STATE OF CONNECTICUT

AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS FOR THE FISCAL YEAR ENDED JUNE 30, 2014
STATE OF CONNECTICUT
COMPREHENSIVE ANNUAL FINANCIAL REPORT

AUDITORS OF PUBLIC ACCOUNTS
JOHN C. GERAGOSIAN ❖ ROBERT M. WARD

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STATE OF CONNECTICUT

AUDITORS OF PUBLIC ACCOUNTS

State Capitol
210 Capitol Avenue
Hartford, Connecticut 06106-1559

JOHN C. GERAGOSIAN

ROBERT M. WARD

February 11, 2015

Governor Dannel P. Malloy
Members of the General Assembly

We have audited the financial statements and certain other information of the Comptroller of the State of Connecticut as they pertain to the central accounting of state financial operations, on a budgetary basis of accounting, for the fiscal year ended June 30, 2014. The auditors' report on the Comptroller's civil list financial statements, the audited civil list financial statements themselves, and the related auditors' report on compliance and internal control over civil list financial reporting are included in a separate report entitled *Annual Report of the State Comptroller – Budgetary Basis*, for the fiscal year ended June 30, 2014, issued December 31, 2014.

We have also audited the financial statements and certain other information of the Comptroller of the State of Connecticut as they pertain to the State of Connecticut's financial position and results of operations on the basis of generally accepted accounting principles (GAAP). The auditors' report on the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, the aggregate remaining fund information, the respective budgetary comparison for the General Fund and the Transportation Fund, the respective changes in financial position and cash flows, where applicable, and the related notes to the financial statements of the State of Connecticut, which collectively comprise the state's basic financial statements are included in a separate report entitled *Comprehensive Annual Financial Report - Fiscal Year Ended June 30, 2014*, known as the state's CAFR.

We have 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. We consider internal control over financial reporting as well as compliance with laws, regulations and other requirements that could have a direct and material effect on the financial statement amounts, in accordance with these standards. We are issuing our Independent Auditors' 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*.

During our audit we became aware of several matters that are considered internal control weaknesses not deemed significant or material but are opportunities to strengthen controls and improve operating efficiencies. The accompanying State Auditors' Findings and Recommendations details these findings and recommendations for corrective action.

We also wish to express our appreciation of the courtesies shown to our representatives during the course of our audit. The assistance and cooperation extended to them by the personnel of the Office of the State Comptroller in making their records readily available and in explaining transactions as required greatly facilitated the conduct of our examination.

Matthew Rugens
Administrative Auditor

Approved:

John C. Geragosian
Auditor of Public Accounts

Robert M. Ward
Auditor of Public Accounts

February 11, 2015
State Capitol
Hartford, Connecticut

INDEPENDENT AUDITORS' 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

Governor Dannel P. Malloy
Members of the General Assembly

We have audited 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, 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 Connecticut as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the state's basic financial statements and have issued our report thereon dated February 11, 2015. Our report includes a reference to other auditors. Other auditors audited the financial statements of certain funds and discretely presented component units of the state, as described in our report on the State of Connecticut's financial statements. This report does not include the results of the other auditors' testing of internal controls over financial reporting or compliance and other matters that are reported on separately by those auditors. The audits of the financial statements of the Bradley International Airport Parking Facility, John Dempsey Hospital, Connecticut State University System, Connecticut Community Colleges and the University of Connecticut Foundation and University of Connecticut Law School Foundation were not conducted in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting:

In planning and performing our audit of the financial statements, we considered the State of Connecticut's internal control over financial reporting (internal control) as a basis for designing our auditing procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of Connecticut's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of Connecticut's internal control.

A *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses or significant deficiencies. However, material weaknesses or significant deficiencies may exist that have not been identified.

Compliance and Other Matters:

As part of obtaining reasonable assurance about whether the State of Connecticut'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 that are required to be reported under *Government Auditing Standards*.

We noted certain other matters that we have reported to management in the following State Auditors' Findings and Recommendations. The state's management responses to findings identified in our audit were not subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on it. In addition, we have reported or will report to management findings in separately issued departmental audit reports covering the fiscal year ended June 30, 2014

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this report is intended solely for the information and use of the Governor, the State Comptroller, the Appropriations Committee of the General Assembly, the Legislative Committee on Program Review and Investigations, and 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. However, this report is a matter of public record and its distribution is not limited.

John C. Geragosian	Robert M. Ward
Auditor of Public Accounts	Auditor of Public Accounts

February 11, 2015
State Capitol
Hartford, Connecticut

OTHER MATTERS – IMPLEMENTATION OF GAAP-BASED BUDGETING

The State Comptroller's budgetary basis financial reporting for fiscal year ended June 30, 2014 reflects the initial year of GAAP-based budgeting. The move to GAAP-based budgeting resulted from the passage of Public Act 11-48 and the passage of the 2013-2014 and 2014-2015 biennial budget plan in Public Act 13-184, as adjusted by Public Act 13-247. The intent of GAAP-based budgeting was to narrow the difference between the accounting for the state budget and the CAFR, which would allow for the CAFR to be the single accounting report for the State of Connecticut.

Passed as part of the *Plan for Conversion to GAAP-Based Budgeting Developed in Accordance With Governor Dannel P. Malloy's Executive Order No. 1*, the details of Public Act 11-48 and the history of efforts leading to its passage from its start in 1993 were described in our *Auditors' Report Office of the State Comptroller for the Fiscal Years Ended June 30, 2011*, and *Auditors' Report Office of the State Comptroller for the Fiscal Years Ended June 30, 2012.*

The Modified Accrual vs Modified Cash Basis of Accounting:

The CAFR uses the modified accrual basis of accounting for all governmental activities, and the full accrual basis for business type activities. Under the modified accrual basis, revenues are recognized when they are both measurable and available to finance expenditures of the fiscal period. Expenditures for each agency are recognized in the period in which a transaction creates a demand on current financial resources. Proper GAAP-based budgeting would provide for these principles in the legally adopted budget for revenues and appropriations.

Under the modified cash basis of accounting formerly used for budgeting, the Office of the State Comptroller was required by statute to follow a practice of recording the accrual of certain revenues, notably income and corporation tax payments, with corresponding expenditures being recorded on a cash basis. If the state had followed the practice of accruing expenditures following the requirements of the modified accrual basis, the salaries and fringe benefits payable and accounts payable incurred but not yet paid would have been added to the liabilities of the General Fund. The result of this practice over the years has been a difference between a yearly balanced budget for the General Fund on the budgetary basis and a deficit in the fund balance of the General Fund reported in the CAFR that had grown to be over $1,000,000,000. GAAP-based budgeting would serve to eliminate this difference.

Establishment of a Statutory Basis of Accounting:

To address the difference noted above, the 2013-2014 and 2014-2015 biennial budget plan for the General Fund contained $53.7 and $72.1 million, respectively, in additional appropriations for each agency that were identified as "nonfunctional – change to accruals." The accruals relate to payments made after the end of the fiscal year for obligations incurred during that fiscal year. Agencies could not charge these appropriations for current spending, but they are available for year-end agency charges. These appropriations are not directly tied to the personal services, other expenses, or other program appropriations detailed in the state budget.

As a result, agency budgets are not directly controlled by GAAP-based budgeting. This practice combined with the previous practice of accruing additional revenues created a statutory basis of accounting unique only to the State of Connecticut.

Public Act 11-48 defined the budget as an estimate of proposed expenditures for a given period or purpose and the means of financing them, determined for the fiscal year ending June 30, 2014, and each fiscal year thereafter, on the basis of generally accepted accounting principles, as promulgated by the Governmental Accounting Standards Board (GASB). Despite the provisions of this public act, it should be noted that GASB has never established any standards for preparing or reporting on a budget prepared on a GAAP basis of accounting. It does however, state in Section 1700.116 of the GASB *Codification of Governmental Accounting and Financial Reporting Standards* that "it is recommended that governmental fund annual budgets be prepared on the modified accrual basis. Many of the modifications or adaptations of the accrual concept in its application to governmental accounting and reporting are similar to typical governmental fund budgetary practices. Thus, often there will be few differences, if any, between the budgetary basis and the modified accrual basis."

This statutory basis of accounting was utilized for the financial statements required under Section 3-115 of the General Statutes. Public Act 11-48, required the State Comptroller to issue unaudited annual financial statements by September 30th for all budgeted funds on a GAAP basis. However, the statements that were issued on September 30, 2014 were not prepared on a GAAP basis of accounting and reflect only a statutory basis of accounting following the requirements of Sections 3-115, 3-115b and Sections 3-114b through 3-114r of the General Statutes. While these statutory requirements are not recognized by the Governmental Accounting Standards Board, the statements prepared were intended to reflect most of the modified accrual basis receivables and payables required for the CAFR. The *Annual Report of the State Comptroller – Budgetary Basis*, for the fiscal year ended June 30, 2014, issued December 31, 2014, also reflected the same accruals. That report received an adverse audit opinion as to compliance with generally accepted accounting principles and a clean audit opinion on compliance with the statutory basis of accounting, as previously described.

In addition, a misconception exists in the interpretation of the term generally accepted accounting principles as it is used in Sections 3-115 and 3-115b of the General Statutes. The standard for GAAP financial reporting is the CAFR which the State Comptroller prepares and releases in February of each year. In accordance with the requirements of GASB, the CAFR is based on the modified accrual basis of accounting for governmental funds and is prepared to specific requirements including the presentation of government-wide financial statements to display the financial position and changes in financial position of its governmental activities, business-type activities, and discretely prepared component units, as well as notes to the financial statements, a management discussion and analysis, and information on depreciation expense, disclosure of all types of debt and infrastructure assets on the financial statements. The effort to implement GAAP as it relates to the State of Connecticut's financial statements issued under Sections 3-115 and 3-115b of the General Statutes included the change to a statutory basis of accounting for the General Fund, Transportation Fund and several other special revenue funds that received legal appropriations from the General Assembly, not a report prepared on a GAAP basis of accounting.

We note that the statutory basis of accounting adopted by the Office of State Comptroller does not carry forward accruals from one fiscal year to the following fiscal year on the Core-CT system. In addition it does not provide monthly financial reporting on a modified accrual or a statutory basis of accounting, but instead continues to utilize the modified cash basis of accounting. This is a compromise method adopted to avoid significant operational changes in Core-CT processes. As a result, budgets are not being controlled on a GAAP basis, and monthly reporting on the Core-CT system is not on a GAAP basis. As we noted in our previous report, state agencies make benefit or provider payments from agency checking accounts that are not directly reflected in the Core-CT system. The Medicaid program at the Department of Social Services is a particular illustration of the weakness of this method, due to the timing and the significant dollar amounts of its bimonthly billings. Our prior report also noted that the University of Connecticut, the University of Connecticut Health Center, the Connecticut State University, the Connecticut Community Colleges, the Office of Legislative Management and the Judicial Department are allowed to operate as limited scope Core-CT agencies. These agencies process their transactions through their own accounting systems and then periodically enter the information into the Core-CT system. As a result, significant receivables and payables can accrue at month or year-end that is not promptly reported on the Core-CT system.

In implementing GAAP-based budgeting, the Office of State Comptroller adopted a method that does not provide monthly reporting on a GAAP or a statutory basis, but instead continues to utilize the modified cash basis of accounting. As a result, the statutory requirements applicable to the Governor's submission of a deficit mitigation plan when a deficit is projected are left unclear. To provide GAAP reporting that is compliant with the modified accrual basis of accounting required by the Government Accounting Standards Board, for the CAFR, the manual entry of miscellaneous accounting information not available on the Core-CT system is still required. To properly monitor budgetary compliance on a modified accrual basis, the Core-CT accounting system would need to provide periodic information on accrued revenues and expenditures without a "close" of the system.

Reconciliation of Fund Balance - General Fund:

As noted above the difference in accounting basis resulted in a deficit in the Unreserved Fund Balance of the General Fund when adjustments were made to reflect the modified accrual basis used under GAAP as required for the CAFR. A reconciliation of the net change in fund balances for the General Fund, as reported under the budgetary and GAAP basis of accounting, has been historically presented in Note 2 of the CAFR. A schedule illustrating the differences in adjustments for the past two fiscal years, is presented below:

Nearest Thousand Dollars	June 30, 2013	June 30, 2014
Unreserved Fund Balance (Deficit) -		
Modified Cash Basis / Statutory Basis	$ 0	$ 0
Adjustments to GAAP Basis:		
Additional Assets:		
Reduction of Income Tax Accrual	(372,500,000)	(437,000,000)
Eliminate Corporation Tax Accrual	(8,900,000)	(7,800,000)
Additional Taxes Receivable	4,400,000	4,400,000
Net Accounts Receivable	291,400,000	326,800,000
Federal and Other Grants Receivable	325,300,000	37,500,000
Due From Other Funds	26,200,000	39,200,000
GAAP Conversion Bonds	0	598,500,000
Total Additional Assets	$ 265,900,000	$ 561,600,000
Additional Liabilities:		
Salaries and Fringe Benefits Payable	(147,400,000)	65,500,000
Accounts Payable - Dept. of Social Services	(550,800,000)	(1,900,000)
Accounts Payable - All Other	(575,300,000)	(538,500,000)
Payable to the Federal Government	(124,600,000)	(202,900,000)
Due to Other Funds	(84,900,000)	(81,000,000)
Total Additional Liabilities	$(1,483,000,000)	$(758,800,000)
Statutory Requirement –		
Change in Accounting Method	0	(529,900,000)
Unreserved Fund Balance (Deficit) -		
GAAP Basis	$(1,217,100,000)	$ (727,100,000)

As shown above, the most significant year to year changes were the results of the transfer of Medicaid funding from the General Fund to the Federal & Other Restricted Account, which previously was an additional asset recorded as Federal and Other Grants Receivable and an additional liability posted to Accounts Payable - Department of Social Services. The significant increase in Additional Assets was largely the result of the issuance of $598,500,000 in GAAP conversion bonds in October 2013, which is an additional debt to the state. The additional salaries and fringe benefits payable and accounts payable are now reflected in the Statutory Requirement – Change in Accounting Method which is the GAAP basis deficit intended to be amortized from the 2016 through the 2028 fiscal years. We also note that proper GAAP budgeting would have corrected the recognition of the July income tax accrual, which represented approximately $437,000,000 in revenues above what would be allowed under GAAP. If complete adoption of GAAP-based budgeting was employed, there would not have been the need to have significant adjustments to reconcile the difference between the Statutory and GAAP basis Fund Balances.

STATE AUDITORS' FINDINGS AND RECOMMENDATIONS

Our review of statewide financial reporting identified internal control weaknesses as defined by auditing standards generally accepted in the United States of America. Although they are not deemed significant deficiencies or material weaknesses per those standards, they are areas that require corrective action. These areas are detailed in the following pages:

Inadequate Financial Reporting Process – Agency Prepared GAAP Adjustment Forms:

Criteria: The Office of the State Comptroller has a long established procedure of requiring state agencies to prepare and submit adjustment forms to report various account balances, accruals, liabilities, contingencies and other information required to report the state's financial position on a GAAP basis to the State Comptroller. These forms are required to be submitted by certain deadlines, with accurate information.

Condition: Our examination found that various state agencies did not submit accurate GAAP adjustment forms. The review of agency prepared forms by our field audit staff found significant errors and omissions in the amounts reported. Some of the more significant errors found were as follows:

- The Department of Energy and Environmental Protection understated contractual obligations by $6,092,819.
- The Department of Emergency Services and Public Protection overstated contractual obligations by $2,759,618.
- The Department of Social Services failed to complete and submit a report of contract retainages totaling $3,867,711.
- The Department of Developmental Services failed to report a total of $7,699,052 in bank balances associated with fiscal intermediaries.
- The Department of Administrative Services failed to completely identify and report $12,280,220 in contractual obligations for the large number of statewide contracts that it administers.
- The Department of Administrative Services submitted its GAAP Form 7 three successive times for its General Services Revolving Fund and has still not corrected all of the errors.
- The Department of Administrative Services – Bureau of Construction Services overstated its contractual retainages by $5,262,531 and its ending balance of construction in progress by $18,830,462.
- The Department of Education understated its contractual obligations by $4,441,356.
- The Department of Economic and Community Development understated its contractual obligations by $8,653,394.

- The Department of Transportation overstated contract retainages by $5,742,532.

Effect: The audit and correction of these errors results in the delay of the preparation and issuance of the state's CAFR and adds to the risk for error.

Cause: Our previous audit noted a similar condition. Although improvement has been shown, there still is a need for the Office of the State Comptroller to provide state agencies with sufficient instruction to ensure the forms contain accurate information.

The calculation of contractual obligations is not done using an automated method, which appears to cause the most difficulties.

Recommendation: The Budget and Financial Analysis Division of the Office of the State Comptroller should continue additional training and monitoring in the preparation and submission of accurate GAAP adjustments. (See Recommendation 1.)

Agency Response: "We agree with this recommendation. As noted, most of the inaccurate reporting by agencies relates to the full value of their contractual obligations. The Comptroller's Office will provide additional guidance with respect to such reporting in the Fiscal Year 2015 closing package and, as a more effective long-term solution, will attempt to gather full contractual obligation amounts in an automated fashion within Core-CT."

SUMMARY OF RECOMMENDATIONS

Status of Prior Audit Recommendations:

Three recommendations were presented in our *Auditors' Report on Internal Control Over Financial Reporting and on Compliance And Other Matters for the Fiscal Year Ended June 30, 2013 State of Connecticut Comprehensive Annual Financial Report*. One of these recommendations is being restated for the fiscal year ended June 30, 2014. A list of the previous recommendations and their resolution are as follows:

1. The Budget and Financial Analysis Division of the Office of the State Comptroller should ensure that all centrally posted journal entries are reviewed and approved independently prior to posting. Our current audit found adequate corrective action has been implemented.

2. The Budget and Financial Analysis Division of the Office of the State Comptroller should provide for additional training and monitoring in the preparation and submission of GAAP adjustments in a timely manner, and should engage the Office of Policy and Management in enforcing the deadlines. It should also consider the automation of the identification of contractual obligations. Our current audit found improvement in the timeliness of submission of GAAP reports. However we continued to find errors in the reports submitted. We are repeating the Recommendation in a modified form. (See Recommendation 1.)

3. The Office of the State Comptroller, the Office of the State Treasurer and the Office of Policy and Management should implement procedures to ensure adequate oversight and centralized financial administration and accounting of capital projects funds. Our current audit found some corrective action made. The $83,998,093 in Capital Bond Fund appropriations greater than 10 years old was reviewed and largely eliminated. Procedures at the Office of State Treasurer were implemented to reconcile all fund balances between the Office of Policy and Management and bond counsel In addition, the Office of State Treasurer sponsored training for all state agencies that included sections on bond allocations, the process of Bond Commission approvals and how the Office of State Treasurer accounts for capital projects within the debt framework.

Current Audit Recommendations:

1. **The Budget and Financial Analysis Division of the Office of the State Comptroller should continue additional training and monitoring in the preparation and submission of accurate GAAP adjustments.**

   Comment:

   Our examination found the State Comptroller had continuing problems accumulating accurate GAAP adjustment data from state agencies.