Office of the State Auditor

Division of State Audit

Department of Financial Institutions
Bismarck, North Dakota

Audit Report for the
Two-Year Period Ended June 30, 2008
Client Code 413

Robert R. Peterson
State Auditor

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Transmittal Letter

January 29, 2009

The Honorable John Hoeven, Governor

Members of the North Dakota Legislative Assembly

Mr. Tim Karsky, Commissioner, Department of Financial Institutions

We are pleased to submit this audit of the Department of Financial Institutions for the two-year period ended June 30, 2008. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Angela Klubberud. Richard Fuher, CPA, was a staff auditor. Cindi Pedersen, CPA, was the audit supervisor and Paul Welk, CPA, was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2320. We wish to express our appreciation to Commissioner Karsky and his staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

INTRODUCTION

The North Dakota Department of Financial Institutions is a regulatory agency exercising oversight responsibilities of financial institutions in North Dakota. The Department has charge of the execution of all laws relating to state banks, trust companies, building and loan associations, mutual investment corporations, mutual savings corporations, banking institutions and other financial corporations, exclusive of the Bank of North Dakota, and all credit unions organized or doing business under the laws of North Dakota. The Department issues licenses to money brokers, collection agencies, small loan companies, consumer finance companies, deferred presentment service providers, agents for deposits, and money transmitter businesses. The Department is responsible to the depositors and creditors of the financial institutions by determining the soundness of the financial institutions and monitoring compliance with applicable rules and regulations.

RESPONSES TO LAFRC AUDIT QUESTIONS

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies.

1. *What type of opinion was issued on the financial statements?*

   Financial statements were not prepared by the Department of Financial Institutions in accordance with generally accepted accounting principles so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

2. *Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?*

   Other than our findings addressing "noncompliance with biennial cash limit" (page 13) the Department of Financial Institutions was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. *Was internal control adequate and functioning effectively?*

   Yes.

4. *Were there any indications of lack of efficiency in financial operations and management of the agency?*

   No.

5. *Has action been taken on findings and recommendations included in prior audit reports?*

   The Department of Financial Institutions has partially implemented the "noncompliance with biennial cash limit" recommendation included in the prior audit report. Our finding "noncompliance with biennial cash limit" (page 13) readdresses this finding.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

   Yes, a management letter was issued and is included on page 16 of this report, along with management's response.

LAFRC AUDIT COMMUNICATIONS

1. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

   There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

2. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

   The Department of Financial Institutions' financial statements do not include any significant accounting estimates.

3. *Identify any significant audit adjustments.*

   Significant audit adjustments were not necessary.

4. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

   None.

5. *Identify any serious difficulties encountered in performing the audit.*

   None.

6. *Identify any major issues discussed with management prior to retention.*

   This is not applicable for audits conducted by the Office of the State Auditor.

7. *Identify any management consultations with other accountants about auditing and accounting matters.*

   None.

8. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

   ConnectND Finance, Human Resource Management System (HRMS) and the Records Management System are high-risk information technology systems critical to the Department of Financial Institutions.

Audit Objectives, Scope, and Methodology

Audit Objectives

The objectives of this audit of the Department of Financial Institutions for the two-year period ended June 30, 2008 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the highest risk areas of the Department of Financial Institutions' operations and is internal control adequate in these areas?

2. What are the significant and high-risk areas of legislative intent applicable to the Department of Financial Institutions' and are they in compliance with these laws?

3. Are there areas of the Department of Financial Institutions' operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Department of Financial Institutions is for the two-year period ended June 30, 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Department of Financial Institutions has examiners based in Fargo and Grand Forks, in addition to the central office in Bismarck. Each location will be included in the audit scope.

Audit Methodology

To meet the objectives outlined above, we:

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report and developed a discussion and analysis of the financial statements.
- Performed detailed analytical procedures including computer assisted auditing techniques. These procedures were used to identify high risk transactions and potential problem areas for additional testing.
- Tested internal control and compliance with laws and regulations which included selecting representative samples to determine if controls were operating effectively and to determine if laws were being followed consistently.

Nonstatistical sampling was used and the results were projected to the population. Further where applicable, populations were stratified to ensure that particular groups within a population were adequately represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample.

- Interviewed appropriate agency personnel.
- Queried the ConnectND (PeopleSoft) ERP system.
- Observed Department of Financial Institutions' processes and procedures.

In aggregate there were no significant limitations or uncertainties related to our overall assessment of the sufficiency and appropriateness of audit evidence.

Discussion and Analysis

The accompanying financial statements have been prepared to present the Department of Financial Institutions' revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

For the two-year period June 30, 2008, operations of the Department of Financial Institutions were primarily supported by the collection of annual assessments and investigation, license, and special examination fees.

FINANCIAL SUMMARY

Revenues consisted primarily of bank and credit union assessment fees, consumer license fees, investigation fees, and special examination fees. Other revenues during the audited period included interest income earned on the Department of Financial Institutions' operating fund and fines and penalties. Total revenues were $2,168,344 for the year ended June 30, 2008 as compared to $2,477,013 for the year ended June 30, 2007. Revenue in 2008 was lower than 2007 due to a decrease in the assessments of banks and credit unions set by the State Banking Board and State Credit Union Board.

Total expenditures for the Department of Financial Institutions were $2,475,093 for the year ended June 30, 2008 as compared to $2,190,652 for the prior year. The increase in total expenditures for the audited period reflects general increases in salaries, employee training, and information technology needs. All other expenditures remained fairly constant.

Financial Statements

STATEMENT OF REVENUES AND EXPENDITURES

	June 30, 2008	June 30, 2007
Revenues and Other Sources:		
Regulatory Fees	$1,807,107	$2,063,926
Licenses, Permits, and Fees	315,127	358,289
Interest and Investment Earnings	43,306	49,648
Fines and Forfeitures	2,804	5,150
Total Revenues and Other Sources	$2,168,344	$2,477,013
Expenditures and Other Uses:		
Salaries and Benefits	$1,928,195	$1,761,629
Travel	186,954	161,191
Fees – Professional Services	9,588	25,033
Rentals/Leases – Building/Land	84,502	57,780
IT – Data Processing	68,406	56,548
Professional Development	82,301	47,136
Operating Fees and Services	25,708	23,863
IT – Equipment under $5,000	33,863	2,039
IT – Communications	16,139	15,890
Supplies – IT Software	7,810	4,445
Supply/Material – Professional	6,701	5,637
Postage	6,399	7,257
Office Supplies	5,733	6,300
Rentals/Leases – Equipment and Other	5,601	4,050
Insurance	3,657	4,310
Printing	3,220	2,651
Other Operating Expenditures	316	4,893
Total Expenditures and Other Uses	$2,475,093	$2,190,652

STATEMENT OF APPROPRIATIONS

For The Fiscal Year Ended June 30, 2008

Expenditures by Line Item:	Original Appropriation	Adjustments	Final Appropriation	Expenditures	Unexpended Appropriation
Salaries and Benefits	$ 4,126,408	$ 7,280	$ 4,133,688	$ 1,928,195	$ 2,205,493
Operating Expenses	1,031,014		1,031,014	546,898	484,116
Contingency	20,000		20,000		20,000
Totals	$ 5,177,422	$ 7,280	$ 5,184,702	$ 2,475,093	$ 2,709,609
Expenditures by Source:					
Other Funds	$ 5,177,422	$ 7,280	$ 5,184,702	$ 2,475,093	$ 2,709,609
Totals	$ 5,177,422	$ 7,280	$ 5,184,422	$ 2,475,093	$ 2,709,609

Appropriation Adjustments:

Increases to the salaries and wages line is due to additional appropriation authority granted by Senate Bill 2189 for market equity increases for classified state employees.

For The Biennium Ended June 30, 2007

Expenditures by Line Item:	Original Appropriation	Adjustments	Final Appropriation	Expenditures	Unexpended Appropriation
Salaries and Benefits	$ 3,412,279		$ 3,412,279	$ 3,238,539	$ 173,740
Operating Expenses	811,982	$ 75,000	886,982	857,215	29,767
Capital Assets	7,500	(7,500)			
Contingency	20,000		20,000	4,445	15,555
Money Transmitters	193,742		193,742	181,545	12,197
Totals	$ 4,445,503	$ 67,500	$ 4,513,003	$ 4,281,744	$ 231,259
Expenditures by Source:					
Other Funds	$ 4,445,503	$ 67,500	$ 4,513,003	$ 4,281,744	$ 231,259
Totals	$ 4,445,503	$ 67,500	$ 4,513,003	$ 4,281,744	$ 231,259

Appropriation Adjustments:

The Emergency Commission approved an additional $75,000 for operating expenses, including a $7,500 transfer from capital assets. This additional funding was needed to cover a multi-state investigation of a mortgage company that was not included in the original budget.

Internal Control

In our audit for the two-year period ended June 30, 2008, we identified the following areas of the Department of Financial Institutions' internal control as being the highest risk:

Internal Controls Subjected To Testing

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls effecting the safeguarding of assets.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the Records Management information system

The criteria used to evaluate internal control is published in the publication Internal *Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered necessary based on our assessment of audit risk. We concluded internal control was adequate.

Auditors are required to report deficiencies in internal control that are significant within the context of the objectives of the audit. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect (1) misstatements in financial or performance information, (2) violations of laws and regulations, or (3) impairments of effectiveness or efficiency of operations, on a timely basis. Considering both qualitative and quantitative factors, we did not identify any significant deficiencies in internal control. However, we noted other matters involving internal control that we have reported to management of the Department of Financial Institutions in a management letter dated January 29, 2009.

Compliance With Legislative Intent

In our audit for the two-year period ended June 30, 2008, we identified and tested the Department of Financial Institutions' compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

- Maintained proper cash balance in the Department of Financial Isntitutions Regulatory Fund at the close of the biennium (North Dakota Century Code section 6-01-01.1).
- Proper State Banking Board and State Credit Union Board member reimbursements (North Dakota Century Code section 6-01-03).
- Proper assessments, penalties, application fees, and examiner fees were charged.
- Compliance with agency appropriation laws (2007 North Dakota Session Laws chapter 8 and 2005 North Dakota Session Laws chapter 36).
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures are made in accordance with OMB policy and state statute.
- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including record keeping, surplus property, lease and financing arrangements in budget requests, and lease analysis requirements.
- Compliance with payroll related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

The criteria used to evaluate legislative intent are the laws as published in the *North Dakota Century Code* and the *North Dakota Session Laws*.

Government Auditing Standards requires auditors to report all instances of fraud and illegal acts unless they are inconsequential within the context of the audit objectives. Further, auditors are required to report significant violations of provisions of contracts or grant agreements, and significant abuse that have occurred or are likely to have occurred.

The results of our tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards*. This finding is described below. Other than this finding, we concluded there was compliance with the legislative intent identified above. We also noted certain inconsequential instances of noncompliance that we have reported to management of the Department of Financial Institutions in a management letter dated January 29, 2009.

Finding 08-1

NONCOMPLIANCE WITH BIENNIAL CASH BALANCE LIMIT

The cash balance in the financial institutions regulatory fund at the end of the 2005-2007 biennium exceeded the amount allowed per North Dakota Century Code (NDCC) section 6-01-01.1(3). The fund's cash balance at the end of the biennium was $1,406,281, which exceeded the amount allowed by $369,909.

NDCC section 6-01-01.1 (3) states that "any cash balance in the financial institutions regulatory fund after all current biennium expenditures are met must be carried forward in the financial institutions regulatory fund for the next succeeding biennium. The balance in this fund at the end of the current biennium may not exceed twenty percent of the department's biennial budget." The department's budget for the 2007-2009 biennium was $5,181,860 which allowed a cash carryover of $1,036,372 at the end of the 2005-2007 biennium.

No recommendation will be made as Senate Bill 2160 of the 2009 Legislative Session amended NDCC section 6-01-01.1. If these amendments are implemented correctly, the above finding will be addressed.

Operations

This audit did not identify areas of the Department of Financial Institutions' operations where we determined it was practical at this time to help to improve efficiency or effectiveness.

Prior Recommendations Not Implemented

The prior recommendation has not been implemented:

NONCOMPLIANCE WITH BIENNIAL CASH BALANCE LIMIT

Finding 06-1

Background

The cash balance in the financial institutions regulatory fund at the end of the 2003-2005 biennium exceeded the amount allowed per North Dakota Century Code (NDCC) section 6-01-01.1 (3). The fund's cash balance at the end of the biennium was $1,224,088 which exceeded the amount allowed by $334,987.

Recommendation

We recommend that the Department of Financial Institutions:

- Ensure the cash balance in the Financial Institutions Regulatory Fund at the end of the biennium not exceed 20% of the department's biennial budget in accordance with section 6-01-01.1 (3) of the North Dakota Century Code.

- Introduce legislation to clarify NDCC section 6-01-01.1 (3).

Status

Partially implemented. See finding on page 13.

Management Letter (Informal Recommendations)

January 29, 2009

Mr. Tim Karsky, Commissioner
Department of Financial Institutions
2000 Schafer Street, Suite G
Bismarck, ND 58501

Dear Mr. Karsky:

We have performed an audit of the Department of Financial Institutions for the two-year period ended June 30, 2008, and have issued a report thereon. As part of our audit, we gained an understanding of the Department of Financial Institutions' internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status.

The following present our informal recommendations.

ACCOUNTS PAYABLE/EXPENDITURES

Informal Recommendation 08-1: We recommend the Department of Financial Institutions ensure individuals do not have access to both data entry and approval roles in PeopleSoft.

PAYROLL

Informal Recommendation 08-2: We recommend the Department of Financial Institutions have an individual with inquiry rights only run the one-time payment query on a monthly basis.

GENERAL

Informal Recommendation 08-3: We recommend the Department of Financial Institutions incorporate the following key elements into the department's code of conduct policy: full, fair, accurate, timely and understandable disclosure in reports and documents; the prompt internal reporting of violations of the code to appropriate person or persons indentified in the code; and descriptions of what constitutes fraudulent behavior.

Informal Recommendation 08-4: We recommend the Department of Financial Institutions establish and perform a fraud risk assessment on a comprehensive and recurring basis; and design and document the necessary control activities to ensure each significant fraud exposure identified during the risk assessment process has been adequately mitigated.

Management of the Department of Financial Institutions agreed with these recommendations.

I encourage you to call myself or an audit manager at 328-2241 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

Angela Klubberud
Auditor in-charge