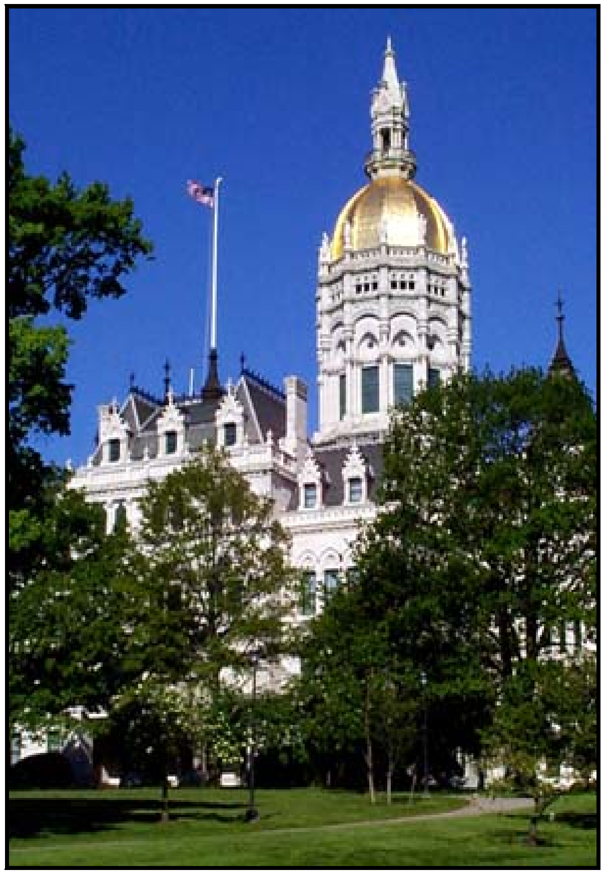
STATE OF CONNECTICUT



AUDITORS' REPORT
DEPARTMENT OF BANKING
FOR THE FISCAL YEARS ENDED JUNE 30, 2005, 2006 and 2007

AUDITORS OF PUBLIC ACCOUNTS
KEVIN P. JOHNSTON ❖ ROBERT G. JAEKLE

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July 23, 2008

AUDITORS' REPORT
DEPARTMENT OF BANKING
FOR THE FISCAL YEARS ENDED JUNE 30, 2005, 2006 and 2007

We have made an examination of the financial records of the Department of Banking for the fiscal years ended June 30, 2005, 2006 and 2007. This report consists of the Comments, Condition of Records, Recommendations and Certification that follow.

This audit has been limited to assessing the Department of Banking's compliance with certain provisions of financial-related laws, regulations and contracts, and evaluating the internal control policies and procedures established to ensure such compliance. Financial statement presentation and auditing have been done on a Statewide Single Audit basis to include all State agencies, including the Department of Banking.

COMMENTS

FOREWORD:

The Department of Banking (Department or Agency) operates under the provisions of Title 36a, Chapters 664 through 669 and Title 36b, Chapters 672 to 672c of the Connecticut General Statutes. The Department functions as a regulatory agency responsible for the supervision, licensing and regulation of financial institutions and organizations within the State. Included among such institutions are State chartered banks and State chartered credit unions, suppliers of consumer credit such as mortgage lenders, brokers, consumer collection agencies, small loan companies, check cashers, and landlord/tenant conflicts. The Department receives the majority of its revenues through the registration, supervision, and examination of the securities business within the State, including brokerage firms, investment banking houses, retail stockbrokers and investment advisors. The Department serves to administer and enforce Connecticut's Truth-in-Lending Law and Connecticut's Uniform Securities Act, among other consumer credit laws.

Howard F. Pitkin was appointed Banking Commissioner on October 1, 2006. John P. Burke served as Banking Commissioner prior to October 1, 2006.

New Legislation:

Public Act 05-177 of the January 2005 Regular Session, made a number of changes to the Connecticut Uniform Securities Act. It enhanced the Banking Commissioner's authority, including his investigative authority, and allowed the Commissioner to prohibit, limit, or impose conditions on broker dealers and investment advisers relating to the custody of securities or funds, among other changes. This Public Act was effective October 1, 2005.

RÉSUMÉ OF OPERATIONS:

Receipts:

Receipts of the Department of Banking are summarized below by fund for the fiscal years ended June 30, 2005, 2006 and 2007:

	2004-2005	**2005-2006**	**2006-2007**
Banking Fund	$23,078,163	$17,998,615	$29,103,183
Grant/Restricted Fund	4,685	-0-	285,043
Total Receipts by Fund	**$23,082,848**	**$17,998,615**	**$29,388,226**

Receipts of the Department of Banking are summarized below by revenue category for the fiscal years ended June 30, 2005, 2006 and 2007:

	2004-2005	**2005-2006**	**2006-2007**
Licenses	$ 6,770,250	$ 2,767,299	$ 7,892,203
Fees	15,061,210	14,577,888	17,040,899
Fines	1,244,900	643,464	4,136,915
Miscellaneous	6,488	9,964	318,209
Total Receipts by Category	**$23,082,848**	**$17,998,615**	**$29,388,226**

Total receipts decreased by 22 percent and increased by 63.3 percent during the fiscal years ended June 30, 2006 and 2007. The "Fees" listed above were generally collected by the Securities and Business Investment Division, which is responsible for collecting registration fees for investment advisors, brokers and for the registration of securities. There are two other divisions within the Department that are responsible for certain revenues: The Financial Institutions Division and the Consumer Credit Division. The large decrease of $5,084,233 and subsequent increase of $11,389,611, in revenues was because licenses for mortgage companies and brokers are required to be paid on a two-year cycle: Licenses within the Consumer Credit Division accounted for $5,023,411 of the decrease in revenues in the fiscal year ended June 30, 2006, and for $5,800,170 of the increase in the fiscal year ended June 30, 2007. Also, during the fiscal year ended June 30, 2007, there was an increase in penalties and broker fees in the Securities Division of $2,846,297 and $633,450, respectively, and an increase in the fees for foreign branch office exams within the Financial Institutions Division in the amount of $1,664,736.

Expenditures:

The expenses of the Department of Banking are made pursuant to appropriations by the General Assembly and are charged to the Banking Fund. Expenditures for the fiscal years ended June 30, 2005, 2006 and 2007, totaled $15,204,261, $15,912,296 and $16,472,325, respectively. Most expenses were charged to the Banking Fund. Those expenditures charged to the Grant/Restricted Fund were for investor education programs. A summary of expenditures by fund is presented below:

	2004-2005	2005-2006	2006-2007
Banking Fund	$15,180,339	$15,884,741	$16,454,815
Grant/Restricted Fund	23,922	27,555	17,510
Total Expenditures	**$15,204,261**	**$15,912,296**	**$16,472,325**

A summary of expenditures for the Department of Banking by account code is presented below:

	2004-2005	2005-2006	2006-2007
Personal Services & Employee Benefits	$12,718,724	$13,919,646	$14,367,251
Employee Expenses, Allowances & Fees	403,908	350,152	509,897
Purchases & Contracted Services	486,714	462,173	411,798
Motor Vehicle Costs	11,360	9,859	10,642
Premises & Property Expenses	719,758	721,471	721,116
Information Technology	228,584	191,686	191,658
Purchased Commodities	51,260	44,334	55,759
Other Charges	409,367	206,511	199,519
Capital Outlays – Equipment	174,586	6,464	4,685
Total Expenditures	**$15,204,261**	**$15,912,296**	**$16,472,325**

Expenditures increased 4.7 percent and 3.5 percent during the fiscal years ended June 30, 2006 and 2007, respectively. Personal services and employee benefits increased 9.4 percent and 3.2 percent during the fiscal years ended June 30, 2006 and 2007, respectively. The increases were due to merit raises, cost-of-living adjustments, and the increase in the State Employees' Retirement System (SERS) fringe benefit rate as established by the State Comptroller. During the audited period there was an increase in filled positions from 110 to 120, which was attributed mostly to the expansion of the Consumer Credit Division.

Fund Balance:

As a result of increases in Banking Fund revenues and relatively consistent expenditures, the budgetary fund balance plus reserve amounts for the fiscal years ended June 30, 2005, 2006 and 2007 was $36,230,366, $38,344,240 and $50,992,608, respectively.

CONDITION OF RECORDS

Our audit of the Department of Banking found areas where improvement is needed, as described in the following findings:

Receivables:

Criteria: The State Comptroller requires all State agencies to report receivable balances each fiscal year as of June 30th. These reports should be complete and accurate. Section 3-7 of the General Statutes allows for the Department to initiate write-offs for any uncollectible amounts, subsequent to minimum collection procedures and subject to certain approvals.

Condition: Our review of the Department of Banking's reporting of receivables to the State Comptroller for the fiscal years ended June 30, 2006 and 2007, indicated that the amounts reported were not complete or accurate. For the fiscal year ended June 30, 2006, we found at least 10 penalties that were not reported and one that was reported for the wrong amount. For the fiscal year ended June 30, 2007, we found at least seven penalties that were not reported and two that were reported for the wrong amount. These errors resulted in reporting understatements of at least $1,040,000; however, it appears the majority of these accounts would have been reported as 100 percent uncollectible and been subject to future write-off consideration.

We also found that write-offs were not initiated as needed. For example, the listing of receivables included many older accounts (32) dated prior to June 30, 2003, which may be eligible for write-off as they were considered uncollectible since they were first recorded. The Department appears to have made the necessary attempts to collect, but the reporting and write-off functions need improvement.

Effect: The amount reported to the State Comptroller does not accurately reflect the balance for accounts receivable.

Cause: Poorly designed internal controls, lack of communication, and employee errors contributed to the incomplete and inaccurate reporting of receivable amounts.

Recommendation: The Department of Banking should design and follow procedures to ensure that accurate receivable balances are reported to the State Comptroller and that write-offs are processed as necessary. (See Recommendation 1.)

Agency Response: "The Department of Banking is very respectful and appreciates highly the work performed by the State Auditors during the audit. Especially noted are the recommendations made with respect to correcting deficiencies revealed in both the Department's financial reporting structure and internal controls framework. Implementation of recommendations made will begin immediately. The Department will take steps to improve communication channels between operating divisions and the business office to help assure that receivable amounts pertaining to assessed fines and penalties are reported both timely and accurately. To illustrate, operational divisions will be surveyed quarterly for fines or penalties about to be levied. Any such assessments will be recorded in a special log. This log will be used to determine which amounts should be investigated further, and which account balances are uncollectible and should therefore be written off. Existing procedures outlined in the State's accounting manual will be followed in performing this task. As a beginning, the Department's receivable balance as of June 30, 2008, will be verified; action will then be initiated to write-off account balances older than five years declared to be uncollectible."

Internal Controls:

Criteria: Internal controls should be designed and followed to ensure that:

For inventory, purchases are recorded properly and the inventory control list accurately reports identifiable assets in accordance with Property Control Manual procedures.

For payroll, compensatory time is authorized in advance and granted for extra work that is significant in accordance with the Department of Administrative Services Manager's Guide and Management Personnel Policy 06-02; also, that compensatory time is accurately recorded and that balances properly reflect actual time earned.

For expenditures, purchase orders and commitment documents are properly authorized and entered into the State's accounting system prior to the receipt of goods or services in accordance with the State Accounting Manual and Section 4-98, subsection (a), of the General Statutes.

For revenue, accountability reports for penalties and fees are prepared and reconciled to the cash amounts received, and documentation to support certain assessments is calculated accurately. For receipts, checks received in the mail are listed immediately on a listing, which includes the date of when the check was received, in accordance with the State Accounting Manual. For deposits, checks are deposited in a timely manner in accordance with Section 4-32 of the General Statutes.

For access to computerized applications, terminated employees' system rights are revoked.

For petty cash, the checks are not signed by the same person who reconciles the account.

Condition: We found that internal controls were not always designed appropriately and/or followed in the following circumstances:

For inventory, the amounts reported to the State Comptroller did not always represent accurately the Department's assets, as required. Problems we found included one item costing $2,212 was reported at a cost of $130,508, two items with a reported cost of $34,971 could not be identified, noncapital items were reported in error, and two items found were not included in the inventory list.

For payroll, we found that eight of nine occurrences of compensatory time earned by managers sampled during our review did not have the necessary prior approvals documented and there were 31 occurrences of compensatory time earned by managers that were not significant in time or duration. Two employees were credited with an incorrect amount of compensatory time. One was given credit for a nine-hour day that was not actually worked, and another was credited with eight hours instead of the actual six hours earned.

For expenditures, our review found that 11 of 25, or 44 percent of expenditure transactions reviewed, had purchase orders that were created after goods or services were received.

For revenues, certain reconciliations in the form of accountability reports of revenue to cash receipts did not occur for penalties and certain application fees, and the calculation to support one assessment amount did not appear to be accurate. For receipts, a listing of receipts was not completed and date stamps were not always used to indicate when items were received. For deposits, checks totaling $93,919 were deposited one day late.

For access to computerized applications, terminated employees' access was not disabled.

For petty cash, the employee who reconciled the petty cash account also was authorized to sign checks.

Effect: For inventory, the amount reported to the State Comptroller did not accurately reflect the actual inventory as of June 30, 2005, 2006 and 2007.

We estimated that the total amount of capital equipment was overstated by $359,429, $205,372, and $204,339, for those respective years.

For payroll, managers appear to have been credited for compensatory time that appeared contrary to the Statewide policy. Nine hours of compensatory time valued at $371, which was paid in error, may not be recovered as the employee has left State service.

For expenditures, committed amounts were not recorded properly and there is less assurance that funds will be available when needed.

For revenues, receipts, deposits, and petty cash, there is less assurance that risks have been minimized, and late deposits sacrifice interest amounts.

For access to computerized applications, unauthorized persons could gain access to the system.

Cause: Proper internal controls were not always designed and followed.

Recommendation: The Department of Banking should appropriately design and follow internal controls to ensure that transactions are correctly processed and recorded in the State's records and that the risks of loss are minimized. (See Recommendation 2.)

Agency Response: "The design and strengthening of internal controls will continue to be an on-going process within the Department of Banking. Where financial/fiscal events warrant, new controls will be developed; existing controls will be either modified or re-aligned to assure the integrity of agency financial accounting transactions. Of note, we plan to address immediately the reconciling of our asset ledger. For June 30, 2008, we want to be assured that the items in our asset accounts are correctly classified so that the dollar amount of our balance for capital equipment is reported correctly on for CO-59 (as of 6/30/2008). Additionally, we will develop a worksheet log for listing checks received daily. This log will be prepared in the mail room and will list the date, amount, and payer of each check received. After a period of eight weeks, an assessment of the feasibility of continuing this task will be made. The Department wishes to thank the Auditors of Public Accounts for their diligence during the audit as well as their willingness to share best practices noted elsewhere. The Department will address each item covered in the report in the manner described above and incorporate your suggestions into our daily operations."

Expenses Not Reported in the Correct Year:

Criteria: Employee travel expense reimbursements should be recorded in the year they are incurred and written policies should encourage employees to submit for reimbursement in a timely manner.

Condition: One employee submitted 33 travel reimbursement requests in the fiscal year ended June 30, 2007, totaling $11,278. None of these expenses were incurred in that fiscal year, but were related to the expenses of two prior fiscal years.

Effect: Expenditures of $650 and $10,628 were understated in the fiscal years ended June 30, 2005 and 2006, respectively, and were overstated in the fiscal year ended June 30, 2007.

Cause: The employee did not submit for reimbursement in a timely manner and there was no written policy to encourage compliance.

Conclusion: It appears this isolated incident was resolved and the Department of Banking has instituted a written policy that was distributed to all employees; therefore, a recommendation is not warranted at this time.

Quarterly and Annual Reporting:

Criteria: In accordance with Section 36a-14, subsection (a) and subsection (b) of the General Statutes, certain reports are to be sent annually to the Governor and the General Assembly's Committee on Banks. Section 36a-14a of the General Statutes requires a quarterly report of revenue collected by Department to be sent not later than 30 days after the close of the first quarter of the fiscal year ending June 30, 2005, and not later than 30 days after the close of each quarter thereafter, to the Committee on Appropriations through the Office of Fiscal Analysis.

Condition: An Annual Report was not sent to the Governor and the Committee on Banks for the year ended December 31, 2005. Quarterly reports of revenue were not sent in a timely manner. The Commissioner appointed October 1, 2006, did issue the 2006 Annual Report, and as of May 21, 2008, was working on the 2007 Annual Report.

Effect: Reports were not always sent to the Governor and other officials as required by the General Statutes.

Cause: A decision to suspend Annual Reports was made by the prior Commissioner. For the quarterly revenue reports, it appears the Department did not realize that the reporting was mandatory under the General Statutes.

Conclusion: The Department of Banking now appears to be sending the annual and quarterly reports; therefore, a recommendation is not warranted at this time.

RECOMMENDATIONS

Status of Prior Audit Recommendations:

- We recommended that the Department of Banking update and maintain its property control records to ensure that Fixed Assets/Property Inventory Reports to the State Comptroller reflect the actual capital inventory as of June 30th, and that internal controls should be improved over changes to the property control records. During our current audit, we found that the inventory records improved, however, reporting to the State Comptroller was not always accurate and this recommendation is repeated and included in Recommendation 2.

- We recommended that the Department of Banking establish accounts receivable records for all unpaid fines, report the total of unpaid fines in accordance with GAAP Reporting Package Form 2, and cancel uncollectible fines in accordance with Section 3-7 of the General Statutes. Although we found that records were established, they were not always accurate and write-offs were not processed; therefore, this recommendation is restated in Recommendation 1.

- We recommended that the Department of Banking deposit all receipts in accordance with Section 4-32 of the General Statutes. We found another occasion of a late deposit and are including this issue in Recommendation 2.

Current Audit Recommendations:

1. **The Department of Banking should design and follow procedures to ensure that accurate receivable balances are reported to the State Comptroller and that write-offs are processed as necessary.**

   Comment:

   The reporting of receivable amounts to the State Comptroller was inaccurate and the receivable amounts deemed uncollectible were not written-off appropriately.

2. **The Department of Banking should appropriately design and follow internal controls to ensure that transactions are correctly processed and recorded in the State's records and that the risks of loss are minimized.**

   Comment:

   Many areas within the Department needed improvements to internal control.

INDEPENDENT AUDITORS' CERTIFICATION

As required by Section 2-90 of the General Statutes we have audited the books and accounts of the Department of Banking for the fiscal years ended June 30, 2005, 2006, and 2007. This audit was primarily limited to performing tests of the Agency's compliance with certain provisions of laws, regulations, contracts and grant agreements, and to understanding and evaluating the effectiveness of the Agency's internal control policies and procedures for ensuring that (1) the provisions of certain laws, regulations, contracts and grant agreements applicable to the Agency are complied with, (2) the financial transactions of the Agency are properly initiated, authorized, recorded, processed, and reported on consistent with management's direction, and (3) the assets of the Agency are safeguarded against loss or unauthorized use. The financial statement audits of the Department of Banking for the fiscal years ended June 30, 2005, 2006 and 2007, are included as part of our Statewide Single Audits of the State of Connecticut for those fiscal years.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Department of Banking complied in all material or significant respects with the provisions of certain laws, regulations, contracts and grant agreements and to obtain a sufficient understanding of the internal control to plan the audit and determine the nature, timing and extent of tests to be performed during the conduct of the audit.

Internal Control over Financial Operations, Safeguarding of Assets and Compliance:

In planning and performing our audit, we considered the Department of Banking's internal control over its financial operations, safeguarding of assets, and compliance with requirements as a basis for designing our auditing procedures for the purpose of evaluating the Agency's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grant agreements, but not for the purpose of providing assurance on the effectiveness of the Agency's internal control over those control objectives.

Our consideration of internal control over financial operations, safeguarding of assets, and compliance requirements was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial operations, safeguarding of assets and compliance with requirements that might be significant deficiencies or material weaknesses. However as discussed below, we identified certain deficiencies in internal control over financial operations, safeguarding of assets, and compliance with requirements that we consider to be significant deficiencies.

A *control deficie*ncy 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 on a timely basis unauthorized, illegal, or irregular transactions or the breakdown in the safekeeping of any asset or resource. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to properly initiate, authorize, record, process, or report financial data reliably, consistent with management's direction, safeguard assets, and/or comply with certain provisions of laws, regulations, contracts, and grant agreements such that there is more than a remote likelihood that a financial misstatement, unsafe treatment of assets, or noncompliance with laws, regulations, contracts and grant agreements that is more than inconsequential will not be prevented or detected by the Agency's internal control. We consider the following deficiencies described in the accompanying Condition of Records and Recommendations sections of this report to be significant deficiencies in internal control over financial operations, safeguarding of assets and compliance with requirements: Recommendations 1 and 2.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with certain provisions of laws, regulations, contracts, and grant agreements or the requirements to safeguard assets that would be material in relation to the Agency's financial operations, noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions and material financial misstatements by the Agency being audited will not be prevented or detected by the Agency's internal control.

Our consideration of the internal control over the Agency's financial operations, safeguarding of assets, and compliance with requirements was for the limited purpose described in the first paragraph of this section and would not necessarily disclose all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

We also noted certain matters which we reported to the Agency's management in the accompanying Condition of Records section of this report.

Compliance and Other Matters:

As part of obtaining reasonable assurance about whether the Department of Banking complied with laws, regulations, contracts and grant agreements, noncompliance with which could result in significant unauthorized, illegal, irregular or unsafe transactions or could have a direct and material effect on the results of the Agency's financial operations, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.* However, we noted certain matters which we reported to the Agency's management and which are described in the accompanying Condition of Records section of this report.

The Department of Banking's response to the findings identified in our audit is described in the accompanying Condition of Records sections of this report. We did not audit the response and, accordingly, we express no opinion on it.

This report is intended for the information and use of the Agency's management, the Governor, the State Comptroller, the Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited.

CONCLUSION

In conclusion, we wish to express our appreciation for the courtesies and cooperation extended to our representatives by the personnel of the Department of Banking during the course of our examination.

Maura F. Pardo
Principal Auditor

Approved:

Robert G. Jaekle	Kevin P. Johnston
Auditor of Public Accounts	Auditor of Public Accounts