

North Dakota
Securities Department
BISMARCK, NORTH DAKOTA

Audit Report

Two-year Period Ended
June 30, 2014

ROBERT R. PETERSON
STATE AUDITOR

Office of the State Auditor
Division of State Audit

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Transmittal Letter

June 25, 2015

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, 2014. 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 Jacqueline Ressler and Krista Lambrecht, CPA, was the staff auditor. Cindi Pedersen, 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 contract, 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 state 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 responses 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 unmodified opinion was issued.

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

Yes.

3. Was internal control adequate and functioning effectively?

Other than our work addressing "Lack of Policies and Procedures Surrounding Broker/Dealer Registration" (page 13), 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?

There were no 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 15 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 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, 2014 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 Securities 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, 2014. 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 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 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. 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 the 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.

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).

For the two-year period June 30, 2014, operations of the North Dakota Securities Department were primarily supported by appropriations from the state's general fund.

Financial Summary

Revenues consisted primarily of licenses and registration fees. These all remained fairly constant for the North Dakota Securities Department, increasing slightly. Total revenues were \$10,094,058 for the year ended June 30, 2014 as compared to \$9,543,695 for the year ended June 30, 2013.

Total expenditures for the North Dakota Securities Department were \$974,829 for the year ended June 30, 2014 as compared to \$920,567 for the prior year. Expenditures all remained fairly constant with a slight increase.

Analysis of Significant Variances - Budgeted and Actual Expenditures

The \$411,368 excess in their operating line over actual expenditures in the 2011-2013 biennium was due to special appropriation of \$240,351 that was unused due to a change in their educational programming. The remaining balance is primarily funding for professional services appropriated for support of litigation related services. Use of this funding is variable, and driven by enforcement action outcomes, and settlement versus litigation.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2014</u>	<u>June 30, 2013</u>
<u>Revenues and Other Sources:</u>		
Licenses – Firms/Agents	\$6,026,445	\$5,647,890
Registration – Securities/Franchises	3,998,629	3,798,074
Fines/Restitution	67,184	95,511
Miscellaneous Revenue	1,800	2,220
Total Revenues and Other Sources	<u>\$10,094,058</u>	<u>\$9,543,695</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$818,243	\$ 762,437
IT Services	45,022	57,060
Other Expenses	27,192	31,610
Travel	32,324	30,674
Supply/Material-Professional	30,730	31,859
Operating Fees and Services	21,318	6,927
Total Expenditures and Other Uses	<u>\$974,829</u>	<u>\$ 920,567</u>

Statement of Appropriations

For The Year Ended June 30, 2014

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	\$ 1,673,763		\$ 1,673,763	\$ 888,804	\$ 784,959
Accrued Leave Payments	585,092	\$ (546,165)	38,927		38,927
Operating Expenses	38,927	546,165	585,092	162,055	423,037
Totals	<u>\$ 2,297,782</u>	<u>\$ 0</u>	<u>\$ 2,297,782</u>	<u>\$ 1,050,859</u>	<u>\$ 1,246,923</u>
Expenditures by Source:					
General Fund	\$ 2,127,782		\$ 2,127,782	\$ 1,027,523	\$ 1,100,259
Other Funds	170,000		170,000	29,086	140,914
Totals	<u>\$ 2,297,782</u>	<u>\$ 0</u>	<u>\$ 2,297,782</u>	<u>\$ 1,056,609</u>	<u>\$ 1,241,173</u>

Appropriation Adjustments:

The \$546,165 transfer from the Accrued Leave Payments to the Operating Expenses line item was to correct the initial amounts transposed for each line. This transfer appears adequate and nets to zero.

Expenditures Without Appropriations Of Specific Amounts:

Investor Restitution Fund has a continuing appropriation authorized by North Dakota Century Code section 10-04-03(5) (\$5,750 of expenditures for this fiscal year).

For The Biennium Ended June 30, 2013

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	\$ 1,519,978		\$ 1,519,978	\$ 1,492,497	\$ 27,481
Operating Expenses	706,441		706,441	295,073	411,368
Totals	<u>\$ 2,226,419</u>	<u>\$ 0</u>	<u>\$ 2,226,419</u>	<u>\$ 1,787,570</u>	<u>\$ 438,849</u>
Expenditures by Source:					
General Fund	\$ 1,909,220		\$ 1,909,220	\$ 1,723,530	\$ 185,690
Other Funds	317,199		317,199	64,040	253,159
Totals	<u>\$ 2,226,419</u>	<u>\$ 0</u>	<u>\$ 2,226,419</u>	<u>\$ 1,787,570</u>	<u>\$ 438,849</u>

Expenditures Without Appropriations Of Specific Amounts:

Investor Restitution Fund has a continuing appropriation authorized by North Dakota Century Code section 10-04-03(5) (\$3,000 of expenditures for this two-year period).

Internal Control

In our audit for the two-year period ended June 30, 2014, we identified the following areas of the North Dakota Securities Department 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 relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the Securities Deposit 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 North Dakota Securities Department in a management letter dated June 25, 2015.

Compliance With Legislative Intent

In our audit for the two-year period ended June 30, 2014, 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 the following legally restricted funds:
 - Investor Education and Technology Fund.
 - Investor Restitution Fund.
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with appropriations and related transfers (2009 North Dakota Session Laws chapter 11 and 2011 North Dakota Session Laws chapter 37).
- 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 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 require 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 no instances of noncompliance that are required to be reported under *Government Auditing Standards*. Thus, we concluded there was compliance with the legislative intent identified above.

While we did not find any items that were required to be reported in accordance with *Government Auditing Standards*, we noted certain inconsequential or insignificant instances of non-compliance that we have reported to management of the North Dakota Securities Department in a management letter dated June 25, 2015.

Operations

Our audit of the North Dakota Securities Department identified the following area of potential improvement to operations, as expressed by our operational objective:

- Are the broker/dealer registration functions implemented by the North Dakota Securities Department operating efficiently and effectively and in compliance with significant high-risk laws and best practices?

Lack of Policies and Procedures Surrounding Broker/Dealer Registration (Finding 14-1)

Condition:

The Securities Department does not have documented formal policies and procedures regarding the regulation of broker-dealers, specifically regarding the following areas; registration, examination, investigation, complaints, and enforcement actions.

Criteria:

The criteria used for this operational improvement was best practices for a regulatory program as documented in the following publications: *Good Practices for Regulatory Inspections: Guidelines for Reformers* from international consultants in regulatory reform Jacobs & Associates as prepared for the World Bank, *Carrying Out a State Regulatory Program* from the National State Auditors Association, and *Best Practice Principles for Regulatory Policy* from the Council on Regulatory Policy & Governance.

Five states were contacted to determine if they had policies and procedures relating to broker-dealer regulation. Of those five states, three had documented policies and procedures and a fourth was in the process of developing sound policies.

Cause:

The Securities Department has not developed any written policies and procedures regarding the regulation of broker-dealers.

Effect or Potential Effect:

The state's exposure to liability is increased if consistency in these areas cannot be documented.

Operational Improvement:

We recommend the Securities Department develop written policies and procedures regarding the regulation of broker-dealers including policies and procedures surrounding the following areas; registration, examination, investigation, complaints, and enforcement actions.

Securities Department Response:

The Commissioner disagrees with the Auditors recommendation. The recommendation is inconsistent with the stated audit objectives provided to the Department. The Department will discuss the recommendation with the Legislative Audit and Fiscal Review Committee.

State Auditor's Concluding Remarks:

The Commissioner states that the “recommendation is inconsistent with the stated audit objectives provided to the Department.” The audit objectives were communicated to the Commissioner in our engagement letter dated April 7, 2015. Specifics were discussed with the Commissioner at the entrance conference on April 16, 2015.

Management Letter (Informal Recommendations)

June 25, 2015

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, 2014, 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.

EXPENDITURES

Informal Recommendation 14-1: We recommend the North Dakota Securities Department properly code expenditures to ensure the PeopleSoft coding is consistent with the nature of the expenditures.

Informal Recommendation 14-2: We recommend the North Dakota Securities Department establish procedures to ensure all purchases made are in accordance with purchasing requirements established by the State Procurement Office.

Management of the 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,

A handwritten signature in cursive script that reads "Jacqueline Ressler".

Jacqueline Ressler
Auditor in-charge

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www.nd.gov/auditor/

or by contacting the
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