REPORT OF THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

847.1
DEPARTMENT OF VETERANS AFFAIRS
A REVIEW OF THE CAL-VET PROGRAM'S
LOAN PROCEDURES AND CASH FLOW ANALYSIS
JANUARY 1979
January 19, 1979

The Honorable Speaker of the Assembly
The Honorable President pro Tempore of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members of the Legislature:

Your Joint Legislative Audit Committee respectfully submits the Auditor General’s report on the loan procedures and cash flow analysis in the Cal-Vet program of the Department of Veterans Affairs.

The report identifies administrative weaknesses in the Cal-Vet loan program which contributed to delinquent property tax penalties of approximately $29,000 in fiscal year 1977–78 and varying criteria used for evaluating the credit status of loan applicants among the 15 district offices.

The Auditor General recommends specific corrective action to be taken by the Department of Veterans Affairs.

The auditors are Harold L. Turner, Audit Manager; Dore C. Tanner, CPA; and Allison G. Sprader.

Respectfully submitted,

Richard Robinson
Assemblyman, 72nd District
Chairman, Joint Legislative Audit Committee
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SUMMARY

The State of California, through the Cal-Vet loan program of the Division of Farm and Home Purchases, Department of Veterans Affairs, offers low interest farm and home loans to California veterans.

We found administrative weaknesses in the program which contributed to:

- Delinquent property tax penalties of approximately $29,000 in fiscal year 1977-78 (page 6)
- Varying criterion used for credit evaluations of loan applicants among the 15 district offices of the Division of Farm and Home Purchases (page 7).

These weaknesses were due in part to the lack of a complete, formal, written operations manual.

On page 9 we recommend specific corrective action to be taken by the Cal-Vet loan program.
INTRODUCTION

In response to a resolution of the Joint Legislative Audit Committee, we have reviewed the Cal-Vet loan program of the Division of Farm and Home Purchases, Department of Veterans Affairs. This review was conducted under the authority vested in the Auditor General by Section 10527 of the Government Code.

We analyzed various functions of the Division, including the methods for cash flow analysis, development of written procedures for the Division's operations and the payment of property taxes. We examined records and interviewed personnel at the Sacramento headquarters and at the three district offices at Concord, Van Nuys and Fresno.

The Cal-Vet loan program, operated by the Division of Farm and Home Purchases, was established in 1921 to provide California veterans with long-term, low interest loans for homes and farms.* Currently, the program finances at 5.6 percent interest and loans up to $43,000 on properties on which improvements do not exceed $53,000. Effective January 1, 1979, the limitations on improvement values will be eliminated.

The Division requires most purchasers to participate in its property tax program. It acts as an agent in the collection and payment of property taxes on approximately 67,000 of its 111,000 loans.

* The Division does not provide home loans as such, but acquires the property and contracts with the veteran purchasing it.
AUDIT RESULT

ADMINISTRATIVE WEAKNESSES
CAUSED BY A LACK OF
ADEQUATE PROCEDURES

The Department of Veterans Affairs, Division of Farm and Home Purchases has several operating weaknesses. These weaknesses are due in large part to a lack of complete, formal, written procedures. Written operating procedures are necessary for division employees to provide effective and efficient service to the veterans and to maintain smooth operations during personnel turnover. Written procedures could have prevented some of the problems we found: late property tax payment penalties of approximately $29,000 for fiscal year 1977-78 and a lack of consistent criteria and procedures for district office personnel to use for credit evaluations of veteran applicants.

Lack of Formal Operations Manual

In an operation as large and complex as the Cal-Vet loan program, compliance with standard procedures is essential. The Division of Farm and Home Purchases (Division), however, has yet to develop a comprehensive procedures manual which identifies areas of authority and responsibility and assures consistency among districts. Development of an operations manual began in 1975 but has not been completed despite four audit recommendations since then.
The August 1975 audit by the Fiscal Management Audits Section, Department of Finance stated:

... there is a need to clearly show who originates transaction requests and what action is to be taken by personnel who receive the request. This could be accomplished through preparing a procedures manual ...

In November 1975, the Cal-Vet loan program's certified public accountants recommended that high priority be given to the development of written policies and procedures for all accounting and financial matters, which would provide the following benefits:

1. Transition periods for new personnel would be less difficult

2. Objectives, responsibilities and authority would be more clearly defined

3. Systems and procedures personnel would benefit substantially from using an operations manual in coordinating the flow of information as EDP becomes increasingly involved in providing operation information.

The September 1976 audit report reiterated the previous year's recommendation to develop a systems and procedures manual. The October 1977 report stated:

The transition difficulties experienced by the new personnel highlight our concern regarding the lack of a systems and procedures manual providing documentation of the processing of transactions and other job responsibilities.
Despite the number of recommendations regarding development of a procedures manual, the manual still is not completed. As of January 1979 only 7 of 15 chapters had been completed and distributed to division employees. The remaining eight chapters are in various stages ranging from no work accomplished to nearly completed. In December 1978, recognizing the importance of completing an operations manual, the Department assigned this function as the job responsibility of a Supervising Property Agent. The division manager estimated that the manual would be completed by June 30, 1979.

The importance of completing the operations manual is compounded by the actual and potential employee turnover. In fiscal year 1977-78, approximately 20 percent of the employees left the Division and employee turnover is expected to continue. Twenty-nine percent of the Division's employees are eligible for retirement under the Public Employees Retirement System; twenty-eight percent of these employees are at least 60 years old and probably will be retiring in the near future. Sixty-seven percent of the division administrative personnel--many have 20 years or more of service with the Department--are eligible for retirement. Without a written, complete, formal operations manual, the knowledge and experience of these employees will be lost at their retirement.
Property Tax Delinquencies

Since 1968 the Division has required that new loan purchasers participate in its property tax program; at present, approximately 67,000 loan purchasers are participating in the program. The Division collects tax payments with the monthly principal and interest payments and pays the taxes in April and December of each year.

In December 1977, however, property taxes on approximately 1,600 properties became delinquent and the Division was required to pay over $29,000 in late payment penalties. The following table shows the first property tax installment and late penalties paid by the Division during the last three years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Property Taxes</th>
<th>Late Penalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>$23.3 million</td>
<td>$5,500</td>
</tr>
<tr>
<td>1977</td>
<td>$25.6 million</td>
<td>$29,000</td>
</tr>
<tr>
<td>1978</td>
<td>$11.9 million</td>
<td>$3,000 (estimated)</td>
</tr>
</tbody>
</table>

The Division stated that:

Penalties for the payment of taxes due December 10, 1977, were caused by a variety of factors as follows:

1) Staff turnover.
2) Errors in billing by counties.
3) New accounts coming into tax payment program at a late date. (Note: Problem now corrected by establishment of September 15 cut-off date to enter Cortac; i.e., county system for handling taxes.)
4) Inflation re dollar amounts of property values and, therefore, taxes paid.
During this time no written operations manual existed and the lack of written procedures contributed to the late penalty payments in 1977 when the Division experienced turnover of key property tax payment personnel.

Subsequent to our review of the property tax problem, the Division's professional staff completed a draft of procedures for processing property tax payments. Development of property tax procedures began in January 1978.

Credit Evaluation Procedures in Processing Loan Applications

District offices are applying varying procedures when evaluating the credit status of loan applicants. This is caused by the lack of a complete, formal, written operations manual and by lax observation of existing procedures. As a result, veterans in some districts are subject to much closer scrutiny and control than veterans in other districts.

The district managers have developed their own policies and procedures in areas not specifically covered by written procedures. Certain of these policies and procedures result in inconsistent treatment of veteran applicants. We found differences in credit policies in the three district offices we visited and the other district offices we contacted. The credit policies ranged from a credit review on every applicant to a credit review only if the applicant appeared to be in a very uncertain financial position. We found that credit reviews are conducted on every applicant in the Concord, Modesto and Redding offices; on almost all
applicants in the Bakersfield, Lakewood and Santa Rosa offices; on a frequent basis in the West Covina office; occasionally in the Fresno, North and South Sacramento, San Bernardino, Santa Clara and Van Nuys offices; and rarely in the San Diego and Ventura offices.

The existing operations manual states that if credit reviews are not conducted, the reasons are to be indicated. Our review of approximately 500 loan files in Sacramento headquarters and the district offices disclosed that division personnel were not following this policy. Credit reviews were not conducted in 54 percent of the files we reviewed, and explanations for failure to conduct credit investigations were not provided in 57 percent of those files.

Indicators of when a credit review should be conducted were fairly standard: short time on the job, few (if any) assets, moderate or heavy debt. However, loans were approved without performing credit checks for applicants with combinations of the above indicators. We found that 12 percent of the approved loans we reviewed were for applicants who did not meet credit standards of the respective district offices. The credit standards section of the existing operations manual does not address procedures to be followed when approving loans for applicants who do not meet existing credit standards.
While there are significant variations in the credit evaluation procedures followed by the district offices, the Division stated that:

Since the Division of Farm and Home Purchases operates the Cal-Vet Loan Program as a benefit for California war time veterans, our philosophy is to extend credit for home purchases whenever practicable and to lean toward the liberal rather than the conservative side. This means that credit standards must, of necessity, be flexible insofar as our Operations Manual is concerned and, therefore, a fair amount of discretion is given to District Offices in making loan decisions within certain constraints. Our low record of repossessions confirms that this has worked well in the past.

CONCLUSION

The Division of Farm and Home Purchases lacks a complete, written, formal operations manual. This contributed to the late payment penalties of $29,000 on delinquent property taxes in fiscal year 1977-78. Further, credit evaluation procedures vary significantly among district offices because they have had to develop their own policies and operating procedures.

RECOMMENDATION

We recommend that the Division of Farm and Home Purchases develop a complete, written, formal operations manual and follow its procedural guidelines.
We further recommend that the Division submit quarterly reports on the progress of development of the operations manual to the Assembly and Senate Committees on Governmental Organization, and submit a completed operations manual to them by December 31, 1979.

We also recommend that copies of the quarterly reports and completed procedures manual be submitted to the Office of the Auditor General.
OTHER PERTINENT INFORMATION

CASH FLOW ANALYSIS IN
THE CAL-VET LOAN PROGRAM

The Department's methods of managing and planning the cash needs of the Cal-Vet loan program do not provide adequate information for the continuous evaluation of its cash position. They also do not provide advance program control to have the desired effect on the cash position.

With an operation as large and complicated as the Cal-Vet loan program, handling millions of dollars monthly, sound management of cash needs is essential. The following program statistics illustrate the need for good cash management practices:

- $351 million of purchase contracts in fiscal year 1977-78
- $163 million of debt service payments in fiscal year 1977-78
- $150 million of bond sales in fiscal year 1977-78
- $1.379 billion of bonds payable as of June 30, 1978
- $1.539 billion of contract receivables on 111,000 purchase contracts as of June 30, 1978.
The Cal-Vet loan program has $100 million of general obligation bonds unsold and available to finance the program from the 1976 voter approval. The Legislature also authorized $500 million of revenue bonds for the program, effective January 1, 1979. An additional $500 million of general obligation bonds was approved by the voters in the November 1978 elections. Authorized and unsold bonds total $1,100,000,000.

The lack of sufficient cash inflow, was due in part by a delay in bond sales following the passing of Proposition 13 and resulted in the curtailment of loans to qualified veterans from June to December 1978. Due to heavy loan demand the Department implemented a statutory preference system of funding new Cal-Vet loans. The preference system is a priority list which ranks qualified veterans into four categories. The Department was only funding loans for the first three of the four categories listed below:

- Veterans wounded or disabled as a result of service
- Former prisoners of war, unremarried spouses of servicemen missing in action and spouses of those killed in the line of active duty
- Veterans released or discharged within 10 years of application for a Cal-Vet loan
- All other eligible veterans.

The Department currently uses three methods to estimate cash needs:
- Cash availability statements

- Estimated cash receipts and disbursements statements

- Cash flow projections.

**Cash Availability Statements**

The cash availability statements, prepared weekly, indicate the amount of cash available at a given time. However, the cash availability statements do not estimate program needs for future periods.

**Estimated Cash Receipts and Disbursements**

A statement of estimated cash receipts and disbursements is prepared annually by the independent auditors to determine if veterans' principal and interest payments are sufficient to meet debt service and operating expenses. However, this does not provide information on cash needs on a short-term basis, such as weekly, monthly or quarterly.

**Cash Flow Projections**

Cash flow projections estimate cash receipts, disbursements and balances within designated periods of time based on past experience and anticipated conditions. Cash flow projections are an effective instrument of control since cash receipts, cash disbursements and cash available at future time periods is estimated. With this information, the Department can formulate plans to meet program objectives with the available funds.
In the Auditor General’s Report* issued in June 1976, we stated that monthly cash flow projections would provide current and reliable estimates of cash needs of the Cal-Vet loan program. Monthly projections would also provide safeguards against changes in economic conditions that might have a material effect on the operations of the Department.

Financial managers at several large lending institutions that we visited believe that regularly prepared cash flow projections are necessary to provide accurate and timely information to manage and plan the cash needs of their organizations.

The Department, however, prepares its cash flow projections on an irregular basis. In the last two years, the Department has prepared six cash flow projections to assess the need for a bond sale or determine the impact on program changes. The following table illustrates the time between cash flow projections:

<table>
<thead>
<tr>
<th>Date Projection Prepared</th>
<th>Number of Months Between Cash Flow Projections</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1977</td>
<td></td>
</tr>
<tr>
<td>November 1977</td>
<td>10 months</td>
</tr>
<tr>
<td>March 1978</td>
<td>4 months</td>
</tr>
<tr>
<td>July 1978</td>
<td>4 months</td>
</tr>
<tr>
<td>September 1978</td>
<td>2 months</td>
</tr>
<tr>
<td>December 1978</td>
<td>3 months</td>
</tr>
</tbody>
</table>

Without timely projections, policy decisions could be based on outdated information. For example, the Department began an outreach program in mid-1977 to inform veterans of the availability of Cal-Vet loans. This program included public service announcements on television and radio. After the start of the program, loan applications and loans increased rapidly. Since no updated cash flow projections were available, the decision to begin a large scale promotion campaign was started without timely information. Further, cash flow projections were not prepared to determine the effects of the outreach program until November 1977.

The Department is currently evaluating the use of computer models for analyzing the cash needs of the Cal-Vet loan program. Computer terminals were installed in December 1978. The Department believes that installation of the computer terminal and use of computer models will facilitate frequent and regular cash flow projections.

Respectfully submitted,

[Signature]

THOMAS W. HAYES
Acting Auditor General

Date: January 15, 1979

Staff: Harold L. Turner, Audit Manager
       Dore C. Tanner, CPA
       Allison G. Sprader
MEMORANDUM

To: Thomas Hayes
   Assistant Auditor General

From: Department of Veterans Affairs
       Telephone: (916) 445-3111

Subject: Report of the Auditor General

Date: January 12, 1979

We basically agree with the conclusions presented in the Report of the Auditor General.

Regarding the completion of a Cal-Vet Loan Operations Manual, we concur that this is an item of top priority. The timetable for its production is attached.

In connection with the comments on cash flow forecasting, the Department recently acquired IBM CRT Terminals for doing interactive programming and some off-line processing at Teale Data Center (TDC). Along with this we will be implementing, in the next 90 days, a forecasting package, available at TDC, called FORESIGHT; it will be useful in making more sophisticated financial projections and for a host of forecasting activities.

This will supplement the daily, weekly and monthly activity reports on lending activities coming from the Cal-Vet Loan District Offices and Headquarters Escrow Section which have been in use for some time.

VIRGINIA MAE DAYS
Director

WCS:vah

Attachment
When totally completed, the Cal-Vet Loan Operations Manual will consist of fifteen (15) chapters. Listed below are the various chapters by number and title; the stage each is in; and the scheduled completion date:

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>TITLE</th>
<th>STATUS</th>
<th>SCHEDULED COMPLETION DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Application Procedure</td>
<td>Is in first rough draft</td>
<td>March 31, 1979</td>
</tr>
<tr>
<td>2</td>
<td>Eligibility</td>
<td>Completed/Printed</td>
<td>In Use</td>
</tr>
<tr>
<td>3</td>
<td>Credit Review</td>
<td>Completed/Printed</td>
<td>In Use</td>
</tr>
<tr>
<td>4</td>
<td>Single Family Residential Dwelling</td>
<td>Completed/Printed</td>
<td>In Use</td>
</tr>
<tr>
<td>5</td>
<td>Conditional Commitments</td>
<td>Completed/Printed</td>
<td>In Use</td>
</tr>
<tr>
<td>6</td>
<td>Presale Commitments</td>
<td>Being Drafted</td>
<td>June 30, 1979</td>
</tr>
<tr>
<td>7</td>
<td>Farms</td>
<td>Being Drafted</td>
<td>June 30, 1979</td>
</tr>
<tr>
<td>8</td>
<td>Mobilehomes</td>
<td>Completed/Printed</td>
<td>In Use</td>
</tr>
<tr>
<td>9</td>
<td>Insurance</td>
<td>Is in first rough draft</td>
<td>April 15, 1979</td>
</tr>
<tr>
<td>10</td>
<td>Home Improvement Loans</td>
<td>Completed/Printed</td>
<td>In Use</td>
</tr>
<tr>
<td>11</td>
<td>Purchase Recommendation Procedure</td>
<td>Being Drafted</td>
<td>June 30, 1979</td>
</tr>
<tr>
<td>12</td>
<td>Escrow</td>
<td>Being Drafted</td>
<td>June 30, 1979</td>
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<td>13</td>
<td>Subsequent Loans</td>
<td>Completed/Printed</td>
<td>In Use</td>
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<td>Property Management</td>
<td>Being Drafted</td>
<td>June 30, 1979</td>
</tr>
<tr>
<td>15</td>
<td>Contract Services</td>
<td>Being Drafted</td>
<td>June 30, 1979</td>
</tr>
</tbody>
</table>

NOTE: The selection of fifteen chapters was purely arbitrary and relates to present needs. At a future time, the number could be expanded or contracted as the situation warrants. Past work on chapters has been prioritized by their usage in the District Offices. Various major administrative and legislative changes causing prior production delays are now hopefully past.

January 11, 1979
Office of the Auditor General

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
Secretary of State
State Controller
State Treasurer
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Democratic/Republican Caucus
California State Department Heads
Capitol Press Corps