STATE OF CONNECTICUT

AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
FOR THE FISCAL YEAR ENDED JUNE 30, 2015
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

January 29, 2016

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, 2015. 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 – Statutory Basis*, for the fiscal year ended June 30, 2015, issued November 30, 2015.

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, 2015,* 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

January 29, 2016
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, 2015, and the related notes to the financial statements, which collectively comprise the state's basic financial statements and have issued our report thereon dated January 29, 2016. 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, 2015

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.

Robert M Ward

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

January 29, 2016
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, 2015, reflects the second 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 and Public Act 14-47. 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 results of the first year of GAAP-based budgeting, and certain issues with its implementation are described in our *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.*

As described in our previous year's report, the statutory basis of accounting adopted by the Office of State Comptroller is not GAAP reporting as recognized by the Government Accounting Standards Board. It is not on a GAAP basis in that it does not carry forward accruals from one fiscal period to the following fiscal period on the Core-CT system. Instead, it continues to utilize the modified cash basis of accounting as a compromise 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. 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.

As a result, the statutory requirements applicable to the Governor's submission of a deficit mitigation plan when a deficit is projected by monthly financial reports are left unclear. To provide GAAP reporting for the CAFR that is compliant with the modified accrual basis of accounting required by the Government Accounting Standards Board, 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 described in our previous year's report, 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 three fiscal years is presented below:

Nearest Thousand Dollars	June 30, 2013	June 30, 2014	June 30, 2015
Unreserved Fund Balance (Deficit) -			
Modified Cash Basis / Statutory Basis	$ 0	$ 0	$ 0
Adjustments to GAAP Basis:			
Additional Assets:			
Reduction of Income Tax Accrual	(372,500,000)	(437,000,000)	(475,000,000)
Eliminate Corporation Tax Accrual	(8,900,000)	(7,800,000)	(19,300,000)
Additional Taxes Receivable	4,400,000	4,400,000	1,900,000
Net Accounts Receivable	291,400,000	326,800,000	398,100,000
Federal and Other Grants Receivable	325,300,000	37,500,000	185,600,000
Due From Other Funds	26,200,000	39,200,000	48,700,000
GAAP Conversion Bonds	0	598,500,000	0
Total Additional Assets	$ 265,900,000	$ 561,600,000	$ 140,000,000
Additional Liabilities:			
Salaries and Fringe Benefits Payable	(147,400,000)	65,500,000	(74,200,000)
Accounts Payable - Dept. of Social Services	(550,800,000)	(1,900,000)	(31,200,000)
Accounts Payable - All Other	(575,300,000)	(538,500,000)	(432,300,000)
Payable to the Federal Government	(124,600,000)	(202,900,000)	(304,700,000)
Due to Other Funds	(84,900,000)	(81,000,000)	(90,800,000)
Total Additional Liabilities	$(1,483,000,000)	$(758,800,000)	$(933,200,000)
Statutory Requirement –			
Change in Accounting Method		(529,900,000)	
Unreserved Fund Balance (Deficit) -			
GAAP Basis	$(1,217,100,000)	$(727,100,000)	$(793,200,000)

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 stating with the 2013-2014 fiscal year, 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 in that initial year of GAAP-based budgeting 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 were reflected in the Statutory Requirement – Change in Accounting Method which is the GAAP-basis deficit intended to be amortized from the 2017 through the 2028 fiscal years. In this second year of GAAP-based budgeting, we again observe that proper GAAP budgeting would have corrected the recognition of the July tax accruals and salaries and fringe benefits payable. If complete adoption of GAAP-basis 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

Revision to the Amortized GAAP Deficit and to Section 2-35 and Section 4-72 of the General Statutes:

In order to implement GAAP based budgeting, the General Assembly passed Public Act 11-48 to revise Section (b) of Section 2-35 and Section 4-72 of the General Statutes to require the Governor propose, and General Assembly enact, a state budget that must exclude as revenues the estimated unappropriated prior year surplus, and include as expenditures, the amount necessary to extinguish any unreserved negative balance in any budgeted fund as reported by the prior year CAFR. Public Act 11-48 also revised Section 3-115 of the General Statutes and required the annual report of the State Comptroller to be prepared in accordance with generally accepted accounting principles.

The 2013-2014 fiscal year budget was initial year of GAAP-based budgeting and under Public Act 11-48 the GAAP deficit that accumulated over many years was to be addressed. By starting with the June 30, 2013 GAAP deficit of $1,217,051,000 as reported in that year's CAFR and by applying the proceeds of $598,500,000 of GAAP Conversion Bonds, an adjusted GAAP deficit for June 30, 2013 totaling $618,551,000 resulted which by Public Act 11-48 was to be amortized in equal amounts of $47,380,846 during the 2016 through 2028 fiscal years. However, after the budget for the 2013-2014 fiscal year was adopted and at the close of that fiscal year, it was found that the June 30, 2014 GAAP deficit as reported by that year's CAFR totaled $707,209,000, which was a $108,658,000 unforeseen increase in the GAAP deficit. The cause of this increase was partly due to the income tax accrual period for that fiscal year containing more payroll days, which increased the variance between the GAAP basis of accounting and the statutory (budgetary) basis. This added an additional $64,000,000 to the GAAP deficit because more General Fund revenue was attributable to the statutory accrual period which ends no later than five business days after the last day of July. The remaining $44,700,000 variance was attributed to various closing adjustments made to accounts payable and receivable as part of preparing the CAFR. Some of these errors were caused by the transfer of the federal portion of the Medicaid program from the General Fund to the Restricted Grants and Accounts Fund in the 2013-2014 fiscal year.

When the General Assembly revised the 2015-2016 and 2016-2017 biennial budget by the passage of Public Act 15-1 in the December 2015 Special Session it addressed this condition by amending Section (b) of Section 2-35 and Section 4-72 of the General Statutes to again require estimated revenues to cover the negative unassigned fund balance as reported by the *Annual Report of the State Comptroller* rather than the CAFR. We note that although it is required by Public Act 11-48, the annual report is not prepared in accordance with GAAP but instead reflects the state's budget act and reporting on a statutory basis of accounting.

In addition, Public Act 15-1 amended Section 3-115d of the General Statutes to now require the revised GAAP deficit to be amortized in equal increments of $60,600,750 in each fiscal year of each biennial budget, during the 2017 through 2028 fiscal years.

Accumulated GAAP Deficit:

As reported in the *Comprehensive Annual Financial Report,* on a government-wide basis which takes into account all non-fiduciary state assets and liabilities (for the primary government including all funds, in addition to the General Fund), the total net position as of June 30, 2015 was a deficit of $35,326,113,000. This is a $22,736,162,000 increase as compared the deficit reported as of June 30, 2014. The increase in the deficit was primarily caused by the reporting of the net pension liability now required by government accounting standards. In addition, there was an expenditure of $113,168,010 from the accumulated balance in the Budget Reserve Fund, an increase in current accounts payable and accrued liabilities, an increase in the current portion of the state's long term liabilities and in the liability for escheated property. These increases in the deficit were partially offset by increases in the cash balance, capital assets and the deferred outflows of resources.

A schedule presenting the deficit on a government-wide basis, from the CAFR Statement of Net Position (Assets) - Total Net Position (Assets), since the CAFR presented this information follows:

Fiscal Year Ended, June 30, 2002	$ (816,926,000)
Fiscal Year Ended, June 30, 2003	$ (1,471,912,000)
Fiscal Year Ended, June 30, 2004	$ (1,780,341,000)
Fiscal Year Ended, June 30, 2005	$ (1,392,024,000)
Fiscal Year Ended, June 30, 2006	$ (784,864,000)
Fiscal Year Ended, June 30, 2007	$ (242,540,000)
Fiscal Year Ended, June 30, 2008	$ (2,203,449,000)
Fiscal Year Ended, June 30, 2009	$ (5,065,237,000)
Fiscal Year Ended, June 30, 2010	$ (9,388,402,000)
Fiscal Year Ended, June 30, 2011	$ (9,856,474,000)
Fiscal Year Ended, June 30, 2012	$(10,555,813,000)
Fiscal Year Ended, June 30, 2013	$(10,457,941,000)
Fiscal Year Ended, June 30, 2014	$(12,589,951,000)
Fiscal Year Ended, June 30, 2015	$(35,326,113,000)

The significant increases in the deficit starting with the fiscal year ended June 30, 2008 and in the succeeding years was the result of increases in total bonded debt and poor economic conditions that resulted in budget deficits, the exhaustion of the Budget Reserve Fund and declines in the valuation of state pension investments. The final significant increase, occurring in the fiscal year ended June 30, 2015, was the result of the implementation of Government Accounting Standards Board Statement No.68, which required employers to post their net pension liability. The net pension liability is defined as actuarial accrued liability less the market value of assets available to fund that liability. In the case of the State Employees Retirement Fund and Teachers' Retirement Fund, the total net pension liability as of a reporting date of June 30, 2015 was $16,014,366,000 and $10,141,454,000, respectively. In the fiscal year ended June 30, 2018, the state will be required to adopt Government Accounting Standards Board Statement No.75, which requires the same reporting of the net liability for other post-employment benefits (retiree health care costs) as for pensions.

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 and corrected were as follows:

- The Office of State Comptroller understated the liability of the SEBAC vs. Rowland settlement by $13,219,000.
- The Department of Energy and Environmental Protection understated contractual obligations by $7,403,846. It also overstated pollution remediation obligations and liabilities for landfill post closures by $12,536,652.
- The Department of Correction understated contractual obligations by $84,166,283.
- The Department of Revenue Services erroneously included $7,877,856 in tax refunds for the research and development credit exchange in its report of tax refunds paid. It also overstated tax refunds by $2,658,923 due to a separate error.
- The Department of Developmental Services failed to report a total of $8,075,296 in bank balances associated with fiscal intermediaries.
- The Department of Administrative Services failed to report $30,426,749 in contractual obligations for one entity and made other errors that overstated contractual obligations by

$12,103,230.

- The Department of Administrative Services – Bureau of Construction Services overstated its contractual retainages by $1,888,989 and its ending balance of construction in progress by $36,112,281.

- The Teachers' Retirement Board included health care fund revenues in its report for the retirement fund, overstating the retirement fund contributions by $50,239,077. It also reported year to date unrealized investment gains overstating investment income by $83,879,571. In its report for the health care fund it overstated revenues by $1,725,334 and understated benefit payments by $2,855,888.

- The Department of Transportation understated infrastructure assets by $49,750,671, and overstated construction in progress by $26,186,518.

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. The Office of State Comptroller responded to our findings by revising some of the forms provided to state agencies. Although some 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 audit finding. The division intends to continue working with state agencies to improve the quality and accuracy of their financial reporting. We will continue this effort, as we have in past years, through written instructions, on-site visits, trainings and telephone access for specific questions. We continue to be grateful to the State Auditors for helping to identify agencies and financial issues that require additional explanation and intervention by the division. In one such case that you have cited, the Teachers' Retirement Board, the division assigned an accounting manager to spend one morning a week over a two month period to assist the Board to balance its major retirement and health accounts. The Office of Policy and Management and the Treasurer's Office also provide assistance to the Board in this matter. Proper agency accounting and reporting will always be a challenge. We look forward to working with the State Auditors in the future to correct all ongoing reporting issues."

SUMMARY OF RECOMMENDATIONS

Status of Prior Audit Recommendations:

One recommendation was presented in our *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*. This recommendation is being repeated for the fiscal year ended June 30, 2015. The previous recommendation and its resolution are as follows:

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 - Our current review found conditions had not significantly improved for many agencies. Therefore, we are repeating the Recommendation.

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.