

DEPARTMENT OF SAVINGS AND MORTGAGE LENDING

Austin, Texas

INTERNAL AUDIT ANNUAL REPORT

Fiscal Year 2023



DEPARTMENT OF SAVINGS AND MORTGAGE LENDING
Austin, Texas

Internal Audit Annual Report
Fiscal Year 2023

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Garza/Gonzalez & Associates

CERTIFIED PUBLIC ACCOUNTANTS

Finance Commission Members and
Audit Committee Members
Department of Savings and Mortgage Lending
Austin, Texas

We performed procedures to determine the effectiveness and efficiency of the Department of Savings and Mortgage Lending's (SML) internal control structure over the Mortgage Examinations Area (the Area); and, its compliance with the Texas Finance Code chapters, Texas Administrative Code rules, and the Area's established policies and procedures, as applicable to the Area, for the 8 months ended April 30, 2023.

The results of our procedures disclosed that SML's internal control structure over the Area were generally adequate and no material instances of noncompliance were noted; however, we did identify certain matters, included in this report, that are opportunities for strengthening internal controls and ensuring compliance with SML's established policies and procedures. Based on the degree of risk or effect of these matters in relation to the audit objective(s), these matters were rated as either Priority, High, Medium, or Low, which is further described in the "Summary and Related Rating of Observations/Findings and Recommendations" section of this report.

We also performed a follow-up of findings and recommendations presented in the prior year internal audit report, that were not fully implemented. This report, which reflects the results and implementation status of our follow-up procedures performed; and, includes all information required for compliance with State of Texas Internal Audit Annual Report requirements, has been prepared by Garza/Gonzalez & Associates, an independent Certified Public Accounting firm, following Generally Accepted Auditing Standards, International Standards for the Professional Practice of Internal Auditing, and the Institute of Internal Auditors' Code of Ethics contained in the Professional Practices Framework.

We have discussed the comments and recommendations from the audit of the Area; and, the implementation status from the follow-up procedures performed, with various SML personnel; and, we will be pleased to discuss them with you in further detail.



June 9, 2023

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INTRODUCTION

The Department of Savings and Mortgage Lending (SML) is a Texas state agency whose mission is “to supervise and regulate the residential mortgage lending and state savings industries in order to protect Texans, provide a healthy residential mortgage lending environment, and maintain safe and sound savings banks and savings associations for the purpose of increasing the economic prosperity of the state.” SML operates under the oversight of the Finance Commission of Texas pursuant to the authority of various provisions of the Texas Finance Code; and, the Texas Administrative Code.

SML’s primary goals, as provided in the 2023-2027 Strategic Plan, are as follows:

1. **Thrift Industry Regulation:** Supervise, regulate, and enforce the organization, operation, and the liquidation of state savings banks and state savings associations.
2. **Mortgage Industry Regulation:** Protect Texas consumers through fair and effective regulation of the residential mortgage industry.
3. **Consumer Responsiveness:** Provide consumer assistance by ensuring compliance with statutes and regulations; and, being responsive to inquiries, requests, and complaints from consumers, industry, public officials, and other state and federal governmental entities.

SML was granted Self-Directed, Semi-Independent (SDSI) status in the 81st Legislative Session. As an SDSI agency, SML is not required to have its budget approved by the Legislature; instead, the Finance Commission is responsible for setting SML’s spending authority or limits. SML’s entire operating funds are generated from fees assessed to regulated entities and are used to fund both, direct and indirect costs. General revenue funds are not used to support SML’s operations.

2023 Internal Audit Plan

Following are the internal audit functions performed, as identified in SML’s 2023 Internal Audit Plan, dated November 28, 2022, and approved by the Audit Committee and Finance Commission on December 16, 2022:

- Risk Assessment & Preparation of the 2023 Internal Audit Plan
- Mortgage Examinations Audit
- Follow-up of Prior Year Internal Audit
- Preparation of the 2023 Internal Audit Annual Report
- Other Tasks

This report contains the results of the Mortgage Examinations Audit; reflects the results of the follow-up procedures performed in the current year of the findings that were presented in the prior year internal audit report; and, meets the State of Texas Internal Audit Annual Report requirements.

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I. Compliance with Texas Government Code 2102: Required Posting of Internal Audit Information

To comply with the provisions of Texas Government Code, 2102.015 and the State Auditor's Office guidelines, within 30 days after approval by the Finance Commission, SML will post the following information on its website:

- An approved fiscal year 2024 audit plan, as provided by Texas Government Code, Section 2102.008.
- A fiscal year 2023 internal audit annual report, as required by Texas Government Code, Section 2102.009.

The internal audit annual report includes any weaknesses, deficiencies, wrongdoings, or other concerns raised by internal audits and other functions performed by the internal auditor as well as the summary of the action taken by SML to address such concerns.

II. Consulting and Nonaudit Services Completed

The internal auditor did not perform any consulting services, as defined in the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing* or any non-audit services, as defined in the *Government Auditing Standards*, 2018 Revision, Technical Update April 2021, Sections 3.64-3.106.

III. External Quality Assurance Review

The internal audit department's most recent *Peer Review Report*, dated December 15, 2021, indicates that its system of quality control has been suitably designed and conforms to applicable professional standards in all material respects.

IV. Internal Audit Plan for Fiscal Year 2023

The approved Internal Audit Plan (Plan) included one audit to be performed during fiscal year 2023. The Plan also included a follow-up of the prior year internal audit recommendations that were not fully implemented as of fiscal year 2022; other tasks as may have been assigned by the Finance Commission or Audit Committee; and, preparation of the 2023 Internal Audit Annual Report.

Risk Assessment

Utilizing information obtained through the completed questionnaires received and background information reviewed, 12 areas were identified as potential audit topics. A risk analysis utilizing 8 risk factors was completed for each individual audit topic and then compiled to develop an overall risk assessment.

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Following are the results of the risk assessment performed for the 12 potential audit topics identified:

HIGH RISK	MODERATE RISK	LOW RISK
Mortgage Examinations Thrift Examinations Thrift Supervision and Compliance	Payroll and Human Resources Revenue Accounting Process Management Information Systems [(MIS) Includes Disaster Recovery Plan]	Legal and Enforcement Financial Reporting (includes Asset Management & Travel) Procurement/ Contract Management/ HUB Consumer Protection Mortgage Licensing and Registration Records Management

In the prior 3 years, the following audits and functions were performed by the internal auditor:

Fiscal Year 2022:

- Risk Assessment & Preparation of the Internal Audit Plan
- Legal & Enforcement Audit
- Preparation of the Internal Audit Annual Report

Fiscal Year 2021:

- Risk Assessment & Preparation of the Internal Audit Plan
- Procurement/Contract Management/HUB Audit
- Follow-Up of the Prior Year Internal Audits
- Preparation of the Internal Audit Annual Report

Fiscal Year 2020:

- Risk Assessment & Preparation of the Internal Audit Plan
- Records Management Audit
- Follow-Up of the Prior Year Internal Audits
- Preparation of the Internal Audit Annual Report

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The internal audit and other tasks performed for fiscal year 2023 were as follows:

Report No.	Audits/Report Titles	Report Date
1.	Mortgage Examinations Audit <i>Objective:</i> To determine whether SML's policies and procedures and internal controls in place over the Mortgage Examinations Area (the Area) are effective to enforce and administer applicable state and federal laws and regulations of the entities it regulates.	6/9/2023
1.	Internal Audit Annual Report – Follow-up of findings and recommendations that were presented in the Prior Year Internal Audit Report. <i>Includes all reported audit results for Fiscal Year 2023.</i>	6/9/2023
-	Other Tasks Assigned by the Finance Commission or the Audit Committee	None

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V. Executive Summary

Mortgage Examinations

BACKGROUND

The Mortgage Examinations Area (Area) is supervised by the Director of Mortgage Regulation, who reports to the Commissioner; and, consists of a Chief Mortgage Examiner, a Review Examiner, 13 Mortgage Examiners, and an Administrative Assistant. The Area's primary functions are to conduct compliance examinations of Residential Mortgage Loan Companies and Mortgage Bankers (collectively, "entities") that it regulates, and the entities' sponsored residential mortgage loan originators (RMLO), to promote the entities' compliance with various state and federal laws when conducting business with Texas consumers. The Area has developed applicable policies and procedures to be used when performing compliance examinations, which are documented in the Policies and Procedures Manual (Manual).

Compliance Examinations

The Chief Mortgage Examiner is responsible for scheduling compliance examinations, based on a risk-focused approach that incorporates the consideration of various factors, and in accordance with the Report of Examination Timing Policy, as follows:

- **Initial examination** (entities never examined): Within 12 months of a quarterly Mortgage Call Report (MCR) showing a cumulative total of 5 or more closed loans, as tracked by the Chief Mortgage Examiner.
- **Re-examination:** The frequency is generally determined by the prior examination rating, as shown below, with additional consideration of other factors; such as, production volume, and complaints received from consumers and/or other regulatory agencies.

Prior exam rating	Examination cycle (months)
5	12
4	24
3	36
2	48
1	60

Semarca, which is used by SML, is an agency-wide information database, that centrally stores and tracks a wide array of information related to regulated entities. On a monthly basis, the Chief Mortgage Examiner generates a report from Semarca, to identify examinations that are due in the coming months, and make assignments to Mortgage Examiners.

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A compliance examination is conducted in the following stages:

- (1) **Initial Planning and Analysis** – Upon receiving an examination assignment, the assigned Mortgage Examiner contacts the Residential Mortgage Loan Company’s “Qualifying Individual”¹ or the Mortgage Banker Representative (collectively, “Contact”) to agree on the examination timing. The Mortgage Examiner then prepares and electronically delivers to the Contact, an Examination Notification Letter, which documents the timing of the scheduled examination, and an Initial Information Request (IIR). For performance tracking purposes, the Examination Notification Letter date is used as the examination start date. The Mortgage Examiner also collects various internal and external information related to the entity to identify risks. Upon receipt of a mortgage transaction log from the entity, as requested in the IIR, the Mortgage Examiner performs a review of loan originators to identify unlicensed activity, and selects a sample of closed and denied loan files. The Mortgage Examiner must select a minimum sample size, in accordance with the Manual; however, the sample size will be expanded, as applicable, to include high-risk loans; such as, wrap loans, and balloon payment loans.
- (2) **Examination** – The Mortgage Examiner reviews the entity’s policies and procedures, and other documentation, as requested in the IIR, to assess its system of compliance management; and, to determine their compliance with applicable state and federal requirements. The Mortgage Examiner also completes an Application Compliance Worksheet (ACW) for each loan file selected for an examination. The ACW workbook, which contains an ACW for each loan file examined, also includes summary tabs that are populated to reflect information entered into each individual ACW, which streamlines the reporting process. The Mortgage Examiner documents the examination results in a Summary of Preliminary Findings (FS) Form, a copy of which is provided to the Contact for the exit meeting. The Contact is requested to sign and return the FS Form to the Mortgage Examiner subsequent to the exit meeting. The workbook and templates used by Mortgage Examiners, along with the examination process overview, and other pertinent information, are published on SML’s website.
- (3) **Report of Examination (ROE)** – The Mortgage Examiner prepares a draft ROE and assigns a compliance rating of 1 to 5, with 1 representing the lowest level of concern, in accordance with the Examination Rating Policy, developed by the Area. The Examination Rating System was established to ensure consistent rating across examinations and adequate supervisory focus. Per the Area’s policy, Mortgage Examiners are expected to submit the draft ROE for review within 12 calendar days of the exit meeting date.

Mortgage Examiners submit a draft ROE to the Area’s designated email monitored by the Administrative Assistant. Upon receipt of a draft ROE, the Administrative Assistant enters applicable examination information to Semarca and proofreads the draft ROE for spelling and grammar, and for consistency with supporting work papers; such as, the number of loan files reviewed. Any edits made are tracked in a copy of the draft ROE, which is provided to the Chief Mortgage Examiner for review.

¹ Defined in the Texas Finance Code (TFC) Chapter 156 as an individual who is licensed under TFC Chapter 157 as an RMLO and designated by a residential mortgage loan company as the company’s representative.

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The Chief Mortgage Examiner reviews the edited draft ROE for quality, accuracy, and content, and makes additional changes, as appropriate. Upon completion of the Chief Mortgage Examiner's review, the ROE becomes final, and the Administrative Assistant submits an electronic copy to the Contact. Serious noncompliance, as identified in SML's Penalty Matrix, is referred to the Legal & Enforcement Department for possible enforcement actions.

If an examination results in a 3-, 4-, or 5-rating, a signed, written response is requested from the entity, to be received within 30 days of the ROE issuance date. The Review Examiner is responsible for monitoring and reviewing written responses.

Documentation obtained or prepared as part of the examination and ROE, is retained electronically in the ApplicationXtender, a document imaging and management system, for the duration of the retention period. Examination information is confidential and may be disclosed to other regulatory agencies only under specific conditions, as described in the Area's Information Sharing Policy.

During the period from September 1, 2022 to April 30, 2023, the Area issued 280 ROEs, covering 4,854 RMLOs, with the following ratings:

Examination Rating	Number of ROEs
1	21
2	109
3	132
4	16
5	2
Total	280

Of the 280 examinations performed, 275 (98.2%) were initiated within established timeframes, which reflects that the Area is on track to meet the established 90% annual performance goal.

Mortgage Examiner Training

Mortgage Examiners are required to obtain, on an annual basis, the following training hours, in accordance with SML's policy:

- Chief Mortgage Examiner & Review Examiner — 80 hours
- Mortgage Examiners — 60 hours

Requirements may be met by any combination of available training; including, agencywide mandatory training (cybersecurity, sexual harassment, etc.), external or inhouse technical training, and attendance at job-related conferences. Training records are maintained by the Human Resources department, and reviewed by the Chief Mortgage Examiner.

AUDIT OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The objective of our audit was to determine whether SML's policies and procedures and internal controls in place over the Mortgage Examinations Area (the Area) are effective to enforce and administer applicable state and federal laws and regulations of the entities it regulates.

Scope

The scope of this audit was to review and/or test the Area's selected functions performed, for the 8-month period from September 1, 2022 through April 30, 2023 (audit period).

Methodology

The audit methodology included a review of applicable laws and regulations, SML's established policies and procedures, and other internal and external documentation; and, remote interviews with selected SML employees.

We obtained and/or reviewed the following internal and external documentation:

- a. Organizational chart of the Area.
- b. Sections of the Texas Finance Code and the Texas Administrative Code applicable to the Area.
- c. Mortgage Examination Policies and Procedures Manual; and, Training Policy.
- d. Sample internal reports utilized by the Area for monitoring examination frequency, and examiner assignment.
- e. Examination tools and templates (ACW, Summary of Preliminary Findings, ROE, etc.) utilized by Mortgage Examiners.
- f. Listing of ROEs issued during the audit period.
- g. Applicable performance measure definitions, goals, and Finance Commission reporting.
- h. Semarca Examination/Examination Note tables user rights listing.
- i. FY23 training records for the Area.

We performed various procedures to achieve the objective of our audit; to include, the following:

1. Reviewed and obtained an understanding of the laws and regulations provided in the Texas Finance Code and Texas Administrative Code, as applicable to the Area.
2. Obtained and reviewed the Area's written policies and procedures, collected other available documentation, and conducted virtual interviews, to obtain an understanding of controls, processes, and current practices in place over the Area. Then, evaluated whether such controls adequately ensure compliance with applicable requirements identified in procedure 1 above.

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3. Obtained a listing of 280 ROEs issued by the Area during the period from September 1, 2022 to April 30, 2023, and selected 21 to test for the following attributes:
 - a. The Examination Notification and the Information Request (and the Mortgage Compliance Guide if a residential mortgage loan company) were sent to the Contact prior to the examination, as required by the applicable TAC rule.
 - b. The minimum number of closed and denied loan files were reviewed, as provided in the Loan Sample Chart included in the Manual.
 - c. All required examination documentation, as listed in the Exam Timeline Checklist, were included in the examination file.
 - d. All fields in the ACW were completed for all loan files selected.
 - e. All fields in the Summary of Preliminary Findings were completed.
 - f. The Summary of Preliminary Findings was signed by the Examiner and the Contact.
 - g. The weaknesses identified in the ACW and the Summary of Preliminary Findings were included in the ROE and its cover letter.
 - h. The assigned ROE rating, as supported by the ACW and the Summary of Preliminary Findings, is consistent with the department's Examination Rating Policy.
 - i. A draft ROE was prepared within 12 days of the Exit date.
 - j. If a 3, 4, or 5 rating —
 - i. a signed, written response was requested in the ROE cover letter, and received within 30 days of the ROE issuance date; and,
 - ii. the entity's response(s), including evidence of payment, were obtained; or, follow-up was performed for instances of non-response.
 - k. The examination information was accurately entered into Semarca.
 - l. The examination was initiated timely, in accordance with the Report of Examination Timing Policy.
4. Obtained the following performance measures reporting for Q1 and Q2, FY23, as presented to the Finance Commission, and agreed the reported numbers to the supporting documentation:
 - a. Number of examination reports issued (key)
 - b. Number of licensees examined (non-key)
5. Reviewed the calculation methodology for the Area's new annual performance measures, *Percentage of examinations initiated within the established timeframes*.
6. Obtained training records for all Mortgage Examiners (excluding those hired during FY23) for fiscal year 2023 as of May 16, 2023, to verify that the required amount of training was completed or planned.
7. Compared the user rights report for Semarca Examination/Examination Notes tables to the organizational charts to verify that the access is restricted to only the individuals who require access to perform their respective job duties.

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VI. Observations/Findings and Recommendations**SUMMARY and RELATED RATING of OBSERVATIONS/FINDINGS and RECOMMENDATIONS**

As SML's internal auditors, we used our professional judgment in rating the audit observations identified in this report. The rating system used was developed by the Texas State Auditor's Office and is based on the degree of risk or effect of the findings in relation to the audit objective(s). The table below presents a summary of the finding and observations in this report and the related rating.

Summary of Observations/Findings & Recommendations and Related Ratings		
Finding No.	Title	Rating
1	Examination Files Testing	Low
Observation No.	Title	Rating
—	None.	—
<u>Description of Rating</u> A finding is rated <i>Priority</i> if the issues identified present risks or effects that if not addressed could <u>critically affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern(s) and reduce risks to the audited entity. A finding is rated <i>High</i> if the issues identified present risks or effects that if not addressed could <u>substantially affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity. A finding is rated <i>Medium</i> if the issues identified present risks or effects that if not addressed could <u>moderately affect</u> the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level. A finding is rated <i>Low</i> if the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(s) audited <u>or</u> the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.		

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OBSERVATIONS/FINDINGS and RECOMMENDATIONS

Report No.	Report Date	Name of Report	Observations/Findings and Recommendations	Fiscal Impact/Other Impact
1	6/9/23	Mortgage Examinations	<p>1. Examination Files Testing</p> <p>Our testing of 21 examination files disclosed the following instances of non-compliance with the Area’s established policies and procedures:</p> <ul style="list-style-type: none"> a. In 3 instances, the “Selection” transaction log was not retained in the examination folder, as required by the “Deliver Loan File Procedure” in the Manual. b. The Loan Sample Chart in the Manual provides the minimum sample size to be reviewed for denied loans. In 5 instances, the minimum sample size was not followed; and, in 3 other instances, we were unable to determine if the minimum sample size was selected, since the transaction logs did not include the loan status information. <p>Recommendation We recommend that training be provided to Mortgage Examiners to enforce the importance of compliance with established policies and procedures; and, to ensure all required procedures are consistently performed.</p> <p>Management’s Response The Department agrees with the recommendation. On June 14, 2023, during the monthly Mortgage Examiner meeting, the Mortgage Examiners were instructed on the importance of: (1) maintaining adequate workpapers including the “Selection” transaction log (the written record selecting the sample size); and (2) reviewing, at least, the minimum sample size for an examination including denied loans. Additionally, to reinforce these requirements, additional training will be provided to the Mortgage Examiners during the annual Examiner meeting. The meeting will reinforce the Mortgage Examination policies and procedures for examinations including maintaining adequate records to reflect the “selected” sample size and that the minimum sample size is reviewed. The post-examination quality control processes will be updated to ensure compliance.</p>	To ensure compliance with established policies and procedures.

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Report No.	Report Date	Name of Report	Observations/Findings and Recommendations	Status (Fully Implemented, Substantially Implemented, Incomplete/Ongoing, or Not Implemented) with explanation if not yet fully implemented
1	6/9/23	2023 Follow-Up	<p><u>Follow-Up of the Prior Year Internal Audit</u></p> <p>Following is the status of the recommendations made during fiscal year 2022 that had not been fully implemented.</p> <p><u>Legal & Enforcement (Report date 5/24/2022)</u></p> <p>1. Written Policies and Procedures (Observation) The Area should set a date as a goal for completing its P&P update to ensure comprehensive and current P&P are available for staff to refer to when performing their assigned functions.</p> <p>2. Quality Control (Observation) SML should assess the existing quality control processes and identify areas that can be enhanced.</p>	<p>Fully Implemented</p> <p>Fully Implemented</p>

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VII. External Audit Services Procured in Fiscal Year 2023

SML procured the internal audit services documented in the approved Internal Audit Plan for fiscal year 2023. No other external audit services were performed.

VIII. Reporting Suspected Fraud and Abuse

SML has provided information on their website homepage on how to report suspected fraud, waste, and abuse to the State Auditor's Office (SAO) by posting a link to the SAO's fraud hotline. SML has also developed a Fraud Prevention Policy that provides information on how to report suspected fraud, waste, and abuse to the SAO.

IX. Proposed Internal Audit Plan for Fiscal Year 2024

The risk assessment performed during fiscal year 2023 was used to identify the following *proposed* area that is recommended for internal audit and other tasks to be performed for fiscal year 2024. The Internal Audit Plan for Fiscal Year 2024 will be developed and presented to the Audit Committee and Finance Commission, for acceptance and approval, at a meeting to be determined at a later date.

- Thrift Examinations Audit
- Follow-up of Prior Year Internal Audits
- Other Tasks Assigned by the Finance Commission

ATTACHMENT

DEPARTMENT OF SAVINGS AND MORTGAGE LENDING
History of Areas Audited
For Fiscal Year 2023

	POTENTIAL AUDIT TOPIC	Fiscal Year Audited/Reviewed										
		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
1	Consumer Protection		A			B*	D					
2	Financial Reporting (Includes Asset Management & Travel)		E*			B	D*/E*					
3	Legal and Enforcement					B	D				A	
4	Management Information Systems [(MIS) Includes Disaster Recovery Plan] ¹				A	B*	C/D*	A1*		C		C
5	Mortgage Examinations			A		B*	D			G*		A
6	Mortgage Licensing and Registration					B*	D			G*		
7	Payroll and Human Resources	F*	E*				E*	F*				
8	Procurement/Contract Management/HUB		E*			B	D*/E*			A		
9	Records Management								A			
10	Revenue Accounting Process					B	D*					
11	Thrift Examinations					A	D					
12	Thrift Supervision and Compliance	A				B*	A/D					

¹ Quarterly vulnerability scans are performed by the DIR or a third-party procured through the DIR, which are considered standardized reviews and therefore not reflected in this schedule by year.

Note: Performance Measures is included in the scope of the applicable audit area(s).

Legend (audits/reviews with asterisk are considered limited scope for the audit area)

- A** Internal audit performed by Garza/Gonzalez & Associates, CPAs.
- A1** Internal audit performed by McConnell & Jones LLP.
- B** Audit performed by the State Auditor's Office (SAO).
- C** IT assessment performed by the Department of Information Resources (DIR) or a third-party vendor procured through the DIR.
- D** Sunset Review performed by the Sunset Advisory Commission.
- E** Post Payment Audit performed by the Comptroller of Public Accounts.
- F** Review performed by the Texas Workforce Commission.
- G** Review performed by the Department of Public Safety.