STATE OF CONNECTICUT

AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

AUDITORS OF PUBLIC ACCOUNTS
KEVIN P. JOHNSTON ❖ ROBERT G. JAEKLE

Table of Contents

November 7, 2007

AUDITORS' REPORT
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STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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, 2006. 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, 2006.

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

A separate report will be issued covering 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, 2006, were as follows:

State Treasurer: *
Denise L. Nappier

Deputy Treasurer:
Howard G. Rifkin

Assistant Deputy Treasurer:
Linda Hershman

Assistant Deputy Treasurer, Second Injury Fund and Unclaimed Property:
Maria M. Greenslade

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, Unclaimed Property:
Madelyn Colon

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

Investment Advisory Council:

The Investment Advisory Council (referred to as "IAC" or "Council" in this report) operates under the provisions of various statutes, primarily Section 3-13b. The Council's statutory responsibilities consist basically of the following:

- Review Trust Fund investments by the State Treasurer (Section 3-13b, subsection (c) (2)).

- Review and approve for adoption, an Investment Policy Statement which shall set forth the standards governing investment of trust funds by the State Treasurer. Any revisions to the Investment Policy Statement shall be made in consultation with and with the approval of the Investment Advisory Council. (Section 3-13b, subsection (c) (1)).

- Give its advice and consent to the appointment of a Chief Investment Officer for the retirement, pension and trust funds (Section 3-13a, subsection (a)).

- Make a complete examination of the security investments of the State and determine as of June 30, the value of such investments in the custody of the Treasurer and report thereon to the Governor (Section 3-13b, subsection (c) (2)).

Further, the Governor may direct the Treasurer to change any investment made by the Treasurer when, in the judgment of the Council, such action is in the best interest of the State. The Council is within the State Treasurer's Office for administrative purposes only and the Treasurer's Office continues to maintain the minutes, provide office space for meetings and other support services. The Council's expenses are paid by the Treasurer's Office from the investment earnings of the retirement and trust funds.

Council Members:

Pursuant to Section 3-13b of the General Statutes, the Investment Advisory Council, as of June 30, 2006, should consist of 12 members. The State Treasurer is an ex-officio member that also serves as Secretary of the Council. Members of the Investment Advisory Council as of June 30, 2006, were as follows:

Ex-officio members:
Denise L. Nappier - State Treasurer and Secretary of the Investment Advisory Council
Robert L. Genuario - Secretary, Office of Policy and Management

Public members:
Clarence L. Roberts, Jr., Chairman
David Himmelreich
James Larkin
David Roth

State Teachers' unions representatives:
Sharon M. Palmer
Michael Freeman
William Murray

State Employees' unions representatives:
Carol M. Thomas
Peter Thor

Reginald Martin also served as a public member of the Council during the audited period.

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 2005-2006 fiscal year, the Treasury incurred approximately $3,109,125 of bank service fees, of which approximately $680,580 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-34 through S-36 and pages O-13 to O-16 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 23, 2007, and included a demonstration of the on-line account inquiry capabilities of the Short Term Investment Fund website that was implemented during the 2005-2006 fiscal year.

As of June 30, 2006, STIF had total net assets of $5,430,166,552. Participant distributions paid and payable during the 2005-2006 fiscal year were $212,646,678 and STIF's expenses were $1,330,913. According to the Annual Report, STIF reported an annual total return of 4.38 percent, exceeding its main benchmark, the MFR (First Tier Institutions-Only Money Fund Report) index, by .37 percent.

Statements and notes on pages F-30 through F-39 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-40 through F-44 of the Annual Report.

Medium-Term Investment Fund:

Section 3-28a of the General Statutes, provides for a medium-term investment fund to be administered by the State Treasurer. As of June 30, 2006, the fund was not open. Due to past economic conditions, expected yields for a medium-term investment fund did not generate sufficient interest among potential investors. However, during the 2006-2007 fiscal year, the Treasurer’s Office established client accounts for the 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. In addition, Public Act 06-51, effective May 8, 2006, calls for the State Treasurer to review and determine to what extent the investment holdings of the State are invested in companies doing business in Sudan and consider divestment of such holdings.

The Pension Funds Management Division is responsible for managing the assets of six pension funds and eight trust funds having total net assets of $22,817,000,000, as of June 30, 2006. The Division invests the assets of these funds in accordance with an investment program through the purchase of ownership interests in a Combined Investment Fund. Each asset class (i.e., Fixed Income, U.S. Equity, etc.) within the Fund holds investments of the Combined Investment Fund. During the audited fiscal year, and as of June 30, 2006, the Combined Investment Fund (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, 2006, the Division employed 92 external advisors to manage and invest the assets of the Combined Investment Fund.

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 Fund. Transfers are made from the investment funds 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 2004-2005 fiscal year and $5,000,000 for the 2005-2006 fiscal year.

During the fiscal years ended June 30, 2006 and 2005, 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 2005-2006 and 2004-2005 fiscal years are summarized below:

CIF	**# of Advisors- June 30, 2006**	**Expenses 2005-2006**	**# of Advisors- June 30, 2005**	**Expenses 2004-2005**
MFIF	13	$ 8,990,536	11	$ 6,734,104
MEF	8	25,959,765	6	22,668,229
ISF	11	25,266,303	10	23,670,373
CRF	1	271,123	1	298,665
CMF	1	183,500	1	249,911
PIF	46	26,288,160	44	29,929,307
REF	12	5,516,828	10	4,757,757
Total	**92**	**$92,476,215**	**83**	**$ 88,308,346**

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 ISF 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 30th. The actual advisor fee expense differed from the reported amount, due to these performance bonus estimations.

Asset Allocation Policy:

The Treasurer's Asset Allocation Policy is presented below. The policy was in force during the period under review.

Investments		Asset Class	Target Policy	Holdings as of June 30, 2006	2005
U.S. Equity	***36%:***	***MEF***	36%	39%	38%
International Equity	***18%:***	***ISF***	18%	24%	20%
Developed Markets	15%	ISF			
Emerging Markets	3%	ISF			
Fixed Income	***30%:***	***MFIF, CRF, CMF***	30%	29%	33%
Cash	1%	CRF			
Core Bonds	20%	MFIF, CMF			
All other fixed income	9%	MFIF			
Real Estate and Alternative	***16%:***	***REF, PIF***	16%	8%	9%
Equity Real Estate	5%	REF			
Alternative Investments	11%	PIF			

The Treasury's Asset Allocation Policy includes lower and upper ranges for the investment allocations as well as the target level. All variations above are within the established ranges except for the International Equity Fund which is over the intended upper range and the Real Estate Fund which is below the intended lower range as of June 30, 2006. Asset allocations are reviewed monthly to determine whether a rebalancing of investments is necessary to maintain the desired allocation levels.

During the fiscal year ended June 30, 2006, the Combined Investment Funds realized an annual total return of 10.55 percent, according to the Annual Report. The fund return of 10.55 percent is higher than the calculated benchmark of the Connecticut Multiple Market Index of 10.01 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. During the previous fiscal year ended June 30, 2005, the Combined Investment Funds realized an annual total return of 10.46 percent which was higher than that year's calculated benchmark of the Connecticut Multiple Market Index of 10.02 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, 2006 and 2005, are presented below.

		Percentage Return	
Combined Investment Funds:		**2005-2006**	**2004-2005**
Net Total Combined Investment Funds		10.55 %	10.46 %
Mutual Equity	(MEF)	10.27 %	8.06 %
International Stock	(ISF)	25.69 %	19.23 %
Real Estate	(REF)	7.09 %	27.74 %
Mutual Fixed Income	(MFIF)	.77 %	7.70 %
Commercial Mortgage	(CMF)	9.69 %	6.95 %
Private Investment	(PIF)	11.74 %	9.58 %
Cash Reserve	(CRF)	4.54 %	2.38 %
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		10.55 %	10.46 %
Teachers' Retirement Fund (TRF)		10.74 %	10.49 %
State Employees' Retirement Fund (SERF)		10.57 %	10.44 %
Municipal Employees' Retirement Fund (MERF)		9.87 %	10.10 %
Probate Court Retirement Fund (Probate)		10.66 %	10.50 %
Judges' Retirement Fund (Judges')		9.10 %	9.77 %
State's Attorneys' Retirement Fund (St. Atty.)		3.63 %	7.16 %
Trust Funds		2.43 %	7.64 %

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 eight 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 and the Andrew Clark Fund.

A more thorough discussion of the Combined Investment Funds, including performance during the 2005-2006 fiscal year, can be found on pages 18 through 58 of the Annual Report.

Statements and notes on pages F-14 through F-29 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-28 of the Annual Report.

Investment Mix:

A summary of the Retirement Funds' investment activity in the Combined Investment Fund is presented below. This information is presented in detail in the Treasurer's Annual Report, pages S-4 through S-9. The amounts below are presented in millions of dollars.

Participant Funds	6/30/05 Market Values	Share Transactions Purch	Share Transactions Redemp	Share Transactions Net	Realized Gain on Redemp	Change in Mkt. Value	6/30/06 Mkt. Values	6/30/06 Percent Holdings	Inv. Income
	$	$	$	$	$	$	$		$
TRF	11,392	1,042	1,027	15	46	737	12,190	53 %	425
SERF	8,175	620	568	52	14	533	8,774	38 %	310
MERF	1,394	136	113	23	2	82	1,501	6 %	54
Probate	72	7	7	0	0	5	77	1 %	3
Judges'	152	18	15	3	0	8	164	1 %	6
St. Atty.	1	0	0	0	0	0	1	0 %	0
All Other	113	6	6	0	0	(2)	110	1 %	4
Totals	**$21,299**	**$1,829**	**$1,736**	**$93**	**$62**	**$1,363**	**$22,817**	**100%**	**$802**

The separate investment funds mentioned previously are used to account for different types of investments. For instance, CRF invests primarily in money market instruments having maturities of two years or less. Most of the MEF and ISF portfolios consist of investments in stocks and most of the MFIF portfolio consists of investments in bonds. The net assets (net worth or equity) of each fund at market gives some idea of the investment mix. A summary of the Combined Investment Fund's activity is presented below. This information is presented in detail in the Treasurer's Annual Report, page S-2. The amounts below are presented in millions of dollars.

Combined Investment Funds	6/30/05 Net Assets	Participant Fund Activity Purch	Participant Fund Activity Redemp	Participant Fund Activity Income Distrib	Participant Fund Activity Net Contrib	Invest Return	6/30/06 Net Assets	6/30/06 Percent Holdings
CRF	$1,578	$ 2,809	$ 3,004	$ 60	$ (255)	$ 60	$1,384	6 %
MEF	8,275	0	20	122	(142)	850	8,982	39 %
ISF	4,489	0	157	105	(262)	1,131	5,357	23 %
MFIF	6,280	385	7	293	85	54	6,419	28 %
REF	400	82	45	61	(24)	24	399	2 %
CMF	21	0	2	2	(4)	2	18	1 %
PIF	1,441	31	60	206	(235)	155	1,360	6 %
Elim. Entry*	(1,185)	(1,478)	(1,559)	(47)	128	(49)	(1,102)	(5)%
Totals	**$21,299**	**$1,829**	**$1,736**	**$802**	**$(709)**	**$2,227**	**$22,817**	**100%**

*The "elimination entry" removes the Cash Reserve Fund investments of each of the other asset classes so that it will not be counted twice in the totals.

Investment Advisory Council Expenditures:

State Treasurer expenditures, for the IAC for the fiscal years ended June 30, 2005 and June 30, 2006, were $11,906 and $14,491, respectively. Amounts were for meeting costs, travel, postage and other expenses.

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 2005-2006 fiscal year and the obligations outstanding, as of June 30, 2006, is presented in the schedule entitled "Changes in Debt Outstanding" shown on page S-31 of the Annual Report, while additional information is contained in the Annual Report pages S-32 and O-1 through O-11. A brief summary follows:

Bonds Outstanding June 30, 2005	$13,933,916,561
Add - Issuances	1,438,165,000
Deduct - Payments at maturity	1,186,512,418
- Bonds refunded or defeased	61,685,000
Bonds Outstanding June 30, 2006	**$14,123,884,143**
Interest paid	**$717,905,682**

Bonds issued in 2005-2006 by type are shown below:

General Obligation - Tax Supported	$1,035,000,000
Debt Service Commitment – UCONN 2000	138,165,000
Special Tax Obligation	250,000,000
Capital City Economic Development Authority	15,000,000
Total Bonds Issued, 2005-2006	**$1,438,165,000**

True interest cost rates for new bonds issued during the 2005-2006 fiscal year ranged from 4.09 percent to 5.26 percent. Bonds issued during the 2005-2006 fiscal year were comprised of new money issues amounting to $1,377,145,000 and refunding issues amounting to $61,020,000.

In addition to the interest paid totaling $717,905,682, during the 2005-2006 fiscal year, the Treasury also made arbitrage rebate payments to the Federal government totaling $2,857,273. Such rebates represent the excess earnings of nontaxable bond proceeds that were invested in STIF prior to project disbursement.

Bonds outstanding at June 30, 2006, include $20,700,000 of Certificates of Participation for the Middletown Courthouse and $17,735,000 of Certificates of Participation for the Connecticut Juvenile Training School Energy Center project. These Certificates are not bonded 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 $5,175,000 is outstanding at June 30, 2006. 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.

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 2003-2004 fiscal year, economic recovery notes amounting to $219,235,000 were issued of which $87,440,000 remained outstanding as of June 30, 2006.

Section 1 of Public Act 03-1, of the September 8 Special Session, authorized the issuance of economic recovery notes for the purpose of funding the deficit in the General Fund for the fiscal year ended June 30, 2004, plus the amount of funding needed to pay any remaining retrospective reimbursements billed by medical providers for services rendered to recipients of medical assistance in the State Administered General Assistance and General Assistance programs. During the 2004-2005 fiscal year, economic recovery notes amounting to $97,700,000 were issued pursuant to this authority, of which $58,650,000 remained outstanding at June 30, 2006.

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, 2006, there was no issuance of short-term debt under this authority.

Public Act 03-6 of the June 30 Special Session required that assessments collected from electric utility customers in the State originally intended for the implementation of conservation and load management programs and renewable energy investment programs be disbursed instead to the State General Fund during the period from July 1, 2004 to July 1, 2006, unless the Department of Public Utility Control authorized a financing order to allow the issuance of rate reduction bonds the proceeds of which would be substituted for the disbursement of the aforementioned assessments. Pursuant to Sections 16-245e to 16-245k of the General Statutes, as amended by Public Act 03-6 of the June 30 Special Session and Public Act 03-1, of the September 8 Special Session, the Department of Public Utility Control approved a financing order dated October 28, 2004, to allow the issuance of $220,000,000 of tax exempt rate reduction bonds as securitization to sustain the funding of conservation and load management programs and renewable energy investment programs. In accordance with this financing order, special obligation bonds of the State amounting to $205,345,000 were issued during the 2004-2005 fiscal year secured by and payable solely from a rate reduction bond charge collected from the customers of electric utilities in the State. As of June 30, 2006, Special Obligation Rate Reduction Bonds outstanding amounted to $153,160,000.

Public Act 03-5, of the June 30 Special Session, effective August 20, 2004, authorized a loan by the State to the Connecticut Resource Recovery Authority (CRRA) of up to $22,000,000 for the fiscal years ending June 30, 2005 and 2006, and for subsequent fiscal years, an additional aggregate amount of $93,000,000. As of June 30, 2006, CRRA had borrowed $21,500,176 from the State pursuant to the loan of which $15,939,212 remained outstanding. Loan receivable records for the CRRA loan are maintained by the State Treasurer's Debt Management Division.

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 2005-2006 fiscal year.

According to the Annual Report of the TEPF, net assets of the fund totalled $155,257,688 at June 30, 2006, and the return on investment was 2.57 percent for the 2005-2006 fiscal year. Participants in the fund at June 30, 2006, included civil list funds and recipients of State agency grant and loan programs as well as others.

At June 30, 2006, a total of $57,611,291 of State funds was invested in the TEPF as shown below:

Fund Classification	Amounts	Annual Report Page No.
	$	
Special Revenue	23,334,051	O-13
Capital Projects	21,723,623	O-14
Enterprise	12,553,617	O-15
Total	**$57,611,291**	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 $60,704,589 for the 2005-2006 fiscal year.

Second Injury Fund claim payments amounted to $38,751,596 on a modified accrual basis for the 2005-2006 fiscal year. A comparison of claim expenditures by category follows:

	2005-2006	**2004-2005**
Stipulations	$10,901,502	$ 8,251,120
Indemnity (lost wages)	21,617,496	20,602,325
Medical	6,232,598	5,859,137
Totals	**$38,751,596**	**$ 34,712,582**

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 169 and 178 for the fiscal years ended June 30, 2005 and 2006, respectively.

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-50 through F-56 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 $20,646,627 was needed to meet the expenses of the WCC for the 2005-2006 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 2.86 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 2005-2006 and 2004-2005 follows:
F41, pg 27

	2005-2006	2004-2005
Assessment collections	$19,014,444	$14,098,574
Other receipts	48,232	36,400
Total Receipts - WCA Fund	**$19,062,676**	**$14,134,974**

Connecticut Higher Education Trust (CHET):

The Connecticut Higher Education Trust (CHET) operates under the provisions of 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 2005-2006 fiscal year.

As of June 30, 2006, the CHET program had net assets of $704,344,241, and 50,268 participant accounts. Operating results for the 2005-2006 fiscal year taken from the Annual Report were as follows:

Net assets at June 30, 2005	$ 595,718,177
Net Participant Contributions	76,957,019
Investment income	34,598,732
Management fees	(2,929,687)
Net assets at June 30, 2006	**$704,344,241**

Financial statements and notes for CHET are presented on pages F-57 through F-62 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, 2006, amounted to $6,672,777 for the School Fund and $444,365 for the Agricultural College Fund. The total fund balances on June 30, 2006, at fair value, amounted to $9,174,249 for the School Fund and $606,609 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-46 through F-49 of the Annual Report. Investment activity is presented on pages S-7 through S-9.

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, 2006, is presented starting on page O-17 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:

Change in Investment Values Due to Bankruptcy:

Subsequent to June 30, 2006, one of the underlying holdings of a partnership in the Private Equity Fund was forced into bankruptcy due to allegations of financial misconduct. This resulted in a reduction of approximately $53,500,000 of value. This amount represented 84 percent of the value of the partnership and 4 percent of the value of the Private Investment Fund. This adjustment was made to the fair value reported as of June 30, 2006.

Establishment of Medium-Term Investment Fund:

The Treasurer's Office established client accounts for the Medium-Term Investment Fund during the 2006-2007 fiscal year.

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.

Negotiating with Uninsured Employers in the Second Injury Fund:

Criteria: According to Section 31-355, of the General Statutes, the Workers Compensation Commissioner may order the Second Injury Fund (the Fund) to provide benefits to an injured worker if an employer fails to carry insurance and is unable to pay benefits in accordance with a finding and award. Section 31-355a, subsection (a), requires that whenever the Fund is required to pay such benefits, the amount shall be collectible by any means provided by law. Tax warrants, including liens on property are allowed in accordance with subsection (b), of the same section. Section 31-288 of the General Statutes states that the principals of a business that knowingly and wilfully fails to provide workers' compensation liability coverage shall be guilty of a class D felony.

Condition: During our review of stipulation payments made from the Second Injury Fund, we noted one case where the Fund negotiated a $66,500 settlement with an injured worker. According to the Fund, this case involved an uninsured employer who was liable for medical costs and lost wages associated with a case that resulted in significant injuries. Through June 30, 2006, there was no provision in the General Statutes for the Fund to negotiate or waive any amount due from any uninsured employers. Section 31-355a allows the Treasurer "any means by law," including tax warrants, to enforce collection against uninsured employers. The Workers' Compensation Commissioner approved the settlement after the Fund had already agreed to the negotiated terms and the employer was not charged with a felony for failure to provide coverage.

Cause: The Fund believes it was in the Fund's best interest to negotiate with the uninsured employer.

Effect: The Fund did not follow Section 31-355a, of the General Statutes for collecting amounts due from uninsured employers.

Recommendation: The Second Injury Fund should seek legal action against uninsured employers for noncompliance with the Workers' Compensation Act and not negotiate receivable amounts due to the Fund. (See Recommendation 1.)

Agency Response: "We disagree with the auditors' recommendation. The Fund maintains the position that it has always had statutory authority under Sec. 31-353 to ***"****make payment by way of final settlement in any matter concerning the fund, subject to the approval of the commissioner, whenever it is for the best interests of the injured employee****"***. It is the Fund's position that Sec. 31-355a applies only to cases where the Fund is required to pay benefits, and does not pertain to cases such as this where the Fund *voluntarily* agreed to contribute to a settlement, *in lieu of* risking an adverse litigation outcome. This particular case involved catastrophic injuries to an elderly trucker with medical bills in the area of $500,000 and with an exposure for indemnity benefits in excess of $300,000. There were significant legal issues involving employer/employee status and the application of the principal employer statute (Sec. 31-291). Any one of the respondents could have been found to be the responsible employer, and the injured worker was just as likely to be determined to be an independent contractor. The Attorney General's Office was not optimistic about a favorable litigation outcome for the Fund and the Workers' Compensation Commissioner urged the parties to consider settlement. The Fund agreed to contribute $66,500 to an $85,000 settlement with the other respondents voluntarily contributing the remaining $18,500, also in lieu of risking an adverse outcome. The approval by the Workers' Compensation Commissioner of the Fund's settlement of this matter for less than 10 percent of its potential liability was in the Fund's and claimant's best interest.

Notwithstanding the Fund's belief that its decision to reach a settlement in the cited case was within its statutory authority, effective July 1, 2006, legislation enacted by the Connecticut General Assembly specifically authorizes the Fund to reach stipulated agreements with claimants and uninsured employers, subject to the approval of the Workers' Compensation Commission, that result in the settlement of a claim **prior** to the issuance of a finding and award by the Workers' Compensation Commission."

Auditors' Concluding Comment: It was determined by the Workers' Compensation Commissioner that the claimant worked for an uninsured employer. Uninsured employers engage in illegal activity when they fail to obtain Workers' Compensation liability coverage and should not be allowed to escape legal penalties due to the Fund's decision to settle a case.

Late Claim Payments by 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 manner 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.

Condition: The Second Injury Fund was ordered to pay a $1,000 penalty by the Workers' Compensation Commissioner. This penalty was paid by the Fund due to a lack of communication from the Attorney General's Office which provides legal representation for the Fund.

Cause: The Attorney General's Office did not attend the settlement hearing and the approved agreement was never forwarded to the Fund for payment.

Effect: The Fund paid $1,000 in penalties that we believe could have been avoided.

Recommendation: The Second Injury Fund, in concert with the Attorney General's Office, should improve controls over the processing of settlement payments to avoid the late payment penalty imposed under Section 31-303 of the General Statutes. (See Recommendation 2.)

Agency Response: "As we responded in the 2005 audit report released by the Auditors' in May 2007, the Fund met with the AG's Office in fiscal year 2007 and has been assured by the AGO that any subsequent order requiring the payment of money by the Fund will be immediately forwarded to the Fund for payment. This 2006 fiscal year penalty occurred prior to the AGO implementing corrective procedures to prevent future penalty payments. Procedures of the SIF were originally written in January 1999 requesting prompt notification by AGO staff to the SIF claims manager of all approved settlements."

Overpayment of Indemnity Benefit:

Criteria: Indemnity benefits for some injured workers are paid pursuant to Sections 31-308a and 31-355 of the General Statutes. The Workers' Compensation Commissioner may order the Fund to pay lump-sum payments for injuries. Internal controls are designed to ensure that only the approved amount is paid to the claimants.

Condition: One claimant who was due a one-time payment for disability benefits was inadvertently placed on the biweekly benefits payroll. As a result, the claimant was overpaid $10,182 before the error was found.

Cause: A processing error put the claimant on the automatic biweekly pay schedule. The claimant continued to be paid biweekly from July 10, 2005, through February 18, 2006.

Effect: The claimant has been overpaid and the Fund is making attempts to collect.

Recommendation: The Second Injury Fund should be sure to pay indemnity benefits in accordance with the amount determined by the Workers' Compensation Commission. (See Recommendation 3.)

Agency Response: "This overpayment was the result of an inadvertent miscommunication between the claims unit and the accounting unit. The staff has since been counseled about the circumstances that led to this misunderstanding. A portion of the overpayment has been applied to subsequent benefits to which the claimant would have been entitled, and the remaining portion of the overpayment will be applied to future benefits for anticipated permanency rating and/or settlement. It is anticipated the overpayment will be fully recouped during this fiscal year."

Cancellation of Cleared Checks:

Criteria: Checks that were issued by the State, but remained as outstanding items are periodically reviewed to determine whether certain action should be taken. If action is required, such as a reissuance or a void, the original check is "cancelled."

Condition: The Core-CT accounting system does not record the status of checks that have been issued. During the audited period, the Cash Management Division used a month-old outstanding check list to determine the status of checks. This condition may allow for the cancellation of checks that had already been cashed.

Cause: The Treasury has not automated this process and the Core-CT system is unable to identify when checks have been cashed.

Effect: The process of reviewing and adjusting for cancelled checks is unnecessarily time-consuming and labor-intensive due to the lack of automation.

Recommendation: The Treasurer's Cash Management Division should consider the use of automated processes that would ensure that checks processed for cancellation had not already been cashed. (See Recommendation 4.)

Agency Response: "As we responded to the Auditors' recommendation in the 2005 report, which has again been repeated in this report, a bank feed of check status information has been available to Core-CT since March 2006, but implementation of the feed has been delayed by Core-CT. However, as we reported in the previous report, in July 2006 we began using the bank's on-line system to ensure the use of current data during the check cancellation process."

Unreconciled Cash Accounts within the Cash Management Division:

Criteria: The Cash Management Division is responsible for maintaining proper internal control over cash and completion of bank reconciliations in a timely manner.

Condition: During our audit of the Cash Management Division, we found that cash was not completely reconciled to the general ledger in a timely manner. Payroll and vendor accounts were reconciled on a monthly basis from the bank to the payment warrants but not directly to the general ledger cash accounts in the Core-CT accounting system. These reconciliations were not conducted in a manner which resolved all variances between the bank records and the Core-CT accounting records. Comprehensive payroll and vendor account reconciliations that agreed with the Core-CT accounting records for the fiscal year ending June 30, 2006, were not completed for our review until December 2006.

The Cash Management Division is responsible for the review of cash account reconciliations that are performed by other State agencies such as the Department of Motor Vehicles (DMV) cash account. Our review disclosed that DMV failed to post a bank deposit totaling $496,099, which is a violation of Section 4-32 of the General Statutes. Also DMV failed to research and resolve their outstanding items.

Although Treasury responded to our prior year's audit report that "All prior year outstanding items have been resolved", our current audit revealed unresolved issues continued to exist.

In our review of zero balance accounts we noted a $700,000 discrepancy between a University of Connecticut Health Center account and the Treasury records. The discrepancy resulted from an error in posting that originated in the 2004 fiscal year.

When the Cash Management Division has identified unresolved posting errors, the agency that originated the transaction is responsible for making the correction. We noted a payment totaling $63,972 that should have been reversed during fiscal year 2004. At the time that the mistake was identified, the bank promptly credited the account on December 18, 2003. However, the originating agency did not record the adjustment in Core-CT and the posting error was carried forward to fiscal years 2005 and 2006.

Cause: The State's Core-CT accounting system was not designed to provide an automated and efficient reconciliation of cash activity.

Effect: Errors in the recording of cash transactions may not be detected and could increase the risk of loss if reconciliations are not completed in a timely manner.

Recommendation: The Cash Management Division should improve internal controls over cash and ensure that reconciliations of cash accounts are performed that completely resolve all variances between the bank and Core-CT records in a timely manner. (See Recommendation 5.)

Agency Response: "As we responded in the 2005 report to the same recommendation repeated by the Auditors' in this 2006 report, we concur with the importance of timely bank reconciliations. The Auditors have accurately stated in both year's reports that we reconcile the payroll and vendor accounts monthly using Core-CT payment documentation. Thus, as our first priority, we verify that funds are not leaving those bank accounts other than to cover valid State payments. As the Auditors have acknowledged on several occasions, original design issues with Core-CT have affected timely transaction review. Reconciliations to the Core-CT general ledger accounts, which include non-cash transactions that do not affect our bank accounts, have taken longer to complete and we are working with the Comptroller's Office to make additional Core-CT system and process improvements."

Unreconciled Interagency Transfer Account within the Cash Management Division:

Criteria: The Interagency Transfer Account (10436) by definition is a clearing account that agencies use to pay other agencies for services rendered. This account should have a zero balance at the end of each monthly cycle. Variances that are due to timing differences should clear the following month.

Condition: During our review of year-end closing procedures, we noted that significant dollar variances in the Interagency Transfer Account were not researched and reconciled during the current audited period and during the fiscal years 2004 and 2005. Although the Interagency Transfer Account is technically not a bank account, it is listed as a bank account in the chart of accounts. The Interagency Transfer Account is more accurately classified as a due to/due from account in the chart of accounts.

Effect: Unresolved interagency billing and payments cause a cumbersome reconciliation at year-end closing. In addition, not reconciling this account in a timely manner may result in errors in the recording of interagency transfer transactions, not being detected in a timely manner.

Cause:- The Core-CT accounting system did not have adequate internal controls to ensure that all interagency transfers were properly coded to the correct accounts. The Interagency Account had not been reconciled for fiscal years 2004 and 2005 because neither the Treasury nor the Comptroller's Office took responsibility for reconciling the account.

Recommendation: State agencies' ability to post to the Interagency Transfer Account should be restricted to ensure proper usage. Reconciliation of the Interagency Transfer Account should be undertaken by the Comptroller's Office since it is technically not a bank account and has no effect on bank balances. (See Recommendation 6.)

Agency Response: "As we responded to the Auditors' in their 2005 audit report, we concur with the recommendation. The Interagency Transfer Account, by definition, is not a bank account and does not reflect cash transactions. Accordingly, reconciliation of the account is the appropriate responsibility of the Comptroller's Office. We have notified the Comptroller's Office of the Auditors' previous recommendation on this issue."

Failure to Monitor Investment Advisor:

Criteria: The Pension Funds Management Division should have a method to value Real Estate Fund investments at their estimated fair values. The method should be consistently applied and seek to establish an estimated fair value for presentation in the Statement of Net Assets. When investments are sold, the Treasury should be able to account for its portion of the proceeds and record any gains on the sale of investments properly. The Treasury should also monitor contractual provisions, which may call for gains on sales of properties to be distributed to the State.

Condition: We found one investment within the Real Estate Fund asset class that was not tracked properly. The investment manager sold a property and recorded a gain from the sale of the investment. The State owns 60.569 percent of this investment and should share accordingly in any gains. The following summarize our concerns in this area:

- The gain from the sale of this investment was not distributed entirely to the State, and it appears the State was entitled to at least an additional $7,874,065, based upon certain contractual provisions. Instead, the Treasury accepted the funds that were distributed, and seems to have been unaware that the investment manager appears to have retained cash in excess of any escrow requirements.

- The State's portion of the gain was not recorded properly within the accounting records until we brought it to their attention. It seems the Treasury misunderstood certain information presented and believed that a substantial *loss* had occurred from the sale of the investment. The cash received was recorded appropriately and, subsequent to our inquiry, the Treasury corrected its records.

- The Treasury's estimate of the fair value of the remaining investments of this manager for the fiscal year ended June 30, 2006, could not be reasonably substantiated. Because of this, the fair value as of June 30, 2006, was written down by $15,898,056 (to $58,985,955) to reflect the capital contributions (cost) of this investment. This was appropriately disclosed in the Treasurer's notes to their financial statements.

Effect: Tracking and accounting for investments improperly can result in financial records being inaccurate.

Cause: The complexities of accounting for and determining the estimated fair values of alternative investments may have contributed to this condition, however, it appears the Treasury mistakenly believed that the net cash proceeds from the sale of the investment were the actual selling price of the investment.

Recommendation: The Treasury should ensure that the complexities of determining fair values and realizing gains for alternative assets within the Real Estate Fund are understood, that gains are distributed in accordance with contractual provisions, and the related accounting is accurately reflected in the financial statements. (See Recommendation 7.)

Agency Response: "Management concurs with the audit finding, and acknowledges that there have been a number of issues with the particular general partnership agreement cited in this finding. This, however, is not representative of the process of accounting for the value of other real estate partnerships.

With regard to the $7.8 million outstanding from the sale of one of the partnership's holdings, it has been general practice with this particular manager that they routinely withhold proceeds from the sale of properties as opposed to delivering the proceeds and immediately recalling the funds as capital calls.

PFM has had varying degrees of success in obtaining necessary information and documentation since the previous administration entered into this partnership agreement on September 15, 1998, with this General Partner. In the future, management will require a more thorough accounting detail of the distribution of funds from the General Partner and request updated information on the amount of reserves being held by the Partnership and ask the General Partner to confirm that such amounts conform to the limitations set forth in capital call section of the Partnership Agreement. In addition, management will request that, in the future, funds be called pursuant to the capital call section of the Partnership Agreement with respect to Management Fees, post-Commitment Period reserves, and amounts paid to complete investments rather than as withheld funds under the Net Cash Flow definition.

As noted by the Auditors', PFM subsequently recorded the gain on the sale of this property prior to the issuance of the June 30, 2006 financial statements. As also noted above, by instructing this general partner to provide more precise documentation, management will be able to determine its completeness and accuracy and this will allow the accounting staff in PFM to properly account for future transactions.

The final audit concern surrounds the estimations of fair value. In practice, as a limited partner, we have typically relied on the general partner to estimate the fair market value of the properties. The use of fair market values is consistent with how we value the combined investment funds on an ongoing basis. However, in the past, we have had difficulty with this particular general partner and our valuation process has not been consistent. Given the history with this particular investment, we will utilize the lower of cost or market valuation going forward."

Financial Reporting Delayed:

Criteria: In accordance with Section 3-37 of the General Statutes, as amended by Public Act 06-51, the Treasurer is required to submit a final audited report for the year ended June 30, 2006, to the Governor and the Investment Advisory Council on or before December 31, 2006. The report usually includes data concerning the State's cash receipts and disbursements processed by the Cash Management Division within the Treasurer's Office, among other information. The Treasury uses information provided by the Comptroller's Office to reconcile accounting, or "book" balances to the actual cash, or "bank" balances.

Condition: The Treasurer was unable to submit a final audited report for the fiscal year ended June 30, 2006, as required by Section 3-37 of the General Statutes. Apparently, there were delays in receiving accounting information regarding the "book" balances from the Comptroller's Office; and, without this information, the Treasury was unable to complete their reconciliations to the cash, or "bank" balances by December 31, 2006.

Cause: Accounting or "book" balances were not available from the Comptroller's Office within the necessary time frame.

Effect: The Treasurer was unable to comply with Section 3-37 of the General Statutes to publish a final audited report by December 31, 2006.

Conclusion: We have no recommendation at this time as the Treasurer's Office must rely on the Comptroller's Office for final data before continuing their work to meet the requirements for publishing a final audited report in accordance with Section 3-37 of the General Statutes.

RECOMMENDATIONS

Status of Prior Audit Recommendations:

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

- The Treasury should comply with Section 1-225 and provide information about the Second Injury Fund's Advisory Board meetings as required. This recommendation has been resolved.

- The Second Injury Fund should seek legal action against uninsured employers for noncompliance with the Workers' Compensation Act and not negotiate receivable amounts due to the Fund. This recommendation has been repeated as Recommendation 1.

- The Second Injury Fund should improve controls over the processing of settlement payments to avoid the late payment penalty. This recommendation has been repeated as Recommendation 2.

- The Second Injury Fund should pay dependency benefits in accordance with the General Statutes. This condition was not noted in our current review.

- State agencies' ability to post to the Interagency Transfer Account should be restricted to ensure proper usage and reconciliation of the Interagency Transfer Account should be undertaken by the Comptroller's Office since it is technically not a bank account and has no effect on bank balances. This recommendation has been repeated as Recommendation 6.

- The Treasurer's Cash Management Division should employ the most efficient manner of check verification and ensure that established internal control procedures for check cancellation are followed. This recommendation has been repeated as Recommendation 4.

- The Cash Management Division should improve internal control over cash and ensure that reconciliations of State cash accounts are performed completely resolving all variances between the bank and Core-CT records in a timely manner**.** This recommendation has been repeated as Recommendation 5.

- State agencies should submit the list of bank accounts on or before September first, each year as required by Section 4-33(b) of the General Statutes. Treasury should maintain accurate records of authorized bank account forms. This recommendation has been resolved.

- The Treasurer's Office should improve contract management procedures, comply with Section 4-98 of the General Statutes, recover amounts due and not agree to compensate vendors until a fully executed contract is in place. This recommendation has been resolved.

Current Audit Recommendations:

The following recommendations resulted from our current review.

1. **The Second Injury Fund should seek legal action against uninsured employers for noncompliance with the Workers' Compensation Act and not negotiate receivable amounts due to the Fund.**

   Comments:

   The Second Injury Fund negotiated a $66,500 settlement with an injured worker involved in a case with an uninsured employer that resulted in significant injuries. Although Section 31-355a of the General Statutes allows the Treasurer "any means by law," including tax warrants, to enforce collection against uninsured employers, the Fund agreed to the negotiated terms and the employer was not charged with a felony for failure to provide coverage.

2. **The Second Injury Fund, in concert with the Attorney General's Office, should improve controls over the processing of settlement payments to avoid the late payment penalty imposed under Section 31-303 of the General Statutes.**

   Comments:

   The Second Injury Fund was ordered to pay a $1,000 penalty by the Workers' Compensation Commissioner. This penalty was paid by the Fund due to a lack of communication from the Attorney General's Office which provides legal representation for the Fund.

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

   Comments:

   One claimant who was due a one-time payment for disability benefits was inadvertently placed on the biweekly benefits payroll. As a result, the claimant was overpaid $10,182 before the error was found.

4. **The Treasurer's Cash Management Division should consider the use of automated processes that would ensure that checks processed for cancellation had not already been cashed.**

   Comments:

   The Core-CT accounting system does not record the status of checks that have been issued. During the audited period, the Cash Management Division used a month-end outstanding check list to determine the status of the checks. This condition may allow for the cancellation of checks that have already been cashed.

5. The Cash Management Division should improve internal controls over cash and ensure that reconciliations of cash accounts are performed that completely resolve all variances between the bank and Core-CT records in a timely manner.

Comments:

During our audit of the Cash Management Division, we found that cash was not completely reconciled to the general ledger in a timely manner. Payroll and vendor accounts were reconciled on a monthly basis from the bank to the payment warrants but not directly to the general ledger cash accounts in the Core-CT accounting system. These reconciliations were not conducted in a manner which resolves all variances between the bank records and the Core-CT accounting records. Comprehensive payroll and vendor account reconciliations that agreed with the Core-CT accounting records for the fiscal year ending June 30, 2006, were not completed for our review until December 2006.

6. State agencies' ability to post to the Interagency Transfer Account should be restricted to ensure proper usage. Reconciliation of the Interagency Transfer Account should be undertaken by the Comptroller's Office since it is technically not a bank account and has no effect on bank balances.

Comments:

Although the Interagency Transfer Account is technically not a bank account; it is listed as a bank account in the chart of accounts. During our review of year-end closing procedures, we noted that significant dollar variances in the Interagency Transfer Account were not researched and reconciled during the current audited period and during the fiscal years 2004 and 2005.

***7.* The Treasury should ensure that the complexities of determining fair values and realizing gains for alternative assets within the Real Estate Fund are understood, that gains are distributed in accordance with contractual provisions, and the related accounting is accurately reflected in the financial statements.**

Comments:

We found one investment within the Real Estate Fund asset class that was not tracked properly. The investment manager sold a property and recorded a gain from the sale of the investment. The gain from the sale of this investment was not distributed entirely to the State, and it appears the State was entitled to at least an additional $7,874,065, based upon certain contractual provisions.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the statement of net assets of the Combined Investment Funds, as of June 30, 2006, 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, 2006, and 2005. We have audited the statement of net assets of the Short Term Investment Fund as of June 30, 2006, and the statement of changes in net assets for the fiscal years ended June 30, 2006, and 2005. 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, 2006, 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, 2006. 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, 2006, and changes in debt outstanding during the fiscal year ended June 30, 2006. These financial statements and schedules, which are presented in the Annual Report of the State Treasurer for the fiscal year ended June 30, 2006, 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, 2006, 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.

As described in the notes to the financial schedules, the State Treasury has prepared the schedules of Civil List Funds investments, as of June 30, 2006, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2006 and debt outstanding, as of June 30, 2006, and changes in debt outstanding during the fiscal year ended June 30, 2006, using accounting practices prescribed by the State Comptroller which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial schedules of the variances between these regulatory accounting practices and accounting principles generally accepted in the United States of America although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the schedules referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the cash and investments of the Civil List Funds as of June

30, 2006, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2006, the balance of bonds outstanding as of June 30, 2006, and bonds issued, retired and refunded, and bond interest payments made during the year ended on that date.

In our opinion, the schedules referred to above present fairly, in all material respects the cash and investments of the Civil List Funds as of June 30, 2006, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2006, the balance of bonds outstanding as of June 30, 2006, 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.

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, 2006, 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.

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, 2006, 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 cash 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