STATE OF CONNECTICUT

AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2007

AUDITORS OF PUBLIC ACCOUNTS

KEVIN P. JOHNSTON ❖ ROBERT G. JAEKLE

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July 16, 2008

AUDITORS' REPORT
STATE TREASURER
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FOR THE FISCAL YEAR ENDED JUNE 30, 2007

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, 2007. 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, 2007.

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, 2007, 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

Acting Chief Investment Officer:
Lee Ann Palladino

Assistant Treasurer, Cash Management:
Lawrence A. Wilson

Acting Assistant Treasurer, Debt Management:
Sarah K. Sanders

Assistant Treasurer, Policy:
Meredith A. Miller

During the audited period, Susan Sweeney served as Chief Investment Officer until her resignation effective June 1, 2007. Sarah K. Sanders was permanently appointed to Assistant Treasurer, Debt Management on August 7, 2007.

* 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 include the following:

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

- Review the 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, 2007, 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, 2007, 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

Clarence L. Roberts, Jr., Chairman
James Larkin
David Himmelreich
David Roth
Sharon M. Palmer
Michael Freeman
William Murray
George H. Mason
Carol M. Thomas
Peter Thor

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 (STIF) and the Medium-Term Investment Fund known as the Short-Term Plus 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 2006-2007 fiscal year, the Treasury incurred approximately $3,207,920 of bank service fees, of which approximately $776,103 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-38 and pages O-13 to O-15 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. Money market instruments are short-term debt and monetary instruments that mature in less than one year and are usually very liquid. 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 28, 2008.

As of June 30, 2007, STIF had total net assets of $5,004,095,757. Participant distributions paid and payable during the 2006-2007 fiscal year were $282,344,750 and STIF's expenses were $1,219,776. According to the Annual Report, STIF reported an annual total return of 5.54 percent, exceeding its main benchmark, the MFR (First Tier Institutions-Only Money Fund Report) index, by .40 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:

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. During the 2006-2007 fiscal year, the Treasurer’s Office established client accounts for the Medium-Term Investment Fund. The Treasurer’s Office refers to the Medium-Term Investment Fund as the Short-Term Plus Investment Fund. As of June 30, 2007, the Short-Term Plus Investment Fund had net assets of $303,976,942. Participant distributions paid and payable during the 2006-2007 fiscal year were $8,788,947 and the Short-Term Plus Investment Fund’s expenses were $27,723.

Statements and notes on pages F-45 through F-52 of the Annual Report deal with the Short-Term Plus 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, 2007, 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 $25,928,000,000, as of June 30, 2007. 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. Each asset class (i.e., Fixed

Income, U.S. Equity, etc.) within the Fund holds investments of the Combined Investment Funds. During the audited fiscal years, and as of June 30, 2007, 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, 2007, the Division employed 106 external advisors to manage and invest the assets of the Combined Investment Funds.

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 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 $5,000,000 for the 2005-2006 fiscal year and $5,000,000 for the 2006-2007 fiscal year.

During the fiscal years ended June 30, 2007 and 2006, 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 2006-2007 and 2005-2006 fiscal years are summarized below:

CIF	# of Advisors- June 30, 2007	Expenses 2006-2007	# of Advisors- June 30, 2006	Expenses 2005-2006
MFIF	12	$ 8,473,079	13	$ 8,990,536
MEF	7	9,473,490	8	25,959,765
ISF	14	28,520,098	11	25,266,303
CRF	1	324,772	1	271,123
CMF	1	100,083	1	183,500
PIF	53	26,525,715	46	26,288,160
REF	18	8,724,247	12	5,516,828
Total	**106**	**$82,141,484**	**92**	**$ 92,476,215**

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 30. 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, 2007	2006
U.S. Equity	***36%:***	***MEF***	36%	38%	39%
International Equity	***18%:***	***ISF***	18%	23%	24%
Developed Markets	15%	ISF			
Emerging Markets	3%	ISF			
Fixed Income	***30%:***	***MFIF, CRF, CMF***	30%	30%	29%
Cash	1%	CRF			
Core Bonds	20%	MFIF, CMF			
All other fixed income	9%	MFIF			
Real Estate and Alternative	***16%:***	***REF, PIF***	16%	9%	8%
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, 2007. Asset allocations are reviewed monthly to determine whether a rebalancing of investments is necessary to maintain the desired allocation levels. Subsequent to June 30, 2007, substantial changes were made to the asset allocation policy to reflect a restructuring of some asset classes and changes in investment strategy.

During the fiscal year ended June 30, 2007, the Combined Investment Funds realized a net total return of 17.34 percent, according to the Annual Report. The fund return of 17.34 percent is below the calculated benchmark of the Connecticut Multiple Market Index of 18.00 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, 2006, the Combined Investment Funds realized an annual total return of 10.55 percent which was higher than that year's calculated benchmark of the Connecticut Multiple Market Index of 10.01 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, 2007 and 2006 are presented below.

Combined Investment Funds:		**Percentage Return** 2006-2007	2005-2006
Net Total Combined Investment Funds		17.34 %	10.55 %
Mutual Equity	(MEF)	18.24 %	10.27 %
International Stock	(ISF)	29.65 %	25.69 %
Real Estate	(REF)	14.21 %	7.09 %
Mutual Fixed Income	(MFIF)	6.92 %	.77 %
Commercial Mortgage	(CMF)	8.17 %	9.69 %
Private Investment	(PIF)	19.56 %	11.74 %
Cash Reserve	(CRF)	5.61 %	4.54 %
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		`17.34 %	10.55 %
Teachers' Retirement Fund (TRF)		17.47 %	10.74 %
State Employees' Retirement Fund (SERF)		17.37 %	10.57 %
Municipal Employees' Retirement Fund (MERF)		16.96 %	9.87 %
Probate Court Retirement Fund (Probate)		16.84 %	10.66 %
Judges' Retirement Fund (Judges')		16.25 %	9.10 %
State's Attorneys' Retirement Fund (St. Atty.)		10.01 %	3.63 %
Trust Funds		8.93 %	2.43 %

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 Funds. 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 2006-2007 fiscal year, can be found on pages 18 through 59 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-29 of the Annual Report.

Investment Mix:

A summary of the Retirement Funds' investment activity in the Combined Investment Funds 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	6/30/06 Market Values	Share Transactions Purch	Redemp	Net	Gain on Redemp	Change in Mkt. Value	6/30/07 Mkt. Values	Percent Holdings	Inv. Income
	$	$	$	$	$	$	$		$
TRF	12,190	2,314	2,340	(26)	651	968	13,783	53 %	483
SERF	8,774	1,120	1,014	106	301	856	10,037	39 %	352
MERF	1,501	170	144	26	19	171	1,717	7 %	61
Probate	77	11	10	1	3	7	88	0 %	3
Judges'	164	23	19	4	2	18	188	1 %	7
St. Atty.	1	0	0	0	0	0	1	0 %	0
All Other	110	5	5	0	0	4	114	0 %	5
Totals	**$22,817**	**$3,643**	**$3,532**	**$111**	**$976**	**$2,024**	**$25,928**	**100%**	**$911**

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 Funds' 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	6/30/06 Net Assets	Participant Fund Activity Purch	Redemp	Income Distrib	Net Contrib	Invest Return	6/30/07 Net Assets	Percent Holdings
CRF	$1,384	$ 4,070	$ 3,105	$ 94	$ 871	$ 94	$2,349	9 %
MEF	8,982	6	613	168	(775)	1,611	9,818	38 %
ISF	5,357	13	767	106	(860)	1,523	6,020	23 %
MFIF	6,419	1,357	311	307	739	435	7,593	29 %
REF	399	448	142	90	216	71	686	3 %
CMF	18	0	10	1	(11)	1	8	0 %
PIF	1,360	212	40	224	(52)	256	1,564	6 %
Elim. Entry*	(1,102)	(2,463)	(1,456)	(79)	(928)	(80)	(2,110)	(8)%
Totals	**$22,817**	**$3,643**	**$3,532**	**$911**	**$(800)**	**$3,911**	**$25,928**	**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, 2006 and June 30, 2007, were $14,491 and $14,057, 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 2006-2007 fiscal year and the obligations outstanding, as of June 30, 2007, is presented in the schedule entitled "Changes in Debt Outstanding" shown on page S-30 of the Annual Report, while additional information is contained in the Annual Report pages S-31 and O-1 through O-12. A brief summary follows:

Bonds Outstanding June 30, 2006	$14,123,884,143
Add - Issuances	1,961,145,000
Deduct - Payments at maturity	1,154,067,296
- Bonds refunded or defeased	719,330,000
Bonds Outstanding June 30, 2007	**$14,211,631,847**
Interest paid	**$746,690,914**

Bonds issued in 2006-2007 by type are shown below:

General Obligation - Tax Supported	$1,616,700,000
Debt Service Commitment – UCONN 2000	135,385,000
Clean Water Fund	180,070,000
Tax Increment Bonds	9,825,000
Childcare Facilities Program Bonds	19,165,000
Total Bonds Issued, 2006-2007	**$1,961,145,000**

True interest cost rates for new bonds issued during the 2006-2007 fiscal year ranged from 3.86 percent to 4.99 percent. Bonds issued during the 2006-2007 fiscal year were comprised of new money issues amounting to $1,403,345,000 and refunding issues amounting to $557,800,000.

In addition to the bonds refunded or defeased totaling $719,330,000, the Treasury also made a payment of $5,225,000 to effect a redemption of Connecticut Health and Educational Facilities Authority bonds. This redemption was made in accordance with Section 10a-186c of the General Statutes which allows the Treasurer to advance funds to the Authority to redeem bonds that are funded by nursing home facilities that have been disposed of due to receivership, bankruptcy or insolvency.

In addition to the interest paid totaling $746,690,914, during the 2006-2007 fiscal year, the Treasury also made arbitrage rebate payments to the Federal government totaling $671,398. Such rebates represent the excess earnings of nontaxable bond proceeds that were invested in STIF prior to project disbursement.

Bonds outstanding at June 30, 2007 include $18,500,000 of Certificates of Participation for the Middletown Courthouse and $17,345,000 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 $4,660,000 is outstanding at June 30, 2007. 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 2002-2003 fiscal year, economic recovery notes amounting to $219,235,000 were issued and the remaining balance of $87,440,000 as of June 30, 2006, was paid in full during the 2006-2007 fiscal year.

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, 2003 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 2003-2004 fiscal year, economic recovery notes amounting to $97,700,000 were issued and the remaining balance of $58,650,000 as of June 30, 2006, was paid in full during the 2006-2007 fiscal year.

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, 2003 to July 1, 2005, 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, 2003, 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 2003-2004 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, 2007, Special Obligation Rate Reduction Bonds outstanding amounted to $125,375,000.

Public Act 03-5, of the June 30 Special Session, effective August 20, 2003, authorized a loan by the State to the Connecticut Resources Recovery Authority (CRRA) of up to $22,000,000 for the fiscal years ending June 30, 2004 and 2005, and for subsequent fiscal years, an additional aggregate amount of $93,000,000. As of June 30, 2007, CRRA had borrowed $21,500,176 from the State pursuant to the loan of which $13,319,761 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 2006-2007 fiscal year.

According to the Annual Report of the TEPF, net assets of the fund totalled $189,080,162 at June 30, 2007, and the return on investment was 3.27 percent for the 2006-2007 fiscal year. Participants in the fund at June 30, 2007, included civil list funds and recipients of State agency grant and loan programs as well as others.

At June 30, 2007, a total of $53,878,278 of State funds was invested in the TEPF as shown below:

Fund Classification	Amounts	Annual Report Page No.
Special Revenue	$15,562,218	O-13
Capital Projects	28,619,106	O-14
Enterprise	9,696,954	O-14
Total	**$53,878,278**	O-14

Second Injury Fund:

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 31-355b). 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 $56,654,098 for the 2006-2007 fiscal year.

Second Injury Fund claim payments amounted to $36,583,857 on a modified accrual basis for the 2006-2007 fiscal year. A comparison of claim expenditures by category follows:

	2006-2007	2005-2006
Stipulations	$ 8,416,740	$ 10,901,502
Indemnity (lost wages)	20,480,143	21,617,496
Medical	7,686,974	6,232,598
Totals	**$36,583,857**	**$ 38,751,596**

The number of stipulated agreements to settle claims increased during the current audited period. According to the Treasurer's Annual Reports, the number of settled claims totaled 178 and 180 for the fiscal years ended June 30, 2006 and 2007, 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-58 through F-64 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. ("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 $20,707,173 was needed to meet the expenses of the WCC for the 2006-2007 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 2.76 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 2006-2007 and 2005-2006 follows:

	2006-2007	2005-2006
Assessment collections	$19,849,827	$19,014,444
Other receipts	15,565	48,232
Total Receipts - WCA Fund	**$19,865,392**	**$19,062,676**

Connecticut Higher Education Trust:

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 2006-2007 fiscal year.

As of June 30, 2007, the CHET program had net assets of $954,791,402, and 66,731 participant accounts. Operating results for the 2006-2007 fiscal year taken from the Annual Report were as follows:

Net assets at June 30, 2006	$ 704,344,241
Net participant contributions	162,577,480
Investment income	90,902,736
Management fees	(3,033,055)
Net assets at June 30, 2007	**$954,791,402**

Financial statements and notes for CHET are presented on pages F-65 through F-71 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 the State 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 asset classes. No direct individual investments were held by the two trust funds. Total fund balances, at cost, on June 30, 2007, amounted to $6,836,743 for the School Fund and $436,780 for the Agricultural College Fund. The total fund balances on June 30, 2007, at fair value, amounted to $9,611,383 for the School Fund and $620,626 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-54 through F-57 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, 2007, is presented starting on page O-16 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:

Changes to the Investment Policy Statement:

Subsequent to June 30, 2007, the Investment Advisory Council adopted changes to the Investment Policy Statement. Those changes included the following:

- The addition of the Liquidity Fund which will replace the Cash Reserve Fund.

- The addition of the Alternative Investment Fund.

- The division of the International Stock Fund into the Developed Markets International Stock Fund and the Emerging Markets International Stock Fund.

- The division of the Mutual Fixed Income Fund into the Core Fixed Income Fund, Inflation Linked Bond Fund, Emerging Market Debt Fund and High Yield Investment Fund.

Pension Obligation Bonds:

Public Act 07-186, An Act Concerning Adequate Funding of Teachers Retirement System, was signed into law on July 10, 2007. With the passage of this Act, and pending the State Bond Commission's approval, the Teacher's Retirement Fund could receive a contribution up to a maximum of $2,000,000,000 from the issuance of Pension Obligation Bonds.

Structured Investment Vehicle Bankruptcy:

The issuer of floating rate notes held by the Short-Term Investment Fund suspended payments on the notes due to bankruptcy. The receivers are negotiating the sale, refinancing or restructuring of the underlying assets as of December 2007 and it is not known what the value of this investment will be. The floating rate notes were secured by assets held by a structured investment vehicle and had an amortized cost of $99,957,621 as of June 30, 2007.

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.

Late Claim Payments by the Second Injury Fund:

Criteria: Section 31-303 of the General Statutes requires the Second Injury Fund (Fund) to make settlement payments to claimants in a timely manner after receiving a fully-executed agreement. The Workers' Compensation Commissioner shall impose a penalty against the Fund for benefits not paid in a timely manner.

Condition: During our audit of the Second Injury Fund, it was found that the Fund was ordered to pay late payment penalties by the Workers' Compensation Commissioner. Two penalties totaling $25,036 were paid due to an apparent lack of communication from the Attorney General's Office, who represents the Fund before the Workers' Compensation Commissioner.

Cause: The Attorney General's Office did not forward the approved agreements to the Fund for payment.

Effect: The Fund paid $25,036 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 1.)

Agency Response: "The Fund met with the AG's Office in December of 2006 to implement corrective procedures to prevent future penalty payments. During this meeting the AG's Office assured the Fund that subsequent orders requiring the payment of money by the Fund will be immediately forwarded to the Fund for payment. The Fund does not control the procedures or staff of another state office; therefore the Fund cannot guarantee the prevention of future late payments and thus the imposition of penalties. The Fund will turn to the Auditors for recommendations of more effective remedies if such late claim payments occur in the future."

Conflicting Statutory and Regulatory Language for the Second Injury Fund:

Criteria: The Second Injury Fund collects assessments from insurance companies and self-insured employers. In prior years, if payments were late, penalties were charged at a rate of fifteen percent per annum in accordance with Section 31-349G-8 of the Regulations of State Agencies. Public Act 05-199, effective July 1, 2007, amended Section 31-354, subsection (a), of the General Statutes, and states, that any employer or any insurance company who fails to pay in accordance with such regulations shall pay a penalty of fifteen percent *or a minimum of fifty dollars (emphasis added*) on the unpaid assessment or surcharge. Regulations are intended to clarify certain information presented in the General Statutes and should not conflict with the General Statutes.

Condition: The Fund has complied with several companies' requests that they not be charged the 15 percent per annum penalty because (1) they did not "fail to pay" their assessments or (2) would prefer to be charged the minimum, $50 penalty.

For example, in two cases, companies who did not pay their assessment amounts in the usual timely manner requested that instead of being charged 15 percent penalties in the amounts of $82,519 and $14,570, that they instead be charged at $50 each. It appears that Section 31-354 may allow for this as the new language included in the General Statutes did not include the phrase, "whichever is greater."

Section 31-349G-8 of the Regulations of State Agencies appears to conflict with the General Statutes in that they were not updated and continue to show that the penalty shall be at 15 percent per annum.

Cause: Public Act 05-199 changed the language in Section 31-354, subsection (a), of the General Statutes, and after stipulating the penalty be "fifteen percent or a minimum of fifty dollars," apparently omitted the phrase "whichever is greater." Also, the Treasury has not updated its Regulations accordingly.

Effect: The Fund is unable to charge penalties for late payments.

Recommendation: The Second Injury Fund should seek to correct language as necessary within Section 31-354, subsection (a), of the General Statutes and update its Regulations accordingly. (See Recommendation 2.)

Agency Response: "The Fund agrees with the recommendation to change the statutes by inserting the additional wording "whichever is greater."

Improper Payments from the Second Injury Fund:

Criteria: Proper internal controls should prevent overpayments from occurring.

Condition: There were eight occurrences in which the Second Injury Fund made overpayments totaling $22,964. The Fund recovered all of these overpayments. A summary of the overpayments made are as follows:

- An injured worker returned to work for six months yet the Fund was unaware of the change in work status and continued to pay benefits in excess of what the injured worker was due totaling $13,203.

- An injured worker received payment for cost of living increases as if the injured worker was disabled for more than five years, which the injured worker was not. The amount of the overpayment was $2,579.

- An injured worker was not removed from the active payroll after a final stipulation agreement was signed. One check was cashed in the amount of $1,046.

- Another injured worker was paid $2,237 without an order from the Workers' Compensation Commissioner. The order was signed and received subsequent to the time the payment was made.

- The Fund approved a medical payment for $2,536 to one vendor; however, the Fund's third-party service provider made the payment to a different vendor in error.

- The Fund failed to notify the third-party service provider that the Fund had negotiated a rate adjustment with the medical provider, who was overpaid $1,291.

- The third-party service provider made a duplicate payment to a medical provider in the amount of $46, and we found during our audit that the State overpaid for contractual services in the amount of $25.

Cause: Internal controls were not always followed.

Effect: The Fund made payments to claimants who were not eligible to receive such amounts and vendors were paid incorrectly, which lessens the assurance that internal controls are operating effectively.

Recommendation: The Second Injury Fund should always follow internal controls to avoid improper payments being made. (See Recommendation 3.)

Agency Response: "The Second Injury Fund agrees with the recommendation that staff follow internal controls to avoid improper payments. The Fund paid out over $43 million in benefits during fiscal year 2007. Errors totaling $22,964 were made and fully collected resulting in no loss to the citizens of Connecticut. The Fund makes every effort to issue correct payments in accordance with governing statutes, recommendations of the Worker's Compensation Commissioner's Office and stipulated agreements."

Outdated Vendor Payment File:

Criteria: The State's automated accounting system known as Core-CT maintains a database of all approved vendors with tax reference numbers and vendors' names and addresses. A contract amendment is required to update the Core-CT vendor database with the correct vendor information including the tax identification number.

Condition: The bank that maintains the State's main depository account merged with another bank and changed its name. Although the entity that resulted had a new tax identification number and a new vendor name, the Core-CT vendor database was not updated accordingly. Payments for services made to this bank were processed through Core-CT despite the fact that they disagreed with the database information. This condition continued into the 2008 fiscal year, after our inquiry.

Cause: The Cash Management Division failed to amend the contract to include the new vendor name and identification number. Internal controls were circumvented and payments continued to be made without a valid vendor file.

Effect: Processing payments under the wrong tax identification number compromised the integrity of the State's vendor payment controls.

Recommendation: The Treasurer's Cash Management Division should amend personal service contracts and update the Core-CT vendor file whenever a vendor has a name change or a change in tax identification number. (See Recommendation 4.)

Agency Response: "The current contract states that the agreement "shall inure to the benefit of each party's heirs, successors, and assigns". While this contract contemplates changes in ownership, we agree with the Audit recommendation, and will acknowledge and consent to this assignment in writing with the bank in question and will work with the Comptroller's Office to make the appropriate data entries in the Core-CT vendor file."

Identification 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 reissue 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 utilized a procedure in which bank information is downloaded to the Core-CT system on a daily basis and dollar differences between the accounting system and the bank are automatically listed. However, check reconciliation is not part of the information that is electronically received from the bank. Under this procedure, the Core-CT system is not able to identify checks that have cleared versus checks that are outstanding. In order to find the specific checks that are outstanding, CMD personnel must refer to an outstanding check list provided by the bank on a monthly basis. Although the Core-CT accounting system supplies the bank with an electronic file of checks that have been issued, the system is not able to process an electronic file from the bank that contains the status of the previously issued checks.

Cause: Treasury's informational needs were not adequately addressed at the time of Core-CT implementation in July of 2003.

Effect: Errors in the recording of cash transactions may not be detected in a timely manner because of Core-CT's inability to download bank files pertaining to paid items.

Recommendation: The Treasurer's Cash Management Division should implement automated processes that would ensure that checks that have been presented for payment and cleared are reflected in the State's accounting records. (See Recommendation 5.)

Agency Response: "We agree that the recommended automated process would be helpful, and we have been pursuing it for two years. A bank feed of check status information has been available to Core-CT since March 2006, but linkage of the feed with the system has been delayed by Core-CT. We have been informed by Core-CT that the linkage and automated updating of check status information should be completed by the end of the current fiscal year."

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 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, 2007, were completed for our review in a timely manner; however, unresolved reconciling items from prior fiscal years continued.

The Cash Management Division continued to employ a manually-intensive method of cash reconciliation for the bank accounts that are maintained on the Core-CT system. Automated comparisons of bank information and general ledger postings should be employed in order to streamline and further automate this process.

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: Automated comparisons of bank information and general ledger postings should be employed in order to streamline and further automate reconciliations of cash accounts to ensure that reconciliations are performed that completely resolve all variances between the bank and Core-CT records in a timely manner. (See Recommendation 6.)

Agency Response: "While we will continue to explore methods and systems for improving the reconciliation process, we have significantly improved the timeliness of reconciliations since the implementation of Core-CT. As the Auditors note, year-end reconciliations for FY 2007 were completed in a timely manner. During FY 2007 approximately 90 percent of the monthly reconciliations were completed in a timely manner. There are outstanding and largely offsetting balances primarily from the first years of Core-CT's operation that need to be adjusted on the State's accounting records and we are working with the Comptroller's Office on this issue."

Failure to Monitor Investment Advisors:

Criteria: The Pension Funds Management Division has a method to value investments within the Real Estate Fund and the Private Investment Fund that should be consistently applied to ensure accurate representation in the financial statements. When investments are sold by the General Partners, the Treasury should be able to account for its (Limited Partner) portion of the proceeds and record any gains on the sale of investments properly. The Treasury should also monitor contractual provisions, to ensure that the General Partners are distributing gains to the State when they are required to do so.

Condition: We found that investments held by the General Partners within the Real Estate and Private Investment Funds are not monitored properly. The following summarize our concerns in this area:

- Gains from certain sales of investments may not have been recorded properly as we found conflicting information presented by General Partners to the State.

- Gains from certain sales of investments may not have been distributed to the State in accordance with certain contractual provisions.

- The market value provided by a General Partner for one investment within the Private Investment Fund was accepted by the Treasury, although certain shares were restricted and could not be traded on the open market at that point in time. Subsequent to our inquiry, the reset value, which is an amount disclosed in the footnotes to the financial statements and intended to reset estimated market values to actual market values, was reduced by $27,706,389.

- We found that manual signature approvals were missing for two outgoing wire transactions totaling $70,657,000. It is the Treasury's practice to document manual signatures on each wire transfer request, however, we did note that the transactions were considered authorized due to electronic "signatures".

- The Pension Fund Management Division should review and verify with the General Partners the reason for significant fluctuations in Private Investment Fund reset values, which would be beneficial to understanding the changes in partnership investments values made by General Partners.

Cause: There appears to be a lack of effective monitoring over the ongoing investments within the Real Estate and the Private Investment Funds subsequent to the commitment of the funds. The Treasury may rely on the General Partners' accounting for certain transactions, which is not appropriate in all circumstances, especially when the General Partners' accounting appears to conflict with other quarterly or annual information already provided to the Treasury.

Effect: Monitoring and accounting for investments improperly can result in financial records being inaccurate and undistributed cash going unnoticed

Recommendation: The Treasury should monitor investments within the Real Estate and the Private Investment Funds more closely to ensure that when transactions occur at the General Partners' level that the State will be able to collect distributions in accordance with contractual provisions and that the related accounting is accurately reflected in the financial statements. (See Recommendation 7.)

Agency Response: "The Pension Fund Management Division has reviewed its control measures in place to monitor our Real Estate and Private Equity Investment Advisors and has clarified staff accountability and the "form" of our related monitoring procedures to ensure, among other things, proper true-up as fluctuations in the accounting of transactions cannot always be prevented.

As part of our internal controls, all wire transfers are thoroughly reviewed, documented and accounted for at the time of receipt and if necessary PFM staff contacts the General Partner for additional accounting detail. Transactions can be complex and the accounting at the General Partnership level for gains/losses on individual properties is not necessarily done at the same point in time as the wire transfer. When differences in timing occur, the accounting records of the CRPTF and the GP will be in conflict.

Our practice, consistent with industry practices of other limited partners, is to rely on the information provided at the time of wire transaction. The year-end audited financial statements of the General Partnership disclose the audited sales of individual investments and going forward the investment sales will be reviewed by qualified staff and communicated to accounting.

Further, on a three month basis PFM staff shall review and comment on fluctuations in unrealized and realized gains and losses that are greater than $10 million and communicate to accounting any findings which are relevant to the reset valuations. This should ensure that material fluctuations in market values are properly recorded at that point.

PFM procedures require that any investment manager identified as not appropriately communicating financial transactions according to its contractual requirements will be monitored at a higher level and potentially placed on the Watch List.

Finally, as part of the outgoing wire transfer oversight process for capital calls, authorized PFM staff shall return all wires to the wire originator. The wire originator shall confirm that the wire has both manual and electronic signatures prior to filing the wires."

RECOMMENDATIONS

Status of Prior Audit Recommendations:

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

- 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 addressed.

- 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. This recommendation has been repeated as Recommendation 1.

- The Second Injury Fund should be sure to pay indemnity benefits in accordance with the amount determined by the Workers' Compensation Commission. This recommendation has been restated to reflect current conditions and is presented as Recommendation 3.

- 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. During the audited period, Core-Ct accounting system was not able to process an electronic file from the bank that contains the status of the previously issued checks. This recommendation has been restated and is presented as current Recommendation 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. This recommendation has been restated to reflect current conditions and is presented as Recommendation 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. This recommendation was adequately resolved.

- 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. This recommendation has been repeated as Recommendation 7.

Current Audit Recommendations:

The following recommendations resulted from our current review.

1. **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:

   During our audit of the Second Injury Fund, it was found that the Fund was ordered to pay late payment penalties by the Workers' Compensation Commissioner. Two penalties totaling $25,036 were paid due to an apparent lack of communication from the Attorney General's Office, who represents the Fund before the Workers' Compensation Commissioner.

2. **The Second Injury Fund should seek to correct language as necessary within Section 31-354, subsection (a), of the General Statutes and update its Regulations accordingly.**

   Comments:

   Public Act 05-199 changed the language in Section 31-354, subsection (a), of the General Statutes, and after stipulating the penalty for failure to pay an assessment of "fifteen percent or a minimum of fifty dollars," apparently omitted the phrase "whichever is greater."

3. **The Second Injury Fund should always follow internal controls to avoid improper payments being made.**

   Comments:

   There were eight occurrences in which the Second Injury Fund made overpayments during our current review. These overpayments totaled $22,964. The Fund recovered all of these overpayments.

4. **The Treasurer's Cash Management Division should amend personal service contracts and update the Core-CT vendor file whenever a vendor has a name change or a change in tax identification number.**

   Comments:

   The bank that maintains the State's main depository account merged with another bank and changed its name. Although the entity that resulted had a new tax identification number and a new vendor name, the Core-CT vendor database was not updated accordingly. Payments continued to be made without a valid vendor file.

5. **The Treasurer's Cash Management Division should implement automated processes that would ensure that checks that have been presented for payment and cleared are reflected in the State's accounting records.**

   Comments:

   The Core-CT accounting system does not record the status of checks that have been issued. Since the Core-CT system is not able to identify checks that have cleared versus checks that are outstanding, Treasury personnel must refer to an outstanding check list provided by the bank on a monthly basis.

6. **Automated comparisons of bank information and general ledger postings should be employed in order to streamline and further automate reconciliations of cash accounts to ensure that reconciliations are performed that completely resolve all variances between the bank and Core-CT records in a timely manner.**

   Comments:

   The Cash Management Division continued to employ a manually-intensive method of cash reconciliation for the bank accounts that are maintained on the Core-CT system. Automated comparisons of bank information and general ledger postings should be employed in order to streamline and further automate this process. Comprehensive payroll and vendor account reconciliations that agreed with the Core-CT accounting records for the fiscal year ending June 30, 2007, were completed for our review in a timely manner, however, unresolved reconciling items from prior fiscal years continued.

7. **The Treasury should monitor investments within the Real Estate and the Private Investment Funds more closely to ensure that when transactions occur at the General Partners' level that the State will be able to collect distributions in accordance with contractual provisions and that the related accounting is accurately reflected in the financial statements.**

   Comments:

   There appears to be a lack of effective monitoring over the ongoing investments within the Real Estate and the Private Investment Funds subsequent to the commitment of the funds. The Treasury may rely on the General Partners' accounting for certain transactions, which is not appropriate in all circumstances, especially when their accounting appears to conflict with quarterly or annual information already provided to the Treasury.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the statement of net assets of the Combined Investment Funds, as of June 30, 2007, 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, 2007 and 2006. We have audited the statement of net assets of the Short-Term Investment Fund as of June 30, 2007, and the statement of changes in net assets for the fiscal years ended June 30, 2007 and 2006. We have audited the accompanying statement of net assets of the Short-Term Plus Investment Fund, including the list of investments as of June 30, 2007, and the related statement of changes in net assets for the fiscal year ended June 30, 2007. We have audited the statements of condition of the other Non-Civil List Trust Funds as of June 30, 2007, together with the related statements of revenue and expenditures, and statements of changes in fund balance and the statements of cash flows for the other Non-Civil List Trust Funds, for the fiscal year ended June 30, 2007. We have also audited the statement of net assets of the Second Injury Fund, together with the related statements of revenues, expenses and changes in fund net assets and the statements of cash flows for the Second Injury Fund, for the fiscal years ended June 30, 2007 and 2006. We have also examined the schedules of Civil List Funds investments, as of June 30, 2007, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2007, and debt outstanding, as of June 30, 2007, and changes in debt outstanding during the fiscal year ended June 30, 2007. These financial statements and schedules 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. Our procedures included confirmation of securities owned as of June 30, 2007, 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, 2007, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2007, and debt outstanding, as of June 30, 2007, and changes in debt outstanding during the fiscal year ended June 30, 2007, 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, 2007, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2007, the balance of bonds outstanding as of June 30, 2007, 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, 2007, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2007, the balance of bonds outstanding as of June 30, 2007, 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, the Short-Term Investment Fund, the Short-Term Plus Investment Fund, the Second Injury Fund and other Non-Civil List Trust Funds as of June 30, 2007, 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, 2007, 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:

In planning and performing our audit, we considered the Office of the State Treasurer's internal control over its financial operations, safeguarding of assets, and compliance with requirements as a basis for designing our auditing procedures for the purpose of evaluating the Agency's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grant agreements, but not for the purpose of providing assurance on the effectiveness of the Agency's internal control over those control objectives.

Our consideration of internal control over financial operations, safeguarding of assets, and compliance requirements was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial operations, safeguarding of assets and compliance with requirements that might be significant deficiencies or material weaknesses. However as discussed below, we identified certain deficiencies in internal control over financial operations, safeguarding of assets, and compliance with requirements that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions , to prevent or detect on a timely basis unauthorized, illegal, or irregular transactions or the breakdown in the safekeeping of any asset or resource. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to properly initiate, authorize, record, process, or report financial data reliably consistent with management's direction, safeguard assets, and/or comply with certain provisions of laws, regulations, contracts, and grant agreements such that there is more than a remote likelihood that a financial misstatement, unsafe treatment of assets, or noncompliance with laws, regulations, contracts and grant agreements that is more than inconsequential will not be prevented or detected by the Agency's internal control. We consider the following deficiencies described in the accompanying "Condition of Records" and "Recommendations" sections of this report to be significant deficiencies in internal control over financial operations, safeguarding of assets and compliance with requirements: the need to fully automate the cash reconciliation process and perform cash reconciliations in a more timely manner; the need to more closely monitor Private Equity and Real Estate transactions at the General Partner level; and the lack of coordination between the Second Injury Fund and the Attorney General's Office regarding Workers' Compensation hearings.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with certain provisions of laws, regulations, contracts, and grant agreements or the requirements to safeguard assets that would be material in relation to the Agency's financial operations, noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions and material financial misstatements by the Agency being audited will not be prevented or detected by the Agency's internal control.

Our consideration of the internal control over the Agency's financial operations, safeguarding of assets, and compliance with requirements was for the limited purpose described in the first paragraph of this section and would not necessarily disclose all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

We also noted certain matters which we reported to Agency management 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