Department of Financial Institutions

June 2005

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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John G. Morgan
Comptroller

June 16, 2005

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Kevin P. Lavender, Commissioner
Department of Financial Institutions
Suite 400, Nashville City Center
511 Union Street
Nashville, Tennessee 37219

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Financial Institutions for the period July 1, 2001, through February 28, 2005.

The review of internal control and compliance with laws and regulations resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
05/053

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COMPTROLLER OF THE TREASURY
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March 24, 2005

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Financial Institutions for the period July 1, 2001, through February 28, 2005.

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of internal control significant to the audit objectives and that we design the audit to provide reasonable assurance of the Department of Financial Institutions' compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Department of Financial Institutions is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit resulted in no audit findings.

We have reported other less significant matters involving the department's internal control and/or instances of noncompliance to the Department of Financial Institutions' management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/th

State of Tennessee

Audit Highlights

Comptroller of the Treasury | Division of State Audit

Financial and Compliance Audit
Department of Financial Institutions
June 2005

AUDIT SCOPE

We have audited the Department of Financial Institutions for the period July 1, 2001, through February 28, 2005. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of external examinations, cash receipts, equipment, expenditures, payroll and personnel, Executive Orders No. 2 and 3, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

AUDIT FINDINGS

The audit report contains no findings.

Financial and Compliance Audit
Department of Financial Institutions

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Financial and Compliance Audit
Department of Financial Institutions

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Financial Institutions. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

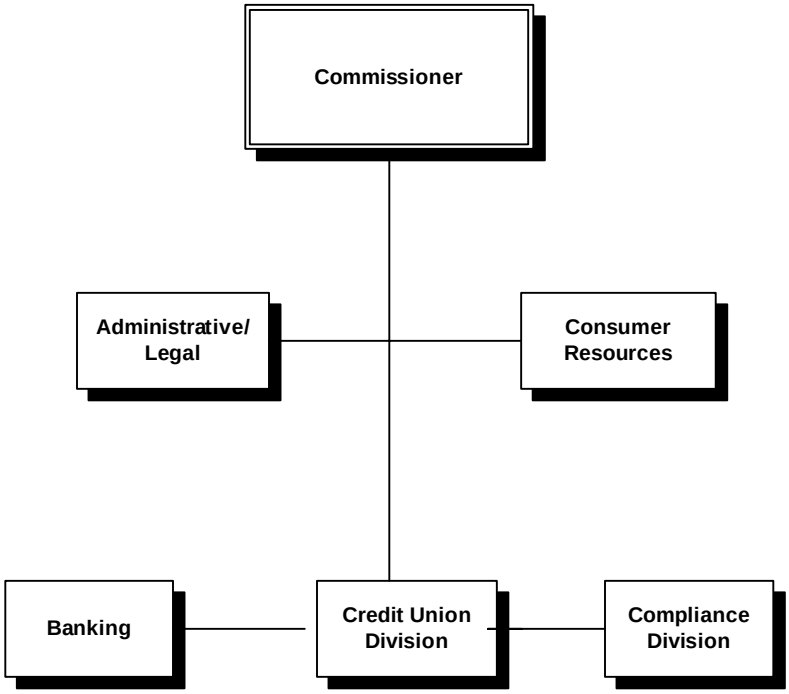
BACKGROUND

The primary mission of the Department of Financial Institutions is to provide the citizens of Tennessee with a sound system of state-chartered financial institutions. The Bank Division is responsible for the regulation and supervision of state-chartered financial institutions such as state-chartered banks, savings banks, saving and loan associations, credit card banks (banks which only engage in credit card operations), and business and industrial development corporations (BIDCOs). The Credit Union Division is responsible for the regulation and supervision of state-chartered credit unions. The Compliance Division is responsible for regulatory oversight activities such as licensing, examination, and complaint resolution for industrial loan and thrift companies; insurance premium finance companies; home mortgage servicing, lending, and brokering; money transmitters (money order issuers); title pledge lending; check cashing; and deferred presentment companies. The Consumer Resources Division is responsible for tracking and resolving consumer complaints, helping to inform citizens of their financial rights, and increasing the effectiveness of existing financial literacy programs.

The Department of Financial Institutions attempts to encourage the development of depository financial institutions while restricting their activities to the extent necessary to safeguard the interests of depositors. The department also works to ensure that both depository and non-depository financial institutions comply with governing laws and regulations.

An organization chart of the department is on the following page.

Tennessee Department of Financial Institutions
Organization Chart



AUDIT SCOPE

We have audited the Department of Financial Institutions for the period July 1, 2001, through February 28, 2005. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of external examinations, cash receipts, equipment, expenditures, payroll and personnel, Executive Orders No. 2 and 3, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration, approving certain state contracts, participating in the negotiation and procurement of services for the state, and providing support staff to various legislative committees and commissions.

PRIOR AUDIT FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Financial Institutions filed its report with the Department of Audit on November 15, 2002. A follow-up of the prior audit finding was conducted as part of the current audit.

RESOLVED AUDIT FINDING

The current audit disclosed that the Department of Financial Institutions has corrected the previous audit finding concerning billing practices and examination records needing improvement.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

EXTERNAL EXAMS

Our objectives for reviewing external exams of institutions regulated by the department were to determine whether

- policies and procedures were adequate, written, and in compliance with laws, regulations, and standards;
- the examinations were properly planned, documented, reviewed, and reported;
- bank and credit union examinations were performed timely, as defined in Sections 45-2-1602 and 45-4-1002, *Tennessee Code Annotated*; and
- the examiners were properly supervised and independent of the companies they are examining.

We interviewed key departmental personnel and reviewed supporting documentation to gain an understanding of the department's procedures and controls over the external exams. We tested a nonstatistical sample of examinations performed for each of the following divisions: the Banking Division, the Compliance Division, and the Credit Union Division. The Banking Division sample included departmental examinations of state-chartered banks and trust companies conducted during July 1, 2001, through January 24, 2005. The Compliance Division sample included examinations of industrial loan and thrift companies, mortgage companies, deferred presentment companies, premium finance companies, and check cashing companies conducted during July 1, 2001, through February 8, 2005. The Credit Union Division sample included examinations of state-chartered credit unions conducted during July 1, 2001, through January 26, 2005. For each of these samples, compliance with *Tennessee Code Annotated* and departmental rules and regulations was tested. The departmental rules and regulations included the planning, documentation, review, report, supervision, and the examiner's independence. Also, all examinations conducted during July 1, 2001, through January 24, 2005, by the Banking Division and the Credit Union Division were tested to determine whether the examinations were timely, as defined in *Tennessee Code Annotated*.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures were adequate, written, and in compliance with laws, regulations, and standards. Based on our testwork, we determined that the examinations were properly planned, documented, reviewed, and reported; bank and credit union examinations were performed timely, as defined in Sections 45-2-1602 and 45-4-1002, *Tennessee Code Annotated*; and the examiners were properly supervised and independent of the companies they examined.

CASH RECEIPTS

Our objectives for reviewing cash receipts controls and procedures were to determine whether

- policies and procedures regarding cash receipts were adequate;
- cash was deposited promptly and intact, in accordance with the Department of Finance and Administration's (F&A) Policy 25 concerning deposit practices; and
- cash receipts transactions were properly recorded.

We interviewed key departmental personnel and reviewed supporting documentation to gain an understanding of the department's procedures and controls over cash receipts. We also tested a nonstatistical sample of cash receipts transactions during the audit period to determine whether cash was deposited promptly and intact, and the transaction was properly recorded.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures regarding cash receipts were adequate. Based on our testwork, we determined that cash was deposited promptly and intact in accordance with F&A Policy 25 and cash receipts transactions were properly recorded.

EQUIPMENT

Our objectives for reviewing equipment controls and procedures were to determine whether

- policies and procedures regarding equipment were adequate;
- equipment was adequately safeguarded;
- equipment information was properly recorded in the Property of the State of Tennessee listing (POST);
- the active equipment listing in POST was complete;
- POST access granted to department employees appeared reasonable, based on the types of duties the employees performed; and
- lost or stolen equipment was reported to the Comptroller of the Treasury and removed from POST.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's procedures and controls over equipment, whether the equipment was adequately safeguarded, and whether lost or stolen equipment was reported to the Comptroller of the Treasury. We selected a nonstatistical sample of equipment from POST to determine whether the equipment information was properly recorded. Equipment information

included state tag number, description, location, and serial number. Equipment items were physically observed at the Nashville City Center Building, while equipment confirmations were used for all other locations. We also selected a haphazard sample of equipment at the Nashville City Center Building to determine whether the equipment listing was complete. We accessed POST to determine which employees were recognized users and to determine these employees' level of access. We reviewed the types of duties these employees performed to determine whether their access appeared reasonable. We examined the listing of equipment from POST to determine whether the lost or stolen equipment reported to the Comptroller of the Treasury had been removed.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures regarding equipment were adequate, equipment was adequately safeguarded, and lost or stolen equipment was reported to the Comptroller of the Treasury. Based on our testwork, we determined that equipment information was properly recorded in POST, the active equipment listing in POST was complete, departmental employees' access to POST was reasonable, and reported lost or stolen equipment was removed from POST.

EXPENDITURES

Our objectives for reviewing expenditure controls and procedures were to determine whether

- policies and procedures regarding expenditures were adequate;
- State of Tennessee Accounting and Reporting System (STARS) access granted to departmental employees appeared reasonable, based on the types of duties the employees performed;
- expenditures for goods or services were authorized, approved, and received;
- supporting documentation was canceled to prevent duplicate payment;
- expenditure transactions were properly recorded;
- payments were made in a timely manner; and
- travel claims were in compliance with the Department of Finance and Administration's (F&A) Policy 8 concerning the State of Tennessee's Comprehensive Travel Regulations.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's procedures and controls over expenditures. We accessed STARS to determine which employees were recognized users and to determine these employees' level of access. We reviewed the types of duties these employees performed to determine whether their access appeared reasonable. A nonstatistical sample of expenditures from the period of July 1, 2001, through November 30, 2004, was selected. These expenditures were tested to determine whether goods or services were authorized, approved, and received; supporting documentation was canceled to prevent duplicate payment; the transaction was

properly recorded; payments were made in a timely manner; and travel claims were in compliance with the State of Tennessee's Comprehensive Travel Regulations. Another nonstatistical sample of the Commissioner's travel expenditures was selected to determine whether expenditures were in compliance with the State of Tennessee's Comprehensive Travel Regulations.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures regarding expenditures were adequate. Based on our testwork, we determined that departmental employees' access to STARS was reasonable; expenditures for goods or services were authorized, approved, and received; supporting documentation was canceled to prevent duplicate payment; expenditure transactions were properly recorded; payments were made in a timely manner; and travel claims were in compliance with F&A Policy 8 concerning the State of Tennessee's Comprehensive Travel Regulations.

PAYROLL AND PERSONNEL

Our objectives for reviewing payroll and personnel controls and procedures were to determine whether

- policies and procedures regarding payroll and personnel were adequate;
- State Employee Information System (SEIS) access granted to department employees appeared reasonable;
- annual performance evaluations were given in accordance with Department of Personnel guidelines;
- personnel files were accurate and contained all required information; and
- payroll disbursements were only made to the department's employees.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's procedures and controls over payroll and personnel. We accessed SEIS to determine which employees were recognized users and to determine these employees' level of access. We selected a nonstatistical sample of employees paid for the period ending December 15, 2004, to determine whether annual performance evaluations were given in accordance with Department of Personnel guidelines and personnel files were accurate and contained all required information. The required information included a W-4 form, an I-9 form, payroll deduction authorization form(s), and an Internet use agreement form. Personnel confirmations were also sent to this sample of employees to determine whether payroll disbursements were only made to departmental employees.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures regarding payroll and personnel were adequate. Based on our testwork, we determined that SEIS access appeared reasonable; annual performance evaluations were given in accordance with Department of Personnel guidelines; personnel files were accurate and

contained all required information; and payroll disbursements were only made to the department's employees.

EXECUTIVE ORDERS NO. 2 AND 3

Executive Order No. 2 concerning financial and other disclosures and Executive Order No. 3 concerning ethics, conflict of interest, and acceptance of gifts were signed by Governor Phil Bredesen on February 3, 2003. Our objectives for reviewing the controls and procedures related to these executive orders were to determine whether

- policies and procedures were adequate;
- applicable employees have completed the appropriate disclosure forms mentioned in Executive Order No. 2 and completed them timely;
- selected employees have completed the State of Tennessee Ethics Policy Receipt Statement; and
- the State of Tennessee Ethics Policy Compliance Certification was completed and submitted by January 31, 2005.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's policies and procedures regarding these executive orders. Executive Order No. 2 applies to the department's Commissioner and all Assistant Commissioners. The completed disclosure forms were obtained to determine whether the forms were completed and completed timely. The forms included the Annual Conflicts Disclosure for 2004, Conflict of Interest Statement for 2004, and Attachment B (Alternate to IRS Form 1040) for 2004. We selected key management employees to determine whether the State of Tennessee Ethics Policy Receipt Statement had been completed. These employees included the Commissioner, all Assistant Commissioners, the Fiscal Officer, and the Director of Information Systems. We also obtained the State of Tennessee Ethics Policy Compliance Certification, as completed by the Department of Financial Institution's Commissioner, to determine whether it was submitted timely.

Based on discussion with departmental employees, it was determined that policies and procedures related to Executive Orders No. 2 and 3 were adequate. Based on our testwork, we determined that the applicable employees have completed the appropriate forms mentioned in Executive Order No. 2 and completed them timely, selected employees completed the State of Tennessee Ethics Policy Receipt Statement, and the State of Tennessee Ethics Policy Compliance Certification was submitted timely.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated,* requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the department's June 30, 2004; June 30, 2003; and June 30, 2002, responsibility letters and December 31, 2003, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated;*
- documentation to support the department's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated;* and
- corrective actions have been implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the department's procedures. We also reviewed the June 30, 2004; June 30, 2003; and June 30, 2002, responsibility letters and the December 31, 2003, internal accounting and administrative control report to determine whether they had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. We interviewed management and reviewed the report. There were no weaknesses identified in the report.

We determined that the Financial Integrity Act responsibility letters and internal accounting and administrative control report were submitted on time, support for the internal accounting and administrative control report was properly maintained, and procedures used were in compliance with *Tennessee Code Annotated.*

OBSERVATIONS AND COMMENTS

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

APPENDIX

ALLOTMENT CODE

The Department of Financial Institutions' allotment code is 336.00.