

North Dakota Securities
Department
BISMARCK, NORTH DAKOTA

Audit Report

Two-year Period Ended
June 30, 2010

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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Transmittal Letter

April 8, 2011

The Honorable Jack Dalrymple, Governor
Members of the North Dakota Legislative Assembly
Ms. Karen Tyler, Commissioner

We are pleased to submit this audit of the North Dakota Securities Department for the two-year period ended June 30, 2010. 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 Kristi Morlock. Lindsey Ressler was the staff auditor. Paul Welk, CPA was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2241. We wish to express our appreciation to Commissioner Tyler and her staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Bob Peterson".

Robert R. Peterson
State Auditor

Executive Summary

Introduction

The North Dakota Securities Department was created as a result of the Securities Act of 1951 with statutory authority under Chapters 10-04, 43-10.1, 51-19, and 51-23 of the North Dakota Century Code. The function of the North Dakota Securities Department is to protect the public and private sector in matters involving the issuance and sale of securities, sale of franchises, sale or execution of pre-need funeral service contracts, and registration of salesman, brokers, or dealers handling the sale of securities. The North Dakota Securities Department also issues cease and desist orders to individuals and corporations attempting to sell securities without approval; provides exemptions for companies who meet the stated requirements; and investigates and prosecutes violators of the state's securities laws. In an effort to achieve uniformity in securities legislation, the North Dakota Securities Department cooperates with the administrators of federal and state securities laws.

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies. Those items and the Office of the State Auditor's response are noted below.

Responses to LAFRC Audit Questions

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

Financial statements were not prepared by the North Dakota Securities Department 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 "lack of procurement procedures" (page 13) and "lack of employee evaluations" (page 14), the North Dakota Securities Department 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?

Other than our finding addressing the "fraud risk assessment" (page 11) we determined internal control was adequate.

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?*

Except the “fraud risk assessment” and “lack of employee evaluations” findings as shown on page 17, the North Dakota Securities Department has implemented all recommendations included in the prior audit report.

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 18 of this report, along with management's response.

LAFRC Audit Communications

7. *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.

8. *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 North Dakota Securities Department's financial statements do not include any significant accounting estimates.

9. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

10. *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.

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

None.

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

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

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

None.

14. 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 Securities Deposit System are high-risk information technology systems critical to the North Dakota Securities Department.

Audit Objectives, Scope, and Methodology

Audit Objectives

The objectives of this audit of the North Dakota Securities Department for the two-year period ended June 30, 2010 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the highest risk areas of the North Dakota Securities Department's operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the North Dakota Security Department and are they in compliance with these laws?
3. Are there areas of the North Dakota Securities Department's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the North Dakota Securities Department is for the two-year period ended June 30, 2010. 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 North Dakota Securities Department has operations in the following locations. Each location was included in the audit scope:

- The central office in the State Capitol.
- Securities Investigators office in Grand Forks.

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 reviewed management's 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. Non-statistical sampling was used and the results were projected to the population. 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) system. Significant evidence was obtained from ConnectND.
 - Observed North Dakota Securities Department's 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.

Management's Discussion and Analysis

The accompanying financial statements have been prepared to present the North Dakota Securities Department's 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).

The following management discussion and analysis was prepared by the North Dakota Securities Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of this supplementary information to ensure it does not conflict with the knowledge we gained as part of our audit.

For the biennium ended or two-year period June 30, 2010, operations of the North Dakota Securities Commission were primarily supported by appropriations from the state's general fund.

Financial Summary

There was a decrease of \$200,270 in Licenses, Permits, and Fees from June 30, 2009 to June 30, 2010. The financial services industry continued to experience turbulence due to volatile capital market conditions and economic contraction. Investment firm closures, as well as hiring freezes or layoffs negatively affected the number of broker dealers, investment advisors, agents, and IA representatives registered with the Department, thus negatively affecting revenue. Additionally, in a period of economic recession, fewer companies issue securities to raise capital due to the likelihood that offerings will not be successful or will be significantly undersubscribed. A decline in securities registrations will have a negative impact on registration revenue collected.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2010</u>	<u>June 30, 2009</u>
<u>Revenues and Other Sources:</u>		
Licenses, Permits, and Fees	\$8,106,415	\$8,306,790
Fines-Forfeitures-Escheat	726,776	780,690
Contributions and Private Grants	50,000	185,000
Miscellaneous Revenue	6,446	5,783
Total Revenues and Other Sources	<u>\$8,889,637</u>	<u>\$9,278,263</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$ 675,657	\$ 628,624
Supply/Material-Professional	90,988	77,208
Operating Fees, Services, and Supplies	77,272	31,460
Equipment and Software	42,917	5,720
Travel	39,522	45,641
IT Services	31,120	26,261
Professional Development	27,579	27,784
Professional Services	19,949	20,021
Rentals/Leases	9,899	9,847
Total Expenditures and Other Uses	<u>\$1,014,903</u>	<u>\$ 872,566</u>

Statement of Appropriations

For The Fiscal Year Ended June 30, 2010

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 1,399,120	\$ 10,000	\$ 1,409,120	\$ 674,675	\$ 734,445
Operating Expenses	706,441		706,441	340,228	366,213
Totals	<u>\$ 2,105,561</u>	<u>\$ 10,000</u>	<u>\$ 2,115,561</u>	<u>\$ 1,014,904</u>	<u>\$ 1,100,657</u>
Expenditures by Source:					
General Fund	\$ 1,788,362	\$ 10,000	\$ 1,798,362	\$ 851,531	\$ 946,831
Other Funds	317,199		317,199	163,373	153,826
Totals	<u>\$ 2,105,561</u>	<u>\$ 10,000</u>	<u>\$ 2,115,561</u>	<u>\$ 1,014,904</u>	<u>\$ 1,100,657</u>

Appropriation Adjustments:

The \$10,000 increase in the Salaries and Benefits line item was due to additional appropriation authority granted by Chapter 15, section 18, of the 2009 Legislative Session for market equity increases for classified state employees.

Statement of Appropriations

For The Biennium Ended June 30, 2009

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 1,265,243	\$ 5,040	\$ 1,270,283	\$ 1,233,759	\$ 36,524
Operating Expenses	575,311		575,311	440,666	134,645
Totals	<u>\$ 1,840,554</u>	<u>\$ 5,040</u>	<u>\$ 1,845,594</u>	<u>\$ 1,674,425</u>	<u>\$ 171,169</u>
Expenditures by Source:					
General Fund	\$ 1,623,355	\$ 5,040	\$ 1,628,395	\$ 1,461,427	\$ 166,986
Other Funds	217,199		217,199	212,998	4,201
Totals	<u>\$ 1,840,554</u>	<u>\$ 5,040</u>	<u>\$ 1,845,594</u>	<u>\$ 1,674,425</u>	<u>\$ 171,169</u>

Appropriation Adjustments:

The \$5,040 increase in the Salaries and Benefits line item was allotted by the Office of Management and Budget from the statewide salary equity pool appropriated pursuant to Senate Bill 2189 of the 60th Legislative Assembly for market equity compensation adjustments for classified employees.

Internal Control

In our audit for the two-year period ended June 30, 2010, we identified the following areas of the North Dakota Securities Department's 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 computer based Securities Program.

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 that internal control was not adequate noting a certain matter involving internal control and its operation that we consider to be a significant deficiency.

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 identified the following significant deficiency in internal control. We also noted other matters involving internal control that we have reported to management of North Dakota Securities Department in a management letter dated April 8, 2011.

Lack of Fraud Risk Assessment (Finding 10-1)

Condition:

The North Dakota Securities Department has not conducted a fraud risk assessment to identify possible instances of fraud or fraudulent activities. No control activities are in place or documented to ensure significant fraud exposures are identified and mitigated. In addition, the system of control activities would need to be adequately tested.

Criteria:

Office of Management and Budget Policy 216 states that all agencies need to perform a fraud risk assessment for each of their functions and diversions.

Cause:

The North Dakota Securities Department did not implement this prior recommendation.

Effect or Potential Effect:

Fraud and fraudulent activities could occur at the North Dakota Securities Department and not be detected.

Recommendation:

We recommend the North Dakota Securities Department establish and perform a fraud risk assessment on a recurring basis. We also recommend the Securities Department design and document the necessary control activities to ensure that each significant fraud exposure identified during the risk assessment process has been adequately mitigated.

Securities Department Response:

The Department agrees with the recommendation and is implementing a system of assessment based on the format recommended by the Fiscal Management Division of the Office of Management and Budget.

Compliance With Legislative Intent

In our audit for the two-year period ended June 30, 2010, we identified and tested North Dakota Securities Department's compliance with legislative intent for the following areas we determined to be significant and of higher risk of noncompliance:

- Proper use of one-time funding for the document storage and retrieval system. (2009 North Dakota Session Laws chapter 11, section 2)
- Proper use of the Investor Restitution Fund for repaying defrauded investors and the Investor Education and Technology Fund mainly used for investor education and technology equipment.
- 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, certification of payroll, and annual performance reviews.

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 has occurred or is likely to have occurred.

The results of our tests disclosed two instances of noncompliance that are required to be reported under *Government Auditing Standards*. The findings are described below. Other than these findings, we concluded there was compliance with the legislative intent identified above.

Lack of Procurement Procedures (Finding 10-2)

Condition:

The North Dakota Securities Department did follow bidding requirements on four of the five purchases over \$2,500 we tested related to speakers for training sessions. They do not have adequate procedures in place to ensure they are following the procurement procedures set by the State Procurement Office.

Criteria:

The OMB Procurement Manual states for purchases of \$2,500.01 to \$25,000 agencies are required to solicit no fewer than three vendors, insofar as practical to submit oral or written informal bids or proposals. If three bids are not received, the agency needs to provide written justification (e.g., "only two known vendors" or "contacted three vendors, only two responded"). Purchases over \$25,000 must have formal sealed bids or proposals with notice to approved vendors on the state bidder list.

North Dakota Administrative Code 4-12-09-01(3)(n) states that contracts for education, instruction, or training need to be procured.

Cause:

This was a prior recommendation that has not been implemented.

Effect or Potential Effect:

The North Dakota Securities Department is not in compliance with procurement policies set by the State Procurement Office.

Recommendation:

We recommend that the North Dakota Securities Department establish procedures to ensure all purchases made are in accordance with the purchasing requirements established by the State Procurement Office.

Securities Department Response:

The Department agrees with the auditor's recommendation. It is the Department's position that the expenditures tested properly qualify as "noncompetitive procurements" from "sole source" providers as permitted under N.D.C.C 54-44.4-05(2)(a) and N.D.A.C. 4-12-09-03. These performers, speakers, and curriculum providers are pivotal to the success of the Department's "Mad About Money" school tours and "Invest North Dakota Teacher Training Academy" programs delivered by the Department to fulfill our youth financial education mission. The uniqueness of the services and resources provided is well documented in our Department records, if not specifically placed in a separate memo to "procurement file." The Department did, however, neglect to complete an Alternate Procurement Request Form for the expenditures and will do so in the future.

Lack of Employee Evaluations (Finding 10-3)

Condition:

The North Dakota Securities Department is not conducting formal written evaluations of all employees on an annual basis. The evaluations were completed during fiscal year 2009 but were not completed during fiscal year 2010.

Criteria:

North Dakota Administrative Code (4-07-10-04) requires that annual written evaluations be completed by management. These evaluations serve as documented support for salary increases based on merit, employee performance, and equity adjustments.

Cause:

The North Dakota Securities Department did not implement this prior recommendation.

Effect or Potential Effect:

The Department is not in compliance with North Dakota Administrative Code and the proper documentation will not be available to support salary increases as they occur.

Recommendation:

We recommend the North Dakota Securities Department complete annual evaluations on all personnel in accordance with section 4-07-10-04 of the North Dakota Administrative Code.

Securities Department Response:

The Department agrees with the recommendation. Written reviews are currently taking place on an 18-month cycle. Reviews will be conducted on an annual basis.

Operations

This audit did not identify areas of North Dakota Securities Department's operations where we determined it was practical at this time to help to improve efficiency or effectiveness.

Prior Recommendations Not Implemented

Prior recommendations have been implemented with the exception of the following:

Fraud Risk Assessment (Finding 08-1)

Recommendation:

We recommend the North Dakota Securities Department:

- Establish and perform a fraud risk assessment on a recurring basis.
- Design and document the necessary control activities to ensure that each significant fraud exposure identified during the risk assessment process has been adequately mitigated, including background investigations, and that each of the identified fraud risks has been adequately tested by management.

Status:

Not Implemented. This recommendation is reissued on page 11.

Lack of Employee Evaluations (Finding 08-2)

Recommendation:

We recommend the North Dakota Securities Department complete annual evaluations on all personnel in accordance with section 4-07-10-04 of the North Dakota Administrative Code.

Status:

Partially Implemented. This recommendation is reissued on page 14.

Management Letter (Informal Recommendations)

April 8, 2011

Ms. Karen Tyler, Securities Commissioner
North Dakota Securities Department
600 E. Boulevard Avenue
Bismarck, ND 58505

Dear Ms. Tyler:

We have performed an audit of the North Dakota Securities Department for the two-year period ended June 30, 2010, and have issued a report thereon. As part of our audit, we gained an understanding of the North Dakota Securities Department's 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.

GENERAL

Informal Recommendation 10-1: We recommend the North Dakota Securities Department expand the code of ethics / code of business conduct to include:

- Full, fair, accurate, timely, and understandable disclosure in reports and documents.
- Compliance with applicable governmental laws, rules, and regulations.
- The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code.

We recommend the North Dakota Securities Department ensure employees acknowledge receipt of the code of ethics / code of business conduct on an annual basis.

EXPENDITURES

Informal Recommendation 10-2: We recommend the North Dakota Securities Department approve correcting entries after they have been posted by OMB and the State Treasurer. This approval should be done by either signing off on the completed journal after it has been posted or by running the NDSALL_VIEW_OMB_STO_JRNLS query and signing off on it periodically.

Informal Recommendation 10-3: We recommend the North Dakota Securities Department look for ways to increase their usage of the purchase card as a form of payment. We further recommend, if necessary, they meet with officials from OMB to facilitate this process by raising purchase card limits, determining which of their vendors they could be making purchase card payments to, or changing the accounting on their purchase cards so as to limit or eliminate the need to reallocate purchase card expenditures.

Management of North Dakota Securities Department 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,



Kristi Morlock
Auditor in-charge

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