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DEPUTY AUDITOR GENERAL

April 17, 2014

The Honorable John Allen, Chair  
Joint Legislative Audit Committee

The Honorable Chester Crandell, Vice Chair  
Joint Legislative Audit Committee

Dear Representative Allen and Senator Crandell:

Our Office has recently completed an initial followup of the Arizona Department of Financial Institutions regarding the implementation status of the 40 audit recommendations (including sub-parts of the recommendations) presented in the performance audit report released in August 2013 (Auditor General Report No. 13-05). As the attached grid indicates:

- 13 have been implemented;
- 21 are in the process of being implemented;
- 5 are not yet applicable; and
- 1 is not implemented.

Our Office will conduct an 18-month followup with the Department on the status of those recommendations that have not yet been fully implemented.

Sincerely,

Dale Chapman, Director  
Performance Audit Division

DC:ss  
Attachment

cc: Lauren W. Kingry, Superintendent  
Arizona Department of Financial Institutions

# Arizona Department of Financial Institutions

## Auditor General Report No. 13-05

### Initial Follow-Up Report

Recommendation	Status/Additional Explanation
<b>Finding 1: Department should enhance its financial enterprise examination strategy</b>	
<p>1.1 The Department should develop and implement written policies and procedures for varying the scope of its examinations based on the financial enterprise's assessed risk. These policies and procedures should identify the types of limited examinations that department staff could perform and the risk ratings that would qualify for the limited examinations.</p>	<b>Implemented at 6 months</b>
<p>1.2 To improve the e-exam program, the Department should:</p> <p>a. Develop and implement written policies and procedures on when it is appropriate to use e-exams;</p> <p>b. Periodically assess whether, when appropriately applied, the e-exam is still effective in detecting violations when compared to the on-site examination; and,</p> <p>c. Once formal policies and procedures are established, consider extending the e-exam to other license types to assist in reducing its backlog.</p>	<p><b>Implemented at 6 months</b></p> <p><b>Implementation in process</b> The Department has developed a policy and procedure for conducting annual reviews of the e-exam to assess its functionality and usefulness. The policy stipulates that this review will assess, among other factors, potential weaknesses and areas of improvement or modification for the e-exam. According to the Department, the first review will take place in January 2015.</p> <p><b>Implemented at 6 months</b></p>
<p>1.3 The Department should better prioritize the scheduling of financial enterprise examinations to ensure that low-risk licensees are not examined sooner than is needed, while high-risk licensees receive more timely reexamination.</p>	<p><b>Implementation in process</b> In February 2014, the Department developed a written policy specifying that examination frequencies are predicated on the licensee's risk rating. For example, the policy allows those licensees with the lowest rating to be reexamined in 3 to 5 years, and requires those licensees with the highest risk rating to undergo another examination and monitoring within 3 to 6 months. Auditors will follow up at 18 months to assess the implementation of this policy.</p>
<p>1.4 The Department should revise its post-examination, risk-rating worksheets to ensure risk can be compared across license types. In revising its risk-rating worksheets, the Department should ensure that:</p> <ul style="list-style-type: none"> <li>Common risk factors, such as management and controls, are included in all worksheets;</li> </ul>	<b>Implemented at 6 months</b>

Recommendation	Status/Additional Explanation
<ul style="list-style-type: none"> <li>All risk-rating worksheets consider the seriousness of the potential violations; and</li> <li>Risk factors are appropriately weighed.</li> </ul>	<p><b>Implemented at 6 months</b></p> <p><b>Implemented at 6 months</b></p>
<p>1.5 The Department should enhance its processes for identifying risks prior to an examination, and in doing so, should consider:</p> <ul style="list-style-type: none"> <li>Expanding the use of existing financial reports that are already submitted by most of its licensees to assess the size and financial performance of licensees compared to their peers; and</li> <li>Identifying financial products that pose the most financial harm to Arizona consumers.</li> </ul>	<p><b>Implementation in process</b> In March 2014, the Department revised its pre-examination process to include a requirement for examiners to review a licensee’s net worth and to compare net worth trends to other licensees within the same licensing group as a means of assessing risk. However, the Department has not yet used this revised process.</p> <p><b>Implementation in process</b> The Department revised its examination policies to include a step in the pre-examination process where enterprise examiners will identify new financial products offered by licensees and assess the potential for financial harm to Arizona consumers. This assessment will help to inform the scope of work based on the examiner’s conclusion. As of March 2014, this portion of the examination policy had not yet been implemented.</p>
<p>1.6 The Department should develop and implement written policies and procedures for conducting followups, including when verification of corrective action or reexamination may be necessary. The Department’s procedures should identify what types of violations should be followed up on, what level of verification is required, and the time frame for when it should verify that licensees have corrected violations.</p>	<p><b>Implementation in process</b> The Department has adopted a licensee monitoring policy that indicates monitoring should be considered when a licensee meets one or more criteria including a recent examination that identified problems or a high volume of complaints. However, its monitoring policy does not address other elements of the recommendation including the level of verification required or the time frame for verifying that licensees have corrected violations.</p>

**Finding 2: Department should enhance its complaint-handling process**

2.1 The Department should enhance its complaint-handling policies and procedures to ensure that department staff consistently and adequately process all complaints in a timely manner. Specifically, the Department should:

- a. Standardize complaint investigation steps and include these steps in its policies and procedures;

**Implementation in process**  
The Department has developed policies and procedures for time frames and has developed some procedures that standardize complaint investigation steps, but these have not yet been included in its policies.

## Recommendation

## Status/Additional Explanation

b. Establish criteria for documenting suspected unlicensed activity on the Watch List;

### Implementation in process

The Department has developed policies and procedures for when to add an individual or entity to its Watch List, and auditors will follow up at 18 months to determine whether these policies have been implemented.

c. Establish and track time frames for resolving complaints, which should include the entire complaint-handling process of opening, investigating, and resolving the complaint, and specific time frames for completing the various steps of its complaint-handling procedures; and

### Implementation in process

The Department has established time frames for the various stages of the complaint process, and has also developed monthly reports to help track timeliness of closed complaints. However, for cases that are still open, the Department's monthly reports do not yet track how long a complaint is open. In addition, the Department plans to conduct biannual reviews of the time frames to ensure the established time frames are followed and are appropriate. The Department's first bi-annual review is scheduled for July 1, 2014.

The Department's biannual review policy stipulates these reviews will occur in January and July, and will review all of the following:

- Timeliness of complaint processing;
- Adherence to established time frames;
- Adherence to established investigative steps;
- A review of the established processing time frames to ensure the processing time frames are appropriate (i.e., neither too rigid or too lax);
- Verification of data entered;
- Accuracy of: data, dates, type of letters sent, and usage of codes and status designations;
- Completeness of information in the database, including clear and concise comments; and
- Verification of entry on the Department's Watch List.

Further, the Department's biannual review policy states that biannual review results regarding how timely examiners are processing complaints may be added as performance measures in examiners' performance evaluations.

d. Analyze its complaint-handling data to assist in determining appropriate timeliness goals for resolving complaints, and use the data to identify the specific time frames for completing the various steps of its complaint-handling process.

### Implementation in process

The Department anticipates that its biannual review process will address this recommendation. For more information, see Rec. 2.1c.

## Recommendation

## Status/Additional Explanation

2.2 The Department should improve its oversight of its complaint-handling function by enhancing its supervisory review process to evaluate the adequacy and timely handling of complaint investigations in a way that is feasible given its available resources, and should document the results of these supervisory reviews in its complaint case files. Specifically, the Department should develop and implement written policies and procedures that require the following:

- a. Verification that all complaints received that are within its jurisdiction are entered into the case management system for investigation;
- b. Periodic review of complaint investigations to ensure that these investigations are progressing in a timely manner, documenting these reviews and any associated decisions, and for any cases that have been open for a long time, guidelines on whether they should be further investigated or closed; and
- c. Review of investigation sufficiency to ensure that the Department's investigative policies and procedures are being followed, including reviewing the steps taken to investigate a complaint and ensuring that identified entities are placed in the Watch List.

### Implemented at 6 months

### Implementation in process

The Department has taken steps to periodically review closed complaints in its biannual review (see Rec. 2.1c for more information). Additionally, the Department reported that it will continue to work with its Information Technology (IT) staff to determine a method of reviewing open complaints. Auditors will follow up at 18 months to review the progress with these steps.

### Implementation in process

The Department anticipates that its biannual review will address this recommendation. For more information, see Rec. 2.1c.

2.3 The Department should develop and implement performance measures to ensure that investigators adhere to the Department's investigative time frames once these time frames have been established.

### Implementation in process

The Department has developed performance measures related to handling complaints within established time frames and has added these to employee performance evaluations. In addition, the Department anticipates that its biannual review of complaints will review employees' progress on these performance measures and will add the results in the employees' performance evaluations. The first biannual review is scheduled for July 2014. For more information, see Rec. 2.1c.

2.4 To help ensure the completeness and accuracy of complaint information in its case management system, the Department should:

- a. Update its complaint-handling policies and procedures to include specific definitions for each of its case status designations, including those related to the final outcome of a complaint investigation; and

### Implementation in process

The Department updated its policies to define correspondence codes, complaint basis codes, and final outcome codes. In addition, the Department anticipates that its biannual review, which is scheduled to first take place in July 2014, will further address this recommendation. For more information, see Rec. 2.1c.

## Recommendation

## Status/Additional Explanation

- b. Develop and implement policies and procedures that require a risk-based review of data entry based on its available resources, including a review of the accuracy of case status designations recorded in the case management system.

### Implementation in process

The Department anticipates that its biannual review, which is scheduled to first take place in July 2014, will address this recommendation. For more information, see Rec. 2.1c.

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## Finding 3: Department should establish a structured approach to set appropriate fees

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3.1 To ensure its fees more fully reflect its costs, the Department should develop a structured approach to evaluate current fees and propose legislative or rule changes that would more closely align its fees with department funding needs. In developing this approach, the Department should do the following:

- a. Assess the efficiency of its operations to ensure costs are as low as possible while considering service quality, and document the results of its assessment. As the Department assesses the efficiency of its operations, it should continue seeking to minimize costs where possible.
- b. Develop and implement a method for estimating department costs, including both direct and indirect costs, and create policies and procedures for using this method.
- c. Establish an allocation methodology for assigning direct payroll costs to licensee category within its currently established accounting system.
- d. After the method is developed and costs are appropriately tracked, the Department should use the costs to analyze its fee structure and determine the appropriate fees to charge.
- e. Include in its policies and procedures a time frame by which it will reevaluate its fees to ensure its fees continue to align with its costs.

### Implementation in process

The Department is in the process of making a change that, according to the Department, involves assessing the efficiency of its operations and will result in greater efficiencies. Specifically, the Department has initiated the process to procure a new document management system that will allow department staff to quickly store and retrieve documents electronically, replacing the current paper filing system. The Department indicated that this system will remove certain redundancies from staff processes, such as double-entry of licensee data into two separate systems.

### Implementation in process

According to the Department, it plans to estimate and track costs by license type. It has begun work on how to allocate direct payroll costs—see Rec. 3.1c.

### Implementation in process

The Department has begun soliciting input from its managers on how to allocate its direct payroll costs. In addition, according to the Department, it has updated the State's payroll system with codes that will be needed to allocate payroll costs.

### Not yet applicable

This recommendation is dependent upon implementation of Rec. 3.1b and c.

### Not yet applicable

This recommendation is dependent upon implementation of Rec. 3.1b, c, and d.

**Recommendation****Status/Additional Explanation**

3.2 When warranted and based on its cost and fee assessment, the Department should propose legislative changes to its statutorily established fee amounts or make appropriate rule changes to revise its fees.

**Not yet applicable**

This recommendation is dependent upon implementation of Rec. 3.1.

3.3 The Department should consider the effect that the proposed fee changes may have on the affected financial institutions and enterprises and obtain their input when reviewing the fees.

**Not yet applicable**

This recommendation is dependent upon implementation of Rec. 3.1 and 3.2.

**Recommendation****Status/Additional Explanation****Sunset factor #2      The extent to which the Department has met its statutory objective and purpose and the efficiency with which it has operated.**

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| <ul style="list-style-type: none"><li>• Separate cash receipts responsibilities to ensure that one employee collects receipts and a different employee records the receipts in the accounting records;</li></ul>                                | <p><b>Not implemented</b></p> <p>According to the Department, the current staffing structure within the Licensing Division makes it impractical and inefficient to segregate these responsibilities. Therefore, the Department has not modified its front office cash-handling procedures that were in place at the time of the audit. However, the Department plans to procure a new e-licensing system by fiscal year 2015 that will incorporate appropriate segregation of duties. The Department also plans to retain a dedicated cashier who will not have the ability to record receipts in the licensing system.</p> |
| <ul style="list-style-type: none"><li>• Require two employees to open the mail and record mail receipts;</li></ul>  | <p><b>Implemented at 6 months</b></p>   |
| <ul style="list-style-type: none"><li>• Require checks received to be locked in a safe prior to deposit;</li></ul>  | <p><b>Implemented at 6 months</b></p>   |
| <ul style="list-style-type: none"><li>• Conduct a complete physical inventory of all capital assets at least annually and update the State's Fixed Asset System for any corrections needed based on the results of the inventory; and</li></ul> | <p><b>Implemented at 6 months</b></p>   |
| <ul style="list-style-type: none"><li>• Maintain all supporting documentation for disposed capital assets and update the State's Fixed Asset System within 5 working days of the disposal.</li></ul>  | <p><b>Implemented at 6 months</b></p>   |
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**Sunset factor #5      The extent to which the Department has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.**

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| <ul style="list-style-type: none"><li>• Develop and implement written policies and procedures to guide the determination of whether or not to provide information to the public, including factors that should be considered when doing so.</li></ul>    | <p><b>Implemented at 6 months</b></p>  |
| <ul style="list-style-type: none"><li>• Establish and implement a supervisory review process based on its available resources to ensure that information in the database related to the final action taken on a case is complete and accurate.</li></ul> | <p><b>Implementation in process</b></p> <p>The Department has established a new policy that requires a secondary review of all final actions entered into the case management system to ensure the final action was appropriately designated. In addition, the Department's new policy establishes guidelines for conducting a biannual review of all final actions and ensuring that they have been accurately marked as such in their system. The biannual review will be conducted every January 1<sup>st</sup> and July 1<sup>st</sup>. The Department reported that it will implement the new review process starting July 1, 2014.</p> |

**Recommendation****Status/Additional Explanation**

- Include a public disclosure on its Web site that its listings of enforcement actions are not complete.

**Implemented at 6 months**

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**Sunset factor #12 The extent to which the Department has used private contractors in the performance of its duties as compared to other states and how more effective use of private contractors could be accomplished.**

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- Ensure that future PIJs include adequate assessments of the new systems' suitability for the Department's needs, including compatibility with the Department's present database, to ensure data conversion is successful and that system requirements are clearly defined within the scope of work;
- Develop and implement a formal system development lifecycle (SDLC) methodology;
- Ensure future IT procurement contracts include provisions for phased payments rather than lump-sum payments prior to work commencing; and
- Closely monitor contractor performance and progress toward meeting milestones to ensure projects progress according to agreed-upon contract terms.

**Implementation in process**

In January 2014, the Department initiated a Project Investment Justification (PIJ) for a document management and licensing information system. As of March 2014, the Department was in the late stages of developing the PIJ. According to the Department, it contracted for the services of an IT project manager to help with the development of the PIJ and staff from the Department of Administration's Arizona Strategic Enterprise Technology (ASET) office to continue to provide oversight and advisement in the PIJ process and over the project more generally.

**Implementation in process**

The Department has begun developing a formal SDLC methodology based in part on SDLC methodology policies it obtained from some federal and state agencies. It plans to have its policy completed by the end of September 2014.

**Not yet applicable**

The Department has not yet initiated a contract to replace its licensing information system. However, according to the Department, it plans to include phased payments that will be tied to specific project milestones.

**Implementation in process**

The Department has not yet initiated a contract to replace its licensing information system. However, the Department's draft PIJ outlines various responsibilities of its project participants with regard to contract monitoring, including responsibilities for monitoring project costs, project risks, and project schedule.

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