

PERFORMANCE AUDIT

# REGISTRAR OF CONTRACTORS

A Report to the Arizona Legislature  
By the Auditor General  
August 1984  
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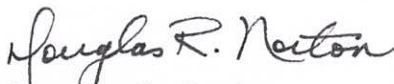
Members of the Arizona Legislature  
The Honorable Bruce Babbitt, Governor  
Mr. David M. Talamante  
Registrar of Contractors

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Registrar of Contractors. This report is in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. The performance audit was conducted as a part of the Sunset Review set forth in A.R.S. §§41-2351 through 41-2379.

The blue pages present a summary of the report; a response from the Registrar of Contractors is found on the yellow pages.

My staff and I will be pleased to discuss or clarify items in the report.

Respectfully submitted,



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Enclosure

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## INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Registrar of Contractors (ROC) in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

### History of Contractor Regulation

Contractor regulation in the United States has developed from simple building laws early in this country's history to the various requirements now found in every state. As early as 1625 the first building law was adopted in America. By the end of the 19th century various entities were developing standards for the construction industry. The first model building codes were developed in 1905 by the National Board of Fire Underwriters. Today, trade specialty codes are used by local jurisdictions as standards for workmanship and safety. Other forms of regulation include zoning, building permits and field inspections. Moreover, some states have found it necessary to find additional ways to protect the consumer from incompetent contractors. According to Hawaii's Sunset Evaluation Report, 21 states require licensure of contractors, usually through a state board or commission. Other states have left this responsibility completely to local jurisdictions.

### Regulation of Contractors in Arizona

The Arizona Registrar of Contractors was established by the Legislature in 1931. In 1981, following the 1979 Auditor General Sunset Review and the 1981 Contractors' Regulatory Study Commission analysis, the Legislature instituted major changes. The 1981 legislation deregulated commercial contractors and established a contractors' recovery fund. Changes involving classification, entry requirements, examinations and the hearing process were also instituted.

The Registrar of Contractors has the primary responsibility for regulating all residential construction contractors in the state. The Registrar, who is appointed by the Governor, oversees all day-to-day operations of the Agency. The duties of the Agency include evaluating applications for examination and licensure, administering examinations, annually reviewing licenses, investigating consumer complaints lodged against licensed and unlicensed contractors, conducting administrative hearings, promulgating rules and regulations, and administering the recovery fund. Table 1 shows a summary of examinations and licenses issued by the ROC for the last 3 years and expected licensing activity for 1983-84 and 1984-85.

TABLE 1  
ACTIVITY FOR  
REGISTRAR OF CONTRACTORS  
FISCAL YEARS 1980-81 THROUGH 1984-85

	<u>FY 1980-81</u>	<u>FY 1981-82</u> (1)	<u>FY 1982-83</u>	<u>FY 1983-84 Estimated</u>	<u>FY 1984-85 Estimated</u>
Applicants for Examinations	4,359	2,650	2,987	3,100	3,500
Licenses:					
Issued	2,439	1,656	1,744	1,875	1,976
Renewed	12,770	10,688	15,240	5,900 (2)	11,000 (2)
Complaints Received					
Licensed	3,906	3,247	2,982	3,928	3,500
Unlicensed	1,288	2,696	2,560	3,300	3,000
Cease and Desist Orders Served	546	1,389	1,350	1,824	1,600
Hearings	1,211	557	514	575	620

(1) Deregulation of commercial contractors became effective in fiscal year 1981-82.

(2) License renewal was staggered beginning in fiscal year 1983-84.

Source: Registrar of Contractors' budget request for fiscal year 1984-85

## Budget and Personnel

The ROC's operating budget is appropriated from the general fund. Table 2 provides budget information for 1980-81, 1981-82, and 1982-83, and estimated figures for fiscal year 1983-84.

TABLE 2  
AGENCY EXPENDITURES (ACTUAL OR APPROVED)  
FISCAL YEARS 1980-81 THROUGH 1983-84

	<u>Actual 1980-81</u>	<u>Actual 1981-82</u>	<u>Actual 1982-83</u>	<u>Approved 1983-84</u>
Full-time employees	74.7	72.7	70.0	70.0
Expenditures:				
Personal services	\$1,133,200	\$1,173,800	\$1,148,900	\$1,290,900
Employee related	224,600	242,200	248,700	292,100
Professional services	61,300	50,300	14,500	11,000
Travel -				
In state	88,700	123,400	51,100	50,000
Out of state	1,500	2,400	1,600	-0-
Other operating	238,100	245,400	185,600	220,000
Equipment	<u>32,300</u>	<u>6,000</u>	<u>2,700</u>	<u>-0-</u>
Total				
Expenditures	<u>\$1,779,700</u>	<u>\$1,843,500</u>	<u>\$1,653,100</u>	<u>\$1,864,000</u>

Source: Compiled by Auditor General staff from Joint Legislative Budget Committee Appropriations Report and Registrar of Contractors' budget requests.

The Agency collects fees for licenses and license renewals. These receipts are deposited into the general fund. The ROC, unlike most regulatory agencies, does not have its own special fund. In addition, contractor cash deposit bonds are held by the State Treasurer for distribution. Table 3 shows the current fees charged by the Agency.



TABLE 3  
CURRENT FEES CHARGED BY THE  
REGISTRAR OF CONTRACTORS

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New license and examination fee	\$135 specialty contractor 210 general contractor
Examination retake	20
Staggered renewal	85 specialty contractor 110 general contractor
Recovery fund (initial fee)	75
Business management book	5
Name change fee	15
Change of qualifying party	50
Solar certification	25
Certifications	3
Inactive status	50
Posting list	1

Source: Registrar of Contractors

The ROC has 70 budgeted positions for fiscal year 1984. Most of its staff are assigned to the Licensing and Compliance Departments.

The Agency's central office is located in Phoenix within the capitol complex. In addition, the ROC maintains six field offices, in Tucson, Flagstaff, Prescott, Lake Havasu City, Yuma and Lakeside. Except for Tucson, field offices are staffed by one individual whose duties focus primarily on licensed complaint investigations and unlicensed activity. Tucson has ten employees and performs all ROC activities.

### Audit Scope and Purpose

The purpose of our review of the Registrar of Contractors was to address the 12 Sunset Factors set forth in A.R.S. §41-2354 and to evaluate the effectiveness of the Agency. Specifically, we examined:

- whether the current level of regulation of contractors is appropriate;
- the extent to which the ROC has been able to effectively enforce statutes and standards governing the contracting industry;
- whether contractor bonding is necessary;
- the extent to which the Agency's EDP system is effectively and efficiently utilized; and
- whether unlicensed contractor enforcement could be strengthened.

The Auditor General and staff express appreciation to the Registrar of Contractors and staff for their cooperation and assistance during the course of our audit.

## SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2354, the Legislature should consider the following 12 factors in determining whether the Arizona Registrar of Contractors (ROC) should be continued or terminated.

1. Objective and purpose in establishing the Agency

The objective and purpose in establishing the Arizona Registrar of Contractors is to protect the public health, safety and welfare. The Legislature stated this intent in the laws of 1981:

"It is the purpose and intent of the legislature to continue the registrar of contractors agency in order to protect the public health, safety and welfare by providing for the continued licensing, bonding and regulation of contractors engaged in residential construction."

To protect public health, safety and welfare, the ROC classifies and qualifies applicants for licensure, investigates complaints against licensed contractors and enforces against construction by unlicensed contractors. In addition, the ROC is responsible for administering the contractors' recovery fund.

2. The effectiveness with which the Agency has met its objective and purpose and the efficiency with which it has operated

The Agency has generally been effective in meeting its stated objective and purpose. However, improvements are needed. The ROC has not aggressively disciplined licensed contractors violating statutory provisions. Consequently, it has not deterred some contractors from repeating statutory violations numerous times. In addition, complaint history data is not effectively utilized and a full range of sanctions is not available to the Registrar (see page 28).

The ROC needs to improve management of its electronic data processing system. Our review disclosed weaknesses in: 1) planning, 2) utilization, 3) internal controls, 4) documentation of procedures, and 5) training (see page 41).

3. The extent to which the Agency has operated within the public interest

The Agency operates within the public interest by ensuring that licensed contractors in Arizona meet minimum standards. In addition, the ROC investigates and resolves complaints against licensed contractors and enforces against construction by unlicensed contractors. However, because the ROC has not aggressively disciplined contractors repeatedly violating statutory provisions, future consumers could be harmed (see page 27).

4. The extent to which rules and regulations promulgated by the Agency are consistent with the legislative mandate

The ROC initiated substantial changes to its rules and regulations based on the statutory changes resulting from the 1979 Auditor General Sunset Review and 1980 Contractors' Regulatory Study Commission findings and recommendations. The rule changes reflect the deregulation of commercial, industrial and public works construction. The changes include modifications to scope of practice, consolidation of some license titles, and changes to various other requirements. The rules and regulations were reviewed by the Attorney General to ensure legality.

5. The extent to which the Agency has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public

The Agency has fulfilled requirements for public notice of Agency actions and changes in rules and regulations. When rules were changed in 1983, public hearings were held in Tucson and Phoenix. The ROC

also sends copies of proposed rules changes to those trade associations or contractors requesting such information.

6. The extent to which the Agency has been able to investigate and resolve complaints that are within its jurisdiction

The Agency investigates complaints against both licensed and unlicensed contractors. If necessary, the Agency's administrative hearing officers adjudicate complaints against licensed contractors. Complaints against unlicensed contractors are adjudicated by the courts.

The ROC has not aggressively disciplined contractors violating statutory provisions. Consequently, it has not deterred some contractors from numerous repetitions of statutory violations. In addition, complaint history data is not effectively utilized (see page 28) and a full range of sanctions is not available to the Registrar (see page 30). The ROC also investigates complaints against unlicensed contractors and can issue cease and desist orders or citations to those individuals.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation

The ROC has full authority to enforce its enabling statutes. A.R.S. §32-1166.A directs the Attorney General or county attorney to represent the Agency in all legal actions. The same statute authorizes the Agency to seek injunctive relief against statute violators. A.R.S. §32-1164 makes certain violations of the enabling statutes class 1 misdemeanors.

8. The extent to which the Agency has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate

The ROC has been active in submitting legislation to increase its effectiveness. Since 1981, the ROC has submitted several successful legislative proposals relating to revocation or suspension of a contractor's license, minimum fines for violations of ROC statutes, increased recovery fund payment limits and payment of attorney's fees, and other changes regarding licensing, bonding and disciplinary actions.

In 1984 the ROC made an unsuccessful attempt to establish its own fund and increase its fees.

9. The extent to which changes are necessary in the laws of the Agency to adequately comply with the factors listed in the Sunset laws

Based on our audit work, we recommend the Legislature consider the following changes to the Registrar of Contractors' statutes:

- Amend the statutes relating to licensing of contractors to require licensure of only health- and safety-related trades and to institute a registration system for all other trades.
- Eliminate examinations and entry requirements for all but health- and safety-related trades.
- Authorize the Registrar of Contractors to impose civil penalties against contractors in violation of statutory provisions of A.R.S. §32-1154.
- Eliminate A.R.S. §32-1152 as it relates to bonding.

10. The extent to which the termination of the Agency would significantly harm the public health, safety or welfare

Termination of the Registrar of Contractors would eliminate the Agency's complaint resolution process, which generally affords the consumer an inexpensive, timely forum to resolve problems with contractors. The ROC, through its administrative hearings, has the power to suspend or revoke a contractor's license if the contractor is found in violation of the statutes. In addition, continued licensure for the health- and safety-related trades ensures some competency in those trade areas.

Termination of the Registrar of Contractors would also eliminate the contractors' recovery fund. The recovery fund provides financial restitution to consumers harmed by licensed contractors.

11. The extent to which the level of regulation exercised by the Agency is appropriate and whether less or more stringent levels of regulation would be appropriate

We recommend changes in the ROC's level of regulation in two areas. First, because licensure is not necessary for most trades, the Registrar of Contractors' level of regulation could be reduced. Some regulation is necessary in Arizona. However, the low potential for harm caused by contractors indicates registration rather than licensure for most trades would offer sufficient consumer protection. In addition, a registration system may provide more consumers the protection offered by the Registrar of Contractors' processes and the recovery fund.

Secondly, the statutory bonding requirement for contractors is unnecessary and could be eliminated. Bonding provides little consumer restitution while unnecessarily restricting entry into the construction industry. Both the Agency and contractors would realize considerable savings if this requirement were dropped.

12. The extent to which the Agency has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished

The ROC said it has used private contractors as needed to assist in the performance of its duties. Private contractors have analyzed the bonding program, revised the license application form and business management book, done laboratory analyses, and typed transcripts for the Agency. In addition, the ROC has retained private attorneys as administrative hearing officers on a temporary basis. The initial EDP programming for the ROC's computer system was also done by a private contractor.



## FINDING I

### THE REGISTRAR OF CONTRACTORS' LEVEL OF REGULATION COULD BE REDUCED

Because licensure is not necessary for most trades, the Registrar of Contractors' (ROC) level of regulation could be reduced. Some regulation is necessary in Arizona. However, the low potential for harm caused by the construction industry indicates registration rather than licensure for most trades would offer sufficient consumer protection. In addition, a registration system would provide more consumers the protection offered by the Registrar of Contractors' processes and the recovery fund.

#### Current Regulation

Arizona Revised Statutes (A.R.S.) require licensure of all contractors working on residential structures. To obtain a license a contractor must pass both a business and trade examination, if required, have the requisite experience, procure a contractor's license bond, and pay the license fee and initial recovery fund assessment. Before 1981 the statutes also required commercial contractors to be licensed. However, that year the Legislature deregulated commercial contracting, concluding that commercial regulation was not necessary for the protection of the public health, safety and welfare.

#### Some Regulation Is Necessary

Some regulation of contractors is needed in Arizona. Licensure is necessary for trades directly affecting health and safety. However, licensure is not necessary for other trades.

CSG Criteria - The Council of State Governments (CSG) has established criteria for determining the proper level of industry regulation. According to CSG, state regulation of an occupation or profession is justified if the unregulated practice of that occupation could cause

significant harm to public health, safety or welfare. To assess the potential for harm, the Council of State Governments, in its publication Occupational Licensing: Questions a Legislator Should Ask, has formulated three questions that should be addressed. These questions are:

1. Whether the unlicensed practice poses a serious risk to the consumer's life, health and safety or economic well-being;
2. Whether users of the service can be expected to possess the knowledge needed to properly evaluate the qualifications of those offering services; and
3. Whether licensing benefits to the public clearly outweigh any potential harmful effects such as the price for services or availability of service providers.

In evaluating the risk to the public, both the seriousness of potential harm and the probability that such harm would actually occur should be considered. The potential for public harm must outweigh the possible negative effects of licensure. A less restrictive level of regulation, such as registration, is appropriate if there is no significant potential for public harm and if consumers have the knowledge and ability to protect themselves through other means.

Licensure of Health and Safety Trades - The state should retain licensure requirements for those construction trades with potential for serious public harm. These health and safety trade areas include electrical, plumbing and mechanics, including heating, air conditioning and refrigeration contractors.

Other states' sunset reviews noted the potential for serious public harm that could be caused by any of these health- and safety-related trades. A North Carolina review of its Examiners of Electrical Contractors' Board concluded that "the total absence of regulation in electrical contracting would endanger the public health, safety and welfare." Plumbers may also affect the health, safety and welfare of the public. Plumbers work directly with home water and sewer lines. A Utah audit report stated that contamination could easily occur if work was not done properly.

An Auditor General survey of the 50 states found that 29 states licensed one or more of the health- and safety-related trades we identified. Some states that do not license contractors at the state level still regulate these trades through individual state boards for each trade or by giving local jurisdictions regulation authority.

Some Regulation Necessary For Other Trades - Some regulation of other trades is necessary for two reasons. First, contractors can potentially cause major financial harm. Without regulation, consumers would not have the restitution processes available to them through the ROC's complaint resolution process and the contractors' recovery fund. Second, unlike many states, Arizona does not place any regulatory powers at the local level except building code standards enforcement.

Low Potential For Harm  
Indicates Registration Sufficient

The low potential for harm to public health and safety indicates that a registration system of regulation would be sufficient for most trades. Many other states have less contractor regulation than Arizona. Our analysis of the ROC's consumer complaints showed financial harm, not public health and safety, is the primary problem. Because of the low potential for harm, entry requirements are unnecessary.

Registration/Licensure Differences - The basic distinctions between registration and licensure involve prerequisites and prequalifications. Under a registration system, any person desiring to engage in an occupation may do so upon paying a registration fee, but there are no prerequisites or prequalifications. In contrast, a licensure system may require a demonstration of competency by means of an examination, and fulfillment of specified education and experience requirements. Under a registration system it is still unlawful to practice without being registered. The following table highlights the distinctions between registration and licensure.

TABLE 4  
DIFFERENCES BETWEEN  
REGISTRATION AND LICENSURE

	<u>Registration</u>	<u>Licensure</u>
1. Fee required	Yes	Yes
2. Experience requirement	No	Yes
3. Examination	No	In some cases
4. Financial protection for consumer*	Yes	Yes
5. State may revoke or suspend those who violate standards of practice	Yes	Yes

\* We recommend the elimination of the contractor bond requirement, making the recovery fund the primary means of consumer financial protection (see Finding III, page 33).

Most States Have Less Regulation Than Arizona - Most states either do not regulate contractors at all or just regulate health- and safety-related trades. Consumers in those states use other methods to resolve problems with contractors. Only 20 states license or register most contractor trades. Three states, Washington, Oregon and Alaska, use a registration system to regulate contractors. Twelve states license only specific contractors who could be harmful to public health and safety, such as electricians and plumbers. The remaining states have no licensing requirements at the state level. However, some local jurisdictions in these states regulate electricians and plumbers.

Consumers in states not licensing any or most contractors can use other methods to resolve problems with contractors. Consumers in these states can appeal to the Attorney General Consumer Fraud Division, the Better Business Bureau or a consumer affairs office, the courts, local building departments, bonding companies, police, local licensing or industry boards, and their city council to resolve contractor complaints.

Complaints Indicate Financial Harm, Not Health and Safety, is the Primary Problem - Our analysis of the ROC's complaints indicates financial harm, not public health and safety, is the primary problem consumers experience with contractors. An Auditor General analysis of complaints against contractors indicates residential contractors pose little harm to public health and safety. We sampled 672 complaints (319 complaints against unlicensed contractors and 353 against licensed contractors) for fiscal year 1982-83 and found only one related to health and safety.\* Also, most complaints (54 percent) were not related to contractor performance. These complaints concerned advertising, monetary disputes and other matters. The following table indexes the complaints in relationship to seriousness.

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\* Unlicensed cases included both consumer complaints and investigative actions initiated by the Registrar of Contractors.

TABLE 5  
SAMPLE RESULTS OF COMPLAINTS AGAINST CONTRACTORS  
INDEXED AS TO SERIOUSNESS

		<u>Licensed</u>	<u>Unlicensed</u>
Poor Workmanship/ Financial Harm	Work of substandard quality	230	27
Aesthetics	Work of standard or better than standard quality but customer is dissatisfied with the results	31	14
Health and Safety	The work resulted in a dangerous situation for the consumer or general public	0	1
Contracting without a license		N/A	140
Advertising without a license		N/A	113
Other		<u>92</u> <sup>(1)</sup>	<u>24</u> <sup>(2)</sup>
Total		<u>353</u>	<u>319</u>

Source: Auditor General analysis of sample complaints against licensed and unlicensed contractors for fiscal year 1982-83. Total complaints received during the period was 5,542.

- (1) Miscellaneous complaints against licensed contractors include failure to pay subcontractors, 2-year statute of limitations, commercial complaints, monetary disputes, and incomplete information.
- (2) Miscellaneous complaints against unlicensed contractors include monetary disagreements and unfair competition allegations.

Consumers can suffer financial harm because of poor workmanship by contractors. Consumers may suffer from such things as failure by the contractor to do the agreed upon work, shoddy but safe workmanship, aesthetically inferior materials, and delay or failure to complete a project. The following examples from our survey of complaints illustrate the financial harm consumers may suffer from contractors.

#### Case One

A consumer paid \$1,729 to have awnings installed. The awnings leaked. The contractor went bankrupt. The consumer filed in court and was awarded a recovery fund payment of \$503.50.

#### Case Two

A contractor replaced grass with gravel and grass grew through the gravel. The contractor resolved the problem by redoing the work.

#### Case Three

A consumer paid \$2,210 to have insulated coating installed. The coating chipped, flaked and peeled. The contractor repaired the work.

#### Case Four

A contractor installed wallpaper. The wallpaper was wrinkled and the seams did not match. The contractor redid the work to the consumer's satisfaction.

#### Case Five

A contractor installed stucco siding. The siding cracked and fell off. In this case, the contractor did not respond to an ROC citation or repair the substandard work. The contractor's license was later revoked.

Entry Requirements Unnecessary - Because of the low potential for public harm, entry requirements such as examinations and experience are unnecessary. The 1979 Auditor General Sunset Review of the ROC recommended the elimination of the examination requirements. In addition, consumers have some ability and knowledge to protect themselves against incompetent contractors.

Entry requirements are necessary when there is a significant potential for immediate, irreparable public harm, such as in the medical profession. Practitioner screening and entry requirements protect against immediate danger to public health and safety that could be caused by professions with a high risk for public harm. However, most contracting cannot seriously endanger the public health and safety.

The 1979 Auditor General Sunset Review of the Registrar of Contractors recommended the elimination of trade examinations. Our 1979 Sunset Review found that examinations did not evaluate the applicants' knowledge, competency, and technical skill in contracting. In addition, the report found no correlation between applicants' success in passing trade examinations and subsequent success or failure in the contracting industry. Finally, even if examinations were effective in screening applicants, the low potential for serious public harm in most trades does not justify the imposition of strict prequalifications.

In recent years, the Registrar has reduced the number of trades subject to unnecessary examination and experience requirements. A.R.S. §32-1122.A.4 allows the Registrar to eliminate examination requirements for trades not significantly impacting public health and safety. In addition, A.R.S. §32-1122.E.1 permits the Registrar to reduce the 4 year experience requirement if the Registrar considers it excessive. Since 1980, the agency has reduced the number of license classifications from 618 to approximately 113, and now requires exams for only 30 of the trades that it currently regulates. All 113 trades, however, have some experience requirement ranging up to 4 years.

Although the statutes allow the Registrar to reduce entry requirements, the Agency is not required to do so. Thus, many trades that do not impact public health and safety continue to be subject to unnecessary entry requirements.



Since most contracting has the potential for financial harm rather than health and safety-related harm, consumers have some ability to protect themselves.

- Consumers can evaluate qualifications before hiring a contractor to perform work. References can be checked, previous customers can be contacted, and the contractor's work on prior jobs could be inspected. Consumers can also obtain complaint history information from the Registrar of Contractors or the Better Business Bureau. In most cases, a consumer would have ample time to check qualifications before engaging a contractor.
- Unlike consumers of highly technical medical and other services, consumers have some proficiency to evaluate the quality of work performed by contractors. In some cases consumers can visually inspect work and note flaws and deficiencies that indicate substandard work.
- Finally, consumers have avenues for redress from financial harm caused by contractors. Consumers can appeal to the State Attorney General's Consumer Fraud Division or the local courts for recourse from contractors. In addition, consumers can receive monetary restitution from the contractors' recovery fund. The fund was established in 1981 to cover claims against contractors. After obtaining a court judgment against a licensed contractor, a consumer may receive up to \$15,000 from the recovery fund.

#### Registration May Provide More Consumers Protection

Registration, rather than licensure, may protect more consumers by possibly bringing more contractors into the Registrar of Contractors' complaint resolution process and the recovery fund.

Some contractors practice illegally because they are unable to meet licensure requirements. An Auditor General survey of 15 unlicensed contractors found that most remained unlicensed because of bonding and examination requirements.\*

Consumers using unlicensed contractors have little recourse except the courts to resolve problems with contractors. If more unlicensed contractors became registered, more consumers would have access to the Agency's two main consumer protection programs - the complaint resolution process and the recovery fund. The complaint resolution process affords consumers a quicker and less expensive alternative than a court case to resolve disputes with contractors. In addition, the Agency would have the power to affect the registration status of a contractor not complying with ROC statutes, rules and regulations.

#### CONCLUSION

Some regulation is still required because of potential financial harm to the consumer. However, the Registrar of Contractors' level of regulation should be reduced for most trades because most contractors pose little harm to public health and safety. A less restrictive system could provide more consumer protection if it resulted in more unlicensed contractors becoming registered.

#### RECOMMENDATIONS

1. The Legislature should consider amending the statutes relating to the licensing of contractors to require licensure for only health- and safety-related trades and to institute a registration system for all other trades.
2. The Legislature should consider amending the statutes to eliminate examinations and entry requirements for all but health- and safety-related trades.

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\* We attempted to contact 319 unlicensed contractors identified in our sample of complaints against unlicensed contractors. However, many had their telephones disconnected or numbers changed, and others would not respond to our questions.

## FINDING II

### LICENSED CONTRACTOR ENFORCEMENT REQUIRES IMPROVEMENTS

The Registrar of Contractors (ROC) needs to strengthen and improve its enforcement of statutory provisions. Current enforcement of contractor standards and other practice requirements is weak and has not prevented some chronic offenders from repeating violations. In addition, complaint history data is not effectively utilized, and a full range of sanctions is not available to the Registrar.

#### Enforcement Authority

The Registrar's statutory purpose is to protect the public by regulating contractors engaged in residential construction. Arizona Revised Statutes (A.R.S.) §32-1104.A.4 states that the Registrar shall employ such personnel and provide such equipment and records necessary to enforce the statutory provisions governing contracting. In addition, A.R.S. §32-1154 states that the Registrar "shall upon the written complaint of any person, investigate the acts of any contractor within the state. . ." and may suspend or revoke the license of a contractor found guilty of committing an unlawful act. Examples of unlawful acts include poor workmanship, failure to complete work, failure to take corrective action, false advertising and failure to meet other practice or business requirements.

Complaints against licensed contractors are handled through the Registrar of Contractors' two-step complaint resolution process. The first step is investigation of the complaint. The second step is sending unresolved complaints to administrative hearings. Each complaint is assigned to an inspector who determines the validity of the complaint and recommends any corrective action to be taken by the contractor.

If this corrective action is not taken or the homeowner is not satisfied with the repairs, the homeowner can request a hearing. It is the Registrar's policy to require the hearing request to be made in writing. During the hearing it is the complainant's responsibility to present evidence demonstrating the contractor's violations. Once the proceedings are concluded, the presiding hearing officer issues a decision and order. This statement documents the officer's evaluation of the case and includes a recommendation for disposition. Either party may request a rehearing, and may appeal to the Superior Court if still not satisfied.

#### Enforcement Has Been Weak

The ROC has not aggressively disciplined contractors violating statutory provisions. Consequently, it has not deterred some contractors from repeating statutory violations numerous times.

In our analysis, we sampled 353 of the 2,982 complaints filed against licensed contractors in fiscal year 1982-83. Of these, 68 (19 percent) went to hearing, with decisions rendered on 64 cases. As of July 20, 1984, two cases were still pending. Thirty-nine percent of the cases going to hearing resulted in suspension or revocation of the contractors' license. However, six of the seven revocations occurred because the contractor failed to appear at the hearing. In 24 valid cases, sanctions did not go into effect because, according to the Registrar, the contractor repaired or completed the work. Fifteen of the 18 suspensions remained in effect until completion of the repair work or until payment was made to the complainant. The following table shows the breakdown of sanctions imposed against contractors.

TABLE 6  
DISPOSITION OF SAMPLED COMPLAINTS THAT WENT  
TO HEARING FOR FISCAL YEAR 1982-83

<u>Disposition</u>	<u>Number</u>	<u>Percent of Total</u>
Complaint withdrawn	5	8%
Not applicable	4	6
Closed	24	36
Probation	7	11
Probation until compliance	1	1
Suspension	3	5
Suspension until compliance	15	23
Revocation	1	1
Revocation - contractor did not appear	<u>6</u>	<u>9</u>
Total	<u>66</u>	<u>100%</u>

Our analysis also disclosed some contractors who had multiple complaints filed against them during this period. Two contractors with many complaints against them were selected for further study and their entire complaint histories were examined.

Case I

A small roofing contractor accumulated 63 complaints in 6 years. These 63 complaints were for poor workmanship or failure to complete work. Some of these complaints took up to 90 days to resolve, with three hearings lasting as long as 270 days. Fourteen of these cases went to hearing. Disciplinary action was taken in nine of these cases. Four of the other five hearing cases resulted from valid complaints in which the contractor had committed a clear statutory violation, but were closed with no disciplinary action taken against the contractor. One case was withdrawn.

The nine disciplinary actions taken included suspension or revocation of license and probation. This contractor's first probation was in 1980 and lasted 120 days. The second and third probations were overlapping and extended from October 1982 to May 1983. These were for 3 and 5 months, respectively. During the 7-month probationary

period 10 additional complaints were filed against this contractor. One complaint was filed during the 1 month of overlap while the contractor was serving two simultaneous probations. (The ROC provided no explanation for this overlap, except that hearing cases are usually treated independently.) Finally, in January 1984, the Registrar suspended this contractor's license for failure to post an additional \$2,000 bond. In March 1984 the Registrar revoked the contractor's license. Because this revocation was appealed, it did not take effect until July 30, 1984. While the revocation was pending this contractor had six additional hearings that resulted in the following actions:

1. A revocation because of default, which was reheard and changed to a 10-day suspension followed by a 90-day probation.
2. A 15-day suspension followed by a 75-day probation with another \$2,000 bond increase.
3. Dismissed, no punishment although a clear violation of statutes.
4. A 60-day probation.
5. A revocation for poor workmanship and wrongful acts.
6. A revocation by default.

#### Comment

Despite this contractor's lengthy pattern of poor workmanship his license was not suspended until January 1984. The fact that two of his probationary periods were overlapping indicates the ROC may not properly examine a contractor's complaint history before issuing a decision. While this contractor's complaint history spans 6 years and contains numerous cases that were drawn out by his refusal or reluctance to make repairs, this issue was only addressed in one of the most recent cases. The hearing decision stated that ". . . a contractor is not entitled to an endless succession of opportunities and an undeterminate time period in which to accomplish proper construction work." The Registrar has felt that it is better to allow a contractor to correct faulty workmanship than to impose harsher penalties.

The second case example describes a remodeling contractor who also had many complaints, almost half of which went to hearing.

#### Case II

This contractor had accumulated 29 complaints in 70 months. Nine of the 13 cases that went to hearing were deemed valid. However, the Registrar has taken action on only two of these cases. Although the Registrar had statutory authority to take action in the other seven cases, these were closed or dismissed because repair work had been done or settlement reached. The first action was a 30-day probation, from December 13, 1978 to January 13, 1979. The second action was a 15-day suspension followed by a 45-day probation, from April 21, 1979 to June 21, 1979. The suspension resulted from the first two complaints filed against the contractor.

#### Comment

The only disciplinary actions taken by the Registrar resulted from the first two valid cases. The other seven valid cases were resolved with no sanctions imposed.

Effect of Weak Enforcement - The weak enforcement of statutes combined with lenient hearing decisions causes several problems. Contractors who continuously violate statutes and are found guilty of poor workmanship and failure to complete work pose potential harm to the public. Future customers of the contractor are not protected from experiencing the same pattern of substandard work. Also, resources are not being effectively and efficiently utilized when the Registrar must process the complaints filed against chronic violators. If enforcement were strengthened, the Compliance and Hearing Departments could devote their resources to other problem contractors.

A primary cause of this weak enforcement is ROC's policy of mediating complaints rather than taking action against incompetent contractors. This does not provide incentive for the contractor to do competent work the first time because the complaint resolution process gives the

contractor numerous opportunities to make repairs. This policy could provide the contractor economic incentive to do shoddy work. If the work results in a complaint, then the contractor can make the necessary repairs without severe penalties. If the consumer does not file a complaint then the contractor may have saved labor and materials.

#### Complaint History Should be Utilized

Currently, the ROC does not adequately consider a contractor's record of prior violations before making enforcement decisions. According to the Registrar's rules, this is allowed but is seldom done. This information should be introduced as evidence in hearings and should be made readily available to the public.

The Registrar of Contractors' rule R 4-9-17 states in part that:

"In any disciplinary proceeding conducted by the Registrar, the licensee's entire license file including the record of prior citations and decisions may be considered by the Registrar in making his decision and order in the case before him, provided these records are introduced into evidence."

The ROC seldom uses this complaint history data because it feels it would be too time consuming to manually sort files and compile this information for each case. However, we found the data is readily available in the Agency files. Each case is considered independently except in instances in which a contractor has many hearings in a short time and the hearing officer is already aware that the contractor is a repeat violator.

Introduction of this data as hearing evidence may help strengthen enforcement of industry standards. Examination of the contractor's entire license file and record of citations and decisions should give the hearing officer a better understanding of the potential threat the contractor poses to the public. In this way, the decision and order can be issued accordingly.



This complaint history data should also be readily available to the public. According to the head of the Licensed Compliance Division, all contractor complaint information is open to the public, but is not easily obtainable. He said many people request information over the telephone, and the ROC Compliance Division secretaries attempt to compile brief summations of a contractor's complaint history. However, these requests are too numerous for the secretaries to provide much detail. Also, the secretaries are reluctant to divulge too much information because they do not have construction experience and are usually not familiar with the complaint circumstances. Consequently, they usually tell the people to come down to the office and examine the files themselves. This could be inconvenient for people living outside the Phoenix metropolitan area.

Computerization of the Compliance Division complaint case data would result in quick, efficient consumer access to the information. The secretaries would not have to spend time manually searching the files to answer consumer telephone information requests. Instead, this information could be compiled by computer and mailed to homeowners making telephone requests. The Oregon Division of Contractors mails contractor complaint data to homeowners who request this information. Oregon went to this system after receiving complaints from contractors that inaccurate information was being given out over the telephone. Providing consumers with computerized complaint history data would increase their awareness of a contractor's status and competence.

#### Civil Penalties Needed

The Registrar of Contractors does not have a full range of enforcement options. Current punishment options are limited to probation, bond increase, and suspension or revocation of license. Authority to impose civil penalties would provide an effective, intermediate sanction short of suspension or revocation of license.

Current punishment options are limited and not always used. The options available to the hearing officer are listed and described in the following table.

TABLE 7

REGISTRAR OF CONTRACTORS'  
CURRENT HEARING DECISION OPTIONS

<u>Decision</u>	<u>Description</u>
Dismissal	Lack of evidence, no basis for action, compliance or settlement
Probation	Monitor activity
Suspension	No work until repair or for a specified time, no work or bidding on new contracts
Revocation	License invalid unless appealed or until reapplication after 1 year
Bond increase (1)	In conjunction with other disciplinary actions

(1) This action should be authorized and allowed as a disciplinary option even if the statutory bonding requirement is eliminated (see Finding III, page 33.)

Civil penalties would be a viable sanction midway between probation and suspension in level of severity. Civil penalties would impact the contractor financially and not just affect the license status. Currently, only the courts can levy fines or monetary penalties against contractors. The Registrar does not have this statutory authority. The Arizona Veterinary Board and Structural Pest Control Board have the option to impose civil penalties. Other states' contractor regulatory agencies also have this option. California can fine contractors up to \$3,000 per offense, and Virginia can fine contractors up to \$1,000 per offense.

CONCLUSION

The Registrar of Contractors' complaint resolution process needs improvements to enhance consumer protection. The process has not deterred some contractors from repeating statutory violations.

## RECOMMENDATIONS

1. The Registrar of Contractors should take stricter enforcement actions against contractors with a history of numerous repeat violations.
2. The Registrar of Contractors should summarize and introduce contractors' case histories as evidence in administrative hearings.
3. The Registrar of Contractors should provide contractors' case history summaries to consumers.
4. The Legislature should empower the Registrar of Contractors to impose civil penalties against contractors in violation of statutory provisions of A.R.S. §32-1154.

### FINDING III

#### CONTRACTOR BONDING REQUIREMENTS COULD BE ELIMINATED

The statutory bonding requirement for contractors is unnecessary and could be eliminated. Bonding provides little consumer protection while unnecessarily restricting entry into the construction industry. Both the Registrar of Contractors (ROC) and contractors could realize significant savings if this requirement were dropped.

#### Statutory Bonding Requirements

Arizona Revised Statutes (A.R.S.) §32-1152 requires that licensed contractors maintain a bond between \$1,000 and \$15,000, depending upon the type of license issued and the projected work volume. Contractors may obtain bonds through a surety company, by depositing the required bond amount in cash with the State Treasurer, or by assigning a certificate of deposit, investment certificate or share account in the required amount to the Registrar of Contractors.

A contractor's bond is subject to claims by a variety of entities, including consumers, contractors and materials suppliers. According to A.R.S. §32-1152.E:

"The bonds or deposit required by subsection B of this section shall be for the benefit of and shall be subject to claims by the registrar of contractors for failure to pay any sum required pursuant to this chapter or by any person who, after entering into a construction contract involving a residential structure with the principal, is damaged by the failure of the principal to perform the contract or by any person furnishing labor, materials or construction equipment on a rental basis used in the direct performance of a construction contract involving a residential structure."

The statutes further state that the person seeking compensation through a bond or cash deposit must sue the surety company and the contractor if claiming against a surety bond or sue only the contractor if claiming against a cash deposit. The surety bond or cash deposit is subject to claims until it is exhausted. In addition, the court may award reasonable attorney fees in a judgment against a surety bond or cash deposit. Finally, the claimant must file suit within 2 years of the act or delivery of goods.

Before the inception of the contractors' recovery fund, a contractor's license bond was the only source of compensation for consumers for contractor malfeasance. The recovery fund was established in 1981 to provide consumers additional financial protection.

#### Bonding Provides Little Consumer Protection

Bonding has provided little consumer protection. In addition, a survey of several bonding companies and an analysis of Agency cash bond payments indicates that the construction industry, not the consumer, benefits most from bonding. The major beneficiaries of the bonding requirement do not need statutory protection. The recovery fund provides more consumer protection than bonding.

Analysis Found Little Benefit to Consumers - We surveyed several bonding companies and analyzed Agency cash bond payments and found that consumers receive little protection from bonding. According to the bonding companies surveyed, most claims against bonds are made by materials suppliers. Two bonding company representatives said that 80 percent of the claims against bonds were from suppliers for nonpayment for supplies and materials. All stated that very few claims were from homeowners.

We also analyzed cash bond payments, as was done for the 1979 Auditor General Sunset Review. As shown in Table 8, our analysis substantiated the 1979 finding that consumers receive only a small portion (19 percent) of the total payments.

TABLE 8

SUMMARY OF CASH BOND PAYMENTS MADE  
TO CONSUMERS AND OTHER GROUPS DURING  
FISCAL YEARS 1977-78 AND 1982-83

<u>1977-78</u>		<u>1982-83</u>	
<u>Group</u>	<u>Percentage of Cash Bond Payments Received</u>	<u>Group</u>	<u>Percentage of Cash Bond Payments Received</u>
Consumers	18.7%	Consumers	19.3%
Suppliers/Contractors	58.0	Contractors	12.6
Unions, Employees and Trustees	<u>23.3</u>	Suppliers	54.8
	<u>100.0%</u>	Bankruptcy Court	8.6
		Government	4.7
			<u>100.0%</u>

Consumers have received little restitution from bonds because suppliers and contractors also have access to the bonds and are usually in a better position to anticipate impending contractor difficulties. This was best summarized in our 1979 Auditor General Sunset Review of the Registrar of Contractors.

The 1979 Sunset Review of ROC concluded that:

- "1. The consumer, according to Registrar personnel, is generally the last to know that the contractor is in trouble. Those who have daily business dealings with the contractor, such as suppliers and other contractors, are in a better position to evaluate the impending insolvency and are the first to take action against the bond.
2. The consumer, unlike those who deal in the bonding process on a daily basis, will, in most cases, file a complaint with the Registrar. Unfortunately, by the time the complaint-filing consumer learns that monetary satisfaction will not be obtained through the complaint process, it is generally too late to file suit against the bond. . . ."

Suppliers and Contractors Do Not Require Protection - The major beneficiaries of the bonding requirement, materials suppliers and contractors, do not need statutory protection against contractor insolvency. Unlike consumers, suppliers and other contractors are sufficiently knowledgeable to protect themselves in business transactions with contractors. In addition, the other two states with recovery funds do not provide this protection to suppliers and contractors, nor does Arizona provide this protection in other professions.

Suppliers and other contractors are able to protect themselves without the statutory bonding requirement. They can utilize generally accepted credit practices and can also require bonds. Since 1981 when commercial contractors were deregulated, no bonding requirement has existed for the estimated 2,000 companies that were previously licensed. In addition, suppliers and contractors continue to do business with what is thought to be a large number of illegally unlicensed contractors - a group that has never been covered by the Registrar's bonding requirement.

The other two states with recovery funds do not have statutory provisions that provide financial protection for materials suppliers or other contractors. Neither Virginia nor Hawaii have contractor license bond requirements that provide supplier or other contractor protection. In addition, neither state allows suppliers or other contractors access to recovery funds. Virginia, however, does give local jurisdictions the option to require bonding. In addition, the Hawaii Contractors Board has discretionary authority to impose bonds for various reasons.

Other regulated professions in Arizona do not have bonding requirements that provide protection to suppliers or others within the profession. As in other business relationships, suppliers and other contractors can themselves institute the necessary procedures for financial protection.

Recovery Fund Provides Better Consumer Protection - The recovery fund provides better protection for the consumer against unscrupulous or insolvent contractors than does bonding, and is less costly to the contractors. As discussed previously, consumers are often unable to claim against contractors' bonds before they are exhausted by suppliers or other contractors. In contrast, the recovery fund not only provides a higher protection amount, but it is limited to claims by consumers only.

In addition to providing more protection, the recovery fund is less costly to contractors than bonding. The initial recovery fund fee is \$75. Subsequent annual renewal charges can vary according to the fund's needs. However, since January 1983 there has been no annual renewal charge. According to our survey of bonding companies, the current annual rate for contractors' license bonds is \$50 per \$1,000 coverage. Table 9 shows the protection provided by each and the costs to contractors.

TABLE 9  
PROTECTION AMOUNTS PROVIDED  
BY BONDING AND RECOVERY FUND AND  
COSTS TO CONTRACTORS

	<u>Contractors</u>	<u>Subcontractors</u>
<u>Bond</u>		
Amount	\$5-15,000 <sup>(1)</sup> Total	\$1-7,500 <sup>(1)</sup> Total
Cost	\$250-750	\$50-375
<u>Recovery Fund</u>		
Amount	\$15,000 per Claim, \$75,000 Total	\$15,000 per Claim, \$75,000 Total
Cost	\$75 <sup>(2)</sup>	\$75 <sup>(2)</sup>

(1) The amount varies based on work dollar volume.

(2) Initial fee is \$75. Subsequent annual charges vary, and no fees have been assessed since January 1983.



Bonding Unnecessarily Restricts  
Entry Into the Construction Industry

The bonding requirement unnecessarily restricts entry into the construction industry. The minimum financial requirements for a bond can exclude contractors from licensure.

Financial Requirements Restrict Practice - The financial requirements to qualify for a bond may exclude some contractors from licensure. Some unlicensed contractors we contacted indicated that the bonding requirement was one of the major restrictions to licensure. ROC staff believe that the main reason contractors practice without licenses is that they cannot meet the bond requirement. Some unlicensed contractors report that they do not have the ready cash (\$1,000 to \$15,000) to obtain a cash bond, or do not meet the financial requirements for a surety bond.

For a cash bond, investment certificate, share account or certificate of deposit, a contractor must provide the required bond amount in cash, based on the work volume. For subcontractors this is \$1,000 to \$7,500. For general contractors \$5,000 to \$15,000 is required. This money is refundable to the contractor if there are no outstanding claims after the 2-year statute of limitations for claims has expired.

Contractors must meet strict financial requirements to qualify for a surety bond. According to some of the companies surveyed, the financial requirements were increased because of the large number of contractor insolvencies during the 1974-75 recession.\* Our survey found that some companies have specific minimum limits on contractor finances. For example, two companies' requirements are as follows:

\* We surveyed the four largest bonding companies as identified by the ROC.

TABLE 10  
TWO BONDING COMPANIES'  
MINIMUM FINANCIAL REQUIREMENTS

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	<u>Company A</u>	<u>Company B</u>
Working Capital	\$ 5,000 for all bond amounts	\$ 5,000 for \$1 to \$5,000 bond \$10,000 for over \$5,000 bond
Net Worth	\$50,000 for all bond amounts	\$25,000 for \$1 to \$5,000 bond \$50,000 for over \$5,000 bond

Depending upon the company, the contractor must meet other requirements to qualify for a bond. One company requires a minimum of 3 years in-state or other work experience. Some require the contractor to have other insurance with the company. Bonding companies may also require that a contractor show a net profit, or in some cases a progressively increasing profit before issuing a bond.

Eliminating Bonding Would Provide  
Savings to Both the Agency and Contractors

Both the Agency and contractors could realize savings if the statutory bonding requirement were eliminated. We calculated that the ROC could save approximately \$32,000 in personal services costs if bonding were eliminated. The costs include two bonding clerks and other related expenses. In addition, by eliminating the bond file from its computer the ROC estimates it would free an additional 15 percent of its computer capacity. Consequently, it would be able to delay future expansion.

Contractors would realize significant savings if bonding were eliminated. We estimated contractors paid surety companies \$1.8 million in 1983. In addition, through February 1984 contractors had \$5.8 million deposited in either cash bonds or certificates of deposit.

## CONCLUSION

The contractor bonding requirement is unnecessary and could be eliminated. Bonding has provided little consumer protection and restricts entry into the construction industry. Both the Agency and contractors would realize significant savings if the bonding requirement were dropped.

## RECOMMENDATIONS

1. The Legislature should consider eliminating A.R.S. §32-1152 as it relates to bonding.
2. If the statutory bonding requirement is eliminated, the ROC should eliminate the two bonding clerk positions.

## FINDING IV

### THE REGISTRAR OF CONTRACTORS' COMPUTER SYSTEM REQUIRES IMPROVED MANAGEMENT

The Registrar of Contractors (ROC) needs to improve management of its electronic data processing (EDP) system. Although the system has enhanced operational efficiency, our review disclosed weaknesses in: 1) planning, 2) utilization, 3) internal controls, 4) documentation of procedures, and 5) training.

#### Computer Obtained to Improve Timeliness and Efficiency of Operations

The Registrar purchased a computer system that was installed in 1982. The ROC was one of the first state agencies to develop a system independent of the Department of Administration data center. The system hardware consists of a minicomputer with 1024K of memory, 15 multipurpose terminals, one word processing terminal, one tape drive, two disk drives and two printers. Risk Management values this equipment at \$135,311. The system is administered by the assistant registrar and two data processing equipment operators.

According to an Agency official, this system has resulted in greater flexibility and improved operational efficiency. Information maintained in the computer includes licensing, compliance, hearing, recovery fund and bonding data. Some of these files contain several thousand records, and computerization allows quicker, more efficient storage, manipulation and retrieval of data.

Before purchasing its own computer system, the ROC received computer support from the Department of Administration data center. However, the Registrar found this arrangement inadequate because it was too time consuming for data retrieval, the data was not current, and the compliance and hearing data was incomplete.

The Auditor General EDP staff conducted a review of the ROC's computer system. The EDP staff regularly conducts EDP internal control reviews for

state agencies, counties and school districts. These internal control reviews evaluate both general and application controls. In addition, the EDP staff performs evaluations using computer-assisted audit techniques. In some cases planning and development assistance is also provided. Their findings and recommendations regarding the ROC computer system are summarized below.

No Plan Exists For Data  
Processing Operations

The Registrar has not prepared and maintained plans for the data processing section. Planning is a mechanism for dealing with problems before they occur. Resource planning transforms information describing expected workload into the hardware and staffing plans necessary to meet data processing commitments.

Agency staff indicated that automating the accounting system and adding a word processing terminal and a statistical package for examination analysis would improve operations. These and other future requirements have not been addressed in a formal planning document. Planning documents would help ensure that current and future data processing needs are met, and that any modifications to the system are directed toward satisfying the Agency's objectives. Short and long range plans for projects, personnel and equipment could increase the effectiveness of the system.

EDP System  
Underutilized

The Registrar's staff does not always use the data processing system to full capacity. Certain processes are still done manually that could be more efficiently done on the computer. Also, the data processing section is not meeting the reporting needs of the staff.

The EDP system is not being used to its full capacity. For example, the Licensing Division staff manually calculate the difference between two dates for all license applications for licensing reports. This is done to determine the elapsed time from when an application is received until a license is issued. Although the system is capable of doing time analyses, the ROC does not know how to use the computer for this purpose. Also, the staff must manually search microfiche for information because the automated license file is not accessible by qualifying party name. Computer programs can perform these functions more efficiently.

Some of the staff reporting needs are not being met by the EDP section. Every division manager or supervisor interviewed expressed a need for additional reports, ranging from statistical and timing analyses to word processing and accounting information. The managers were hesitant to submit EDP user requests because of their unfamiliarity with the system and its capabilities.

#### Weaknesses Exist in Data Processing Internal Controls and Backup

Our EDP review disclosed some deficiencies in the Registrar's data processing access controls and its backup and contingency plan. Gaining access to the computer is too easy, and use of the computer is not restricted. Also, the backup and recovery procedures needed in case of business interruption are incomplete.

According to a guide published by The American Institute of Certified Public Accountants (AICPA), ". . . access controls provide safeguards to ensure that EDP resources are properly utilized . . . Proper access controls will assist in the prevention or detection of deliberate or accidental errors caused by improper use or manipulation of data files, unauthorized or incorrect use of a computer program, and/or improper use of computer resources."\*

\* Computer Services Executive Committee, The Auditor's Study and Evaluation of Internal Control in EDP Systems (New York: American Institute of Certified Public Accountants, 1977).

Access Controls Not Utilized - The AICPA guide lists three controls that pertain to computer access. These include:

General control No. 13 - Access to program documentation should be limited to those persons who require it in the performance of their duties.

General control No. 14 - Access to data files and programs should be limited to those individuals authorized to process or maintain particular systems.

General control No. 15 - Access to computer hardware should be limited to authorized individuals."

The Registrar does not comply with any of these controls. The system allows easy access with a one-character log-on command. In addition, the Agency does not properly restrict the ability to call up utility programs and change them. Moreover, the EDP staff does not always use the password/protect commands available to prevent unauthorized access to its report writing software. The Agency could acquire the software to update its operating system and use passwords to control access to the computer. Also, the Agency could make better use of the system's optional file access control features.

The Agency does not appropriately restrict the use of its computer system. Computer programs are available to any employee with the limited knowledge required to use them. Additionally, programmers frequently have access to all programs and data files in the system. Unrestricted access may result in unauthorized use of information, concealment of errors or irregularities, and programs used contrary to management objectives. Examples of potential problems could include the changing of a contractor's license or bond status or incorrectly showing that license and recovery fund fees had been paid.

Incomplete Backup and Recovery Plan - The Registrar has no written contingency plans for disaster recovery. Backup facilities have not been tested to check the compatibility of equipment and the effectiveness of backup procedures. The Registrar does have a data entry contingency support agreement with the Department of Administration, but it is limited to "backup support and availability of data entry equipment in the event of disaster or interruption to data entry equipment at either agency." An effective, workable agreement would cover machine time availability, application processing priorities, information exchanges on equipment configuration changes, and cost.

The computer can rapidly become an integral part of Agency operations. When it goes down, operations come to a standstill, or creep along at a reduced rate. According to an authoritative EDP manual, ". . . it is wise to give adequate consideration and planning for backup facilities that can be used when such malfunctions occur."\*

In the Registrar's case, a system malfunction or a disaster in the system would impair Agency operations. ROC would have to revert to manual processing, which would result in slower response time to the public. Also, as the Agency is continually adding more files, dependence on the system is increasing. In the event of system breakdown, people trained only on the computer would have a difficult time adjusting to manual procedures. Also, new equipment may take a long time to arrive, which further emphasizes the need for an adequate backup and recovery plan.

EDP Section Lacks an Adequate  
Standards and Procedures Manual

The data processing section's standards and procedures manual is weak. The manual lacks documentation, program and operation standards. Computer operator manuals should be developed that clearly outline operational steps to be followed. Such manuals are useful in training new

\* Martin B. Roberts, EDP Controls - A Guide For Auditors and Accountants  
(New York: John Wiley & Sons, 1983)



operators and provide necessary documentation to compare actual performance against planned operations. A manual should include organization and job descriptions, application documentation standards, systems and project development, program change policies and backup procedures. The American Institute of Certified Public Accountants' The Auditor's Study and Evaluation of Internal Control in EDP Systems states in general control No. 17: "A well-written manual of systems and procedures should be prepared for all computer operations and should provide for management's general or specific authorization to process transactions."

Because the data processing section's standards and procedures manual is weak, most of the procedures for data processing operations are unstructured and informal. EDP employees cannot determine whether their work meets minimum standards. The assistant registrar, who oversees the system, has no uniform basis for evaluating the effectiveness of the EDP personnel. Staff turnover and the complexity of the data processing environment increase the need for clear, comprehensive guidelines. Uniform, written policies are essential to a reliable computer operation.

#### Agency Personnel Lack Adequate EDP Training

It is evident from the lack of knowledge about the system and its capabilities expressed by the EDP staff and other Agency personnel that they have not been adequately trained. Training appears to have taken lower priority than it should have in the system implementation. Formal training sessions need to be implemented. The division managers need to be shown how the computer can be applicable to their respective areas. The EDP staff needs to be trained to maximize use of the system's capabilities for such things as reports, timing analyses, accounting and word processing.

#### CONCLUSION

The Registrar of Contractors does not get the maximum benefits from its electronic data processing system. Improvements are needed in planning, utilization, internal controls, procedure documentation and training.

## RECOMMENDATIONS

1. The Registrar of Contractors should implement a plan to direct data processing efforts.
2. The Agency should develop a request form to facilitate the management of user data processing requests.
3. The Agency should strengthen its data processing internal controls. It should acquire a more recent version of the Level-6 operating system, which uses passwords to control computer access. Management should restrict access to programs and data files and review all program changes to ensure that they are authorized and compatible with the objectives of the Agency.
4. The Agency should expand and clarify its data processing backup and recovery agreement. The contract should cover:

- machine time availability,
- application processing priorities,
- information exchanges on equipment configuration changes, and
- cost.

The Agency should also develop a disaster recovery contingency plan. The plan should cover evacuation, emergency power-off procedures, removal of data files and equipment, and resumption of operations at the backup facility.

5. The Agency should develop an adequate standards and procedures manual. The manual should include:
  - organization and job descriptions,
  - application documentation standards,
  - systems/project development,
  - program change policies, and
  - backup procedures.
6. The data processing staff should receive additional training to more fully utilize the computer system.

## OTHER PERTINENT INFORMATION

During the course of our audit, we reviewed information regarding unlicensed contractor enforcement.

Arizona law requires all residential contractors to obtain a license to work in the state.\* Contracting without a license is illegal under Arizona Revised Statutes (A.R.S.) §32-1151 and is a class 1 misdemeanor. A contractor can be fined not less than \$500 for the first offense and not less than \$750 for the second or any subsequent offense. Advertising without a license is also illegal unless "unlicensed" appears in the advertisement. This violation under A.R.S. §32-1165 is a class 2 misdemeanor. Repeat violators of the advertising statutes are issued cease and desist orders. Fines can be levied by the courts for continued advertising violations.

The Registrar of Contractors (ROC) has nine investigators in Phoenix and Tucson for unlicensed contractor enforcement. Also, employees at the five satellite offices throughout the state spend about 50 percent of their time investigating complaints against unlicensed contractors. The investigators monitor construction sites for unlicensed contractors, document complaints against unlicensed contractors, and investigate illegal advertising. Investigators may issue cease and desist orders and citations, depending upon the severity of the violation. Investigators also assist in preparing cases for court prosecution.

The ROC investigates consumer complaints, as well as generating its own complaints. The Agency's unlicensed enforcement workload consists mostly of Agency-generated cases rather than complaints by consumers. Our analysis found that 81 percent of the complaints concerning unlicensed contractors are generated by ROC investigators. Forty-four percent of that activity involved citing contractors for illegal advertising. The

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\* Licensure is not required for projects of less than \$750, including labor and materials, under A.R.S. §32-1121.A.10.

investigators check the neighborhood and local newspaper classified advertisements daily to identify advertising by unlicensed contractors. The investigators then contact these contractors listed using an assumed name and phone number. The investigator then issues a cease and desist order for illegal advertising.

Both local officials and ROC personnel state that large numbers of contractors work without licensure. Two local city building inspectors estimate large numbers of unlicensed contractors working within their cities. The estimates are based on observations made during local inspections and the officials' overall knowledge of the area. One inspector estimated as many as 20 percent of all residential contractors in his city are unlicensed. Another said there are several known, unlicensed residential contractors working in his city.

ROC officials say that large numbers of unlicensed contractors are still working. One Agency official stated that there are "thousands and thousands of unlicensed contractors out there." Still another admitted that they are just hitting the tip of the iceberg in their attempt to reduce unlicensed construction.

Other States - Some localities in other states have used local building inspectors to help deter unlicensed contracting. One locality similar to Phoenix has successfully coordinated local enforcement and prosecution. States such as Colorado, New Mexico, and Minnesota have had success with local building inspectors enforcing against unlicensed practice. In those states inspectors have the power to issue cease and desist orders to unlicensed contractors, forcing termination of their work. Those surveyed gave several reasons for success. They noted that inspectors are closer to the problem on a daily basis, thereby making them more aware of the situation. Also, visibility makes them more effective. If contractors know the inspector who has to inspect their work can cite them for unlicensed activity or shut down the job, they are less likely to work without licenses.

Denver coordinates local enforcement with the courts to reduce unlicensed construction. In Denver, building inspectors are responsible for monitoring code violations and for enforcing the licensing laws. Inspectors investigate job sites to document any unlicensed activity. If violations are found, the inspector can order work to be stopped and issue a court summons. These complaints are handled by the local courts and result in substantial fines. According to the program administrator, through this joint effort the city estimates that work by unlicensed contractors has been reduced by 90 percent in some trades, and 50 percent overall.

Locals Favor Enforcement Responsibility - Our survey of local building inspectors in Arizona indicated they support increased enforcement powers. Building inspectors favor restoration of A.R.S. §32-1168, allowing them to require licensure before issuing building permits. Giving local officials increased powers, such as the ability to shut down an unlicensed contractor job site, would strengthen enforcement against unlicensed contractors.

A survey of local municipalities found some in favor of restoration of A.R.S. §32-1168, which requires contractors to provide proof of licensure before a building permit is issued. At least two municipalities already have this requirement. Local building inspectors favor having the authority to require contractors to show proof of licensure. The availability of the ROC weekly computer printout of licensed contractors could help inspectors determine the validity of the contractors' proof of licensure.

Before 1981, A.R.S. §32-1168 required city building departments to check for a valid contractor license before issuing a building permit. A.R.S. §32-1168 stated:

"Each county, city, or other political subdivision or authority of the state or an agency, department, board or commission of the state which requires the issuance of a permit or license as a condition precedent to the construction, alteration, improvement, demolition, or repair for which a license is required under this chapter shall as a part of the application procedures which it utilizes, require that each applicant for such permit or license file a signed statement that the applicant is currently licensed under the provisions of this chapter, with his license number. . . ." (emphasis added)

According to the ROC, this law was eliminated by mistake when new ROC legislation was formulated in 1981. The ROC favors reenactment of A.R.S. §32-1168.

## SUMMARY

The Office of the Auditor General has conducted a performance audit of the Registrar of Contractors (ROC) in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Arizona Registrar of Contractors was established by the Legislature in 1931. The Agency has the primary responsibility for regulating all residential contractors in the state. The Registrar, appointed by the Governor, oversees all day-to-day operations of the Agency. The duties of the Agency include evaluating applications for examination and licensure, administering examinations, annually renewing licenses, investigating consumer complaints lodged against licensed and unlicensed contractors, conducting administrative hearings, promulgating rules and regulations, and administering the contractor's recovery fund, which was established in 1981 to compensate consumers for damages by licensed contractors.

### The Registrar of Contractors' Level of Regulation Could Be Reduced (see page 13)

Some contractor regulation is necessary in Arizona. However, the low potential for harm indicates registration rather than licensure for most trades would offer sufficient consumer protection. In addition, a registration system may provide more consumers the protection offered by the Registrar of Contractors' complaint resolution process and the recovery fund.

Licensure is necessary for a few trades, such as electrical and plumbing, directly affecting health and safety. In addition, the potential for financial harm necessitates some consumer protection. However, the low potential for harm to the public health and safety indicates that a registration system of regulation would be sufficient for most trades. An analysis of nearly 700 ROC consumer complaints showed that only one

complaint involved a potential for harm to public health and safety. Thus, for most trades, strict entry requirements are unnecessary.

In fact, registration rather than licensure may protect more consumers by possibly making more contractors subject to the Registrar of Contractors' complaint resolution and recovery fund processes. Under a registration system, contractors would not be required to meet unnecessarily restrictive entry requirements.

The Legislature should consider amending the statutes related to licensing of contractors to require licensure for only health- and safety-related trades and to institute a registration system for all other trades.

#### Licensed Contractor Enforcement Requires Improvement (see page 23)

Current enforcement of contractor standards and other industry requirements is weak and has not prevented some chronic offenders from repeating violations.

The ROC has not aggressively disciplined contractors violating its statutory provisions. The ROC has not imposed any sanctions against violators in some valid cases. In one case, the ROC allowed a repeat offender to continue working if repairs were made, although the contractor was serving multiple concurrent probations. Consequently, it has not deterred some contractors from repeating statutory violations numerous times. In addition, complaint history data is not effectively utilized, and a full range of sanctions is not available to the Registrar.

The Registrar of Contractors should take stricter action against contractors with histories of repeat violations. Further, the Registrar of Contractors should introduce contractors' case histories as evidence in administrative hearings. The Registrar of Contractors should also provide contractors' case history summaries to consumers. Finally, the Legislature should empower the Registrar of Contractors to impose civil penalties against contractors found in violation of its statutory provisions.



Contractor Bonding Requirements  
Could Be Eliminated (see page 33)

Bonding provides little consumer restitution yet unnecessarily restricts entry into the construction industry. Both the Registrar and contractors could realize significant savings if this requirement were dropped.

Bonding has provided little consumer protection. An analysis of recovery fund claims shows that consumers do not receive total restitution from bonds. In addition, our survey of several bonding companies and an analysis of ROC case bond payments found that the construction industry, not the consumer, benefits the most from bonding. However, the construction industry can protect itself through generally accepted credit practices or establishing its own bonding requirements. Without bonding, consumers would still have the contractors' recovery fund, which provides greater financial protection than bonding and is less costly to contractors.

Both the Agency and contractors could realize a savings if the statutory bonding requirement were eliminated. Contractors could save an estimated \$1.8 million. We calculated that the ROC could save approximately \$32,000 in personal services costs if bonding were eliminated.

The Registrar of Contractors' Computer System Requires  
Improved Management (see page 41)

Although the Registrar's electronic data processing (EDP) system has improved its efficiency, our review identified several weaknesses. The ROC has not prepared and maintained plans for the data processing section. In addition, the Registrar's staff does not always use the data processing system to full capacity. Our EDP review also disclosed some deficiencies in the Registrar's data processing access controls and in its backup and contingency plan. Finally, the data processing section standards and procedures manual is weak, and EDP training of Agency personnel has been inadequate. Computer operator manuals should exist to clearly outline operational steps to be followed.



## Registrar of Contractors

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August 10, 1984

Douglas R. Norton  
Auditor General  
111 West Monroe, Suite 600  
Phoenix, AZ 85003



Re: Performance Audit

Dear Mr. Norton:

My staff and I have had an opportunity to review the performance audit completed by your office. We find ourselves in agreement with the basic elements of your findings and anticipate supporting many of your recommendations in the next legislative session. There are, however, some conclusions with which we disagree or which require some clarification. I will attempt to briefly cover those areas in this response.

### FINDING I

This finding recommends that "registration" versus "licensing" be substituted for some of the contractor trades that present a low risk potential for harm to the public. While we agree with this position generally, additional statutory amendments are unnecessary to effect this recommendation. Additionally, in reaching your finding and recommendations, I believe too little consideration has been given to the "welfare" aspect of this agency's purpose for existence.

In setting forth the number one objective and purpose of the Registrar, it is undisputed that: "It is the purpose and intent of the Legislature to continue the Registrar of Contractors agency in order to protect the public, health, safety and welfare". (emphasis added) Finding number one stresses the health and safety aspect with less regard for the economic well being of the consumer which should be on an equal ground. We believe that licensing should continue not only for those trades that directly affect health and safety but also for those trades which have shown a history for a high potential of harm to the public's economic well being i.e. welfare.

To do otherwise would open the door to fly-by-night contractors who could easily register for a trade and obtain, in effect, the States' seal of approval. A registration without any prequalification would increase the potential for harm to the public. Let me emphasize the I am speaking of those non-health and safety trades which nevertheless have proven to be high risk trades because of the potential for economic harm. Furthermore, the licensed contractors who are serious about maintaining a good business relationship in this State would be subsidizing these high economic risk trades through their payments into the recovery fund. This office owes licensed contractors a greater duty.

As noted in your report, this agency has taken positive steps to reduce regulation wherever necessary and practical. These adjustments were made pursuant to existing authority in A.R.S. §32-1122(A)(4) and §32-1122(E)(1). We believe these existing statutes are sufficient to effect your recommendations. In my opinion, further legislative amendments would not be helpful.

#### FINDING II

The recommendation is that the Registrar take stricter enforcement actions against contractors with repeat violations. We agree. In my opinion, this agency has an excellent compliance and hearing staff and our statutes are being effectively enforced. At least part of this problem, if not most, can be attributed to the nature of this agency's statutorily imposed administrative process. When a repeat offender is before the Registrar, it is almost always in the context of a complaint filed by a member of the public. If the Registrar revokes the license of a contractor in this context then we deprive the complaining party of any relief under our statutes. The revoked contractor has no incentive to perform any corrective or repair work on behalf of the injured complainant if the license is to remain revoked regardless of the repair or corrective work. Consequently, this agency has attempted to discipline this category of contractor without eliminating the complainant's remedy. The inducement to the contractor is the retention of a license if the complaining party is satisfied.

A possible solution to the above dilemma is to allow the Registrar limited authority to order payments from the recovery fund in those instances where a revocation would otherwise deny the complainant of a remedy. This alternative would prevent the failed but good-faith efforts noted in your report. We suggest legislation be introduced providing the Registrar with limited authority to order payment from the recovery fund in these types of cases. This suggestion is made in addition to accepting your recommendation that the Legislature authorize the Registrar of Contractors to impose civil penalties for violations of A.R.S. §32-1154.

The other two recommendations in Finding II deal with the use of a contractor's complaint history for our hearing purposes and for dissemination to the public. We agree that Rule R4-9-17 should be utilized in determining the appropriate discipline against a repeat offender. However, it is my opinion that this rule applies only to prior administrative decisions and

order of this agency and not to complaints that are resolved prior to hearing. To conclude otherwise and allow the introduction of complaints not subjected to the administrative process would be a violation of the contractor's constitutional due process rights.

The mere filing of a complaint with this agency does not necessarily mean that the contractor has performed improperly or is not fit to hold a license. This agency can only make that determination after an administrative hearing. To use the complaints in the manner suggested in your report, without the procedural safeguards of an administrative hearing, would be improper.

The use of these same complaints in the licensing section of this agency is a different matter. In all likelihood the simple filing of a complaint, in the absence of a statute that states otherwise, is public information that is accessible to the public. Computerization of the complaint case data will help in this area. However, given the due process limitations noted above, this data will have to be prepared very carefully in order to insure fairness to the contractor.

#### FINDING III

Finding III recommends that the Legislature eliminate the bonding requirement imposed in A.R.S. §32-1152. We agree. Our own independent study and experience confirms that consumers are afforded little protection through the existence of the bond. The bond serves primarily as limited credit insurance for suppliers and other licensed contractors. The recovery fund has proven much superior in providing protection to the public at a much lower cost to the contractor. We also agree that this cost factor unnecessarily restricts entry into the construction industry.

The elimination of the bond has an indirect relationship to the discussion contained in Finding I. If the bond is eliminated for a trade that is also reduced to a registration status, an influx of potential irresponsible contractors could result. Although bonds do in fact act as an entry barrier to the construction industry, they do help to discourage the fly-by-night operator who is in business to make a profit and run. Consequently, I would like to reemphasize the point made in this response that those trades with a history of high economic risk not be reduced to registration status but continue as a licensed trade. I believe this to be necessary in light of the recommendation to eliminate the bonding requirement for all trades.

#### FINDING IV

The deficiencies with our data processing system expressed in this finding generally do not reflect either the condition that actually exists or the desired end product. Further, the potential negative effects alluded to in the finding are hypothetical in nature with very little to suggest their actual occurrence.

The computer system installed at the Registrar of Contractors was an experiment in decentralized computerization as opposed to the shared centralized

mainframe approach. The experiment is not complete but is generally perceived as a success by senior staff at the State Data Processing division. One of the major strengths and reasons for the success of our system is its lack of a highly structural, bureaucratic environment generally associated with a large computer system. Our success is attributable to remaining informal and flexible. In the evaluation of our system criteria derived from a large scale data processing operation was used which is neither appropriate nor desirable.

#### Other Pertinent Information

Finally, the report ends with a discussion of the agency's enforcement of the statutes prohibiting unlicensed contractor activity. It is noted that a substantial part of the agency's activity is self-generated. I believe this to be a positive factor in that the investigators are actively attempting to prevent harm to members of the public who may unwittingly employ an unlicensed contractor. It should also be noted that licensed contractors consider this active enforcement to be one of the more important functions of the agency. Given the time, money and energy that a licensed contractor has expended in obtaining a contractor's license, it would hardly be fair for this agency to take a relaxed attitude towards enforcement against unlicensed contractors.

We do agree, however, that the local building inspectors are somewhat closer to this problem on a daily basis. The Registrar has, in the recent past, attempted to revive A.R.S. §32-1168 as noted in your report. In order to facilitate the reenactment of the statute, we recommend that the investigatory authority of the Registrar remain the same. That is, the burden of identifying the unlicensed contractor would remain with this State agency. However, legislation is needed to allow the local authorities to act on the investigation and recommendation of this office. For example, if the Registrar advises the local building inspection department that there are unlicensed contractors working on a particular site, they would then withhold or revoke the building permit. This removes the burden for the local agencies of having to verify licensure each time a permit is issued.

One other statutory change merits discussion here. Local officials could also be instrumental in stopping unlicensed contractor activity, especially as against repeat offenders and those who continue working unlawfully despite the revocation of a building permit. Presently, A.R.S. §32-1166 requires that any action for injunctive relief be made through the Attorney General or the County Attorney's office. This statute could be amended to allow prosecution at the city or town level by that political subdivision's attorney. The amendment would be a minor change but would allow local jurisdictions to take a direct hand if unlicensed activity was a priority or a particular problem within their jurisdiction.

This new procedure would complement the present misdemeanor prosecutions at the local level. Our investigators could work with the city or town officials to determine which cases might warrant civil prosecution at the Superior Court level.

Taken in its entirety and given the statutory mandates of the Registrar, we believe this report to be a positive one especially in the light of the previous audit, completed in October, 1979, which concluded that the Registrar had failed to protect the public adequately. In the five years since that audit, this agency has undergone a remarkably successful change. Today, because of the efforts of my predecessor, Aaron Kizer, and his staff, this agency is an effective office for consumer protection. Furthermore, a healthy dialogue has been established with many contractor associations to the mutual benefit of the Registrar and the industry. We intend to continue in the same manner.

Thank you for your kind cooperation and that of your staff.

Sincerely,

A handwritten signature in cursive script that reads "David M. Talamante".

David M. Talamante  
Registrar of Contractors

/hmb