STATE OF CONNECTICUT

AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2008

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

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July 24, 2009

AUDITORS' REPORT
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FOR THE FISCAL YEAR ENDED JUNE 30, 2008

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, 2008. 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, 2008.

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, 2008, 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

Assistant Treasurer, Debt Management:
Sarah K. Sanders

Assistant Treasurer, Policy:
Meredith A. Miller

* 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, 2008, 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, 2008, 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

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

Clarence L. Roberts, Jr. served during the audited period as Chairman until his term expired.

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 2007-2008 fiscal year, the Treasury incurred approximately $3,827,624 of bank service fees, of which approximately $453,859 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-46 through S-51 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 27, 2009.

As of June 30, 2008, STIF had total net assets of $5,054,521,656. Participant distributions paid and payable during the 2007-2008 fiscal year were $205,184,804 and STIF's expenses were $1,157,785. According to the Annual Report, STIF reported an annual total return of 4.13 percent, exceeding its main benchmark, the MFR (First Tier Institutions-Only Money Fund Report) index, by .06 percent.

Statements and notes on pages F-34 through F-43 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-44 through F-48 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 Medium-Term Investment Fund includes both the Extended Investment Portfolio and the Short-Term Plus Investment Fund programs. The Extended Investment Portfolio had net assets of $217,041,439 as of June 30, 2008.

As of June 30, 2008, the Short-Term Plus Investment Fund had net assets of $310,314,034. Participant distributions paid and payable during the 2007-2008 fiscal year were $13,986,492 and the Short-Term Plus Investment Fund’s expenses were $61,086.

Statements and notes on pages F-49 through F-56 of the Annual Report deal with the Short-Term Plus Investment Fund.

Community Banking Initiative:

Pursuant to Section 3-24k of the General Statutes, the Treasurer may invest up to $100,000,000 from available State operating cash in certificates of deposit issued by community banks and community credit unions. Investments in such certificates of deposit at amortized cost amounted to $68,500,000 as of June 30, 2008.

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 $25,872,000,000, as of June 30, 2008. 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 within the Fund holds investments of the Combined Investment Fund. During the audited fiscal year, the International Stock (ISF) and the Mutual Fixed Income (MFIF) were eliminated and their investment portfolios were transferred into six new asset classes which were added to the Combined Investment Funds. As of June 30, 2008, the Combined Investment Fund (CIF) consisted of the Mutual Equity (MEF), Developed Market International Stock (DMISF), Emerging Market International Stock (EMISF), Core Fixed Income (CFIF), Inflation Linked Bond (ILBF), Emerging Market Debt (EMDF), High Yield Debt (HYDF), Real Estate (REF), Private Investment (PIF), Commercial Mortgage (CMF), and the Liquidity (LF) Funds. Record keeping and custody of most assets is provided by a master custodian (State Street Bank). As of June 30, 2008, the Division employed 124 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. Administrative expenses of the Combined Investment Funds, excluding external advisor expenses, were approximately $5,800,000 for the 2007-2008 fiscal year and $5,400,000 for the 2006-2007 fiscal year.

During the fiscal years ended June 30, 2008 and 2007, external advisors managed all of the CIF portfolios. The number of external 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 2007-2008 and 2006-2007 fiscal years are summarized below:

CIF	**# of Advisors- June 30, 2008**	**Expenses 2007-2008**	**# of Advisors- June 30, 2007**	**Expenses 2006-2007**
MFIF	0	$ 3,381,768	12	$ 8,473,079
CFIF	6	3,995,812		
ILBF	2	359,428		
EMDF	4	1,445,788		
HYDF	4	1,629,335		
MEF	7	21,876,645	7	9,473,490
ISF	0	10,526,016	14	28,520,098
DMISF	12	13,227,084		
EMISF	2	5,610,307		
LF	1	373,544	1	324,772
CMF	1	73,500	1	100,083
PIF	62	39,588,806	53	26,525,715
REF	23	13,013,373	18	8,724,247
Total	**124**	**$115,101,406**	**106**	**$ 82,141,484**

The above consists of the Mutual Fixed Income (MFIF), Core Fixed Income (CFIF), Inflation Linked Bond (ILBF), Emerging Market Debt (EMDF), High Yield Debt (HYDF), Mutual Equity (MEF), International Stock (ISF), Developed Market International Stock (DMISF), Emerging Market International Stock (EMISF), Liquidity (LF), Commercial Mortgage (CMF), Private Investment (PIF), and the Real Estate (REF) Funds.

During the audited period, the International Stock Fund and the Mutual Fixed Income Fund were closed and their portfolio assets were transferred into newly created asset portfolio funds. The Investment Policy Statement was amended to include asset allocation and investment policies for these new funds. The International Stock portfolio was reallocated to the Developed Market International Stock Fund and the Emerging Market International Stock Fund. The Mutual Fixed Income portfolio was reallocated to the Core Fixed Income Fund, the Inflation Linked Bond Fund, the Emerging Market Debt Fund and the High Yield Debt Fund.

Asset Allocation Policy:

The two largest retirement plan portfolios invested by the State Treasurer are the Teachers Retirement Fund (TRF), and the State Employees' Retirement Fund (SERF) which together represent approximately 92 percent of the total assets under management. The asset allocation policy for these two retirement plans is presented below. This policy was implemented during the period under review.

	As of June 30, 2008			
	TRF		SERF	
Investment Class	**Target Policy**	**Actual Holdings**	**Target Policy**	**Actual Holdings**
U.S. Equity				
Mutual Equity Fund	25%	31.1%	26%	31.9%
International Equity				
Developed Markets International Stock	20%	19.9%	20%	20.5%
Emerging Markets International Stock	9%	4.8%	9%	5.4%
Fixed Income				
Liquidity Investment	6%	5.4%	4%	3.5%
Core Fixed Income	13%	17.5%	13%	16.0%
Inflation Linked Bond	6%	4.2%	6%	4.3%
Emerging Markets Debt	4%	3.9%	4%	4.0%
High Yield Bond	2%	2.7%	2%	3.2%
Real Estate and Alternative				
Private Investment	10%	6.8%	11%	7.1%
Real Estate	5%	3.7%	5%	4.1%

Asset allocations are reviewed monthly to determine whether a rebalancing of investments is necessary to maintain the desired allocation levels. During the audited period, 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, 2008, the Combined Investment Funds realized a net total return of (4.71) percent, according to the Annual Report. During the previous fiscal year ended June 30, 2007, the Combined Investment Funds realized an annual total return of 17.34 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, 2008 and 2007 are presented below.

		Percentage Return	
Combined Investment Funds:		**2007-2008**	**2006-2007**
Net Total Combined Investment Funds		(4.71) %	17.34 %
Mutual Equity	(MEF)	(12.99) %	18.24 %
International Stock	(ISF)		29.65 %
Developed Market International Stock	(DMISF)	(14.60) %	
Emerging Market International Stock	(EMISF)	0.19 %	
Real Estate	(REF)	6.04 %	14.21 %
Mutual Fixed Income	(MFIF)		6.92 %
Core Fixed Income	(CFIF)	5.65 %	
Emerging Market Debt	(EMDF)	5.59 %	
High Yield Debt	(HYDF)	(1.88) %	
Inflation Linked Bond	(ILBF)	16.81 %	
Commercial Mortgage	(CMF)	12.05 %	8.17 %
Private Investment	(PIF)	13.66 %	19.56 %
Cash Reserve	(CRF)		5.61 %
Liquidity	(LF)	4.59 %	
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		(4.71) %	17.34 %
Teachers' Retirement Fund (TRF)		(4.77) %	17.47 %
State Employees' Retirement Fund (SERF)		(4.83) %	17.37 %
Municipal Employees' Retirement Fund (MERF)		(4.11) %	16.96 %
Probate Court Retirement Fund (Probate)		(4.16) %	16.84 %
Judges' Retirement Fund (Judges')		(4.11) %	16.25 %
State's Attorneys' Retirement Fund (St. Atty.)		0.37 %	10.01 %
Trust Funds		2.08 %	8.93 %

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 2007-2008 fiscal year, can be found on pages 14 through 74 of the Annual Report.

Statements and notes on pages F-14 through F-31 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-42 of the Annual Report.

Investment Mix:

A summary of the Retirement Funds' investment activity in the Combined Investment Fund is presented below. Amounts presented as transfers resulted from the movement of existing investments out of the International Stock Fund (ISF) and Mutual Fixed Income Fund (MFIF) and into the six new asset classes created during the audited period. The amounts below are presented in millions of dollars.

Participant Funds	6/30/07 Market Values	Share Transactions Purch	Redemp	Net	Gain on Redemp	Change in Mkt. Value	6/30/08 Mkt. Values	Percent Holdings	Inv. Income
	$	$	$	$	$	$	$		$
TRF	13,783	10,488	8,503	1,985	188	(1,414)	14,542	53 %	520
SERF	10,037	5,358	5,217	141	323	(1,171)	9,330	39 %	372
MERF	1,717	954	909	45	135	(270)	1,627	7 %	65
Probate	88	48	48	0	7	(14)	81	0 %	4
Judges'	188	107	103	4	13	(28)	177	1 %	7
St. Atty.	1	1	1	0	0	0	1	0 %	0
Trust Funds	114	95	94	1	1	(2)	114	0 %	5
Transfers		(8,867)	(8,867)						
Totals	**$25,928**	**$8,184**	**$6,008**	**$2,176**	**$667**	**$(2,899)**	**$25,872**	**100%**	**$973**

A summary of the Combined Investment Fund's activity is presented below. The amounts below are presented in millions of dollars.

Combined Investment Funds	6/30/07 Net Assets	Participant Fund Activity Purch	Redemp	Income Distrib	Net Contrib	Invest Return	Fund Transfers	6/30/08 Net Assets
LF	$2,349	$ 6,661	$ 6,849	$ 82	$ (270)	$ 82		$2,161
MEF	9,818	196	632	160	(596)	(1,222)		8,000
ISF	6,020	0	44	35	(79)	460	(6,401)	0
DMISF	0	1,307	17	71	1,219	(925)	4,814	5,108
EMISF	0	0	0	8	(8)	(276)	1,588	1,304
MFIF	7,593	0	275	112	(387)	268	(7,474)	0
CFIF	0	0	1,209	203	(1,412)	127	5,822	4,537
ILBF	0	870	8	5	857	39	276	1,172
EMDF	0	361	22	9	330	(10)	727	1,047
HYDF	0	156	1	30	125	(14)	648	759
REF	686	320	9	50	261	56		1,003
CMF	8	0	1	1	(2)	1		7
PIF	1,564	308	25	266	17	214		1,795
Elim. Entry*	(2,110)	(1,995)	(3,084)	(59)	1,148	(59)		(1,021)
Totals	**$25,928**	**$8,184**	**$6,008**	**$973**	**$1,203**	**$(1,259)**	**0**	**$25,872**

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

The investment activity information is presented in detail in the Treasurer's Annual Report, pages S-

2 through S-17.

Investment Advisory Council Expenditures:

State Treasurer expenditures, for the IAC for the fiscal years ended June 30, 2007 and June 30, 2008, were $14,491 and $17,711, 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 2007-2008 fiscal year and the obligations outstanding, as of June 30, 2008, is presented in the schedule entitled "Changes in Debt Outstanding" shown on page S-43 of the Annual Report, while additional information is contained in the Annual Report pages S-44 and O-1 through O-12. A brief summary follows:

Bonds Outstanding June 30, 2007	$14,211,631,847
Add - Issuances	3,919,708,271
Deduct - Payments at maturity	1,235,101,790
- Bonds refunded or defeased	458,675,000
Bonds Outstanding June 30, 2008	**$16,437,563,328**
Interest paid	**$755,089,381**

Bonds issued in 2007-2008 by type are shown below:

General Obligation - Tax Supported	$1,366,085,000
General Obligation – Teachers' Retirement Pension Obligation Bonds	2,276,578,271
Special Tax Obligation – Transportation Fund	250,000,000
Connecticut Housing Finance Authority - Special Needs Housing Bonds	27,045,000
Total Bonds Issued, 2007-2008	**$3,919,708,271**

True interest cost rates for new bonds issued during the 2007-2008 fiscal year ranged from 3.43 percent to 5.88 percent. Bonds issued during the 2007-2008 fiscal year were comprised of new money issues amounting to $3,688,623,271 and refunding issues amounting to $231,085,000.

In addition to the interest paid totaling $755,089,381, during the 2007-2008 fiscal year, the Treasury also made arbitrage rebate payments to the Federal government totaling $863,929. Such rebates represent the excess earnings of nontaxable bond proceeds that were invested in STIF prior to project disbursement.

The Teachers' Retirement Pension Obligation Bonds were issued pursuant to Public Act 07-186 to fund a portion of the unfunded pension liability of the Teachers' Retirement Fund.

In accordance with Section 17a-485e of the General Statutes, the State Treasurer and the Office of Policy and Management entered into a contract to provide State assistance to the Connecticut Housing Finance Authority (CHFA) for the payment of debt service on Authority bonds issued for the purpose of providing mortgage loans under the Supportive Housing Initiative program. The statute allows State assistance for such bonds in an aggregate principal amount not to exceed $70,000,000. As of June 30, 2008, CHFA Special Needs Housing Bonds outstanding totaled $25,915,000.

Special Obligation Rate Reduction 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. Public Act 07-1 of the June Special Session appropriated funds for the defeasance of Special Obligation Rate Reduction Bonds. During the audited period the remaining outstanding bonds amounting to $110,990,000 were refunded.

Bonds outstanding at June 30, 2008 include $16,195,000 of Certificates of Participation for the Middletown Courthouse and $16,940,000 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 $4,115,000 is outstanding at June 30, 2008. 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.

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, 2008, CRRA had borrowed $21,500,176 from the State and the entire amount had been paid back. The State received $2,635,625 in interest income over the life of the loan. Loan receivable records for the CRRA loan were 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 2007-2008 fiscal year.

According to the Annual Report of the TEPF, net assets of the fund totalled $174,430,738 at June 30, 2008, and the fund's total return was 2.68 percent for the 2007-2008 fiscal year. Participants in the fund at June 30, 2008, included civil list funds and recipients of State agency grant and loan programs as well as others.

At June 30, 2008, a total of $46,943,954 of State funds was invested in the TEPF as shown below:

Fund Classification	Amounts	Annual Report Page No.
Special Revenue	$14,473,017	O-13
Capital Projects	24,211,138	O-14
Enterprise	8,259,799	O-14
Total	**$46,943,954**	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 $45,049,929 for the 2007-2008 fiscal year.

Second Injury Fund claim payments amounted to $37,539,670 for the 2007-2008 fiscal year. A comparison of claim expenditures by category follows:

	2007-2008	2006-2007
Stipulations	$ 9,975,232	$ 8,416,740
Indemnity (lost wages)	21,289,614	20,480,143
Medical	6,274,824	7,686,974
Totals	**$37,539,670**	**$ 36,583,857**

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 180 and 181 for the fiscal years ended June 30, 2007 and 2008, respectively.

Financial statements and notes for the SIF are presented on pages F-62 through F-68 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 State Treasury. 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 of the amount needed to meet the expenses of the WCC for the fiscal year. Based on the projection, less the balance in the WCC account, the Treasurer assessed insurance companies and self-insured employers during the audited period at a rate based on 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 2007-2008 and 2006-2007 follows:

	2007-2008	2006-2007
Assessment collections	$20,563,416	$19,849,827
Other receipts	22,343	15,565
Total Receipts - WCA Fund	**$20,585,759**	**$19,865,392**

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 2007-2008 fiscal year.

As of June 30, 2008, the CHET program had net assets of $1,076,674,472, and 79,536 participant accounts. Operating results for the 2007-2008 fiscal year taken from the Annual Report were as follows:

Net assets at June 30, 2007	$ 954,791,402
Net participant contributions	158,260,254
Net decrease from operations	(36,377,184)
Net assets at June 30, 2008	**$1,076,674,472**

Financial statements and notes for CHET are presented on pages F-69 through F-75 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, 2008, amounted to $6,921,473 for the School Fund and $442,348 for the Agricultural College Fund. The total fund balances on June 30, 2008, at fair value, amounted to $9,248,700 for the School Fund and $596,314 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-57 through F-61 of the Annual Report. Investment activity is presented on pages S-12 through S-17.

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, 2008, 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:

On December 5, 2008 the Short-Term Investment Fund recognized a $24,000,000 loss in value related to the write-down of medium-term notes with a maturity value of $100,000,000 which were secured by a structured investment vehicle. The Short-Term Investment Fund reserve account had a balance of $53,100,000 as of June 30, 2008 which was able to cover the $24,000,000 adjustment without affecting share values for the Fund participants.

Pursuant to Section 3-16 of the General Statutes, on March 6, 2009, the Governor approved a request from the State Treasurer for temporary borrowing to cover potential cash flow needs of the State.

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.

Unreconciled Cash Accounts within Cash Management Division:

Criteria: It is the responsibility of the Cash Management Division to research and resolve unidentified variances when reconciling the bank accounts. An automated accounting system such as the State's Core-CT accounting system should have the functionality to perform automated bank reconciliations which would identify all outstanding items as to date and amount.

Condition: When the Core-CT system was implemented during the 2004 fiscal year, we noted that the State's 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, leaving unresolved bank variances dated back to the inception of Core-CT in fiscal year 2004. As of June 30, 2008 the payroll account had a negative variance of ($10,286,504) and the vendor account variance was a positive $10,343.462. The Cash Management Division reclassified the payroll account variance of ($10,286,504) to the vendor account without explaining the adjustment. Due to formatting problems, Core-CT is unable to access data posted to the system prior to February 2005 preventing an identification of the original postings that led to the variances in these accounts. Although the Core-CT system has the potential to receive information from the bank electronically and list outstanding transactions, the CMD continues to rely on a manual reconciliation process to reconcile to the State's vendor and payroll accounts.

Cause: The necessary electronic downloads are not obtained from the bank; therefore, CMD is incapable of automatically reconciling the vendor and payroll account. In addition the inability of Core-CT to process information before February 2005 is a major factor in CMD inability to verify the unexplained variances in both payroll and vendor account.

Effect: Cash Management made a $10,343,462 adjustment between the payroll and vendor account without proper explanation. Errors in the recording of cash transactions may not be detected in a timely manner because bank reconciliations are not done in the most efficient manner available. The automation of the bank reconciliation process would improve the ability to calculate available cash balances.

Recommendation: The Cash Management Division should improve internal controls over cash accounts and ensure all variances between the bank and Core-CT records are explained and have been completely resolved. (See Recommendation 1.)

Agency Response: "After extensive research by our office and the Comptroller's Office, at our request the Comptroller's Office adjusted Core's June 30, 2008 balances for the payroll and vendor general ledger accounts for the largely off-setting variances from the first four years of Core-CT, resulting in a favorable net General Fund write-up of $57,000. During those years, as agencies throughout the state were learning to use Core-CT and system issues were being identified and resolved, a large number of posting errors occurred that resulted in the large, basically off-setting variances in the payroll and vendor accounts. As noted by the Auditors, a Core formatting issue prevents access to original postings made prior to February 2005 that caused the bulk of the variances. We do not expect a repeat of this audit exception as we have significantly improved the timeliness of reconciliations since the implementation of Core-CT."

Core-CT Unauthorized Override of Bank Deposit Data:

Criteria: Section 4-33(a) of the General Statutes states agencies shall promptly notify the Auditors of Public Accounts and the Comptroller of any unauthorized, illegal, irregular or unsafe handling or expenditure of state funds or breakdowns in the safekeeping of any other resources of the state or contemplated action to do the same within their knowledge.

Treasury does not have the authority or the ability to change the deposit amount data submitted by the bank. If there are any discrepancies with a deposit, the depositing agency should contact the Treasury to research and resolve the issue with the bank.

Condition: During our audit of Cash Management, an incident of irregular and unsafe handling of State funds regarding bank deposits was brought to our attention. An employee from the Department of Banking contacted a Core-CT employee and requested a change in a deposit amount received from the bank. The Core-CT employee went into the system and overrode deposit information that was received from the bank. We were informed about this incident nine months after it was discovered by Treasury staff.

Cause: Treasury failed to notify the Auditors of Public Accounts of the unauthorized override of bank deposit data in a timely manner. The Core-CT employee did not follow accepted procedures designed to protect the integrity of cash deposit data.

Effect: If employees can easily override the Core-CT system and change the deposit data that is submitted by the bank, it exposes the State to a serious fraud risk.

Recommendation: Treasury should report irregular and unsafe handling of the State funds in a timely manner and request that Core-CT administration improve security procedures to protect the integrity of bank data. (See Recommendation 2.)

Agency Response: "When we learned of the unauthorized $210 adjustment, we took the steps necessary to ensure that the deposit record was corrected, and informed Core-CT and the agency that such adjustments were improper. We have subsequently been informed by Core-CT that the system was modified to prevent such an adjustment in the future. The Comptroller's Office has confirmed modification of the system to protect against such an incident in the future (we are awaiting the Comptroller's written confirmation)."

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 the bank's computer system. 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 3.)

Agency Response: "Starting June 30, 2008, Core-CT went operational with the acceptance of cleared vendor check data from the bank, comparison of the data to the Core issue file to assist in reconciliation, and updating check status for agency, Comptroller and Treasury inquiry. Cleared checks from July 2005 to present (except for a couple of isolated months) have been loaded into Core. We are working through some data issues and have begun development of a similar process for the payroll account. Once the work on the development of the new programs is completed and implemented we do not expect a repeat of this audit recommendation. Core believes it will complete the development of the new program by the end of the fiscal year, barring unforeseen circumstances."

Breakdown in Positive Pay Service:

Criteria: The State's main depository bank provides a service called Positive Pay. The service requires the client to send a file of issued checks to the bank each day checks are written. When those issued checks are presented for payment at the bank, they are compared electronically against the list of transmitted checks. When a check is presented that does not have a "match" in the file, it becomes a "suspect item". The client can go online and view the suspect checks. The client reviews the image and instructs the bank to pay or return the check.

On a daily basis, the Accounts Payable Division of the Comptroller's Office (AP) and Core-CT independently send information to the main depository bank regarding the issuance of vendor payments. The bank should reconcile the AP fax with the file from Core-CT as part of the Positive Pay Service.

Condition: We were informed by Treasury personnel that on January 6, 2009, a vendor check which had been escheated and removed from the list of issued checks over eighteen months prior was presented to the bank for payment. Because the list of previously escheated checks had been added back into the list of issued checks in error, the check was paid by the bank. Core-CT had sent an electronic file of the checks issued for the day which had the list of escheated checks imbedded in it. There was a difference of over $1,500,000 between the file total transmitted by Core-CT and the total faxed by AP. The bank failed to follow their own internal control procedures when they did not reconcile the fax sent by AP and the file sent from Core-CT.

Cause: The bank's failure to follow prescribed internal control procedures over the Positive Pay transactions contributed to this condition. It is unclear how Core-CT imbedded the escheated files into the daily Positive Pay file. Core-CT must implement internal control procedures to ensure this situation is not repeated.

Effect: If these transactions had gone undetected, a payee could have put in a claim with the Unclaimed Property Division and received a duplicate payment from the State. The Treasurer's Cash Management Division detected the problem when the check turned up as unreconciled.

Recommendation: Treasury should verify, on a daily basis, that the total checks issued amount per the Comptroller's Office and the total checks issued amount per Core-CT are in agreement and request that Core-CT administration improve procedures to protect the integrity of bank data. (See Recommendation 4.)

Agency Response: "Current Cash Management internal control verification procedures which are performed the next day identified the improperly paid $35 check the very next day, and the problem was corrected the very day it was identified. Furthermore, on January 21, 2009, Core-CT implemented programming changes to prevent the erroneous inclusion of extra items in the Positive Pay file. In our view, that system enhancement should obviate the need for a duplicate verification process."

Securities Lending Collateral:

Criteria: According to Section 3-13d of the General Statutes, the Treasurer may lend securities from the Combined Investment Fund provided that at the time of the execution of the loan at least one hundred percent of the market value of the security lent shall be received as consideration in the form of cash or securities guaranteed by the United States government or any agency of the United States government. The Combined Investment Fund realized net income of $28,370,117 from securities lending activity during the audited period.

Condition: As of June 30, 2008, securities with a market value of $3,276,218,029 were on loan. Of this amount, $2,943,595,112 was secured with cash collateral and $332,622,917 was secured by non-cash collateral. The market value of the non-cash collateral received amounted to $348,364,288 in the form of United States government securities amounting to $30,573,590, domestic corporate bonds and equity amounting to $60,692,845 and foreign fixed income and equity amounting to $257,097,853.

Cause: The foreign fixed income and equity collateral was received to secure the loan of international fixed income and equity securities amounting to $242,791,652 and was considered to be safe. The domestic corporate bonds and equity collateral received was also considered to be safe. Also, the master custodian bank that administers the securities lending program has indemnified the State against the loss of any lent securities. If borrowers fail to return the lent securities, the master custodian bank is obligated to replace any lost securities.

Effect: Approximately ninety-one percent of the total collateral received was in the form of cash or United States government securities. It appears that the collateral that is non-compliant with the statutory requirement is of a secure nature.

Recommendation: The Treasurer's Pension Fund Management Division should ensure that collateral received for security lending purposes is in compliance with the requirements of Section 3-13d of the General Statutes. (See Recommendation 5.)

Agency Response: **"**Pension Fund Management agrees with the auditors finding and is now in compliance with the statutory requirements. While best practices accepts the type of collateral that historically served as consideration for the lending of securities from the combined investment funds, Pension Fund Management has initiated a legislative proposal that would amend the current statute to allow additional types of collateral as security to facilitate the lending of securities and maximize income to the combined income funds without materially increasing risk."

Open-ended Real Estate Investment Trusts:

Criteria: The State Treasury's Investment Policy Statement guidelines for the Real Estate Fund's investments stipulate that contracts should include clearly-defined redemption provisions; usually, such contracts also include a defined contract-end period. It is the Treasury's practice to document manual signatures on each wire transfer request.

Condition: The Treasury contracted with two Real Estate advisors to manage investments totaling $175,000,000. The investments were managed through limited partnership agreements that did not contain dissolution dates for the partnerships. These open-ended contracts did not appear to have clearly-defined redemption provisions. Redemption requests could be postponed indefinitely if the general partner concluded that partnership cash flows could be adversely impaired or if other limited partners had previous redemption requests pending.

We found that manual signature approvals were missing for two outgoing wire transactions related to Real Estate Fund operations totaling $101,000,379; it was noted that transactions were considered authorized due to electronic "signatures."

Cause: Investment advisors were hired to manage open-ended, commingled Real Estate Investment Trusts, whose structure does not appear to have met the investment guidelines in the Investment Policy Statement for Real Estate Funds. Investment Policy Statement guidelines recognize that there may be situations in which all of the recommended contract provisions may not be able to be negotiated and allows for deviations from the guidelines if the reason for deviating from accepted guidelines is documented and approved. The lack of a clearly-defined redemption provision was considered during the due diligence process for both of the open-ended Real Estate Investment Trusts. Management of the Treasury did not sign the wires as Treasury procedures dictate.

Effect: The lack of contract provisions that address partnership dissolution dates and on-demand redemption creates a combination that could prevent Treasury from redeeming funds when necessary from these investment managers. Contract terms stipulate that the Treasury must first wait in line for other investors who may have requested earlier redemption of their funds. A "line" that doesn't include the State Treasury, has already formed for one of these investments.

Recommendation: The Office of the State Treasurer should avoid investment arrangements that do not contain timely redemption provisions when there is a lack of a contract-end period and follow internal procedures for signing wire transaction requests. (See Recommendation 6.)

Agency Response "As required, the Investment Policy Statement was followed and the redemption provision was documented and presented to the Treasurer for approval. It was documented that the redemption provision represented an advantage over a typical closed-end fund where the funds are invested by the manager until the maturity of the fund, which is typically 8 to 10 years. While there is no guarantee that a redemption request for an open-end fund will be honored immediately, (there have been periods of redemption queues) the open-end structure has worked reasonably well for many decades.

PFM will review the Investment Policy Statement to ensure it is reflective of best practices for the management of real estate investment funds, including the redemption provision of open-ended funds and clarify or modify if necessary.

Regarding liquidity management, the IPS was modified during October 2007 and included a new fund, the Liquidity Fund. During May 2008, the fund was presented to the IAC and included a discussion on the strategic management of cash for all plans and trusts. The cash management strategy recognized that Real Estate and other private investments represent long-term, illiquid commitments of capital and that liquidity planning should ensure that all short-term cash flow needs were met. This liquidity strategy has proved valuable during the recent market downturn, where cash needs have been fully funded through the liquidity fund.

Treasury staff acknowledges that it did not properly sign off on the wire transfer documentation, although all electronic verifications were properly made. All wire transfer documentation will be reviewed prior to filing to ensure procedures are properly followed."

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, 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. Our current review did not disclose late penalty payments. We have not repeated this 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. Proposed legislation has been submitted to amend this statute. This recommendation is resolved.

- The Second Injury Fund should always follow internal controls to avoid improper payments from being made. This recommendation is not repeated.

- 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**.** The vendor file was updated during the current audited period and this recommendation has been resolved.

- 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. This recommendation has been repeated as current Recommendation 3.

- 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. This recommendation has been restated to reflect current conditions and presented as current Recommendation 1.

- 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. This recommendation has been addressed during the current audited period and is not repeated.

Current Audit Recommendations:

The following recommendations resulted from our current review.

1. **The Cash Management Division should improve internal controls over cash accounts and ensure all variances between the bank and Core-CT records are explained and have been completely resolved.**

Comments:

When the Core-CT system was implemented during the 2004 fiscal year, the State's payroll and vendor account cash reconciliations were not conducted in a manner which resolved all variances between the bank records and the Core-CT accounting records. Unresolved bank variances persisted until June 30, 2008 when the payroll account had a negative variance of ($10,286,504) and the vendor account variance was a positive $10,343.462. The Cash Management Division reclassified the payroll account variance of ($10,286,504) to the vendor account but was unable to identify the original transactions that led to the variances between the two accounts because the Core-CT system was unable to access data posted to the system prior to February 2005.

2. **Treasury should report irregular and unsafe handling of the State funds in a timely manner and request that Core-CT administration improve security procedures to protect the integrity of bank data.**

Comments:

During our audit of Cash Management, an incident of irregular and unsafe handling of State funds regarding bank deposits was brought to our attention. An employee from the Department of Banking contacted a Core-CT employee and requested a change in a deposit amount received from the bank. The Core-CT employee went into the system and overrode deposit information that was received from the bank. We were informed about this incident nine months after it was discovered by Treasury staff.

3. **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:

During the audited period, the Cash Management Division utilized a procedure in which check reconciliation was not part of the information that is electronically received from the bank. In order to find the specific checks that are outstanding, CMD personnel must refer to the bank's computer system. 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.

4. **Treasury should verify, on a daily basis, that the total checks issued amount per the Comptroller's Office and the total checks issued amount per Core-CT are in agreement and request that Core-CT administration improve procedures to protect the integrity of bank data.**

   Comments:

   On January 6, 2009, a vendor check which had been escheated and removed from the list of issued checks over eighteen months prior was presented to the bank for payment. Because the list of previously escheated checks had been added back into the list of issued checks in error, the check was paid by the bank. Core-CT had sent an electronic file of the checks issued for the day which had the list of escheated checks imbedded in it. There was a difference of $1,500,000 between the file total transmitted by Core-CT and the total faxed by AP. The bank failed to follow its own internal control procedures when it did not reconcile the fax sent by AP and the file sent from Core-CT.

5. **The Treasurer's Pension Fund Management Division should ensure that collateral received for security lending purposes is in compliance with the requirements of Section 3-13d of the General Statutes.**

   Comments:

   As of June 30, 2008, securities with a market value of $3,276,218,029 were on loan. Of this amount, $2,943,595,112 was secured with cash collateral and $332,622,917 was secured by non-cash collateral. The non-cash collateral received included domestic corporate bonds and equity amounting to $60,692,845 and foreign fixed income and equity amounting to $257,097,853. The Statute requires such collateral to be in the form of cash or United States government securities.

6. **The Office of the State Treasurer should avoid investment arrangements that do not contain timely redemption provisions when there is a lack of a contract-end period and follow internal procedures for signing wire transaction requests.**

   Comments:

   The Treasury contracted with two Real Estate advisors to manage investments totaling $175,000,000. The investments were managed through limited partnership agreements that did not contain dissolution dates for the partnerships and did not appear to have clearly-defined redemption provisions. We also found that manual signature approvals were missing for two outgoing wire transactions related to Real Estate Fund operations totaling $101,000,379; it was noted that transactions were considered authorized due to electronic "signatures."

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the accompanying statement of net assets of the Combined Investment Funds, as of June 30, 2008, and the related statements of changes in net assets for the fiscal years ended June 30, 2008 and 2007. We have audited the accompanying statement of net assets of the Short-Term Investment Fund, including the list of investments as of June 30, 2008, and the related statements of changes in net assets for the fiscal years ended June 30, 2008 and 2007. 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, 2008, and the related statement of changes in net assets for the fiscal year ended June 30, 2008. We have audited the statements of condition of the other Non-Civil List Trust Funds as of June 30, 2008, 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, 2008. 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, 2008 and 2007. We have also examined the schedules of Civil List Funds investments, as of June 30, 2008, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2008, and debt outstanding, as of June 30, 2008, and changes in debt outstanding during the fiscal year ended June 30, 2008. 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 accompanying financial statements of the Tax Exempt Proceeds Fund, Inc. or the Connecticut Higher Education Trust. These financial statements were audited by other auditors whose reports thereon have been included with the accompanying financial statements. We did not audit the accompanying Schedules of Rates of Return for the Short-Term Investment Fund, which were examined by other auditors whose reports thereon have been included with the accompanying financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements 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, 2008, 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, 2008, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2008 and debt outstanding, as of June 30, 2008, and changes in debt outstanding during the fiscal year ended June 30, 2008, 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, 2008, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2008, the balance of bonds outstanding as of June 30, 2008, 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, 2008, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2008, the balance of bonds outstanding as of June 30, 2008, 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, 2008, and the results of their operations and changes in net assets for the year then ended, and the changes in fund balance for the other Non-Civil List Trust Funds and cash flows for the Second Injury Fund and 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 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 are presented at the cash adjusted fair values, which utilize the investment advisors' March 31, 2008, 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*. However, we noted certain matters which we reported to Agency management in the accompanying "Condition of Records" and "Recommendations" sections of this report.

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 deficie*ncy 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 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.

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 the significant deficiency described above is not 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.

The State Treasury's responses to the findings identified in our audit are described in the accompanying "Condition of Records" section of this report. We did not audit the State Treasury's response and, accordingly, we express no opinion on it.

This report is intended for the information and use of Agency management, 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

AUDITORS' REPORT

STATE TREASURER

STATE FINANCIAL OPERATIONS

FOR THE FISCAL YEAR ENDED JUNE 30, 2008