

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, 2004
Client Code 413

Robert R. Peterson
State Auditor



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Transmittal Letter

February 24, 2005

Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
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, 2004. 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 Michael W. Schmitcke, CPA; Richard Fuher was the staff auditor; and Fred Ehrhardt, CPA was the audit supervisor. Inquiries or comments relating to this audit may be directed to the audit supervisor (701) 328-3647. 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 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, examination authority over the Bank of North Dakota, and all credit unions organized or doing business under the laws of this state. The Department conducts examinations of state-chartered banks, the Bank of North Dakota, state-chartered credit unions, consumer finance companies, and agents for deposit. Additionally, the Department issues licenses to money brokers, collection agencies, and sale of check 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 REQUESTS

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

1. *Were expenditures made in accordance with legislative appropriations and other state fiscal requirements and restrictions?*

Yes.

2. *Were revenues accounted for properly?*

Yes.

3. *Were there adequate financial controls and procedures?*

Yes.

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

Yes.

5. *Do financial records and reports reconcile with state fiscal offices?*

Yes.

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

Yes.

7. *Was there any indication of fraud or dishonesty?*

No.

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

Other than our work addressing "online consumer applications" (see page 16) there were no indications of a lack of efficiency in financial operations and management of the Department of Financial Institutions.

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

There were no recommendations included in the prior audit report.

10. *Were all activities of the agency encompassed within appropriations of specific amounts?*

Yes.

11. *Has the agency or institution implemented the Statewide Accounting and Management Information System (SAMIS), including the cost allocation system?*

Yes. The Department of Financial Institutions is using the SAMIS system, but is not using the cost allocation system since they do not receive federal funds.

12. *Has the agency developed budgets of actual anticipated expenditures and revenues on at least a quarterly basis and compared (on at least a quarterly basis) actual expenditures and revenues on the accrual basis to budgeted expenditures and revenues?*

Yes.

Background Information

The mission of the Department of Financial Institutions is to maintain public confidence in North Dakota financial institutions by ensuring the financial industry operates in a safe and sound manner while complying with applicable rules and laws.

Tim Karsky, Commissioner, who is appointed by the Governor and confirmed by the North Dakota Senate, heads the Department of Financial Institutions.

The Department of Financial Institutions has charge of the execution of all laws relating to state banks, trust companies, building and loan associations, mutual investment corporations, mutual saving corporations, banking institutions, other financial corporations, and all credit unions organized or doing business under the laws of this state as well as examination authority over the Bank of North Dakota. The Department of Financial Institutions also issues licenses to money brokers, collection agencies, consumer finance companies, agents for deposits, and sale of check businesses.

The Department of Financial Institutions is comprised of three divisions:

- Banking Division
 - Credit Union Division
 - Consumer Division
-

The Department of Financial Institutions regulates the financial services providers mentioned above through three divisions. The Banking Division regulates state-chartered banks and independent trust companies. The Credit Union Division regulates state-chartered credit unions. The Consumer Division regulates money brokers, deferred presentment service providers (payday lenders), consumer finance companies, collection agencies, and sale of check companies.

The Commissioner, in conjunction with the State Banking Board (seven members) and the State Credit Union Board (five members), provides supervisory authority over North Dakota state-chartered banks and credit unions. All members of these Boards are appointed by the Governor. The Commissioner serves as chairperson on each Board.

The Department of Financial Institution's budget for the 2003-2005 biennium totals \$3,711,384. This represents a 2.6 percent increase over the 2001-2003 budget. There were no state general funds included in the Department's current budget.

More information can be obtained from the Department of Financial Institutions home page at: www.state.nd.us/dfi/

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, 2004 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the most important areas of the Department of Financial Institution'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 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 for the two-year period ended June 30, 2004 was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. To meet the objectives outlined above, we:

Audit Methodology

- Prepared financial statements from the data used in the state's Comprehensive Annual Financial Report and reviewed management's discussion and analysis of the financial statements.
- Performed detailed analytical procedures for expenditures.
- Tested samples of expenditures.
- Reviewed prior year audit workpapers.
- Interviewed appropriate agency personnel.
- Reviewed the Department of Financial Institution's written plans and applicable manuals.
- Reviewed the Department of Financial Institution's biennial report.
- Reviewed the Department of Financial Institution's information technology plan.
- Observed the Department of Financial Institution's processes and procedures.
- Reviewed North Dakota Century Code Chapters 6-01, 6-05, 13-03, 13-04.1, 13-05, 51-17, and the 2001 and 2003 Session Laws.
- Conducted a review of the Records Management System.
- Searched for recent studies or reports relating to the Department of Financial Institutions.

Management's Discussion And Analysis

The accompanying financial statements have been prepared in a condensed form to present the Department of Financial Institution's financial position and results of operations in a manner similar to that used for financial reporting in the private sector. All fund types are condensed and reported in one column. Accordingly, the accompanying summary 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 Department of Financial Institution's management. We have applied certain limited procedures, which consisted primarily of management inquiries 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 two-year period ended June 30, 2004, 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

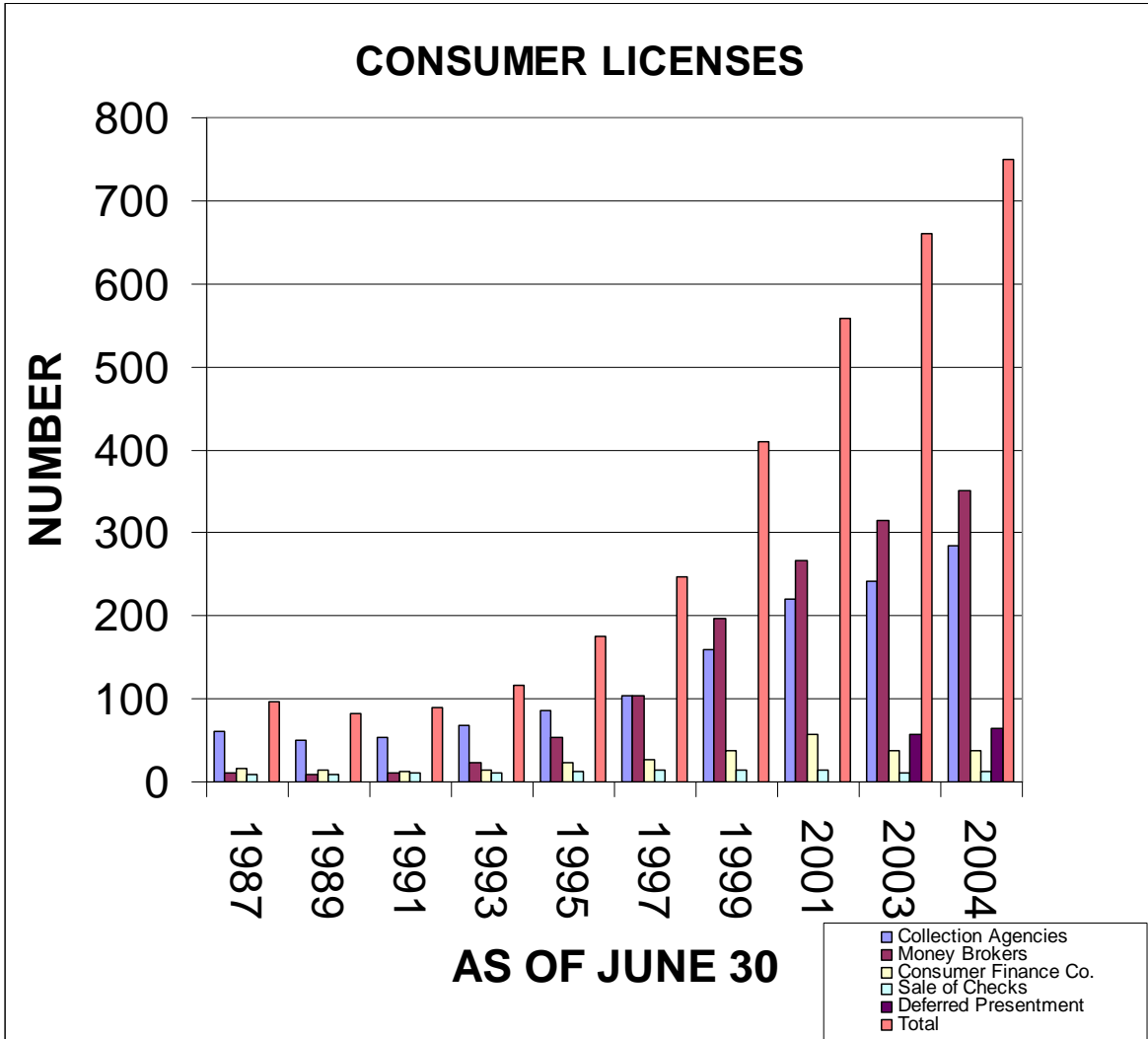
Revenue consists of bank and credit union assessment fees, consumer license fees, investigation fees, and special examination fees. Other revenue during the audited period included interest income earned on the Department of Financial Institution's operating fund and fines and penalties. Total revenue for fiscal year ended June 30, 2004 was \$2,060,984 as compared to \$1,821,945 for fiscal year ended June 30, 2003. The largest increase was in the area of bank examiner fees. These fees are based on the assets of the bank and credit unions, which increased by 20% and 11%, respectively, during the audit period. Licenses, permits, and fees have also increased, due to new licenses in the Consumer Division. See page 9 for a chart representing the growth that has occurred in the Consumer Division.

Total expenditures for the Department of Financial Institutions were \$1,834,615 for the year ended June 30, 2004 as compared to \$1,648,756 for the prior year.

The increase in expenditures for salaries and benefits reflected general salary increases, the reclassification of the examiners,

and an additional 1.5 FTE authorized by the fifty-eighth Legislative Assembly in House Bill 1008.

The Department of Financial Institutions has also been involved in legal proceedings with Cybrcollect, Inc., a collection agency. The Department issued a cease and desist order against Cybrcollect, Inc. in 2003. Cybrcollect, Inc. requested an administrative hearing. A hearing officer recommended a Findings of Fact regarding the hearing, but the Commissioner for the Department of Financial Institutions issued his own Findings of Fact and Conclusions of Law and Order. Cybrcollect, Inc. appealed the decision to District Court and was successful. They were also successful in obtaining a judgment for their attorney fees for approximately \$50,000. The Department has appealed this decision to the State Supreme Court and oral arguments will be held March 3, 2005. Cybrcollect, Inc. has appealed the District Court's decision on the amount of fees awarded to the State Supreme Court. If Cybrcollect, Inc. is successful in their entire argument, the Department could be liable for their attorney fees in excess of \$150,000. At this time we don't feel the State Supreme Court would reverse the District Court's decision on the fees, and are hopeful they will find the Department does not owe anything. Because we can't predict the outcome, there is a potential liability for the Department.



Condensed Financial Statements

STATEMENT OF NET ASSETS

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
<u>Assets:</u>		
Cash and Cash Equivalents	\$ 979,154	\$ 733,794
Accounts Receivable	12,881	6,852
Interest Receivable	358	237
Due From Other State Funds		15,237
Total Assets	<u>\$ 992,393</u>	<u>\$ 756,120</u>
<u>Liabilities:</u>		
Accounts Payable	\$ 4,249	\$ 6,894
Accrued Payroll	125,766	103,403
Due to Other State Funds	3,645	13,812
Compensated Absences Payable	131,597	131,242
Total Liabilities	<u>\$ 265,257</u>	<u>\$ 255,351</u>
<u>Net Assets:</u>		
Unrestricted	<u>\$ 727,136</u>	<u>\$ 500,769</u>
Total Net Assets	<u>\$ 727,136</u>	<u>\$ 500,769</u>

STATEMENT OF REVENUES AND EXPENSES

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
<u>Revenues and Other Sources:</u>		
Examiner Fees	\$ 1,724,423	\$ 1,564,910
Licenses, Permits, and Fees	274,819	236,020
Interest Income	5,690	9,055
Miscellaneous Revenue	1,702	1,550
Fines and Forfeits	54,350	370
Transfers In		10,040
Total Revenues and Other Sources	\$ 2,060,984	\$ 1,821,945
<u>Expenses and Other Uses:</u>		
Salaries and Benefits	\$ 1,418,291	\$ 1,270,670
Major Operating Expenses:		
Travel	144,583	143,857
Building Lease	59,993	46,259
IT Equipment Under \$5,000		43,178
Dues and Professional Development	42,804	30,843
Professional Services	47,300	30,141
Data Processing	21,358	22,500
IT Contractual Services	22,158	12,086
Other Operating Expenses	78,128	49,222
Total Expenses and Other Uses	\$ 1,834,615	\$ 1,648,756

STATEMENT OF APPROPRIATIONS

For The Fiscal Year Ended June 30, 2004

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	\$ 2,984,539		\$ 2,984,539	\$ 1,417,935	\$ 1,566,604
Operating Expenses	672,726	\$ 54,119	726,845	401,089	325,755
Totals	<u>\$ 3,657,265</u>	<u>\$ 54,119</u>	<u>\$ 3,711,384</u>	<u>\$ 1,819,024</u>	<u>\$ 1,892,359</u>
Expenditures by Source:					
Other Funds	\$ 3,657,265	\$ 54,119	\$ 3,711,384	\$ 1,819,024	\$ 1,892,359
Totals	<u>\$ 3,657,265</u>	<u>\$ 54,119</u>	<u>\$ 3,711,384</u>	<u>\$ 1,819,024</u>	<u>\$ 1,892,359</u>

Appropriation Adjustments:

The Emergency Commissioner approved a \$62,000 increase to the operating expenses line item. The Emergency Commission stated that only \$52,000 of the \$62,000 can be spent on legal fees and \$10,000 on financial literacy training.

The fifty-eighth Legislative Assembly passed House Bill 1022. Section 2 of House Bill 1022 required the Department of Financial Institutions to transfer \$7,881 of appropriation authority to the Information Technology Department as part of the statewide Information Technology Consolidation Initiative.

For The Biennium Ended June 30, 2003

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	\$ 2,759,337	\$ (23,540)	\$ 2,735,797	\$ 2,457,400	\$ 278,397
Operating Expenses	731,818	75,628	807,446	794,172	13,274
Equipment	52,700	21,825	74,525	68,771	5,754
Contingency	20,000	(20,000)			
Totals	<u>\$ 3,563,855</u>	<u>\$ 53,913</u>	<u>\$ 3,617,768</u>	<u>\$ 3,320,343</u>	<u>\$ 297,425</u>
Expenditures by Source:					
Other Funds	\$ 3,563,855	\$ 53,913	\$ 3,617,768	\$ 3,320,343	\$ 297,425
Totals	<u>\$ 3,563,855</u>	<u>\$ 53,913</u>	<u>\$ 3,617,768</u>	<u>\$ 3,320,343</u>	<u>\$ 297,425</u>

Appropriation Adjustments:

The (\$23,540) Salaries and Benefits line item decrease consisted of the following four items:

- The fifty-seventh Legislative Assembly in Senate Bill 2008, Section 2, gave the Department of Financial Institutions the authority to hire an additional 0.5 FTE. The Emergency Commission approved \$41,659 for the additional 0.5 FTE.
- The fifty-seventh Legislative Assembly in House Bill 1015, Section 5, approved a market equity adjustment for classified employees. The Department received an additional \$1,286 as a result of House Bill 1015.
- The Emergency Commission approved a transfer from the Salaries and Benefits line item in the amount of \$46,606. Of that amount \$24,781 went to the Operating Expenses line item and \$21,825 went to the Equipment line item to cover IT equipment purchases.
- The Emergency Commission approved a transfer from the Salaries and Benefits line item in the amount of \$19,879, which also went to the Operating Expenses line item.

The \$75,628 Operating Expenses line item adjustment consisted of the following three items:

- Under Senate Bill 2008, Section 2, the Department received authority to hire an additional 0.5 FTE. The Emergency Commission approved \$10,968 to cover anticipated expenditures that will be incurred to hire the additional 0.5 FTE.
- The \$20,000 transfer from the Contingency line item to the Operating Expenses line item was approved by the Emergency Commission to cover the cost of installing the Department's new Financial Institutions Records Management System.
- The \$24,781 and \$19,879 transferred from the Salaries and Benefits line item were used for IT services, copier lease, printing, building improvements, central services, records automation, and professional development for examiners.

Internal Control

In our audit for the biennium two-year period ended June 30, 2004, we identified the following areas of the Department of Financial Institution's internal control as being the most important:

Internal Controls Subjected To Testing

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls relating to compliance with legislative intent.
- Controls surrounding the Statewide Accounting and Management Information System (SAMIS).
- Controls surrounding the computer-based Records Management System

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 significant. Our consideration of internal control would not necessarily disclose all matters that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements that would be material may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control and its operation that we consider to be material weaknesses. However, we noted one matter involving internal control that we have reported to management of the Department of Financial Institutions in a separate letter dated February 24, 2005.

Compliance With Legislative Intent

In our audit for the two-year period ended June 30, 2004, we identified and tested the Department of Financial Institution's compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

Legislative Intent Subjected To Testing

- Biennial cash balance in excess of 20% of the biennial budget (NDCC 6-01-01.1).
- State Banking Board member reimbursements (NDCC 6-01-03).
- Reviewed NDCC Chapters 6-01, 6-05, 13-03.1, 13-04.1, 13-05, and 51-17 to determine if the proper assessments, penalties, application fees, and examiner fees were charged.
- Appropriations (Chapter 33 of the 2001 Session Laws and Chapter 8 of the 2003 Session Laws).
- 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.
- 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 results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. However, we noted an immaterial instance of noncompliance that we have reported to management of the Department of Financial Institutions in a separate letter dated February 24, 2005.

Operations

Our audit of the Department of Financial Institutions identified the following area of potential improvement to operations:

Operational
Improvement 04-1

ONLINE CONSUMER APPLICATIONS

Issue:

Currently, the Department of Financial Institutions licenses approximately 840 consumer-type businesses but only 15% currently apply online; the remaining license applications or renewal forms are received through the mail. It takes the Department approximately 15 minutes to manually enter a license application into the Records Management System (System) and as a result a significant amount of resources are spent each year entering the application information. Time is also spent reviewing the annual renewal forms and manually updating any changed information. Additional time is spent each year opening mail, receipting checks, preparing deposits, posting payment amounts, and reconciling records. If the payment was made electronically all of these functions would be performed automatically.

Process:

We reviewed the procedures for processing consumer license applications and payments with management of the Department of Financial Institutions. Their System currently processes annual consumer license applications and renewals along with the license fees for money brokers, collection agencies, consumer finance companies, agents for deposits, and sale of check businesses through the Internet. All consumer license applications processed online are entered by the applicant and require no additional data entry by department employees. The online renewal form automatically updates the appropriate data on the System. All license applications not processed online are mailed to the department where an employee manually enters the license application information, or any changed data from the renewal form, into the System. The initial application is only filed once; however, a renewal form and the filing fee must be resubmitted on an annual basis. Since approximately the same percentage of payments are made online as applications filed, it can be determined that if an entity initially files an application by mail that same entity will continue to file the renewal form and payment by mail each year thereafter.

Possible Solution:

The Department of Financial Institutions developed the Records Management System in an effort to make the financial institution's data more accessible to the Department as well as the public, and reduce the amount of time spent licensing consumer companies for both the Department of Financial Institutions and applicants. The Department of Financial Institutions has done an excellent job of utilizing the System's capabilities; however, if more consumer license applications and renewals were processed online, a significant amount of resources could be saved by the Department of Financial Institutions.

Based on our analysis we recommend the Department of Financial Institutions adopt appropriate policies and procedures to encourage consumer companies to complete their consumer license applications and subsequent renewals online.

Department of Financial Institution's Response:

We recognize the inefficiency of having to manually enter application information or edit renewal information as well as the associated resources expended. Prior to the audit recommendation we had discussed this issue and were struggling with how to get a higher level of licensees to apply or renew online. Each year we send each licensee a unique code along with the renewal forms in an effort to encourage the online renewal and this met with limited success initially we are seeing more online renewals. We do intend to implement the solutions offered by the audit staff in an attempt to increase the use of the online application or renewals; however, some of the incentives necessary may require legislative changes.