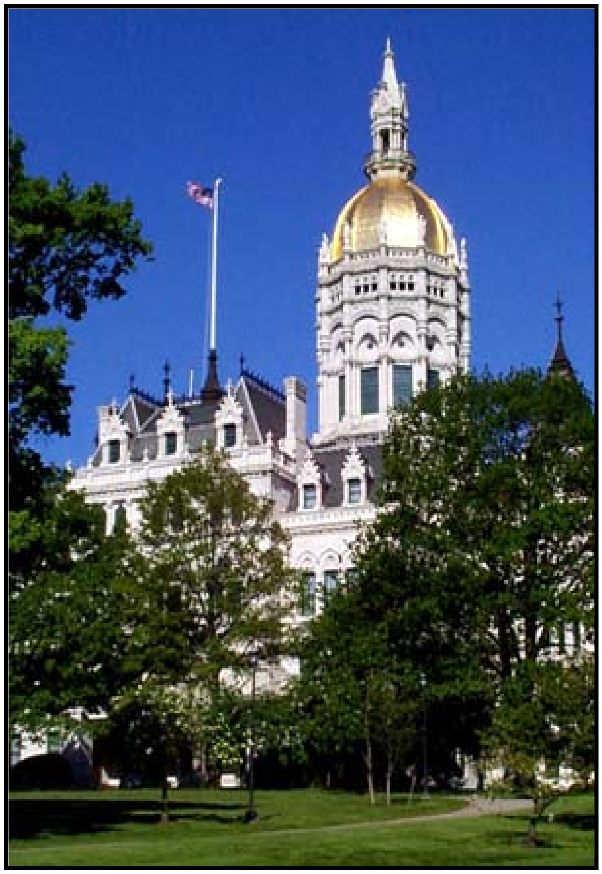
STATE OF CONNECTICUT



AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2011

AUDITORS OF PUBLIC ACCOUNTS
JOHN C. GERAGOSIAN ❖ ROBERT M. WARD

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STATE OF CONNECTICUT

AUDITORS OF PUBLIC ACCOUNTS

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State Capitol
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May 16, 2012

AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2011

We have made an examination of the financial records of the Office of the State Treasurer as they pertain to state financial operations for the fiscal year ended June 30, 2011. Throughout this report, we will refer to various financial statements and schedules contained in the Annual Report of the Treasurer (Annual Report), State of Connecticut, including its statutory appendix for the fiscal year ended June 30, 2011.

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 Office of 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 receipt and investment of state monies, 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, Cash Management Division, Debt Management Division, 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, 2011, were as follows:

State Treasurer: *
Denise L. Nappier

Deputy Treasurer:
Jonathan A. Harris

Chief of Staff:
Christine Shaw

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

Chief Investment Officer:
Lee Ann Palladino

Assistant Treasurer, Cash Management:
Lawrence A. Wilson

Assistant Treasurer, Debt Management:
Sarah K. Sanders

Acting Assistant Treasurer, Policy:
Donald A. Kirshbaum

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

Investment Advisory Council:

The Investment Advisory Council (IAC) 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 by the approval of the Investment Advisory Council. (Section 3-13b, subsection (c) (1)).

- Give 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 when, the council determines such action is in the best interest of the state. The council is within the Treasury for administrative purposes only and the Treasury continues to maintain the minutes, provide office space for meetings and other support services. The council's expenses are paid by the Treasury 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, 2011, should consist of 12 members. The State Treasurer is an ex-officio member that also serves as Secretary of the Council. As of June 30, 2011, members of the Investment Advisory Council were as follows:

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

Joseph D. Roxe, Chairman
David Himmelreich
David Roth
Sharon M. Palmer
Michael Freeman
William Murray
Carol M. Thomas
Peter Thor
Thomas Barnes
Stanley Morten

New Legislation:

Public Act 10-179 authorized the issuance of special obligation economic recovery revenue bonds to finance a transfer to the General Fund of $956,000,000. The bonds were to be secured by certain revenues collected through a monthly charge imposed upon each customer of the electric utilities within the state. The net proceeds of the bonds were to be deposited in the General Fund. The authorization to issue such bonds was repealed pursuant to Public Act 11-61, effective June 21, 2011.

In accordance with Public Act 10-95, commencing October 1, 2010, and monthly thereafter, the Treasurer shall submit a report to the General Assembly joint standing committees for appropriations and finance and the Office of Fiscal Analysis detailing cash balances and authorized but unissued bonds of the state.

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 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 2010-2011 fiscal year, the Treasury incurred $4,442,173 of bank service fees, of which $647,422 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 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, investment strategies and administrative enhancements are discussed. The latest meeting was held March 29, 2012.

As of June 30, 2011, STIF had total net assets of $4,494,226,177. Participant distributions paid and payable during the 2010-2011 fiscal year were $11,300,006 and STIF's expenses were $1,244,108. According to the Annual Report, STIF reported an annual total return of 0.23 percent, exceeding its main benchmark, the MFR (Rated First Tier Institutional Average) index, by .15 percent.

Statements and notes on pages F-39 through F-50 of the Annual Report deal with the Short Term Investment Fund. STIF Schedules of Rates of Return are included on page F-49 of the Annual Report.

Medium-Term Investment Fund:

Section 3-28a of the General Statutes establishes the Medium-Term Investment Fund to be administered by the State Treasurer. 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 $225,182,804 as of June 30, 2011.

As of June 30, 2011, the Short-Term Plus Investment Fund had net assets of $19,551,246. Participant distributions paid and payable during the 2010-2011 fiscal year were $324,706 and the Short-Term Plus Investment Fund's expenses were $9,972.

Statements and notes on pages F-51 through F-57 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 $32,000,000 as of June 30, 2011.

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 ensuring that pension and trust fund investments are made in compliance with state statutes and guidelines. This includes administering state law regarding divestment of companies doing business in Northern Ireland that have not adopted the MacBride principles and divestment of companies doing business in Iran or Sudan.

The Pension Funds Management Division is responsible for managing the assets of six pension funds and eight trust funds with net assets of approximately $25,184,000,000 as of June 30, 2011. 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 (CIF). Each asset class within the fund holds investments of the Combined Investment Fund. As of June 30, 2011, the Combined Investment Fund 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), Alternative Investment (AIF) 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, 2011, the division employed 156 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 retaining professional investment advisors, is charged against the investment income of the Combined Investment Fund. Generally, 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 $7,200,000 for the 2010-2011 fiscal year and $6,500,000 for the 2009-2010 fiscal year.

During the fiscal years ended June 30, 2011 and 2010, 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 2010-2011 and 2009-2010 fiscal years are summarized below:

CIF	# of Advisors- June 30, 2011	Expenses 2010-2011	# of Advisors- June 30, 2010	Expenses 2009-2010
CFIF	5	$ 3,625,463	5	$ 3,499,757
ILBF	2	976,317	2	901,014
EMDF	5	4,462,954	5	4,544,477
HYDF	4	2,511,539	4	2,544,771
MEF	9	10,311,111	9	10,744,251
DMISF	14	23,227,562	14	22,085,148
EMISF	4	16,214,103	4	12,333,677
LF	6	3,744,527	6	2,892,287
CMF	1	25,000	1	37,125
PIF	65	35,220,447	66	38,755,761
REF	36	19,081,930	35	17,417,848
AIF	5	1,803,589		-
Total	**156**	**$121,204,542**	**151**	**$115,756,116**

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

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.

	As of June 30, 2011			
	TRF		SERF	
Investment Class	**Target Upper Range**	**Actual Holdings**	**Target Upper Range**	**Actual Holdings**
U.S. Equity				
Mutual Equity Fund	35%	26.5%	35%	27.4%
International Equity				
Developed Markets International Stock	27%	21.9%	27%	21.9%
Emerging Markets International Stock	12%	10.6%	12%	10.6%
Fixed Income				
Liquidity Investment	10%	4.2%	7%	3.1%
Core Fixed Income	20%	10.1%	20%	10.3%
Inflation Linked Bond	8%	4.1%	8%	4.1%
Emerging Markets Debt	5%	4.5%	5%	4.5%
High Yield Bond	3%	2.8%	3%	2.8%
Real Estate and Alternative				
Private Investment	14%	8.9%	14%	8.9%
Real Estate	7%	4.3%	7%	4.3%
Alternative Investment	10%	2.1%	10%	2.1%

Asset allocations are reviewed monthly to determine whether a rebalancing of investments is necessary to maintain the desired allocation levels.

During the fiscal year ended June 30, 2011, the Combined Investment Funds realized a net return of 20.63 percent. During the previous fiscal year ended June 30, 2010, the Combined Investment Funds realized an annual total return of 12.88 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, 2011 and 2010 are presented below.

		Percentage Return	
Combined Investment Funds:		**2010-2011**	**2009-2010**
Net Total Combined Investment Funds		20.63 %	12.88 %
Mutual Equity	(MEF)	31.80 %	14.01 %
Developed Market International Stock	(DMISF)	26.30 %	11.03 %
Emerging Market International Stock	(EMISF)	28.55 %	25.23 %
Real Estate	(REF)	16.12 %	(20.18) %
Core Fixed Income	(CFIF)	4.49 %	11.81 %
Emerging Market Debt	(EMDF)	16.06 %	23.02 %
High Yield Debt	(HYDF)	15.96 %	24.54 %
Inflation Linked Bond	(ILBF)	7.23 %	9.48 %
Commercial Mortgage	(CMF)	4.61 %	6.75 %
Private Investment	(PIF)	19.89 %	17.32 %
Liquidity	(LF)	1.20 %	0.98 %
Alternative Investment	(AIF)	-	-
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		20.63 %	12.88 %
Teachers Retirement Fund (TRF)		20.77 %	12.87 %
State Employees Retirement Fund (SERF)		21.15 %	12.93 %
Municipal Employees Retirement Fund (MERF)		17.87 %	12.57 %
Probate Court Retirement Fund (Probate)		18.06 %	12.53 %
Judges Retirement Fund (Judges)		18.69 %	12.73 %
State's Attorneys Retirement Fund (St. Atty.)		9.94 %	10.34 %
Trust Funds		9.83 %	13.26 %

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 Policemen and Firemen 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 2010-2011 fiscal year, can be found on pages 16 through 76 of the Annual Report.

Statements and notes on pages F-14 through F-38 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 and trust fund investment activity in the Combined Investment Fund is presented below. The amounts below are presented in millions of dollars.

Participant Funds	6/30/10 Market Values	Share Transactions Purch	Share Transactions Redemp	Share Transactions Net	Gain on Redemp	Change in Mkt. Value	6/30/11 Mkt. Values	Percent Holdings	Inv. Income
	$	$	$	$	$	$	$		$
TRF	12,273	1,980	2,171	(191)	203	1,858	14,143	56 %	456
SERF	7,789	919	1,060	(141)	156	1,177	8,981	36 %	291
MERF	1,471	188	165	23	7	197	1,698	7 %	56
Probate	72	7	7	0	1	9	82	0 %	2
Judges	150	20	33	(13)	8	14	159	1 %	5
St. Atty.	1	0	0	0	0	0	1	0 %	0
Trust Funds	114	4	4	0	0	6	120	0 %	4
Totals	**$21,870**	**$3,118**	**$3,440**	**$(322)**	**$375**	**$3,261**	**$25,184**	**100%**	**$814**

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

Combined Investment Funds	6/30/10 Net Assets	Participant Fund Activity Purch	Redemp	Income Distrib	Net Contrib	Invest Return	6/30/11 Net Assets
LF	$2,219	$ 3,365	$ 3,860	$ 15	$ (510)	$ 27	$1,736
MEF	5,290	28	235	93	(300)	1,649	6,639
DMISF	4,435	184	282	95	(193)	1,167	5,409
EMISF	2,072	100	100	30	(30)	595	2,637
CFIF	2,701	6	0	110	(104)	121	2,718
ILBF	1,062	0	0	21	(21)	78	1,119
EMDF	1,176	10	170	33	(193)	175	1,158
HYDF	693	0	30	50	(80)	104	717
REF	784	209	0	46	163	150	1,097
CMF	4	0	1	0	(1)	0	3
PIF	2,014	158	0	330	(172)	391	2,233
AIF	0	512	0	0	512	7	519
Elim. Entry*	(580)	(1,454)	(1,238)	(9)	(207)	(14)	(801)
Totals	**$21,870**	**$3,118**	**$3,440**	**$814**	**$(1,136)**	**$4,450**	**$25,184**

*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, 2010 and June 30, 2011, were $8,978 and $14,010, 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 2010-2011 fiscal year and the obligations outstanding, as of June 30, 2011, 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, 2010	$19,174,639,529
Add- Issuances	2,367,810,000
Deduct - Payments at maturity	1,949,339,706
- Bonds refunded or defeased	383,080,000
Bonds Outstanding June 30, 2011	**$19,210,029,823**
Interest paid	**$959,603,244**

Bonds and Notes issued in 2010-2011 by type are shown below:

General Obligation - Tax Supported	$1,247,035,000
Special Tax Obligation – Transportation Fund	737,675,000
Bradley International Airport	152,380,000
Clean Water Fund	182,935,000
CHFA Special Needs Housing	17,785,000
CHFA Emergency Mortgage Assistance	30,000,000
Total Bonds Issued, 2010-2011	**$2,367,810,000**

True interest cost rates for new bonds issued during the 2010-2011 fiscal year ranged from 0.30 percent for bonds authorized under the federal American Recovery and Reinvestment Act to 4.77 percent for Connecticut Housing Finance Authority (CHFA) Emergency Mortgage Assistance Program bonds. Bonds issued during the 2010-2011 fiscal year were comprised of new money issues amounting to $2,030,720,000 and refunding issues amounting to $337,090,000.

In addition to the interest paid totaling $959,603,244, during the 2010-2011 fiscal year, the Treasury also made arbitrage rebate payments to the federal government totaling $3,330,029. Such rebates represent the excess earnings of non-taxable bond proceeds that were invested in STIF prior to project disbursement.

The Office of Policy and Management and the State Treasurer entered into a contract with CHFA to provide state assistance for the payment of debt service costs related to the Emergency Mortgage Assistance Program authorized pursuant to Section 8-252 of the General Statutes. During the audited period, CHFA Emergency Mortgage Assistance Program bonds in the amount of $30,000,000 were issued and $29,165,000 was outstanding at June 30, 2011.

Economic recovery notes in the principal amount of $915,795,000 were outstanding at June 30, 2011. The economic recovery notes were issued pursuant to Public Act 09-2, of the June 2009 Special Session, which authorized the State Treasurer to issue notes in an amount not to exceed the amount of the General Fund deficit for the fiscal year ended June 30, 2009, plus the cost of issuance and interest payable on such notes through June 30, 2011.

In accordance with Section 3-20 of the General Statutes, whenever the State Bond Commission has adopted a resolution authorizing bonds, the Treasurer may issue temporary notes in anticipation of the sale of bonds. Such bond anticipation notes amounting to $581,245,000 were issued during the 2008-2009 fiscal year. Bond anticipation notes amounting to $353,085,000 matured in April 2010 and new bond anticipation notes totaling $353,085,000 were issued at that time with a maturity date of May 19, 2011. The remaining $228,160,000 of bond anticipation notes matured in June 2011.

Bonds outstanding at June 30, 2011 include borrowing for the following long-term obligations that are not considered debt of the state but are included in the debt service budget:

- $8,645,000 of Certificates of Participation for the Middletown Courthouse.

- $15,625,000 of Certificates of Participation for the Connecticut Juvenile Training School Energy Center project.

- $2,255,000 of Connecticut Development Authority lease revenue bonds for the New Britain Government Center.

- $100,155,000 Capital City Economic Development Authority bonds subject to a contract to pay assistance to the authority in an amount equal to the annual debt service of the outstanding amount of bonds issued by the authority pursuant to Section 32-608 of the General Statutes.

- $66,575,000 of child care facilities bonds issued by the Connecticut Health and Educational Facilities Authority. Pursuant to Section 10a-194c of the General Statutes, the state has agreed through a memorandum of understanding between the Department of Social Services and the authority to provide the debt service for such child care facilities bonds.

- $76,720,000 of CHFA special needs housing bonds. 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 for the purpose of providing mortgage loans under the Supportive Housing Initiative.

Tax Exempt Proceeds Fund (TEPF):

The Tax Exempt Proceeds Fund was formed pursuant to Sections 3-24a through 3-24h of the General Statutes, to serve as a vehicle to allow the State Treasurer to comply with arbitrage requirements of the Tax Reform Act of 1986 regarding the proceeds of tax-exempt bond issues passed 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.

Due to the steep decline in yields for short-term investments during recent years, it is no longer necessary to invest bond proceeds in a revenue neutral fund such as TEPF to avoid a liability for arbitrage earnings. In fact, recent fund earnings have been inadequate to cover the agreed-upon management fee for TEPF, and the fund administrator has waived certain fees to avoid a negative fund return. Consequently, it was decided to end the TEPF effective December 31, 2011 and make grant and loan payments directly to recipients using electronic funds transfer and invest the remaining state balances with the Treasurer’s Short-Term Investment Fund.

The TEPF was incorporated as a regulated investment company and managed by a firm retained by the State Treasurer. The TEPF was audited by a firm of independent public accountants for the fiscal year ended June 30, 2011, and a close-out audit was performed for the six-month period from July 1, 2011 to December 31, 2011.

According to the annual report of the TEPF, net assets of the fund totalled $95,545,031 at June 30, 2011. The fund had net investment income of $3,560 during the 2010-2011 fiscal year. Participants in the fund at June 30, 2011, included civil list funds and recipients of state agency grant and loan programs as well as others.

At June 30, 2011, a total of $11,891,953 of state funds was invested in the TEPF as shown below:

Fund Classification	Amounts	Annual Report Page No.
Special Revenue	$10,695,420	O-13
Enterprise	1,196,533	O-14
Total	**$11,891,953**	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 $31,670,117 for the 2010-2011 fiscal year.

Second Injury Fund claim payments amounted to $31,760,873 for the 2010-2011 fiscal year. A comparison of claim expenditures by category follows:

	2010-2011	2009-2010
Stipulations	$ 6,664,250	$ 10,782,487
Indemnity (lost wages)	19,419,200	22,056,446
Medical	5,677,423	5,305,199
Totals	**$31,760,873**	**$ 38,144,132**

The number of stipulated agreements to settle claims decreased during the current audited period. According to the Treasurer's annual reports, the number of settled claims totaled 181 and 177 for fiscal years ended June 30, 2010 and 2011, respectively.

Financial statements and notes for the SIF are presented on pages F-61 through F-67 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-insured companies report directly to the State Treasury. A list of these 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-insured companies 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.

Workers' Compensation Administration Fund assessment collections amounted to $14,482,727 for 2010-2011 fiscal year.

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 is not an 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 Connecticut Higher Education Trust was audited by independent public accountants for the 2010-2011 fiscal year.

During the audited period, the Treasurer acting as trustee for CHET entered into a management agreement to provide a second CHET program manager for plan participants. Effective September 30, 2010, CHET began offering both a direct plan and an advisor plan. The direct plan is offered directly by the state and the advisor plan is marketed to plan participants by a financial manager.

As of June 30, 2011, the CHET programs had net assets of $1,621,199,390. Operating results for the 2010-2011 fiscal year taken from the Annual Report were as follows:

	Total	**Direct Plan**	**Advisor Plan**
Net assets at June 30, 2010	$1,265,851,220	$1,265,851,220	$ 0
Net participant contributions	153,094,597	116,932,491	36,162,106
Net increase from operations	202,253,573	201,543,987	709,586
Net assets at June 30, 2011	**$1,621,199,390**	**$1,584,327,698**	**$ 36,871,692**

Financial statements and notes for the CHET programs are presented on pages F-70 through F-89 of the Annual Report.

Trust Funds:

In addition to investment-type trust funds of the Pension Funds Management Division and those in CHET, the Treasurer is also responsible for the administration of certain other trust funds that fall within the statutory jurisdiction of the office. 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, 2011, amounted to $6,923,740 for the School Fund and $442,315 for the Agricultural College Fund. The total fund balances on June 30, 2011, at fair value, amounted to $9,716,936 for the School Fund and $626,061 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-59 through F-62 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, 2011, 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 Event:

Effective December 30, 2011, the Tax Exempt Proceeds Fund ceased operations. At a shareholder meeting held on December 1, 2011, shareholders voted to approve the plan of liquidation and, as of December 30, 2011, there remained no shareholders in the fund.

CONDITION OF RECORDS

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

Late Payment Penalty Paid by Second Injury Fund:

Criteria: Section 31-303 of the General Statutes requires the Second Injury 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: Subsequent to our audited period, the fund was ordered to pay a late payment penalty by the Workers' Compensation Commissioner in the amount of $1,625. The penalty was imposed because the fund mailed the check to an incorrect address. In another instance, the fund authorized an Automated Clearing House (ACH) payment that failed to settle in a timely manner because the recipient's banking information was not updated. The ACH had to be reversed and a check was issued. The fund mailed this check four days after the deadline.

Cause: Procedures were not followed when an outdated tax form was used to justify the mailing address, and an ACH transaction was attempted without verifying banking information or having procedures within the fund to process such a payment appropriately.

Effect: The fund paid $1,625 in penalties that we believe could have been avoided.

Recommendation: The Second Injury Fund should develop procedures for payment processing to ensure that settlement payments are fully executed within statutory timeframes to avoid penalties. (See Recommendation 1.)

Agency Response: "We concur with the Auditors' recommendation. With regard to the $1,625 penalty, the employee that used an outdated tax form brought the error to management's attention, and has since been advised of appropriate procedure. With respect to the ACH payment, the Fund has updated its procedures concerning ACH payment processing in accordance with the Office of the State Comptroller's State Accounting Manual. In addition, the Fund will review its procedures with respect to circumstances where ACH payments may not be feasible."

Payment Issued to the Potential Surviving Spouse

Criteria: In accordance with Section 31-306 of the General Statutes, death benefits and burial expenses shall be paid to the dependant spouse in the event of death resulting from a compensable injury. Section 31-307a of the General Statutes authorizes the Second Injury Fund to provide the injured employee with a cost-of-living adjustment when they are entitled to receive compensation under Section 31-307 of the General Statutes.

Condition: The Second Injury Fund reached a $225,000 settlement with a potential surviving spouse, which appears to be in violation of section 31-306 and 31-307a of the Connecticut General Statutes. The injured worker's spouse did not meet the statutory requirements to qualify as the surviving spouse; therefore, the claims manager had no authority to process the payment. The settlement review committee granted a payment authority of $450,000 to settle the injured worker's claim for future cost-of-living adjustments under Section 31-307a of the General Statutes. The injured worker's spouse had no legal standing to make any claim for settlement funds. However, two separate stipulated agreements were awarded, under which the injured worker only received $225,000 for her future cost-of-living adjustments and the spouse of the injured worker was granted a separate award of $225,000. The Second Injury Fund's internal control procedures were circumvented to allow settlement funds to be paid to an individual that did not have a valid claim.

Cause: The settlement review committee reviews proposed payments for compliance and a separate payment to an ineligible individual should have been denied. However, the proposed agreement was presented to the settlement review committee as a single payment of $450,000 to an injured worker. It appears that the Second Injury Fund was seeking to minimize potential liability by protecting self-interest instead of the injured worker's interest.

Effect: The Second Injury Fund is not consistently applying Section 31-306 and 31-307a of the Connecticut General Statutes and is failing to adhere to the internal controls established by the fund. Failure to follow established internal control procedures can expose the fund to potential fraudulent acts.

Recommendation: The Second Injury Fund should consistently apply Section 31-306 and 31-307a of the General Statutes and should strengthen internal controls to prevent exposure to fraudulent acts. (See Recommendation 2.)

Agency Response: "We concur with the Auditors' recommendation. The Treasury will, going forward, reconstitute the settlement review committee and establish procedures which make clear the limits of its mandate."

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 Cash Management Division should work with the Comptroller's Office to establish an accounts receivable account to track overpayment recoveries, which would also assist in reconciling the overpayment recoveries adjustments to the payroll account and resolve all prior years' non-banking transactions in the payroll account in a timely manner. This recommendation has been resolved.

- The Second Injury Fund should comply with all aspects of Section 31-349 of the General Statutes, and should only make monetary settlements for claims that are valid liabilities of the fund. This recommendation has been resolved.

- The Second Injury Fund should comply with Sections 31-306 and 31-307a of the General Statutes and not negotiate statutory provisions to avoid perceived liability under the threat of litigation. Our current review did not disclose any further incidents. This recommendation is not repeated.

- The Debt Management Division should have procedures to ensure bond counsel opinions are complete. This condition did not exist for the current period under audit. The recommendation has been resolved.

- The Treasurer's Office should comply with Section 3-13a and obtain the advice and consent of the Investment Advisory Council prior to hiring pension fund employees. Pursuant to Public Act 11-82, the statute was changed by eliminating this requirement for all employees other than chief investment officers. This recommendation is not repeated.

- The Treasury should work to improve accounting deficiencies, address the applicability of leverage requirements, clarify redemption provisions and execute contracts on its own behalf in accordance with established procedures. These issues were resolved during the current audited period.

- The Treasurer's Pension Fund Management Division should appoint a local tax filing agent to expedite the repatriation of capital gains from foreign countries. The Treasury was conducting a search for a Taiwan tax agent as of February 2012. This recommendation will not be repeated because it appears that appropriate action is being taken.

Current Audit Recommendations:

The following recommendations resulted from our current review.

1. **The Second Injury Fund should develop procedures for payment processing to ensure that settlement payments are fully executed within statutory timeframes to avoid penalties.**

   Comments:

   Subsequent to our audited period, the fund was ordered to pay a late payment penalty by the Workers' Compensation Commissioner in the amount of $1,625. The fund mailed this check four days after the deadline. The fund authorized an Automated Clearing House (ACH) payment that failed to settle in a timely manner because the recipient's banking information was not updated. Procedures were not followed when an outdated tax form was used to justify the mailing address, and an ACH transaction was attempted without verifying banking information or establishing procedures within the fund to process such a payment appropriately.

2. **The Second Injury Fund should consistently apply Section 31-306 and 31-307a of the General Statutes and should strengthen internal controls to prevent exposure to fraudulent acts.**

   Comments:

   The Second Injury Fund reached a $225,000 settlement with a potential surviving spouse, which appears to be in violation of section 31-306 and 31-307a of the Connecticut General Statutes. The injured worker's spouse does not meet the statutory requirements to qualify as the surviving spouse; therefore, the claims manager had no authority to process the payment. The settlement review committee granted a payment authority of $450,000 to settle the injured worker's claim for future cost-of-living adjustments under Section 31-307a of the General Statutes. However, two separate stipulated agreements were awarded, under which the injured worker only received $225,000 for her future cost-of-living adjustments and the spouse of the injured worker was granted a separate award of $225,000. The fund's internal control procedures were circumvented to allow settlement funds to be paid to an individual that did not have a valid claim on such funds.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the accompanying statement of net assets of the Combined Investment Funds, as of June 30, 2011, and the related statements of changes in net assets for the fiscal years ended June 30, 2011 and 2010. We have audited the accompanying statement of net assets of the Short-Term Investment Fund, including the list of investments as of June 30, 2011, and the related statements of changes in net assets for the fiscal years ended June 30, 2011 and 2010. 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, 2011, and the related statements of changes in net assets for the fiscal years ended June 30, 2011 and 2010. We have audited the statements of condition of the other Non-Civil List Trust Funds as of June 30, 2011, 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, 2011. 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, 2011 and 2010. We have also examined the schedules of Civil List Funds investments, as of June 30, 2011, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2011, and debt outstanding, as of June 30, 2011, and changes in debt outstanding during the fiscal year ended June 30, 2011. 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 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, 2011, 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, 2011, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2011 and debt outstanding, as of June 30, 2011, and changes in debt outstanding during the fiscal year ended June 30, 2011, 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, 2011, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2011, the balance of bonds outstanding as of June 30, 2011, 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, 2011, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2011, the balance of bonds outstanding as of June 30, 2011, 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, 2011, 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, the Private Investment Fund and the Alternative 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, the Private Investment Fund and the Alternative Investment Fund are presented at the cash adjusted fair values, which utilize the investment advisors' prior quarter or in some cases prior two month ending estimated values adjusted for cash flows of the funds during the subsequent months 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.

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 Treasury's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grant agreements, but not for the purpose of expressing an opinion on the effectiveness of the State Treasury's internal control over those control objectives. Accordingly, we do not express an opinion on the effectiveness of the Office of State Treasurer's internal control.

A *deficiency in internal* control 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 and correct on a timely basis misstatements, unauthorized, illegal, or irregular transactions or the breakdown in the safekeeping of any asset or resource. A *material weakness* is a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions and/or material noncompliance with certain provisions of laws, regulations, contracts, and grant agreements that would be material in relation to the State Treasury's financial operations will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control over financial operations, safeguarding of assets, and compliance with requirements was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial operations, safeguarding of assets, and compliance with requirements that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over the State Treasury's financial operations, safeguarding of assets, or compliance with requirements that we consider to be material weaknesses, as defined above. However, we consider the following deficiency, described in detail in the accompanying Condition of Records and Recommendations sections of this report to be a significant deficiency: Recommendation 2 – the payment of a settlement award by the Second Injury Fund to an ineligible individual by contravening settlement review committee approval. A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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 State Treasury 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 State Treasury 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 State Treasury 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 Office of the State Treasurer during the course of our examination.

Thomas W Willametz
Administrative Auditor

Approved:

John C. Geragosian	Robert M. Ward
Auditor of Public Accounts	Auditor of Public Accounts