STATE OF CONNECTICUT

AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

AUDITORS OF PUBLIC ACCOUNTS

KEVIN P. JOHNSTON ♦ ROBERT G. JAEKLE

Table of Contents

June 10, 2003

AUDITORS' REPORT
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FOR THE FISCAL YEAR ENDED JUNE 30, 2002

We have made an examination of the financial records of the Treasurer of the State of Connecticut as they pertain to State financial operations for the fiscal year ended June 30, 2002.Throughout this report, we will refer to various financial statements and schedules contained in the Annual Report of the Treasurer, State of Connecticut, including its statutory appendix (Annual Report) for the fiscal year ended June 30, 2002.

This report on the above examination consists of the following Comments, Recommendations and Certification.

Separate reports are issued covering the activities of the Investment Advisory Council and the internal operations of the State Treasury.

COMMENTS

FOREWORD:

The State Treasurer operates primarily under the provisions of Article Fourth of the State Constitution and Title 3, Chapter 32 of the General Statutes. Major duties include responsibilities for the receipt and investment of State moneys, disbursements and, when authorized, issuances of State obligations (borrowing).

In addition to the Executive Office of the Treasurer, the Treasury is organized into several divisions. This report includes our review of the Pension Funds Management Division, the Cash Management Division, the Debt Management Division, the Second Injury Fund and administrative requirements for the Connecticut Higher Education Trust. Comments on some of the major functions of these Divisions are presented in various sections of this report.

Officers and Officials:

The officers and officials of the Treasury Department as of June 30, 2002, were as follows:

State Treasurer: *
Denise L. Nappier

Deputy Treasurer:
Howard G. Rifkin

Assistant Deputy Treasurer:
Linda Hershman

Chief Investment Officer
Susan Sweeney

Assistant Treasurer, Cash Management:
Lawrence A. Wilson

Assistant Treasurer, Debt Management:
Catherine Boone

Assistant Treasurer, Policy:
Meredith A. Miller

Assistant Treasurer, Second Injury Fund:
Alberta Mendenhall

Assistant Treasurer, Unclaimed Property:
Madelyn Colon

* As used in ensuing comments of this report, the term "Treasurer" refers to the State Treasurer.

RÉSUMÉ OF OPERATIONS:

Cash Management Division:

The Cash Management Division is responsible for the coordination of core banking services for all State agencies, receipt and disbursement tracking and reporting, bank account reconciliation, check administration, cash forecasting, cash control, outreach to State agencies, and the administration and investment of the Short Term Investment Fund.

Cash management is defined as "the proper collection, disbursement and control of cash resources." Through four units, the Cash Management Division works to (a) speed and secure deposits of State revenues, (b) control disbursement of State funds in conjunction with the Comptroller's Office and other agencies, (c) minimize banking costs, (d) maintain accurate and timely records, and (e) productively use and invest available funds.

Deposits made to local depository accounts are regularly transferred electronically to concentration accounts for disbursement and investment purposes. Section 3-27e of the General Statutes allows the Treasury the option of paying for fees directly. During the audited period, fees for bank-provided depository, disbursement and cash management services for all State agencies were managed through a combination of direct payment and compensating balance arrangements whereby banks provide credits to pay bank fees in exchange for balances left on account with the bank by the Treasury. The direct payment option allows the Treasury to invest the cash balances in the State's Short Term Investment Fund (STIF), which returns greater interest than that earned under compensating balance arrangements. The direct payments of bank fees are made using the interest earned on the cash balances invested in STIF. During the 2001-2002 fiscal year, the Treasury incurred approximately $3,126,220 of bank service fees, of which approximately $714,715 was covered by compensating balance arrangements. The Division continues to implement procedures to accelerate the collection of State receipts through the use of lock-boxes, electronic transfers and increased use of concentration account deposit tracking services.

The Cash Management Division also approves and tracks all banking relationships and bank service charges for all State agencies. When necessary, the Treasury will coordinate cash management service enhancements for individual agencies and will assist in the development and review of Requests for Proposals for more complicated cash management banking needs. The Division meets regularly with State agencies and recommends improvements in the agencies' banking relationships.

During the 2001-2002 fiscal year, the Cash Management Division continued its implementation of the Community Reinvestment Initiative whereby the Treasurer invests excess funds in certificates of deposit from qualified banks. As of June 30, 2002, the Treasury had $40,812,722 invested through this program. All certificates of deposit have maturities of one year or less.

Schedules on pages S-30 through S-34 and pages O-12 to O-20 of the Annual Report deal with the Civil List Funds, which are the responsibility of the Cash Management Division.

Short Term Investment Fund (STIF):

STIF was established and is operated under Sections 3-27a through 3-27i of the General Statutes. It provides State agencies, funds, political subdivisions and others with a mechanism for investing at a daily-earned rate with interest from day of deposit to day of withdrawal. STIF also provides participants with daily access to their account balances. Investments are mainly in money market instruments. The administrative functions and the actual investing of cash are the responsibility of the Cash Management Division. STIF maintained its AAAm rating by Standard and Poor's throughout the audited period.

The Treasurer's Office holds an annual meeting for STIF shareholders, where information such as fiscal year performance of STIF, investment strategies and administrative enhancements are discussed. The latest meeting was held January 23, 2003 and included a review of the 2001-2002 fiscal year STIF Comprehensive Annual Financial Report.

As of June 30, 2002, STIF had total net assets of $ 3,540,477,702. Participant distributions paid and payable during the 2001-2002 fiscal year were $ 108,736,391 and STIF's expenses were $783,275. According to the Annual Report, STIF reported an annual total return of 2.61 percent, exceeding its main benchmark, the MFR (First Tier Institutions-Only Money Fund Report) index, by .39 percent.

Statements and notes on pages F-28 through F-36 of the Annual Report deal with the Short Term Investment Fund. Also, STIF has an independent review of its Schedules of Rates of Return. This information is included on pages F-37 through F-41 of the Annual Report.

Medium-Term Investment Fund:

The 1997 Regular Session of the General Assembly passed Public Act 97-212, Section 3, codified in Section 3-28a of the General Statutes, creating a medium-term investment fund to be administered by the State Treasurer. As of June 30, 2002, the fund was not open. We were informed that investor agencies had not expressed a need for a medium-term investment fund.

Pension Funds Management Division:

In general, the Pension Funds Management Division (PFMD) operates under the provisions contained primarily in Part I, Chapter 32, of the General Statutes, particularly Sections 3-13a, 3-13b, 3-13d, 3-31a and 3-31b.

The Division's responsibilities include the development, execution and management of investment programs of the pension and trust funds. The Division is also charged with the responsibility of making sure that pension and trust fund investments are made in compliance with State statutes and guidelines. This includes administering State law regarding corporations doing business in Northern Ireland or Iran. The Investment Advisory Council (IAC), which is within the State Treasurer's Office for administrative purposes only, reviews investments authorized by statute, recommends investment policies to the Treasurer, examines investments of the State as of June 30, and reports the value of such to the Governor. A separate report is issued on the Investment Advisory Council.

The Pension Funds Management Division is responsible for managing the assets of six pension funds and nine trust funds having total net assets of more than $18,700,000,000, as of June 30, 2002. The Division invests the assets of these funds in accordance with an investment program through the purchase of ownership interests in the Combined Investment Funds. The Combined Investment Funds contain seven asset classes. During the audited fiscal year, and as of June 30, 2002, the Combined Investment Funds (CIF) consisted of the Mutual Fixed Income (MFIF), Mutual Equity (MEF), Real Estate (REF), International Stock (ISF), Private Investment (PIF), Commercial Mortgage (CMF), and the Cash Reserve (CRF) Funds. Record keeping and custody of most assets is provided by a master custodian (State Street Bank). As of June 30, 2002, the Division employed 68 external advisors to invest the Combined Investment Funds’ assets.

The cost of operating the Treasury's Pension Funds Management Division, including the cost of personnel and professional investment advisors retained, is charged against the investment income of the Combined Investment Funds. Transfers are made from the investment fund to a special General Fund account from which Pension Funds Management Division operating expenses (salaries, advisor and management fees, supplies, etc.) are paid. Expenses of the Combined Investment Funds, excluding external advisor expenses, were approximately $5,000,000 for the 2001-2002 fiscal year.

During the fiscal years ended June 30, 2002 and 2001, outside advisors managed all of the CIF portfolios. The number of outside advisors and advisor expenses by fund, as reported in the Combined Investment Funds financial statements and notes included in the State Treasurer's Annual Report, for services rendered during the 2001-2002 and 2000-2001 fiscal years are summarized below:

CIF	# of Advisors- June 30, 2002	Expenses 2001-2002	# of Advisors- June 30, 2001	Expenses 2000-2001
MFIF	10	$10,766,845	10	$ 12,409,908
MEF	8	18,468,060	10	31,104,059
ISF	6	15,058,168	6	10,124,114
CRF	1	221,652	1	261,204
CMF	1	442,777	1	566,633
PIF	35	42,177,620	35	44,315,086
REF	7	4,711,148	7	6,094,929
Total	**68**	**$91,846,270**	**70**	**$ 104,875,933**

The above consists of the Mutual Fixed Income (MFIF), Mutual Equity (MEF), International Stock (ISF), Cash Reserve (CRF), Commercial Mortgage (CMF), Private Investment (PIF), and the Real Estate (REF) Funds.

The performance-based fee structures for investment advisors for the MEF, ISF and MFIF are based on whether the investment advisors' returns exceeded their relative benchmarks during the year. If investment returns of the advisors exceed the benchmark returns, they have the potential to earn significant incentive fees. It appears more investment advisors outperformed their benchmark in the ISF, compared to the MEF where many investment advisors did not appear to meet their earnings benchmark.

The management fees for the MFIF, MEF and ISF as reported in the Annual Report are based on estimates of the performance bonus, which is paid subsequent to June 30. The actual advisor fee expense differed from the reported amount, due to these performance bonus estimations.

Asset Allocation Policy:

The Investment Advisory Council approved the Investment Policy Statement for the Combined

Investment Funds at a meeting of the Council held March 13, 2002. The Treasurer's Asset Allocation Policy as of June 30, 2002, approved as part of the Investment Policy Statement is presented below.

Asset Class		CIF	Target Policy	Holdings as of June 30, 2002
U.S. Equity	***36%:***	***MEF***	36%	36%
International Equity	***18%:***	***ISF***	18%	12%
Developed Markets	15%	ISF		
Emerging Markets	3%	ISF		
Fixed Income	***30%:***	***MFIF, CRF, CMF***	30%	37%
Cash	1%	CRF		
Core Bonds	20%	MFIF, CMF		
Inflation-linked Bonds	1%	MFIF		
High-yield Bonds	5%	MFIF		
Non-U.S. Emerging Markets	3%	MFIF		
Real Estate and Alternative	***16%:***	***REF, PIF***	16%	15%
Equity Real Estate	5%	REF		
Alternative Investments	11%	PIF		

The Treasury's Asset Allocation Policy includes lower and upper ranges for the investment allocations. All variations above are within the established ranges except for the Private Investment Fund (PIF) and the Fixed Income. The PIF's established target allocation of 11 percent is also its maximum. Currently, holdings are 12 percent, which exceeds its maximum allocation by 1 percent.

During the fiscal year ended June 30, 2002, the Combined Investment Funds realized a negative annual total return of (6.39) percent, according to the Annual Report. The return was higher than that of the S&P 500 index of negative (17.99) percent, but lower than the Lehman Aggregate Bond and blended index returns of 8.63 percent and negative (5.12) percent, respectively. The "blended index" is a 50/50 blend of the S&P 500 and the Lehman Aggregate Bond indexes. We note that in fiscal year ended June 30, 2002, the Treasury started calculating a blended index known as the Connecticut Multiple Market Index to more accurately compare the overall return of the fund against market conditions using the weighted averages of the asset classes. The fund return of negative (6.39) percent was higher than the calculated benchmark of the new Connecticut Multiple Market Index of negative (9.60) percent. These indexes represent four "benchmarks" used by the Division to evaluate investment return. Another benchmark is the actuarially determined assumed rate of return of 8.5 percent that is internally established. During the previous fiscal year ended June 30, 2001, the Combined Investment Funds realized a negative annual total return of (3.68) percent.

A summary of the percentage returns of the Combined Investment Funds and the retirement and trust funds that are invested in the Combined Investment Funds, as reported in the State Treasurer's Annual Report, for the fiscal years ended June 30, 2002 and 2001 are presented below.

Combined Investment Funds:		Percentage Return 2001-2002	2000-2001
Net Total Combined Investment Funds		(6.39)%	(3.68)%
Mutual Equity	MEF	(14.95)%	(9.55)%
International Stock	ISF	(9.00)%	(13.29)%
Real Estate	REF	0.81 %	14.45 %
Mutual Fixed Income	MFIF	5.64 %	8.03 %
Commercial Mortgage	CMF	1.19 %	10.88 %
Private Investment	PIF	(10.81)%	(6.25)%
Cash Reserve	CRF	3.03 %	6.35 %
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		(6.39)%	(3.68)%
Teachers' Retirement Fund (TRF)		(6.58)%	(3.71)%
State Employees' Retirement Fund (SERF)		(6.62)%	(3.72)%
Municipal Employees' Retirement Fund (MERF)		(6.41)%	(3.55)%
Probate Court Retirement Fund (Probate)		(5.89)%	(3.20)%
Judges' Retirement Fund (Judges')		(5.88)%	(2.81)%
State's Attorneys' Retirement Fund (St. Atty.)		(7.94)%	(1.75)%
Trust Funds		1.16 %	4.09 %

Investment performance for individual retirement funds varies based on the mixture of asset class types held by each. The investment performance for trust funds is a composite of returns earned by nine trust funds that participate in the Treasurer's Combined Investment Fund. Trust Funds include the School and Agricultural College Funds, The Soldiers' Sailors' and Marines' Fund, the Police and Fireman's Survivors' Benefit Fund, Endowment for the Arts, Hopemead Fund, Ida Eaton Cotton Fund, Andrew Clark Fund and the Tobacco and Health Trust Fund.

A more thorough discussion of the Combined Investment Funds, including performance during the 2001-2002 fiscal year, can be found on pages 15 through 53 of the Annual Report.

Statements and notes on pages F-6 through F-21 of the Annual Report deal with the Combined Investment Funds. Supplemental information on the pension plans and trust funds is included on pages S-1 through S-25 of the Annual Report.

Debt Management Division:

The Treasurer has the responsibilities to manage the debt of the State and to administer the financial needs of the bonding programs enacted by the State legislature and authorized by the Bond Commission. These responsibilities are carried out through the Debt Management Division.

A summary of bonds issued, paid, or refunded in the 2001-2002 fiscal year and the obligations outstanding, as of June 30, 2002, is presented in the schedule entitled "Changes in Debt Outstanding" shown on page S-27 of the Annual Report, while additional information is contained in the Annual Report pages S-28 and O-1 through O-11. A brief summary, follows:

Bonds Outstanding June 30, 2001	$11,673,511,116
Add - Issuances	2,742,670,000
Deduct - Payments at maturity	874,666,532
- Bonds refunded or defeased	1,184,860,000
Bonds Outstanding June 30, 2002	**$12,356,654,584**
Interest paid	**$627,847,187**

Bonds issued in 2001-2002 by type is shown below:

General Obligation - Tax Supported	$1,822,335,000
Debt Service Commitment – UCONN 2002	100,000,000
Special Tax Obligation	820,335,000
Total Bonds Issued, 2001-2002	**$2,742,670,000**

True interest cost rates for new bonds issued during the 2001-2002 fiscal year ranged from 3.95 percent to 4.79 percent. Bonds issued during the 2001-2002 fiscal year were comprised of new money issues amounting to $1,621,000,000 and refunding issues amounting to $1,121,670,000.

In addition to the interest paid totaling $627,847,187, during the 2001-2002 fiscal year, the Treasury also made arbitrage rebate payments to the Federal government totaling $2,251,353. Such rebates represent the excess earnings of nontaxable bond proceeds that were invested in STIF prior to project disbursement.

Bonds outstanding at June 30, 2002 include $28,595,000 of Certificates of Participation for the Middletown Courthouse and $19,165,000 of Certificates of Participation for the Connecticut Juvenile Training School Energy Center project. These Certificates are not debt of the State; however, the State is obligated to pay a base rent under leases for these facilities, subject to the annual appropriation of funds or the availability of other funds therefor. The base rent is appropriated as debt service. The Certificates of Participation are included on the Treasurer's Debt Management System for control purposes.

Further, the Connecticut Development Authority issued $9,275,000 of its lease revenue bonds for the New Britain Government Center in the 1994-1995 fiscal year, of which $6,950,000 was outstanding at June 30, 2002. The State is obligated to pay the base rent subject to the annual appropriation of funds. These payments are budgeted in the Treasurer's debt service budget as lease payments and are included in the above summary.

Bonds outstanding at June 30, 2002 also include $154,020,000 of Second Injury Fund bonds outstanding. These bonds will be payable solely from future assessment revenue of the Second Injury Fund, and the State has no contingent obligation either directly or indirectly for the payment of such bonds.

Under Section 3-16 of the General Statutes, the Governor on April 10, 1990 authorized the Treasurer to enter into short-term borrowing of up to $550,000,000. On April 4, 1991, the Governor increased this amount by $200,000,000. Therefore, the authorized limit on short-term borrowing outstanding at any given time as of June 30, 1995 could total $750,000,000. There were no short-term borrowings outstanding at June 30, 1995. On August 30, 1995, the Governor approved short-term borrowing in a principal amount up to, but not exceeding, a total of $400,000,000 at any one time. He further stated that "Upon issuance of any such obligations any such approvals for any previous temporary borrowings not outstanding shall be revoked and shall cease and terminate and be of no further effect." As of June 30, 2002, there was no issuance of short-term debt under this authority. For the purpose of funding the deficit in the General Fund for the fiscal year ending June 30, 2002, Section 111, of Special Act 02-1, of the May 9 Special Session, effective August 15, 2002, authorized the Treasurer to issue economic recovery notes of the state in an amount not to exceed the amount of such deficit plus the costs of issuance of such notes. All such notes shall mature no later than five years after the date of issuance, and may be issued whenever the Treasurer determines that the cash requirements of the General Fund must be met by such borrowing and shall be scheduled so as to minimize the need for additional temporary borrowing pursuant to section 3-16 of the General Statutes.

Tax Exempt Proceeds Fund (TEPF):

The Tax Exempt Proceeds Fund, codified as Sections 3-24a through 3-24h of the General Statutes, serves as a vehicle to allow the State Treasurer to comply with "arbitrage" requirements of the Tax Reform Act of 1986 with regard to the proceeds of nontaxable bond issues passed through to municipalities, nonprofit organizations and others as grants and loans. The "arbitrage" provision of the Tax Reform Act requires that any earnings on bond proceeds in excess of the interest rate on the bonds be "rebated" to the Federal government unless those proceeds are invested in other tax-exempt securities. Under the Tax Reform Act, such pass-throughs are not considered expended when the State advances the funds to the recipient. Accordingly, without TEPF the State would have to track the investment of proceeds of some bond issues until they are ultimately disbursed to contractors and vendors. Proceeds deposited into the fund can leave it only for a payment to a contractor, a vendor, or as a reimbursement.

The TEPF was incorporated as a regulated investment company and is managed by a firm retained by the State Treasurer. In addition to State agencies, TEPF may be used by authorities, municipalities and others. The TEPF was audited by a firm of independent public accountants for the 2001-2002 fiscal year.

According to the Annual Report of the TEPF, net assets of the fund totalled $201,724,618 at June 30, 2002, and the return on investment was 1.48 percent for the 2001-2002 fiscal year. Participants in the fund at June 30, 2002, included civil list funds and recipients of State agency grant and loan programs as well as others.

At June 30, 2002, a total of $84,115,838 of State funds was invested in the TEPF as shown below:

Fund Classification	Amounts	Annual Report Page No.
General Fund	$ 870,828	O-12

Special Revenue	52,469,047	O-12
Capital Projects	6,495,388	O-14
Enterprise	24,280,575	O-15
Total	**$84,115,838**	O-15

Second Injury Fund (SIF):

The operations of this fund are provided for by various statutes of the Workers' Compensation Act, Chapter 568, of the General Statutes (notably Sections 31-310 and 31-349 through 31-355a). This Act provides protection for employees suffering occupational injuries or diseases and establishes criteria determining whether benefits due employees are to be paid by the employers (or their insurance carrier) or out of the Second Injury Fund (SIF). The Treasurer is the custodian of SIF. Per Section 31-349e of the General Statutes, there is an advisory board to advise the custodian of SIF on matters concerning administration, operation, claim handling and finances of the fund.

Fund revenues consisted mainly of assessments levied against self-insured employers and companies writing workers' compensation or employers' liability insurance and totaled $110,563,466 for the 2001-2002 fiscal year.

Authorizations for claim payments are made by the Attorney General's Office. Such payments amounted to $41,506,210 on a modified accrual basis for the 2001-2002 fiscal year.

A comparison of claim expenditures by category follows:

	2001-2002	**2000-2001**
Stipulations	$11,577,643	$ 25,584,975
Indemnity (lost wages)	23,652,885	21,155,382
Medical	6,275,682	5,774,641
Totals	**$41,506,210**	**$ 52,514,998**

The number of stipulated agreements to settle claims decreased during the current audited period. According to the Treasurer's Annual Reports, the number of settled claims totaled 323 and 209 for the fiscal years ended June 30, 2001 and 2002, respectively. Funding sources for the settlement of stipulated claims mainly came from the issuance of a total of $224,100,000 of Second Injury Fund Special Assessment Revenue Bonds of which $154,020,000 were outstanding at June 30,2002.

Additional comments concerning the operations of the Second Injury Fund are included in the "Condition of Records" section of this report.

Financial statements and notes for the SIF are presented on pages F-47 through F-54 of the Annual Report.

Workers' Compensation Commission - Administrative Expenses:

As authorized under the Workers' Compensation Act of the General Statutes, the Second Injury and Compensation Assurance Fund and the administrative expenses of the Workers' Compensation Commission (WCC), are financed by assessments against companies writing workers' compensation or employers' liability insurance and by assessments against self-insured employers.

Assessments are based on workers' compensation benefits paid by the applicable companies. Data concerning the companies writing workers' compensation insurance is furnished by the State Insurance Department. Self-insurers report directly to the Treasury Department. A list of such companies is supplied by the Workers' Compensation Commission (WCC). ("Certificates of Solvency" are issued by that Commission.) By far, the greater portion of assessments is levied against insurance companies rather than self-insured employers.

Under Section 31-345 of the General Statutes, the Treasurer must assess and collect from the above insurance carriers and self-insurers amounts to reimburse State expenses incurred by the WCC in the administration of workers' compensation benefits.

In accordance with Section 31-345, the WCC's chairman notified the Treasurer that $23,628,210 was needed to meet the expenses of the WCC for the 2001-2002 fiscal year. Based on the above projection, less the balance in the WCC account, the Treasurer assessed insurance companies and self-insured employers during the audited period at a rate of 3.75 percent of their preceding fiscal year's payments for workers' compensation benefits. Collections of these assessments are deposited into the Workers' Compensation Administration Fund.

A summary of Workers' Compensation Administration (WCA) Fund assessment receipts and total WCA Fund receipts for fiscal years 2001-2002 and 2000-2001 follows:

	2001-2002	**2000-2001**
Assessment collections	$20,308,536	$ 19,701,007
Other receipts	42,075	60,462
Total Receipts - WCA Fund	**$20,350,611**	**$ 19,761,469**

Connecticut Higher Education Trust (CHET):

The Connecticut Higher Education Trust (CHET) was established pursuant to Public Act 97-224, codified as Sections 3-22e through 3-22o of the General Statutes. CHET is a trust, available for participants to save and invest for higher education expenses, that is privately managed under the supervision of the Treasurer. The Trust is an instrumentality of the State, however; the assets of the Trust do not constitute property of the State and the Trust shall not be construed to be a department, institution or agency of the State. CHET is a qualified State tuition program in accordance with guidelines contained in Section 529 of the Internal Revenue Service code. While money is invested in CHET, there are no taxes (Federal or State) on the earnings. Amounts can be withdrawn to pay for tuition, room and board, or other qualified higher education expenses. There are no State taxes paid on qualified withdrawal earnings. The program began accepting applications in January 1998.

The Connecticut Higher Education Trust was audited by a firm of independent public accountants for the 2001-2002 fiscal year.

As of June 30, 2002, the CHET program had net assets of $207,969,184, and 26,330 participant accounts. Operating results for the 2001-2002 fiscal year taken from the Annual Report were as follows:

Net assets at June 30, 2001	$ 93,931,702
Net Participant Contributions	121,812,720
Investment income	(6,965,594)
Penalties for non-qualified withdrawals	1,214
Management fees	(759,907)
Administration fee	(50,951)
Net assets at June 30, 2002	**$207,969,184**

Financial statements and notes for CHET are presented on pages F-55 through F-60 of the Annual Report.

Trust Funds:

In addition to investment-type trust funds of the Pension Funds Management Division (described earlier in this report) and those in CHET, the Treasurer is also responsible for the administration of certain other trust funds which fall within her statutory jurisdiction. Some of these funds are described in the ensuing section.

School and Agricultural College Funds:

The administration of these two trust funds is provided for in Sections 3-40 through 3-55 of the General Statutes. Under Article Eighth, Section 4, of the Constitution of Connecticut, the School Fund is a perpetual fund whose interest is to be used in support of State assistance to public schools. Annually, fund earnings are transferred to the General Fund from which public education grants are made. Under Section 10a-115 of the General Statutes, net income of the Agricultural College Fund is transferred to the University of Connecticut.

Investments consisted of participation in the Treasurer's major investment funds discussed earlier. No direct individual investments were held by the two trust funds. Total fund balances (at cost), on June 30, 2002, amounted to $6,193,347 for the School Fund and $395,585 for the Agricultural College Fund. The total fund balances on June 30, 2002, at fair value, amounted to $8,162,880 for the School Fund and $526,399 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-43 through F-45 of the Annual Report. Investment activity is presented on pages S-4 through S-6.

Insurance Companies Trusteed Securities:

Pursuant to Section 38a-83 of the General Statutes, securities are deposited with the Treasurer to be held in trust for policy holders of insurance companies as a prerequisite to such companies transacting business in any state requiring such protection. A listing of insurance companies and their security deposits, as of June 30, 2002, is presented starting on page O-21 of the Annual Report.

Each company depositing these securities is required, per Section 38a-11, subsection (e), to pay $250 annually to defray the cost of custodial services, which is collected by the Insurance Department.

Subsequent Events:

Distribution of Realized Gains:

Subsequent to June 30, 2002, the Private Investment Fund received approximately $267,000,000 representing realized gains that had not been previously distributed by a limited partner.

Writs of Summons Against General Partner:

One limited partnership in the Private Investment Fund experienced a reduction in market value of approximately $4,000,000 subsequent to June 30, 2002. The same limited partnership obtained two writs of summons against a former general partner and a business associate alleging embezzlement of partnership funds.

CONDITION OF RECORDS

Our review of the financial operations of the State Treasury disclosed some areas requiring additional attention. These areas are described on the following pages.

Second Injury Fund Claims Management:

Criteria: The Second Injury Fund (the Fund) is responsible for specific types of workers' compensation claims under Section 31-349 of the General Statutes. Appropriate procedures should be in place for claims analysts to monitor injured workers' case files to determine the claimants' continued eligibility for benefits. Adequate supervision of the monitoring of claim files should ensure that claimants do not receive benefits beyond their eligibility period for provisions that require:

- Dependents to meet certain age and other requirements
- Widows receiving survivorship benefits to remain unmarried
- Injured workers to remain disabled and unable to return to work
- Claimants who are deceased to no longer receive benefits

Condition: During our review of indemnity and medical benefit payments made by the Second Injury Fund, it was found that adequate procedures were not in place to monitor active claimant files. We found that, of 41 cases reviewed, one claims analyst had five of seven cases with inadequate backup documentation to support payments made. One claimant was receiving dependency benefits without verification that the dependent met the eligibility requirements over the past three years; a widow was receiving survivorship benefits without it being determined that she had not remarried for over two years; two more cases had no medical bills or medical reports to support continued disability for approximately two and five years respectively. Until we brought these to the Fund's attention, it appears that no monitoring occurred in most of these cases.

In another case, the Fund reported to us on March 20, 2002, that compensation payments were made for over two and one half years before the Fund realized the claimant was deceased. The Fund calculated that $91,087 was overpaid since July 5, 1999 and has recovered all amounts due.

It is clear that improved procedures are needed to ensure that case file maintenance is adequate. The Fund needs to implement a uniform method of documenting case file reviews along with a tickler file system to indicate when cases require more attention, such as those noted above. This would allow claims analysts to review source documents to verify that claimants are being paid properly. This uniform system of documenting claims review would enable supervisors to track and evaluate the work of claims analysts.

Cause: Procedures to properly supervise claims analysts and monitor case files within the Fund were lacking.

Effect: The Fund may be paying benefits to claimants that are not eligible to receive such benefits.

Recommendation: The Second Injury Fund should develop procedures to supervise the claims analysts who should be monitoring all active claims to ensure that claimants continue to remain eligible to receive benefits. (See Recommendation 1.)

Agency Response: "The Second Injury Fund has prepared a Best Practices and Procedures Manual after discovering in April 2002 that inadequate Claims Analyst procedures had resulted in the payment to a claimant who had been deceased for two and one half years, however, the entire overpayment has since been recovered. The new procedures manual is in the final stages of preparation and is expected to be available in January 2003 and will ensure proper supervisory oversight of the work of Claims Analysts.

As noted by the auditors, although additional examples of inadequate procedures were discovered, the Fund had not made any improper payments to claimants.

Issuance of the procedures manual is among the number of recommendations identified by the Treasurer's Blue Ribbon Commission resulting in the Fund's ongoing Improvement Project designed to strengthen the Fund's procedures and practices."

Failure to Safeguard Assets within the Second Injury Fund:

Criteria: Section 31-303 of the General Statutes requires the Second Injury Fund (the Fund) to make settlement payments to claimants in a timely fashion after receiving a fully executed agreement. The Workers' Compensation Commissioner shall impose a 20 percent penalty against the Fund for benefits not paid in a timely manner. Certain payments to an individual from a State agency may be administratively intercepted to settle outstanding amounts collectible by another State agency. Intercept claims from other State agencies should not cause undue delay in processing the appropriate payments to claimants.

Condition: During our audit of the Second Injury Fund, it was found that the Fund failed to pay a claimant's settlement amount of $125,000 by the agreed-upon due date of July 4, 2001 and delayed the processing of the payment until August 14, 2001. In accordance with Section 31-303 of the General Statutes, the Commissioner imposed a 20 percent penalty against the Fund and ordered them to pay an additional $24,374 to the claimant. It appears this penalty payment could have been avoided.

The Fund delayed paying the original amount of $125,000 because they received an intercept claim from the Bureau of Child Support Enforcement (BCSE) in the amount of $3,132. This notification was received by the Fund on June 22, 2001 via telephone and fax and directed the Fund to withhold $3,132 from the claimant's settlement and to disburse the remaining settlement amount appropriately. The Fund did not disburse the $121,868 until August 14, 2001, which was well after the release date from BCSE and the original deadline of July 4, 2001. Because of the delay, the penalty of

$24,374 was ordered to be paid by the Fund to the claimant. This matter was reported to the Governor and other State Officials in a letter dated June 17, 2002.

Cause: The BCSE intercept claim apparently caused some confusion within the Fund on how to proceed with the payment; a Treasury official stated the Fund was awaiting original documents to be sent from BCSE before authorizing payment to the claimant.

Effect: The Fund failed to safeguard the State's assets in that a late payment penalty of $24,374 could have been avoided.

Recommendation: The Second Injury Fund should improve control over the safeguarding of assets by avoiding the penalty for late payment of claims imposed under Section 31-303 of the General Statutes. (See Recommendation 2.)

Agency Response: "As reported by the Office of the Treasurer in a letter to the Governor on August 16, 2002, the Second Injury Fund revised the settlement processing procedures in order to prevent mishandling of timely settlements and late penalty fees being imposed on the Fund as noted in this audit finding.

The Office of the Treasurer is extremely cognizant of the importance of maintaining proper internal controls over State assets, and we believe the appropriate corrective action has been implemented to ensure their safeguard."

Underpayment of Indemnity Benefit

Criteria: According to Section 31-307c of the General Statutes, the Second Injury Fund (the Fund) shall pay a base rate of compensation plus cost-of-living increases to all injured workers awarded benefits prior to October 1, 1953.

Condition: During our audit of the Second Injury Fund we tested 40 case files out of approximately 500 active cases to determine whether compensation benefits for claimant payroll were calculated and paid in accordance with the General Statutes. We discovered that one claimant was owed a substantial amount because the Fund had failed to accurately calculate the claimant's compensation benefits. The claimant was injured prior to October 1, 1953 and in accordance with 31-307c of the General Statutes, should have received the compensation rate equal to the original base rate plus cost-of-living increases. The Fund was paying only the cost-of-living increases while also using the incorrect base rate to calculate the benefit. After we brought it to their attention, the Fund calculated that $12,853 was the underpayment from 1987 to May 2002 and a payment was made to correct the underpayment. Although the Fund's calculation appears accurate for the respective period, we note that reliable records were no longer available for years prior to 1987 to determine whether additional amounts were underpaid. This is the only case within the Fund to which Section 31-307c of the General Statutes applies.

Cause: The Fund did not discover that indemnity benefit calculation procedures related to injuries occurring between 1953 to 1969 had been applied to this case, which had an injury date *prior* to October 1, 1953.

Effect: The claimant was underpaid for an undetermined number of years. There did not appear to be any other active indemnity claims occurring before October 1, 1953 that would be affected.

Conclusion: No recommendation is necessary. Our review indicated that procedures in place for indemnity benefits occurring after October 1, 1953 were adequate.

Reconciliation of Wire Transfer Records to Bank Records:

Criteria: The Pension Funds Management Division usually initiates wire transfers from accounts maintained by the Master Custodian to accounts maintained by investment advisors.

Condition: During our audit of the Combined Investment Funds we noted that the amount of a wire transfer did not agree with the actual cash transferred from the direct deposit account. On June 21, 2002, the Master Custodian transferred $5,776,259 from available cash in the Combined Investment Funds to a private equity investment advisor. The amount transferred represented a capital call of $5,039,540 plus a management fee payment of $736,719. The management fee portion was not posted to the accounting records until July 29, 2002, although the cash transaction occurred in the prior month.

Cause: The Pension Funds Management Division did not realize that the Master Custodian transferred the entire amount to the investment advisor in June. A payment from Pension Funds Management operating funds was made in July 2002 for the management fee of $736,719 and that payment was used by the Master Custodian to replenish the Combined Investment Funds' cash for the June 2002 management fee disbursement.

Effect: The management fee was paid in June although records indicated it was not paid until July. Internal control is compromised if accounting records do not accurately reflect cash transactions.

Recommendation: The Pension Funds Management Division should reconcile wire log records and custodian cash accounting records to the direct deposit account cash transaction record on a monthly basis. (See Recommendation 3.)

Agency Response: "The Pension Funds Management Division (PFM) concurs with the recommendation and now performs a formal monthly reconciliation to account for the timing differences of receipts and disbursements from the general ledger cash balance against the alternative investments direct deposit account statements.

The audit finding noted by the auditors is the only foreign currency wire transaction within the alternative investments portfolio that is paid in Euro dollars. Since PFM does not have the capabilities to execute any Euro dollar transactions, PFM authorized the Custodian to wire funds from the PFM account to the manager. This particular disbursement included the private equity management fee and a capital call. All other expensed management fee payments are paid separately from the capital calls. In order to account for this expensed fee, PFM had to transfer cash to reimburse the account. Unfortunately, the two transactions did not occur in the same accounting month resulting in a timing difference as noted by the auditors."

RECOMMENDATIONS

Status of Prior Audit Recommendations:

Our prior audit examination resulted in five recommendations. The following is a summary of those recommendations and the action taken by the State Treasury.

- The Second Injury Fund should ensure that settlement checks include the claimant's name as payee, and should not make the check intentionally payable to anyone other than the appropriate, named claimant. New procedures designed to ensure that the claimant is listed as payee were implemented during the current period.

- The Second Injury Fund should always make attempts to recover overpayments and should not write off valid receivable amounts without proper authorization. This recommendation is not repeated.

- The Debt Management Division should have internal controls that ensure adjustments are posted accurately, timely and reconciled to the Comptroller; the Cash Management Division should promptly review and research out of balance entries that impact on the financial statements. This recommendation has been resolved.

- The Treasurer's Office should monitor sums deposited into Tax Exempt Proceeds Fund suspense accounts and ensure that the disposition of such sums is accomplished in adherence to accepted procedures. This recommendation was adequately addressed.

- The Treasury should confirm the value of stock distributions on hand with the broker on a regular basis. This recommendation is not repeated.

Current Audit Recommendations:

The following recommendations resulted from our current review.

1. **The Second Injury Fund should develop procedures to supervise the claims analysts who should be monitoring all active claims to ensure that claimants continue to remain eligible to receive benefits.**

   Comments:

   It is clear that improved procedures are needed to ensure that case file maintenance is adequate. The Fund needs to implement a uniform method of documenting case file reviews along with a tickler file system to indicate when cases require more attention. This would allow claims analysts to review source documents to verify that claimants are being paid properly. This uniform system of documenting claims review would enable supervisors to track and evaluate the work of claims analysts.

2. **The Second Injury Fund should improve control over the safeguarding of assets by avoiding the penalty for late payment of claims imposed under Section 31-303 of the General Statutes.**

   Comments:

   During our audit of the Second Injury Fund, it was found that the Fund failed to pay a claimant's settlement amount of $125,000 by the agreed-upon due date of July 4, 2001 and delayed the processing of the payment until August 14, 2001. In accordance with Section 31-303 of the General Statutes, the Commissioner imposed a 20 percent penalty against the Fund and ordered them to pay an additional $24,374 to the claimant. It appears this penalty payment could have been avoided.

3. The Pension Funds Management Division should reconcile wire log records and custodian cash accounting records to the direct deposit account cash transaction record on a monthly basis.

Comments:

During our audit of the Combined Investment Fund, we noted that the amount of a wire transfer did not agree with the actual cash transferred from the direct deposit account. On June 21, 2002, the Master Custodian transferred $5,776,259 from available cash in the Combined Investment Funds to a private equity investment advisor. The amount transferred represented a capital call of $5,039,540 plus a management fee payment of $736,719. The management fee portion was not posted to the accounting records until July 29, 2002, although the cash transaction occurred in the prior month.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the statement of net assets of the Combined Investment Funds, as of June 30, 2002, the related statements of operations for the fiscal year then ended and the statement of changes in net assets for the fiscal years ended June 30, 2002, and 2001. We have audited the statement of net assets of the Short Term Investment Fund as of June 30, 2002, and the statement of changes in net assets for the fiscal years ended June 30, 2002, and 2001. Further, we have audited the balance sheet of the Second Injury Fund and the statements of condition of the other Non-Civil List Trust Funds as of June 30, 2002, together with the related statements of revenue and expenditures and statements of changes in fund balance for each and the statement of cash flows for the other Non-Civil List Trust Funds, for the fiscal year ended June 30, 2002. We have also examined the schedules of Civil List Funds investments, the Civil List Funds cash receipts and disbursements and debt outstanding, as of June 30, 2002, and changes in debt outstanding during the fiscal year ended June 30, 2002. These financial statements and schedules, which are presented in the Annual Report of the State Treasurer for the fiscal year ended June 30, 2002, are the responsibility of the management of the State Treasury. Our responsibility is to express an opinion on the financial statements and schedules based on our audit.

We did not audit the financial statements of the Tax Exempt Proceeds Fund or the Connecticut Higher Education Trust. These financial statements were audited by other auditors.

We conducted our audit in accordance with *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedules.

Our procedures included confirmation of securities owned as of June 30, 2002, by correspondence with the custodians. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Combined Investment Funds, Short Term Investment Fund, Second Injury Fund and other Non-Civil List Trust Funds as of June 30, 2002, and the results of their operations, the changes in net assets for the Combined Investment Funds, the Short Term Investment Fund, changes in fund balance for the Second Injury Fund and other Non-Civil List Trust Funds and cash flows for the other Non-Civil List Trust Funds for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the schedules referred to above present fairly, in all material respects the investments of the Civil List Funds as of June 30, 2002, and the balance of bonds outstanding as of June 30, 2002, and bonds issued, retired and refunded, and bond interest payments made during the year ended on that date, all in accordance with the modified cash basis of accounting, a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

As explained in Note 1B to the financial statements of the Combined Investment Funds, the State Treasurer's policy is to present investments at fair value. The fair value of most of the assets of the Real Estate Fund, the Commercial Mortgage Fund and the Private Investment Fund and the limited partnership investment of the Mutual Fixed Income Fund are estimated by investment advisors in the absence of readily ascertainable market values, and reviewed and adjusted, when appropriate, by the State Treasurer. The fair value of most of the assets of the Real Estate Fund and the Private Investment Fund and the limited partnership investment of the Mutual Fixed Income Fund are presented at the cash adjusted fair values, which utilize the investment advisors' March 31, 2002, quarter ending estimated values adjusted for cash flows of the Funds during the subsequent quarter that affect the value at the Funds' level. Adjustments are made for underlying investments that experienced significant changes in value during the quarter, if deemed appropriate. We have reviewed the investment advisors' values, the relevant cash flows and the procedures used by the State Treasurer in reviewing the estimated values and have read underlying documentation and, in the circumstances, we believe the procedures to be reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the investments existed, and the differences could be material.

Compliance:

Compliance with the requirements of laws, regulations, contracts and grants applicable to the State Treasury is the responsibility of the State Treasury's management.

As part of obtaining reasonable assurance about whether the Agency complied with laws, regulations, contracts, and grants, noncompliance with which could result in significant unauthorized, illegal, irregular or unsafe transactions or could have a direct and material effect on whether the financial statements referred to above are free of material misstatements, we performed tests of its compliance with certain provisions of laws, regulations and contracts. However, providing an opinion on compliance with these provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests did not disclose any instances of noncompliance that are required to be reported herein under *Government Auditing Standards*. We noted certain other immaterial instances of noncompliance which, we will disclose in our audit report on the "State Treasurer-Departmental Operations." That report will be released at a later date.

Internal Control over Financial Operations, Safeguarding of Assets and Compliance:

The management of the State Treasurer's Office is responsible for establishing and maintaining effective internal control over its financial operations, safeguarding of assets, and compliance with the requirements of laws, regulations and contracts applicable to the Agency. In planning and performing our audit, we considered the Agency's internal control over its financial operations, safeguarding of assets, and compliance with requirements that could have a material or significant effect on the Agency's financial operations in order to determine our auditing procedures for the purpose of evaluating the State Treasury's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations and contracts, and not to provide assurance on the internal control over those control objectives.

However, we noted certain matters involving the internal control over the Agency's financial operations, safeguarding of assets, and/or compliance that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over the Agency's financial operations, safeguarding of assets, and/or compliance that, in our judgment, could adversely affect the Agency's ability to properly record, process, summarize and report financial data consistent with management's authorization, safeguard assets, and/or comply with certain provisions of laws, regulations, contracts, and grants. We believe the following finding represents a reportable condition; the lack of an effective system of monitoring the eligibility of Second Injury Fund claimants.

A material or significant weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants or the requirements to safeguard assets that would be material in relation to the Agency's financial operations or noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions to the Agency being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over the Agency's financial operations and over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material or significant weaknesses. However, we believe that the reportable condition described above is not a material or significant weakness.

We also noted other matters involving internal control over the Agency's financial operations and over compliance which are described in the accompanying "Condition of Records" and "Recommendations" sections of this report.

This report is intended for the information of the Governor, the State Comptroller, the Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited.

CONCLUSION

In conclusion, we wish to express our appreciation for the cooperation and courtesies extended to our representatives by the personnel of the State Treasurer's Office during the course of our examination.

Thomas W. Willametz
Administrative Auditor

Approved:

Kevin P. Johnston
Auditor of Public Accounts

Robert G. Jaekle
Auditor of Public Accounts

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