



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

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**Department of the Treasury  
Office of Public Finance**

July 1, 2011 to June 30, 2013

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**Stephen M. Eells  
State Auditor**

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## New Jersey State Legislature

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The Honorable Stephen M. Sweeney  
President of the Senate

The Honorable Sheila Y. Oliver  
Speaker of the General Assembly

Mr. Albert Porroni  
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Enclosed is our report on the audit of the Department of the Treasury, Office of Public Finance for the period of July 1, 2011 to June 30, 2013. If you would like a personal briefing, please call me at (609) 847-3470.

A handwritten signature in black ink, appearing to read "Stephen M. Eells".

Stephen M. Eells  
State Auditor  
September 25, 2013

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### *Scope*

We have completed an audit of the Department of the Treasury, Office of Public Finance (OPF) for the period July 1, 2011 to June 30, 2013. Our audit included activities accounted for in the state's General Fund, and several special revenue funds and discretely presented component units.

The OPF manages all issuances of state-backed debt. Its primary responsibility is to oversee the issuance of debt with a goal of achieving the lowest cost of capital. During our audit period, the OPF managed 17 bond sales and 6 Tax and Revenue Anticipation Notes totaling \$17.3 billion.

### *Objective*

The objective of our audit was to determine whether the OPF has adequate procedures in place to manage the issuance of state-backed debt in accordance with applicable regulations.

The audit was conducted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section I, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

### *Methodology*

Our audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. In preparation for our testing, we studied legislation, the administrative code, executive orders, circular letters promulgated by the Department of the Treasury, and policies of the office. Provisions we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our samples of financial transactions. We also read budget messages, reviewed financial trends, and interviewed office personnel to obtain an understanding of the programs and the internal controls.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions on our audit objectives, as well as internal controls and compliance. Sample populations were sorted and transactions were randomly and judgmentally selected for testing.

### *Conclusions*

We found that the Office of Public Finance has adequate procedures in place to manage the issuance of state-backed debt in accordance with applicable regulations. In making this determination, we identified a weakness in the monitoring of bond issuance costs.

We also observed the need for a policy governing the use of bond premiums and the need to improve documentation related to underwriter fees for negotiated bond sales.

## Bond Issuance Costs

### **Monitoring of bond issuance costs should be improved.**

Bond sales incur issuance costs including bond ratings, printing, advertising, legal and trustee fees, and other related expenses. These costs are paid from the bond proceeds and vary depending on the size and complexity of the sale. For each sale, an estimate of the anticipated costs is deposited into a trustee bank account from which payments are made to various vendors. Unexpended funds should be returned to the state and used for the sale's intended purpose or for debt service. The OPF does not have adequate procedures in place to identify and address unexpended balances in these accounts.

Twelve sales with \$8 million in anticipated costs were completed between July 1, 2011 and March 31, 2013. We confirmed the balances and the activity in trustee bank accounts for 10 of the 12 sales with deposits totaling \$5.9 million and payments of \$5 million. As of April 30, 2013, 4 of the 10 sales had unspent balances totaling \$295,000 and no outstanding issuance costs. We also identified an additional three accounts with \$122,000 in unspent funds for bonds issued in 2009. Inactive accounts increase the risk of undetected errors or irregularities.

Bond issuance costs can be approved for payment by either the OPF or the issuer. The OPF is not always aware of which costs have been paid. The OPF provided a schedule of paid and outstanding costs of issuance for bond sales in our audit scope, however, a bond counsel cost of \$36,000, which the OPF listed as outstanding, had already been paid. We also identified a duplicate payment for \$958 authorized by the issuer that was not detected by the OPF.

### **Recommendation**

We recommend the OPF develop procedures for monitoring bond issuance costs that timely identify and provide for the proper disposition of unspent balances.



## Observations

### Bond Premiums

#### **A policy should be developed regarding the use or limitation of bond premiums.**

Investors are willing to pay above par value for bonds when coupon rates are higher than prevailing interest rates. Issuers have the flexibility to set coupon rates that generate greater bond premiums. There is no legislative limitation on the coupon rate. The state uses these premiums to fund projects, pay future debt service, or pay issuance costs. During our audit period, the eight new (non-refunding) bond sales generated \$330 million in premiums, of which \$70 million was set aside for debt service. Two Transportation Trust Fund Authority bond sales

accounted for \$254 million of the \$330 million. According to the OPF, at the discretion of the Treasurer's Office, the entire \$254 million was used to fund transportation projects.

The state has no law, regulation, or policy governing the use of premiums. Setting aside all or a portion of premiums for debt service would reduce the resources needed in future years for interest expense, thereby lowering borrowing costs. An inquiry to other states disclosed some have laws or policies governing the use of bond premiums. The OPF and the Department of the Treasury should consider developing a policy governing the use or limitation of premiums.

### **Underwriter Fees**

**Documentation related to underwriter fees should be improved.**

Bond underwriters are selected through either a negotiated or competitive process. A negotiated sale is typically used for large complex deals when flexibility is desired. The lead underwriter is selected through a competitive bidding process. Unlike a competitive sale, where the underwriter is chosen on the basis of the lowest true interest cost, the underwriter for a negotiated sale is selected based on factors including the underwriter's proposed deal structure, experience with the state, presence in New Jersey, distribution capabilities, and cost. Proposals for negotiated deals include the underwriter's fee structure expressed as a dollar amount per \$1000 of par value.

We reviewed seven negotiated sales and found actual fees for five were \$2.1 million more than those proposed and two that were less than those proposed. (See chart below)

Par Value	Proposed Fee per \$1000	Actual Fee per \$1000	Proposed Fee	Actual Fee	Increase (Decrease)
\$ 1,315,000,000	\$ 3.90	\$ 3.93	\$ 5,129,815	\$ 5,166,293	\$ 36,478
\$ 1,041,745,000	\$ 3.00	\$ 3.51	\$ 3,125,235	\$ 3,652,993	\$ 527,758
\$ 281,140,000	\$ 3.75	\$ 3.74	\$ 1,054,275	\$ 1,051,244	\$ (3,031)
\$ 399,365,000	\$ 2.96	\$ 3.63	\$ 1,183,038	\$ 1,449,144	\$ 266,106
\$ 1,247,000,000	\$ 3.60	\$ 3.66	\$ 4,489,200	\$ 4,564,456	\$ 75,256
\$ 2,010,225,000	\$ 2.26	\$ 2.90	\$ 4,543,109	\$ 5,825,109	\$ 1,282,000
\$ 877,065,000	\$ 2.50	\$ 2.48	\$ 2,192,663	\$ 2,178,594	\$ (14,069)
	Total		\$ 21,717,335	\$ 23,887,833	\$ 2,170,498

It is not the OPF's practice to document the fee approval process or the reason for these increases. While the OPF needs flexibility to make changes in light of fluctuating needs and changing markets, including the ability to adjust compensation as appropriate, these decisions should be adequately documented.





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CHRIS CHRISTIE  
Governor

KIM GUADAGNO  
Lt. Governor

ANDREW P. SIDAMON - ERISTOFF  
State Treasurer

September 19, 2013

John J. Termyna  
Assistant State Auditor  
Office of Legislative Services  
Office of the State Auditor  
125 South Warren Street  
PO Box 067  
Trenton, New Jersey 08625-0067

Dear Mr. Termyna:

I am pleased to acknowledge receipt of the draft audit report regarding the Office of Public Finance in the Department of the Treasury for the period July 1, 2011 to June 30, 2013, and appreciate the opportunity to review and respond to same.

I am also pleased that the audit concluded that the Office of Public Finance has in place adequate procedures to manage the issuance of state-supported debt obligations in compliance with various applicable laws and regulations.

The audit report also noted certain matters that merit the attention of management. The following paragraphs describe the current status and planned improvements to address the areas noted.

#### **Bond Issuance Costs**

**Finding:** Monitoring of bond issuance costs should be improved.

**Recommendation:** The State Auditor recommends that the OPF develop procedures for monitoring bond issuance costs that timely identify and provide for the proper disposition of unspent balances.

**Treasury Response:** OPF is in the process of canvassing the various trustee banks that hold funds for costs of issuance on behalf of the several bond-issuing state authorities to identify all such accounts, their funding sources, dates of origin and current balances. OPF will compile this data into a master spreadsheet or database against which to account for invoice payments. OPF will further establish a procedure for periodically reviewing the data to identify accounts no longer needed for their intended purposes, and initiate closure and proper disposition of the remaining balances in accordance with the governing bond covenants and statutes.

#### **Bond Premiums**

**Observation:** A policy should be developed regarding the use or limitation of bond premiums.

**Treasury Response:** As duly noted in the audit report, investors in the State's tax-exempt bond offerings often demand coupon rates and bond prices that result in the payment of a premium to the issuer. It is Treasury's policy that the amount of bond premium be limited by market demands. It is also Treasury's goal that bond premium realized be only the amount necessary to ensure the most efficient bond pricing. While the use of the bond premium is governed and limited by the authorizing bond documents and State

law, the Treasurer reserves the right to apply the premium to the purpose or purposes permitted within such limitations, based on his best judgment under the circumstances prevailing at the time of issuance.

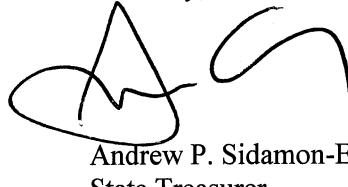
**Underwriter Fees**

**Observation:** Documentation related to underwriter fees should be improved.

**Treasury Response:** The audit report duly notes the importance of the State and the bond issuer retaining flexibility to make adjustments in light of fluctuating needs and changing market dynamics, including associated adjustments in underwriter compensation when appropriate. We also recognize the prudence of adequately documenting any such adjustments, and expect that all adjustments or modifications from the original accepted proposals will be suitably documented and preserved by OPF in the permanent files relating to the bond issue.

In closing, I, along with the OPF Director and staff, would like to thank and commend you and your audit team for their professionalism, thoroughness and, importantly, willingness to delve into the unique and complex subject of municipal bond issuance and management.

Sincerely,

A handwritten signature in black ink, appearing to read 'Andrew P. Sidamon-Eristoff', with a large, stylized initial 'A' and a long, sweeping flourish extending to the right.

Andrew P. Sidamon-Eristoff  
State Treasurer

- c: Robert Romano, Deputy State Treasurer
- Steven Petrecca, Assistant State Treasurer
- James Petrino, Director, Office of Public Finance