subsequent to March 31, 1997;
2. Architecture and engineering and other project costs amounting to approximately \$126,000; and
3. Management costs for services provided by other City agencies.

We noted that the budget was not updated after the project was substantially changed and that budget variance analysis was not performed. Further we found that certain Special Fund expenditures aggregating to \$6.3 million were being redesignated to other funding sources, which indicate that the initial use of Special Funds may have been for purposes other than that set out in the respective ordinances.

### ***Manager's Drive Development and West Loch Commercial Projects***

The City has recently issued request for proposals for the sale of the Manager's Drive and West Loch Commercial projects. As of the date of our inquiries, results of those proposal efforts have not been finalized. DPW has estimated the market value of these properties at an average of about \$7.75 and \$5.95 million, respectively. Both of these projects have forecasted revenues in excess of forecasted expenditures.

Forecasted expenditures for the Manager's Drive Development and West Loch Commercial projects appear to be understated. The Manager's Drive Development project did not include interest costs aggregating to \$279,000 as of March 31, 1997 and did not include any interest costs to be incurred subsequent to March 31, 1997. Both projects did not include costs for services performed by other City agencies. In addition, no budget was prepared and budget variance analysis was not performed for these projects.

## ***Recommendations***

Significant steps should be taken to improve the management and oversight of the Special Fund. These include:

1. Preparation of financial forecasts for each ongoing capital project (such as Ewa Villages and Kekaulike) on a quarterly basis.
2. Preparation of an annual financial forecast estimating development proceeds at projected completion for development projects (such as Pawaa, Manager's Drive and West Loch Commercial). Additionally, forecasts should be updated whenever there is a significant change in development plans, timing, cost or strategy to provide needed information to the City to evaluate and monitor its development projects.
3. Preparation of budgets and analysis of budget variances for all housing projects on a regular basis.
4. Revising financial forecasts and budgets more frequently when project parameters change to update revenue and expenditure assumptions for external and internal factors impacting the housing project. The resulting financial forecasts and budgets will provide more meaningful information to those individuals responsible for monitoring and reviewing project results and serve as a valuable financial tool for management when making future project decisions.
5. Reconciliation of project revenues and expenses to the City's financial reporting system on a regular basis.
6. In addition to reviewing the budgets for the individual projects in the Special Fund, an overall budget which considers the overall results of the Special Fund should be prepared.
7. The Director of Finance is currently responsible for the administration of the Special Fund as stated in Chapter 6, Article 46 of the Revised Ordinance of the City and County of Honolulu. Alternatively, an individual from DHCD who manages the projects from both a fiscal and operational standpoint, should be responsible for the overall management and reporting of the Special Fund activities.

The timely utilization of financial forecasts, budget variance analysis and reconciliations will allow DHCD and the City's management to detect unfavorable situations and take appropriate actions in a timely fashion.

Further, DHCD's financial forecasts should be revised to reflect all significant changes in development plans, as well as the findings and observations contained in this report, and forward the revised financial forecasts to the City Council within a reasonable time period.

Finally, as the repayment date of the Bond Anticipation Notes approaches, the City needs to assess the availability of sales proceeds from Ewa Villages to pay off the notes. It should also consider, at a minimum, the following in determining whether to refinance the Bond Anticipation Notes on a short or long term basis:

1. Costs associated with the issuance of debt;
2. Interest costs;
3. Future short and long term financing requirements of the Special Fund (i.e., to use available proceeds to pay off the Bond Anticipation Notes or to fund other projects of the City);
4. Prepayment considerations; and
5. Restrictive debt covenants.