New Jersey State Legislature
Office of Legislative Services
Office of the State Auditor

State of New Jersey Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

For Fiscal Year Ended June 30, 2007

Richard L. Fair
State Auditor

New Jersey State Legislature

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Governor of New Jersey

The Honorable Richard J. Codey
President of the Senate

The Honorable Joseph J. Roberts, Jr.
Speaker of the General Assembly

Mr. Albert Porroni
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We have audited the financial statements of the State of New Jersey as of and for the year ended June 30, 2007 and have issued our report thereon dated February 29, 2008. In connection with that audit, we tested internal controls and compliance to laws and regulations. The results of our tests are contained in our Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*.

The audit was performed and this report is submitted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section 1, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

Richard L. Fair
State Auditor
May 29, 2008

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of New Jersey as of and for the year ended June 30, 2007, which collectively comprise the state's basic financial statements and have issued our report thereon dated February 29, 2008. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the discretely presented component units, the pensions and other employee benefits trust funds, the Dental Expense Program, and the Port Authority of New York and New Jersey, as described in our report on the State of New Jersey's basic financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the pensions and other employee benefits trust funds, Dental Expense Program, and two discretely presented component units, the New Jersey Sports and Exposition Authority and the Casino Reinvestment Development Fund, were not audited in accordance with *Government Auditing Standards.*

Internal Control over Financial Reporting

In planning and performing our audit, we considered the State of New Jersey's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of New Jersey's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of New Jersey's internal control over financial reporting.

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

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying schedule of findings and responses to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described in the accompanying schedule of findings and responses is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of New Jersey's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

The State of New Jersey's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the State of New Jersey's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the management of the State of New Jersey, the legislature, and the federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Richard L. Fair
State Auditor
February 29, 2008

Financial Statements and Notes to the Financial Statements Reporting

Background

The Department of the Treasury's Office of Management and Budget - Financial Reporting (OMBFR) is responsible for preparing the financial statements and the notes to the financial statements for inclusion in the Comprehensive Annual Financial Report (CAFR). The majority of the fund financial statements are based on transactions processed through the New Jersey Comprehensive Financial System (NJCFS) and adjustments prepared by the OMBFR accountants through the use of journal vouchers. The NJCFS data is uploaded into the SAS Financial Management System (SASFM) which creates the final financial statements. Governmental Accounting Standards Board Statement No. 34 (GASB 34) statements, component units and off-line funds audited by independent certified public accounting firms are entered directly through journal entries into the SASFM by the OMBFR for inclusion in the CAFR. The OMBFR may also make adjustments to financial statements through entries on SASFM. The management's discussion and analysis, notes to the financial statements, statistical section and certain other information are included in the CAFR through use of other software programs.

Finding

Certain weaknesses in the internal control over financial reporting were evident based on the occurrence of the following activity.

- An audit adjustment was necessary for the General Fund balance sheet as a result of an incorrect journal voucher being recorded which caused the Federal government receivables to be overstated by $394 million and the Departmental accounts receivables to be understated by $394 million. The OMBFR does not have a formalized policy to analytically review its financial statement balances from year to year. An analytical review comparing year to year balances may have prevented the misstatement.

- A formula error in a spreadsheet resulted in a $3.8 billion overstatement of future debt service payments in the notes to the financial statements. An audit adjustment was recorded to correct the error. The spreadsheet's structure had changed from the prior year and an independent review of the spreadsheet's changes was not performed.

- A misposting of a SASFM adjusting entry resulted in a $70 million overstatement in the account Invested in capital assets, net of related debt and a $70 million understatement in the account Net Assets, Unrestricted on the Statement of Net Assets. The recommended audit adjustment was not recorded by management. A supervisory review of the accountant's supporting detail did not uncover the error.

- Proposed but unrecorded audit adjustments of $36 million were the result of differences in the accrual estimates for various tax receivables and payables, and for Medicaid payable accruals. The Department of the Treasury's Office of Revenue and Economic Analysis (OREA) is responsible for the tax accrual estimates and the departments of Children and Families, Human Services, and Health and Senior Services are responsible for the Medicaid accruals. The OMBFR does not have a formalized policy to review the accruals presented by these agencies.

Recommendation

We recommend that the OMBFR formalize procedures to:

- analytically review financial statement amounts to lessen the risk that material incorrect journal voucher activity may occur and not be detected in a timely manner,

- review all spreadsheets which have had structural changes,

- strengthen the supervisory review of all significant entries prepared by the accountants, and

- independently review significant accrual calculations received from other offices/agencies for reasonableness and subsequent activity.

Management's Response

The Office of Management and Budget (OMB) appreciates the State Auditor Office's comments to strengthen certain weaknesses. The audit adjustment relating to the incorrect journal voucher which caused the federal government receivables to be overstated by $394 million and the departmental receivables to be understated by $394 million had no impact on the total receivables reported on the financial statements. Also, the misposting of a SASFM adjusting entry that resulted in a $70 million overstatement in the account Invested in Capital Assets, Net of Related Debt, and a $70 million understatement in the account Unrestricted Net Assets had no impact on the Total Net Assets. OMB recognizes that Statement of Auditing Standards No. 112, *Communicating Internal Control Related Matter Identified in an Audit*, has increased the number of deficiencies reported in FY07 as opposed to prior years. The language used to describe deficiencies has become stricter, therefore, causing findings that would be in a management letter in prior years to be in the Report on Internal Control in FY07. OMB agrees with the recommendations and will implement review procedures for the 2008 CAFR reporting.

Capital Asset Accounting and Reporting

Background

Under Governmental Accounting Standards Board Statement No. 34 (GASB 34), capital assets of the state are to be recorded at historical cost in the Statement of Net Assets in the

Government-wide Financial Statements. Capital assets include land, land improvements, easements, buildings, building improvements, equipment, infrastructure, and intangible assets. Works of art, historical treasures, and similar assets are not capitalized and depreciated because the assets cannot be reasonably valued and/or the assets have inexhaustible useful lives. The state maintains the Land, Building and Asset Management system (LBAM) managed by the Department of the Treasury's Office of Management and Budget - Financial Reporting (OMBFR) to account for the state's capital assets. The Department of Transportation (DOT) separately accounts for the state's road and bridge related infrastructure assets. The DOT reports their capital asset information to the OMBFR for inclusion in the LBAM. The OMBFR is responsible for the reporting of buildings and construction in progress and obtains this information primarily from the Division of Property Management and Construction and its FOXPRO project management system. All agencies are responsible for accurate recording of their capital assets in the LBAM.

Finding

The state did not implement all the needed processes and related internal controls to ensure complete and accurate reporting of all capital assets.

The financial statement amounts and notes to the financial statements for capital assets were revised numerous times after being presented to the auditors. The OMBFR made changes based on various auditor inquiries and subsequent information they obtained from agencies. The OMBFR has taken great strides since the implementation of GASB 34 to improve its capital asset reporting, including the phasing in of the LBAM beginning in fiscal year 2004; however, reporting issues continue to exist which require additional review.

Recommendation

We recommend that the OMBFR strengthen its review of reports generated by the LBAM for accuracy on a timely basis.

Management's Response

The Office of Management and Budget (OMB) appreciates the efforts of your staff in the review of the Statewide Land and Building Asset Management system (LBAM). OMB acknowledges the findings and has taken steps to strengthen reporting from LBAM. During FY08 controls have been implemented to ensure accuracy that includes programming changes to LBAM and additional training designed to reduce reporting errors by the agencies.