STATE OF CONNECTICUT

AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

AUDITORS OF PUBLIC ACCOUNTS

KEVIN P. JOHNSTON ♦ ROBERT G. JAEKLE

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July 14, 2004

AUDITORS' REPORT
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STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

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, 2003.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, 2003.

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

Separate reports will be 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, 2003, 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 2002-2003 fiscal year, the Treasury incurred approximately $2,671,368 of bank service fees, of which approximately $507,633 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.

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 March 19, 2004 and included a review of the 2002-2003 fiscal year STIF Comprehensive Annual Financial Report.

As of June 30, 2003, STIF had total net assets of $ 3,276,078,820. Participant distributions paid and payable during the 2002-2003 fiscal year were $ 59,630,088 and STIF's expenses were $901,802. According to the Annual Report, STIF reported an annual total return of 1.64 percent, exceeding its main benchmark, the MFR (First Tier Institutions-Only Money Fund Report) index, by .44 percent.

Statements and notes on pages F-29 through F-37 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-38 through F-42 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, 2003, 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 eight trust funds having total net assets of more than $18,300,000,000, as of June 30, 2003. 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, 2003, 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, 2003, the Division employed 65 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 $6,000,000 for the 2002-2003 fiscal year.

During the fiscal years ended June 30, 2003 and 2002, 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 2002-2003 and 2001-2002 fiscal years are summarized below:

CIF	# of Advisors- June 30, 2003	Expenses 2002-2003	# of Advisors- June 30, 2002	Expenses 2001-2002
MFIF	9	$ 9,007,994	10	$ 10,766,845
MEF	7	13,885,595	8	18,468,060
ISF	6	12,077,535	6	15,058,168
CRF	1	402,399	1	221,652
CMF	1	417,400	1	442,777
PIF	34	40,393,005	35	42,177,620
REF	7	4,872,125	7	4,711,148
Total	**65**	**$81,056,053**	**68**	**$ 91,846,270**

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 of the MEF and increases in fees for REF resulted in the expense fluctuations that occurred over the two-year period in those Funds.

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, 2003, approved as part of the Investment Policy Statement is presented below.

Asset Class	CIF		Target Policy	Holdings as of June 30, 2003
U.S. Equity	***36%:***	***MEF***	36%	36.1%
International Equity	***18%:***	***ISF***	18%	11.1%
Developed Markets	15%	ISF		
Emerging Markets	3%	ISF		
Fixed Income	***30%:***	***MFIF, CRF, CMF***	30%	40.4%
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%	12.4%
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 Fixed Income. The upper range for Fixed Income is 33% and the upper range for Cash is 1%.

During the fiscal year ended June 30, 2003, the Combined Investment Funds realized an annual total return of 2.49 percent, according to the Annual Report. The fund return of 2.49 percent is lower than the calculated benchmark of the Connecticut Multiple Market Index of 3.88 percent. The Connecticut Multiple Market Index is a blended index calculated by the Treasury to compare the overall return of the fund against market conditions using the weighted averages of various indexes associated with the asset classes. These indexes represent "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, 2002, the Combined Investment Funds realized a negative annual total return of (6.39) 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, 2003 and 2002 are presented below.

		Percentage Return	
Combined Investment Funds:		**2002-2003**	**2001-2002**
Net Total Combined Investment Funds		2.49 %	(6.39) %
Mutual Equity	MEF	0.48 %	(14.95) %
International Stock	ISF	(6.39)%	(9.00) %
Real Estate	REF	3.30 %	0.81 %
Mutual Fixed Income	MFIF	12.03 %	5.64 %
Commercial Mortgage	CMF	20.62 %	1.19 %
Private Investment	PIF	(11.94)%	(10.81)%
Cash Reserve	CRF	1.80 %	3.03 %
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		2.49 %	(6.39) %
Teachers' Retirement Fund (TRF)		2.13 %	(6.58) %
State Employees' Retirement Fund (SERF)		2.06 %	(6.62) %
Municipal Employees' Retirement Fund (MERF)		2.12 %	(6.41) %
Probate Court Retirement Fund (Probate)		2.88 %	(5.89) %
Judges' Retirement Fund (Judges')		2.41 %	(5.88) %
State's Attorneys' Retirement Fund (St. Atty.)		3.85 %	(7.94) %
Trust Funds		8.88 %	1.16 %

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. During the fiscal year, Trust Funds included 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 which was closed during the year.

A more thorough discussion of the Combined Investment Funds, including performance during the 2002-2003 fiscal year, can be found on pages 16 through 56 of the Annual Report.

Statements and notes on pages F-12 through F-28 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 2002-2003 fiscal year and the obligations outstanding, as of June 30, 2003, is presented in the schedule entitled "Changes in Debt Outstanding" shown on page S-26 of the Annual Report, while additional information is contained in the Annual Report pages S-27 and O-1 through O-11. A brief summary, follows:

Bonds Outstanding June 30, 2002	$12,356,654,584
Add - Issuances	2,552,885,000
Deduct - Payments at maturity	958,197,484
- Bonds refunded or defeased	745,070,000
Bonds Outstanding June 30, 2003	**$13,206,272,100**
Interest paid	**$643,434,743**

Bonds issued in 2002-2003 by type is shown below:

General Obligation - Tax Supported	$1,600,460,000
Economic Recovery Notes	219,235,000
Debt Service Commitment – UCONN 2000	96,210,000
Special Tax Obligation	636,980,000
Total Bonds Issued, 2002-2003	**$2,552,885,000**

True interest cost rates for new bonds issued during the 2002-2003 fiscal year ranged from 1.95 percent to 4.23 percent. Bonds issued during the 2002-2003 fiscal year were comprised of new money issues amounting to $1,804,145,000 and refunding issues amounting to $748,740,000.

In addition to the interest paid totaling $643,434,743, during the 2002-2003 fiscal year, the Treasury also made arbitrage rebate payments to the Federal government totaling $3,530,959. Such rebates represent the excess earnings of nontaxable bond proceeds that were invested in STIF prior to project disbursement.

Bonds outstanding at June 30, 2003 include $26,740,000 of Certificates of Participation for the Middletown Courthouse and $18,825,000 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 $6,545,000 is outstanding at June 30, 2003. 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, 2003 also include $111,130,000 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, 2003, 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. During the 2002-2003 fiscal year, economic recovery notes amounting to $219,235,000 were issued.

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 2002-2003 fiscal year.

According to the Annual Report of the TEPF, net assets of the fund totalled $190,421,956 at June 30, 2003, and the return on investment was 0.92 percent for the 2002-2003 fiscal year. Participants in the fund at June 30, 2003, included civil list funds and recipients of State agency grant and loan programs as well as others.

At June 30, 2003, a total of $62,989,148 of State funds was invested in the TEPF as shown below:

Fund Classification	Amounts	Annual Report Page No.
	$	
General Fund	805,227	O-12
Special Revenue	43,873,917	O-12
Capital Projects	277,094	O-14
Enterprise	18,032,910	O-15
Total	**$62,989,148**	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 $95,145,679 for the 2002-2003 fiscal year.

Authorizations for claim payments are made by the Attorney General's Office. Such payments amounted to $40,401,756 on a modified accrual basis for the 2002-2003 fiscal year.

A comparison of claim expenditures by category follows:

	2002-2003	2001-2002
Stipulations	$10,097,962	$ 11,577,643
Indemnity (lost wages)	22,548,391	23,652,885
Medical	7,755,403	6,275,682
Totals	**$40,401,756**	**$ 41,506,210**

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 209 and 177 for the fiscal years ended June 30, 2002 and 2003, 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 $111,130,000 were outstanding at June 30, 2003.

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-48 through F-55 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 $24,279,354 was needed to meet the expenses of the WCC for the 2002-2003 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 3.91 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 2002-2003 and 2001-2002 follows:

	2002-2003	**2001-2002**
Assessment collections	$21,383,555	$ 20,308,536
Other receipts	27,381	42,075
Total Receipts - WCA Fund	**$21,410,936**	**$ 20,350,611**

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 2002-2003 fiscal year.

As of June 30, 2003, the CHET program had net assets of $332,013,553, and 35,273 participant accounts. Operating results for the 2002-2003 fiscal year taken from the Annual Report were as follows:

Net assets at June 30, 2002	$ 207,969,184
Net Participant Contributions	108,916,551
Investment income	16,363,520
Management fees	(1,220,453)
Administration fee	(15,249)
Net assets at June 30, 2003	**$332,013,553**

Financial statements and notes for CHET are presented on pages F-56 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, 2003, amounted to $6,301,649 for the School Fund and $416,527 for the Agricultural College Fund. The total fund balances on June 30, 2003, at fair value, amounted to $8,565,626 for the School Fund and $565,976 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-44 through F-46 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, 2003, is presented starting on page O-21 of the Annual Report.

Each company depositing these securities is required, pursuant to 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:

Sale of Investments by Limited Partnership:

On July 11, 2003, a limited partnership in the Private Investment Fund entered into a definitive purchase agreement for sale of interests in its entire portfolio. The Combined Investment Fund's interest in this limited partnership had a cost basis of $27,500,000 but was valued at zero as of June 30, 2003.

Termination of Association with Investment Advisor:

Subsequent to June 30, 2003, the Treasurer took steps to sever all ties with an investment advisor firm that manages three limited partnership investments in the Private Investment Fund and one investment in the Mutual Fixed Income Fund. The investment advisor firm and its general counsel were convicted on Federal charges of bribery, racketeering, conspiracy and obstruction of justice. This case is related to the criminal conviction of former State Treasurer Paul J. Silvester for solicitation of bribes in return for directing investments. Also, a managing partner and consultant of the investment advisor firm plead guilty to Federal crimes.

Request for Investigation:

The Treasurer requested that the United States Attorney for Connecticut and the Securities and Exchange Commission investigate alleged connections between certain principals of a partnership in which the Private Investment Fund has a limited partnership interest and individuals involved in criminal and improper activities.

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.

Overpayment of Indemnity Benefit:

Criteria: Section 31-307 of the General Statutes states that for any injury resulting in total incapacity the injured employee shall receive benefits in accordance with Section 31-310. Section 31-308a of the General Statutes allows benefits for partial incapacity. For partial incapacity benefits, the Worker's Compensation Commission determines a comparable wage for the position which accounts for the injured employee's reduced earning capacity based on the proportionate loss of physical ability caused by the injury.

Condition: During our testing of Indemnity Benefits, it was found that one claimant who was receiving biweekly indemnity benefits was overpaid $17,046 for the period of April 8, 2002 through May 31, 2003. The overpayment is made up of two parts, an overpayment of cost of living benefits of $3,303 and an overpayment of the base rate of $13,743. The claimant was receiving benefits in accordance with Section 31-307 for total incapacity. On June 27, 2002, a Worker's Compensation Commissioner reduced the benefits to partial incapacity under Section 31-308a retroactive to April 8, 2002. Although Section 31-308a does not allow for cost of living adjustments, the Fund paid a cost of living adjustment from April 8, 2002 to June 27, 2002. Section 31-308a also carries lower maximum allowable compensation rates than that of Section 31-307. The Fund continued to pay the base compensation rate under Section 31-307 of $743 instead of the maximum allowable under Section 31-308a of $513 for approximately 12 months.

Cause: The Fund must continue to pay benefits until Worker's Compensation Commission decisions are rendered. The retroactive decision by the Commissioner resulted in an overpayment of cost of living adjustments that was not recovered. In addition, the Fund did not recognize the need to reduce the base compensation rate when the status of the benefits to be paid to the claimant changed from total incapacity to partial incapacity.

Effect: The claimant was overpaid $17,046. The Second Injury Fund will recover this overpayment by deducting $100 per week from this claimant's continuing biweekly benefits.

Recommendation: The Second Injury Fund should be sure to pay indemnity benefits in accordance with the amount determined by the Worker's Compensation Commission. (See Recommendation 1.)

Agency Response: "The overpayment to the claimant resulted when the Workers Compensation Commission on June 27, 2002 changed the claimant's benefit status retroactive to April 8, 2002. After receiving notice of the action, the Fund claims examiner failed to consult the Basic Compensation Rate table with the result that until the error was discovered, both COLA and compensation overpayments were made to the claimant in the amount reported by the auditors. As noted by the Auditors, the Fund has been recovering $100 per week from the claimant's continuing biweekly benefits since June 2003.

The claims examiner has been counseled and retrained in checking the basic compensation rate table when a claimant's status has changed. In addition, the Fund has implemented a quality assurance program to review all claim analysts caseloads and claims managers supervision of caseloads to ensure timely case file examinations."

Bank Reconciliations:

Criteria: Good internal control dictates that the bank reconciliations are performed accurately, completely and in a timely manner.

Condition: We found that 23 out of 27, or 85 percent of the June 30, 2003 bank statement reconciliations, were not performed in a timely manner. Ten of the account reconciliations were completed in September 2003 and thirteen were completed in October 2003.

Our review of year-end bank reconciliations for June 30, 2003, disclosed 25 items from 5 different bank accounts that were unresolved for over 6 months. The net dollar value of the unresolved items was $726,085.

We noted one checking account that held a surplus cash balance of $725,514 that originated primarily during March 2003. The account was closed on October 29, 2003, after our inquiry. These surplus funds should have been removed from the checking account and made available for spending by the General Fund in a more timely manner.

Cause: It was believed that the cash balance of $725,514 was required to be held in a non-interest bearing checking account for the liquidation of outstanding payments.

Effect: Bank reconciliations were not performed accurately and completely, which may increase the risk of loss.

Recommendation: Treasury should perform bank reconciliations in a timely manner and increase efforts to adequately explain and resolve outstanding items. (See Recommendation 2.)

Agency Response: "Past practices and schedules provided to and approved by the Auditors of Public Accounts called for year-end bank account reconciliations to be completed by September 20 of each year. This schedule is predicated on receiving the final Available Cash Report from the Comptroller's Office by early August of each year. This year, the final report for June 30, 2003, was received on September 18, 2003, over six weeks later than in 2002. We completed all the reconciliations by October 8, 2003. Thus, despite receiving the necessary report six weeks late, we completed the reconciliations within three weeks of the traditional completion date. Given the delay in receiving the Available Cash Report, which we understand was due to issues related to implementation of the new Core-CT financial system, we believe that we completed the reconciliations in a satisfactory, although not ideal, timeframe.

The 25 outstanding items (out of over three million reconciled transactions annually) have been resolved, resulting in a net <u>increase</u> of over $700,000 in fund balances.

While we aggressively attempt to minimize bank account balances and invest cash not needed to cover disbursements, remaining account balances do earn interest -- albeit at a somewhat lower rate than we can achieve in our Short-Term Investment Fund -- in the form of "earnings credits" that offset banking charges."

RECOMMENDATIONS

Status of Prior Audit Recommendations:

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

- 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. Our current review disclosed that benefit rates for one claimant were not changed when the claim status changed. This recommendation has been restated and presented as Recommendation 1.

- The Second Injury Fund should be sure to safeguard assets and comply with Section 31-303 of the General Statutes. This recommendation is not repeated.

- The Pension Fund Management Division should reconcile wire log records and custodian cash accounting records to the direct deposit account cash transaction record on a monthly basis. This recommendation has been resolved.

Current Audit Recommendations:

The following recommendations resulted from our current review.

1. **The Second Injury Fund should be sure to pay indemnity benefits in accordance with the amount determined by the Worker's Compensation Commission.**

   Comments:

   During our testing of Indemnity Benefits, it was found that one claimant was overpaid $17,046 in benefits. The Second Injury Fund will recover this overpayment by deducting $100 per week from this claimant's continuing biweekly benefits. The overpayment is made up of an overpayment of cost of living benefits of $3,303 and an overpayment of the base rate of $13,743. Care should be taken to ensure that benefit rates are changed accordingly when claim status changes.

2. **Treasury should perform bank reconciliations in a timely manner and increase efforts to adequately explain and resolve outstanding items.**

   Comments:

   We found that 23 out of 27, or 85 percent of the bank statement reconciliations, were not performed in a timely manner. Our review of completed reconciliations disclosed many unexplained items that remained unresolved for over six months. Excess funds held in a non-interest bearing checking account amounting to $725,514 were not transferred into interest bearing accounts in a timely manner.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the statement of net assets of the Combined Investment Funds, as of June 30, 2003, 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, 2003, and 2002. We have audited the statement of net assets of the Short Term Investment Fund as of June 30, 2003, and the statement of changes in net assets for the fiscal years ended June 30, 2003, and 2002. 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, 2003, 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, 2003. 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, 2003, and changes in debt outstanding during the fiscal year ended June 30, 2003. These financial statements and schedules, which are presented in the Annual Report of the State Treasurer for the fiscal year ended June 30, 2003, 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, 2003, 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, 2003, 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, 2003, and the balance of bonds outstanding as of June 30, 2003, 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, 2003, 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*.

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 need to perform bank reconciliations in a more timely manner.

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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