Office of the State Auditor

Audit Report

Department of State
Commercial Recording

July 1, 1995 to November 30, 1996
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Enclosed is our report on the audit of the Department of State, Commercial Recording for the period July 1, 1995 through November 30, 1996.

If you would like a personal briefing, please call me at (609) 292-3700.
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Department of State
Commercial Recording

Scope
We have completed an audit of Department of State, Commercial Recording for the period July 1, 1995 through November 30, 1996. Our audit included financial activities accounted for in the state’s General Fund.

Total expenditures of the agency during the 17 month audit period were $8.1 million. The prime responsibility of Commercial Recording is to serve as the central depository and disseminator of commercial information for the State of New Jersey. Revenues of the agency totaled $38.4 million during our audit period and the major components of revenue were filing and service fees.

Objectives
The objectives of our audit were to determine whether financial transactions were related to the agency's programs, were reasonable and were recorded properly in the accounting systems. We also tested for resolution of significant conditions noted in our prior report.

This audit was conducted 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.

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, administrative code, circular letters promulgated by the State Comptroller, and policies of the agency. Provisions that we considered significant were documented and compliance with those requirements was verified by interview and observation and through our samples of financial transactions. We also read the budget message, reviewed financial trends, and interviewed agency personnel to obtain an understanding of the programs and the internal control structure.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide
conclusions about the validity of transactions as well as internal control and compliance attributes. Sample populations were judgmentally selected.

To ascertain the status of findings included in our prior report, we identified corrective action, if any, taken by the agency and walked through the system to determine if the corrective action was effective.

**Conclusions**

We found that the financial transactions included in our testing were related to the agency’s programs, were reasonable and were recorded properly in the accounting systems. In making this determination, we noted certain internal control weaknesses and matters of compliance with laws and regulations meriting management’s attention.

We also found that the agency has resolved the significant issues noted in our prior report except for matters related to the collection of annual report late filing fees. These issues had been updated and restated in our current report.

Details of our findings and recommendations follow.
Late Filers Of Annual Reports

N.J.S.A. 14A:4-5 states that every profit corporation authorized to transact business in the state shall file an annual report and pay a fee of $40 to Commercial Recording. If the report is not filed within 30 days after its due date and after written demand it remains unfiled for 30 more days, the corporation shall forfeit to the state a penalty of $200. The statute provides limited and overly restrictive methods for collecting the penalty. These methods are as follows:

- A civil action may be prosecuted by the Attorney General,
- In lieu of a civil action, the Secretary of State may issue a certificate to the Clerk of the Superior Court where it is entered as a docketed judgment against the corporation, or
- The Secretary of State may revoke the company’s corporate charter when they fail to file for two consecutive years. The certificate of incorporation would be reinstated upon payment of all fees and fines due to the Secretary of State.

The agency's records for nonfilers as of July 1996 include 70,000 companies which are one year delinquent and 20,000 companies which are two years delinquent in filing their annual reports. Commercial Recording is not assessing or collecting the annual report late filing penalty. Because of the magnitude of the late filings, the current methods for collecting the penalty prior to the revocation of the company’s corporate charter are cumbersome and cost prohibitive. The statute does not allow the agency to establish a process whereby an assessment of the penalty can be made by direct billing. The ability to assess and collect directly would provide a better method for the agency to comply with the legislation. The current late filing penalty amount of $200 which is 500 percent of the $40 annual filing fee may be considered disproportionate. A progressive graduated late filing penalty can provide a more proportionate sanction based on the lateness of the filing. This will provide a means to increase compliance and provide for the collection of additional revenue.
Increased filing compliance enhances the quality of the agency's corporate database and the ability to provide accurate corporate information.

Additionally, the agency has not implemented the collection of the penalty for corporations reinstated after revocation for consecutive years nonfiling. The agency reinstates approximately 3,000 corporate charters annually revoked due to consecutive years nonfiling.

**Recommendation**

We recommend the statute be amended to allow the agency to establish a process whereby an assessment of the penalty can be made by direct billing. Also, the agency should implement the collection of the penalty as part of the reinstatement process for corporations which were revoked due to consecutive years nonfiling.

\[\text{Automated Information Systems}\]

The agency is solely reliant on its automated information systems for the processing, capturing and disseminating of Corporate Charter and Uniform Commercial Code filing data.

A proprietary optical imaging system is utilized for the storage and retrieval of Corporate and Uniform Commercial Code documents. The hardware environment on which the system runs is no longer manufactured and critical components of the system are no longer covered by the manufacturer's service contract. This makes the agency's ability to keep the system fully functional and to obtain timely and economical maintenance doubtful. System failure could cause the agency to be almost totally dysfunctional in their ability to provide current Uniform Commercial Code services. Corporate filing services could experience substantial delays in delivering critical services and possible discontinuance of some services. The inability of the agency to provide these services would cause the interruption and probable loss of fees collected for these services. Fiscal year 1996 revenue in potentially affected areas were in excess of $10 million. Adequate resources are available to address the existing optical imaging systems replacement. The Secretary of State
Fund was established to provide the agency with an additional annual appropriation for the purchase of an automated information system. This fund had an unobligated carry-forward balance in excess of $5.4 million at the end of fiscal year 1996.

No disaster recovery plan exists for the agency's automated information system. Therefore, the resumption of operations and the ability to provide services in an efficient and effective manner in the event of a system failure or prolonged shutdown is not assured.

**Recommendation**

We recommend the agency replace their optical imaging system with current technology utilizing resources available in the Secretary of State Fund. The agency should also develop a disaster recovery plan for the automated information system.

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**Appropriation Charges**

Unrelated expenses were charged to the agency's appropriated expedited fee account.

The agency's appropriated expedited fee account was charged $42,000 for expenses attributable to the Office of the Secretary of State. Fiscal year 1996 appropriations language states that "Receipts in excess of those anticipated from the over-the-counter service surcharges are appropriated to the costs of Commercial Recording...". By including the charge, the department has decreased the resources available to the agency and understated the cost of operations for the Office of the Secretary of State.

**Recommendation**

We recommend that the department adhere to the intent of allowable uses of funds in the agency's appropriated expedited fee account as provided for in the appropriations act.

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Mr. Richard L. Fair  
State Auditor  
Office of the State Auditor  
CN 067  
Trenton, NJ 08625-0067

Dear Mr. Fair:

Contained herein are my responses to the findings stated in your current audit report covering the activities of the Division of Commercial Recording.

I am indeed pleased that your audit verified the dramatic improvements that have been made within the Division since your previous visit. I have been, and remain, committed to developing this vital business services unit into the finest one in America, one that also meets the rigorous program and financial standards applied by your Office.

My staff and I have no disagreement with the findings indicated in the report. Here are the steps we have taken to rectify the areas of concern:

**Annual Report Late Filing Fee**

The Governor's Budget for fiscal year 1998 includes a proposal to implement a late filing fee for corporations who are delinquent in filing annual reports. After considerable discussion regarding the administrative aspects of a graduated fee structure, the one recommended is a fixed amount. While the specific language of the change in statute has not been drafted, I have every confidence that it will encourage corporations to file promptly rather than pay the late filing premium. The late filing fee, while providing an incentive for potential late filers to file on-time, will also correct an injustice suffered by those corporations who already file in a timely manner.

**System Obsolescence—Automated Information Systems**

I have been aware of the potential nightmare associated with the aging FileNet optical imaging system since my arrival. That system is part of a larger automated information systems (AIS) support structure that is critical to the Division of Commercial Recording.
At the point of your last audit, the Division was dependent upon a Prime Computer system to serve as the computing platform for the new software being developed to modernize commercial filing services. The mammoth AIS project was near a standstill. With the limited resources available, I created a new task group to prioritize and get the project moving. That decision resulted in the acquisition of a new SUN platform to replace the outdated and grossly inadequate PRIME computer. It also resulted in a project timetable that scheduled replacement of the current optical imaging system as one of our last major acquisitions. We were also aware of the absence of a disaster recovery plan for the various computer-based systems.

Currently, we are in the final stages of completing the Request for Proposal (RFP) in preparation of replacing the FileNet system with an open-architecture system that works well with our new computing platform. We hope to have the new imaging system in place and fully operational within the next 9 - 12 months.

The RFP for disaster recovery services is being crafted with release scheduled for April of this year. Early informal quotes suggest that we will be able to purchase the services required from existing vendors and implement a disaster recovery plan within a very short time after we have signed contracts.

Unrelated Expenses - Expedited Fee Account

This charge was incorrectly applied. Unfortunately, the billing arrived near the end of the fiscal year when year-end closings were at full tilt. During the rush to get all transactions processed, a misapplication occurred. We have reviewed this issue with the employees responsible for such transactions to ensure compliance with the provisions of the appropriations act.

Very truly yours,

Lonna R. Hooks
Secretary of State