

**DEPARTMENT OF FINANCIAL INSTITUTIONS**

**FOR THE YEARS ENDED  
JUNE 30, 1995, AND JUNE 30, 1994**

**Arthur A. Hayes, Jr., CPA**  
Director

**Charles K. Bridges, CPA**  
Assistant Director

**Ronald E. Anderson, CPA**  
Audit Manager

**Rachel Hisle, CPA**  
In-Charge Auditor

**Kris Birdine**  
**Marc Edinbough**  
**Wilma Hooker**  
Staff Auditors

**Leslie Bethea**  
Editor

October 30, 1996

The Honorable Don Sundquist, Governor  
and

Members of the General Assembly  
State Capitol  
Nashville, Tennessee 37243

and

The Honorable Bill Houston, Commissioner  
Department of Financial Institutions  
Fourth Floor, John Sevier Office Building  
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the compliance audit of the Department of Financial Institutions for the years ended June 30, 1995, and June 30, 1994.

Consideration of the internal control structure and tests of compliance disclosed a deficiency, which is detailed in the Results of the Audit section of this report. The department's administration has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Very truly yours,

W. R. Snodgrass  
Comptroller of the Treasury

WRS/tp  
96/107

State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Compliance Audit

**Department of Financial Institutions**

For the Years Ended June 30, 1995, and June 30, 1994

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## AUDIT OBJECTIVES

The objectives of the audit were to consider the department's internal control structure; to test compliance with certain laws, regulations, contracts, or grants; and to recommend appropriate actions to correct any deficiencies.

## INTERNAL CONTROL FINDING

### **Policy And Procedures For Financial Institution Examinations Are Not Followed**

The Department of Financial Institutions does not have adequate procedures for and controls over examination documentation and review. Five of the 17 examinations reviewed contained deficiencies in either the performance or the review of prescribed examination procedures (page 7).

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"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit  
1500 James K. Polk Building, Nashville, TN 37243-0264  
(615) 741-3697

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AUDIT REPORT  
DEPARTMENT OF FINANCIAL INSTITUTIONS  
FOR THE YEARS ENDED JUNE 30, 1995, AND JUNE 30, 1994

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TABLE OF CONTENTS

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	<u>Page</u>
<u>INTRODUCTION</u>	1
Post-Audit Authority	1
Objectives of the Audit	1
Scope of the Audit	1
<u>BACKGROUND AND ORGANIZATION</u>	2
Legislative History	2
Organization	2
<u>PRIOR AUDIT FINDINGS</u>	2
<u>RESULTS OF THE AUDIT</u>	4
Audit Conclusions	4
Report on the Internal Control Structure	5
Finding and Recommendation	7
• Policy and Procedures for financial institution examinations are not followed	7
Compliance Report	10

DEPARTMENT OF FINANCIAL INSTITUTIONS  
FOR THE YEARS ENDED JUNE 30, 1995, AND JUNE 30, 1994

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INTRODUCTION

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**POST-AUDIT AUTHORITY**

This is a report on the compliance audit of the Department of Financial Institutions. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes 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.

**OBJECTIVES OF THE AUDIT**

The objectives of the audit were

1. to consider the department’s internal control structure to determine auditing procedures for the purpose of testing compliance with certain laws, regulations, contracts, or grants;
2. to test compliance with certain laws, regulations, contracts, or grants; and
3. to recommend appropriate actions to correct any deficiencies.

**SCOPE OF THE AUDIT**

The audit is limited to the period July 1, 1993, through June 30, 1995, and was conducted in accordance with generally accepted government auditing standards.

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## BACKGROUND AND ORGANIZATION

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### LEGISLATIVE HISTORY

The Tennessee Banking Act, Section 45-1-101 of *Tennessee Code Annotated*, created a banking agency as a division of the Department of Insurance. The Public Act of 1973 changed the Division of Banking to the Department of Banking and charged the department with the execution of all laws governing persons engaged in banking in the state. Legislation in 1983 gave the department regulatory powers over industrial loan and thrift companies and changed the name of the department to the Department of Financial Institutions. On July 1, 1983, the regulation of savings and loan companies and credit unions was transferred by executive order from the Department of Commerce and Insurance to the Department of Financial Institutions.

### ORGANIZATION

The Commissioner of Financial Institutions is responsible for administering and enforcing laws that provide the citizens of Tennessee with a sound system of state-chartered banks. These laws provide for and encourage the development of such banks while restricting their activities to the extent necessary to safeguard the interests of their depositors. The task requires an annual examination of each bank. Additionally, the department maintains a staff to ensure the enforcement of all laws governing state-chartered credit unions, state-chartered savings and loan companies, industrial loan and thrift companies, and licensed money order issuers. An organization chart is on the following page.

The Department of Financial Institutions is part of the General Fund of the State of Tennessee and is reported in allotment code 336.00.

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### PRIOR AUDIT FINDINGS

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There were no findings in the prior audit report.



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## RESULTS OF THE AUDIT

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### **AUDIT CONCLUSIONS**

#### Internal Control Structure

We considered the internal control structure to determine auditing procedures for the purpose of testing compliance with certain laws, regulations, contracts, or grants. The report on the internal control structure is on the following pages. A deficiency, along with a recommendation and management's response, is detailed in the finding and recommendation, which follow the report on the internal control structure.

#### Compliance with Laws and Regulations

With respect to the items tested, the department complied with the provisions of certain laws, regulations, contracts, or grants. The compliance report follows the finding and recommendation.

## **Report on the Internal Control Structure**

April 9, 1996

The Honorable W. R. Snodgrass  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have applied procedures to test the Department of Financial Institution's compliance with the provisions of certain laws, regulations, contracts, or grants for the years ended June 30, 1995, and June 30, 1994, and have issued our report thereon dated April 9, 1996. We performed the procedures in accordance with generally accepted government auditing standards.

We considered the department's internal control structure in order to determine our procedures for the purpose of testing the department's compliance with certain laws, regulations, contracts, or grants and not to provide assurance on the internal control structure.

The Department of Financial Institution's management is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

The Honorable W. R. Snodgrass  
April 9, 1996  
Page Two

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the department's ability to comply with laws, regulations, contracts, or grants. However, we did note the following deficiency:

- Procedures for and controls over examinations are inadequate

This deficiency is described in the Finding and Recommendation section of this report.

We also noted certain matters involving the internal control structure and its operation that we have reported to the department's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director  
Division of State Audit

AAH/tp

## FINDING AND RECOMMENDATION

### POLICY AND PROCEDURES FOR FINANCIAL INSTITUTION EXAMINATIONS ARE NOT FOLLOWED

#### FINDING:

The Department of Financial Institutions does not comply with its policies and procedures for its institutional examination documentation and review. The working papers for 17 examinations (four banks, four credit unions, three money transmitters, three premium finance companies, and three loan and thrift companies) were reviewed.

For three institutional examinations, the working papers did not contain evidence that certain prescribed procedures were performed. The following weaknesses were noted:

- For one credit union examination, no documentation could be provided showing that the board of directors' meeting minutes had been reviewed.
- For one premium finance company, the examination did not verify whether or not the institution's management had a copy of the Premium Finance Company Act of 1980 (*Tennessee Code Annotated*, Title 56, Chapter 37).
- For one premium finance company, the examination did not disclose the institution's basis for determining refunds of unearned interest.

The Safety and Soundness Division includes a standardized Examination Work Program in its bank examinations section which lists the various job assignments. The document requires the initials of the examiners and the reviewer of each assignment. The document also includes provisions should the examiner in-charge or the regional supervisor choose to waive particular tasks not considered applicable or necessary. The work programs for two examinations did not indicate that the examiner in-charge had reviewed the work assigned to the examiners. In addition, several job assignments on the programs had no written evidence that they were either assigned to an examiner or waived by the examiner-in-charge or the regional supervisor. Because working papers are not reviewed by upper-level management unless the report reveals problems, there is a decreased probability of detecting inadequate working paper documentation, incomplete assignment review, and incorrect report information.

Apparently, there are no professional standards within the banking industry to govern the performance, documentation, completion, and review of examinations. Also, the examinations clearly state that they are not audits and they should not be considered such. Furthermore, the differences in the structures, purposes, and regulatory requirements between the various types of entities examined make it impossible to prescribe a uniform set of procedures and guidelines applicable to all examinations. Nevertheless, all examinations should be adequately performed,

documented, and reviewed, and the results of examinations included in the reports should be adequately substantiated and documented in the working papers.

RECOMMENDATION:

At a minimum, the Assistant Commissioners for the Credit Union and Compliance Divisions and the Chief Administrator for the Bank Division should enforce their existing policies governing the department's administration of examination activities. Furthermore, to the extent possible, they should consider developing departmental policies to ensure examination working papers and reports are thorough, consistent, and properly completed. These policies should address the performance, completion, documentation, retention, and review of examination working papers along with the supervision of financial institution examiners.

MANAGEMENT'S COMMENT:

We concur. As noted by the auditors, the Department has policies and procedures designed to ensure workpapers document the work performed at examinations and the identity of the examiner performing that function; however, in each of our three operating divisions, one or more exceptions to these policies and procedures were noted.

Corrective action has been or will be taken as follows:

The shortcomings noted in the two Premium Finance Company examinations were brought to the attention of the two examiners involved. In addition, during a meeting of examiners on August 20, 1996, the importance of completing examination workpapers in their entirety was emphasized to all our Compliance examiners. The Bank Division is taking steps to standardize the organization of our workpapers and, as part of that process, will include a step to assure that the Examiner Work Program is reviewed for completeness. A few examiners will be brought in to work on this project prior to year-end. Workpaper documentation for our Credit Union Division should not normally be a problem as the majority of our workpapers are contained in the examination software which is called the Auto-mated Integrated Regulatory Examination System (AIRES). In the one exception noted, the examiner responsible was having some difficulties with this new examination program and has since left the Department.

In addition, we recently submitted Records Disposition Authority (RDA) requests with the Department of General Services to ensure consistent retention schedules for working papers as is done with other Department records. We are currently awaiting approval of the Department of General Services to these requests.

We concur that the Assistant Commissioners of our three operating divisions need to ensure enforcement of existing policies governing the Department's administration of examination activities. As noted above, we are taking steps to ensure that policy exceptions are eliminated and, in our Bank Division, we will be undertaking a project to ensure that our working papers are organized in a consistent manner throughout our three Field Districts. RDAs are also in process to ensure consistent retention requirements for Department workpapers.

## **Compliance Report**

April 9, 1996

The Honorable W. R. Snodgrass  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have applied procedures to test the Department of Financial Institution's compliance with the provisions of certain laws, regulations, contracts, or grants for the years ended June 30, 1995, and June 30, 1994. We performed the procedures in accordance with generally accepted government auditing standards.

Compliance with laws, regulations, contracts, or grants applicable to the Department of Financial Institutions is the responsibility of the department's management. Our objective was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that the Department of Financial Institutions complied with the provisions referred to in the preceding paragraph, except for one instance of noncompliance that we have reported to the department's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director  
Division of State Audit

AAH/tp

