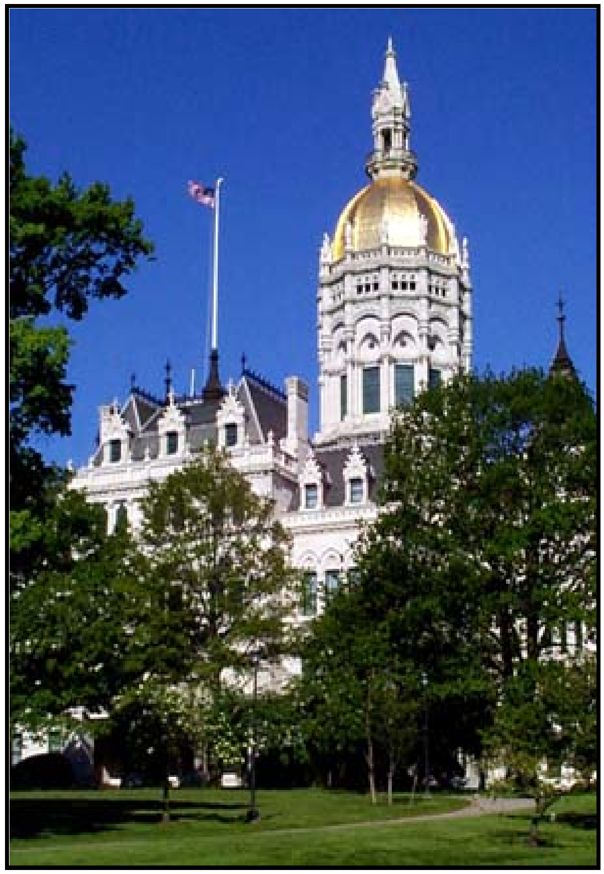
STATE OF CONNECTICUT



AUDITORS' REPORT
OFFICE OF THE STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED
JUNE 30, 2012

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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Hartford, Connecticut 06106-1559

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ROBERT M. WARD

March 27, 2013

AUDITORS' REPORT
OFFICE OF THE STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2012

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, 2012. 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, 2012.

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, 2012, were as follows:

State Treasurer: *
Denise L. Nappier

Deputy Treasurer:
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, 2012, 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, 2012, 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
Michael Freeman
William Murray
Carol M. Thomas
Peter Thor
Thomas Barnes
Joshua Hall
Janice Carpenter
Laurence N. Hale

Also serving as members of the Investment Advisory Council during the audited period were Stanley Morten and Sharon M. Palmer.

New Legislation:

Public Act 12-77, effective October 1, 2012, expanded the settlement authority of the Second Injury Fund to allow the Treasurer to make stipulated settlements when it is in the best interest of an injured employee's dependents or for claims by an employer or insurer.

Pursuant to Public Act 12-104, Section 28, the sum of $222,393,607 previously reserved from the General Fund surplus for the 2010-2011 fiscal year for early redemption of a portion of the outstanding economic recovery notes was transferred to the resources of the Budget Reserve Fund. Economic recovery notes outstanding as of June 30, 2012 amounted to $747,935,000.

Public Act 11-82, effective October 1, 2012, amended Section 3-16 of the General Statutes to limit temporary borrowing for the cash needs of the state to a maturity period of two years.

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 Office of the State Comptroller 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 2011-2012 fiscal year, the Treasury incurred $4,440,969 of bank service fees, of which $726,407 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-47 through S-53 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.

Common Cash Pool Borrowing:

During the 2011-2012 fiscal year, the state had borrowed amounts from available cash in certain capital projects funds to cover cash needs in the common cash pool. Such borrowings were paid back in full as of June 30, 2012.

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 Office of the State Treasurer 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, 2012, STIF had total net assets of $4,893,571,939. Participant distributions paid and payable during the 2011-2012 fiscal year were $7,557,772 and STIF's expenses were $1,300,499. According to the Annual Report, STIF reported an annual total return of 0.16 percent, exceeding its main benchmark, the MFR (Rated First Tier Institutional Average) index, by 0.11 percent.

Statements and notes on pages F-39 through F-51 of the Annual Report deal with the Short Term Investment Fund. STIF Schedules of Rates of Return are included on page F-50 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 $2,104,419 as of June 30, 2012.

As of June 30, 2012, the Short-Term Plus Investment Fund had net assets of $3,320,425. Participant distributions paid and payable during the 2011-2012 fiscal year were $122,050 and the Short-Term Plus Investment Fund’s expenses were $5,239.

Statements and notes on pages F-52 through F-58 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 were redeemed or transferred to the Medium-Term Investment Fund during the 2011-2012 fiscal year and as of June 30, 2012 there was a zero balance in the Community Banking Initiative program.

Pension Funds Management Division:

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 $23,977,000,000 as of June 30, 2012. 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, 2012, 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, 2012, the division employed 161 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 $8,700,000 for the 2011-2012 fiscal year and $7,200,000 for the 2010-2011 fiscal year.

During the fiscal years ended June 30, 2012 and 2011, external advisors managed 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 2011-2012 and 2010-2011 fiscal years are summarized below:

CIF	# of Advisors- June 30, 2012	Expenses 2011-2012	# of Advisors- June 30, 2011	Expenses 2010-2011
CFIF	5	$ 3,423,470	5	$ 3,625,463
ILBF	2	869,547	2	976,317
EMDF	5	6,708,389	5	4,462,954
HYDF	4	2,499,366	4	2,511,539
MEF	8	15,550,517	9	10,311,111
DMISF	14	21,138,049	14	23,227,562
EMISF	4	15,973,426	4	16,214,103
LF	6	5,155,864	6	3,744,527
CMF	1	25,000	1	25,000
PIF	84	38,178,430	65	35,220,447
REF	22	16,520,051	36	19,081,930
AIF	6	5,323,200	5	1,803,589
Total	**161**	**$131,365,309**	**156**	**$121,204,542**

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, 2012			
	TRF		SERF	
Investment Class	**Target Upper Range**	**Actual Holdings**	**Target Upper Range**	**Actual Holdings**
U.S. Equity				
Mutual Equity Fund	35%	26.9%	35%	28.2%
International Equity				
Developed Markets International Stock	27%	19.7%	27%	19.8%
Emerging Markets International Stock	12%	9.4%	12%	9.5%
Fixed Income				
Liquidity Investment	10%	3.9%	7%	2.6%
Core Fixed Income	20%	9.9%	20%	10.0%
Inflation Linked Bond	8%	3.6%	8%	3.7%
Emerging Markets Debt	5%	4.9%	5%	4.9%
High Yield Bond	3%	2.9%	3%	2.9%
Real Estate and Alternative				
Private Investment	14%	10.9%	14%	10.6%
Real Estate	7%	5.6%	7%	5.5%
Alternative Investment	10%	2.3%	10%	2.3%

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, 2012, the Combined Investment Funds realized a negative return of (0.90) percent. During the previous fiscal year ended June 30, 2011, the Combined Investment Funds realized a net return of 20.63 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, 2012 and 2011 are presented below.

		Percentage Return	
Combined Investment Funds:		**2011-2012**	**2010-2011**
Net Total Combined Investment Funds		(0.90) %	20.63 %
Mutual Equity	(MEF)	3.27 %	31.80 %
Developed Market International Stock	(DMISF)	(12.48) %	26.30 %
Emerging Market International Stock	(EMISF)	(14.16) %	28.55 %
Real Estate	(REF)	7.19 %	16.12 %
Core Fixed Income	(CFIF)	7.63 %	4.49 %
Emerging Market Debt	(EMDF)	4.78 %	16.06 %
High Yield Debt	(HYDF)	6.23 %	15.96 %
Inflation Linked Bond	(ILBF)	11.91 %	7.23 %
Commercial Mortgage	(CMF)	(6.48) %	4.61 %
Private Investment	(PIF)	5.92 %	19.89 %
Liquidity	(LF)	(0.14) %	1.20 %
Alternative Investment	(AIF)	(1.62) %	-
Retirement and Trust Funds:			
Net Total Return Retirement and Trust Funds		(0.90) %	20.63 %
Teachers Retirement Fund (TRF)		(0.96) %	20.77 %
State Employees Retirement Fund (SERF)		(0.90) %	21.15 %
Municipal Employees Retirement Fund (MERF)		0.47 %	17.87 %
Probate Court Retirement Fund (Probate)		0.64 %	18.06 %
Judges Retirement Fund (Judges)		1.11 %	18.69 %
State's Attorneys Retirement Fund (St. Atty.)		5.36 %	9.94 %
Trust Funds		6.61 %	9.83 %

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 2011-2012 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-43 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	6/30/11 Market Values	Share Transactions Purch	Share Transactions Redemp	Share Transactions Net	Gain on Redemp	Change in Mkt. Value	6/30/12 Mkt. Values	Percent Holdings	Inv. Income
	$	$	$	$	$	$	$		$
TRF	14,143	1,805	1,962	(157)	174	(687)	13,473	56 %	369
SERF	8,981	695	883	(188)	126	(450)	8,469	35 %	234
MERF	1,698	188	171	17	27	(66)	1,676	7 %	47
Probate	82	7	10	(3)	1	(2)	78	0 %	2
Judges	159	16	15	1	1	(4)	157	1 %	5
St. Atty.	1	0	0	0	0	0	1	0 %	0
Trust Funds	120	4	4	0	0	3	123	1 %	4
Totals	**$25,184**	**$2,715**	**$3,045**	**$(330)**	**$329**	**$(1,206)**	**$23,977**	**100%**	**$661**

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

Combined Investment Funds	6/30/11 Net Assets	Participant Fund Activity Purch	Redemp	Income Distrib	Net Contrib	Invest Return	6/30/12 Net Assets
LF	$1,736	$ 3,354	$ 3,543	$ 17	$ (206)	$ 2	$1,532
MEF	6,639	0	301	104	(405)	192	6,426
DMISF	5,409	90	95	106	(111)	(671)	4,627
EMISF	2,637	0	0	40	(40)	(370)	2,227
CFIF	2,718	56	257	99	(300)	199	2,617
ILBF	1,119	0	279	17	(296)	115	938
EMDF	1,158	0	0	11	(11)	55	1,202
HYDF	717	0	0	50	(50)	43	710
REF	1,097	176	0	32	144	88	1,329
CMF	3	0	2	0	(2)	0	1
PIF	2,233	390	0	192	198	141	2,572
AIF	519	37	0	0	37	(7)	549
Elim. Entry*	(801)	(1,388)	(1,432)	(7)	51	(3)	(753)
Totals	**$25,184**	**$2,715**	**$3,045**	**$661**	**$(991)**	**$(216)**	**$23,977**

*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's expenditures, for the IAC for the fiscal years ended June 30, 2012 and June 30, 2011, were $16,558 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 State Bond Commission. These responsibilities are carried out through the Debt Management Division.

A summary of bonds issued, paid, or refunded in the 2011-2012 fiscal year and the obligations outstanding, as of June 30, 2012, is presented in the schedule entitled Changes in Debt Outstanding shown on page S-44 of the Annual Report, while additional information is contained in the Annual Report pages S-45 and O-1 through O-12. A brief summary follows:

Bonds Outstanding June 30, 2011	$19,210,029,823
Add- Issuances	2,494,615,000
Deduct - Payments at maturity	1,575,316,696
- Bonds refunded or defeased	1,063,585,000
Bonds Outstanding June 30, 2012	**$19,065,743,127**
Interest paid	**$935,294,177**

Bonds and Notes issued in 2011-2012 by type are shown below:

General Obligation - Tax Supported	$1,779,065,000
Special Tax Obligation - Transportation Fund	455,075,000
UCONN 2000	211,635,000
CHEFA Childcare Facilities Program	28,840,000
CHFA Emergency Mortgage Assistance	20,000,000
Total Bonds Issued, 2011-2012	**$2,494,615,000**

True interest cost rates for new bonds issued during the 2011-2012 fiscal year ranged from 1.02 percent for General Obligation refunding bonds to 4.68 percent for Connecticut Housing Finance Authority (CHFA) Emergency Mortgage Assistance Program bonds. Bonds issued during the 2011-2012 fiscal year were comprised of new money issues amounting to $1,525,960,000 and refunding issues amounting to $968,655,000.

In addition to the interest paid totaling $935,294,177, during the 2011-2012 fiscal year, the Treasury also made arbitrage rebate payments to the federal government totaling $86,600. Such rebates represent the excess earnings of non-taxable bond proceeds that were invested in STIF prior to project disbursement.

During the 2011-2012 fiscal year, the state reoffered $280,000,000 of General Obligation 2005 Series A bonds for the purpose of converting the interest rate mode from variable rate demand bonds to SIFMA (Securities Industry and Financial Markets Association) index bonds. These amounts are not included in the issued, retired or refunded amounts presented in the Annual Report. Prior to this conversion, bondholders had the right to payment on demand and the state had purchased a standby purchase agreement with a bank for protection against a forced bond payment. The reoffering ended the payment on demand feature and subjected the bonds to defined maturity dates.

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, additional CHFA Emergency Mortgage Assistance Program bonds in the amount of $20,000,000 were issued and a total of $48,035,000 was outstanding at June 30, 2012.

Economic recovery notes in the principal amount of $747,935,000 were outstanding at June 30, 2012. 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.

Bonds outstanding at June 30, 2012 include borrowing for the following long-term obligations that are not considered debt of the state but are included in the debt service budget:

- $5,895,000 of Certificates of Participation for the Middletown Courthouse.
- $15,150,000 of Certificates of Participation for the Connecticut Juvenile Training School Energy Center Project.
- $1,550,000 of Connecticut Development Authority lease revenue bonds for the New Britain Government Center.
- $97,535,000 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.
- $63,280,000 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.
- $73,650,000 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 30, 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 period from July 1, 2011 to December 30, 2011. According to the audited financial statements, the fund had net investment income of $203 for the period ended December 30, 2011.

Financial statements and notes for the Tax-Exempt Proceeds Fund are presented on pages F-95 through F-102 of the Annual Report.

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 $32,919,405 for the 2011-2012 fiscal year.

Second Injury Fund claim payments amounted to $31,902,533 for the 2011-2012 fiscal year. A comparison of claim expenditures by category follows:

	2011-2012	2010-2011
Stipulations	$ 5,872,331	$ 6,664,250
Indemnity (lost wages)	20,499,111	19,419,200
Medical	5,531,091	5,677,423
Totals	**$31,902,533**	**$31,760,873**

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 138 and 177 for fiscal years ended June 30, 2012 and 2011, respectively.

Financial statements and notes for the SIF are presented on pages F-64 through F-70 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 $24,808,886 for 2011-2012 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 federal or state taxes 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 2011-2012 fiscal year.

During the prior audit 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, 2012, the CHET programs had net assets of $1,792,101,881. Operating results for the 2011-2012 fiscal year as presented in the Annual Report were as follows:

	Total	Direct Plan	Advisor Plan
Net assets at June 30, 2011	$1,621,199,390	$1,584,327,698	$36,871,692
Net participant contributions	157,012,475	99,114,744	57,897,731
Net increase from operations	13,890,016	11,853,021	2,036,995
Net assets at June 30, 2012	**$1,792,101,881**	**$1,695,295,463**	**$96,806,418**

Financial statements and notes for the CHET programs are presented on pages F-71 through F-94 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, 2012, amounted to $6,923,675 for the School Fund and $442,408 for the Agricultural College Fund. The total fund balances on June 30, 2012, at fair value, amounted to $10,000,737 for the School Fund and $644,194 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-60 through F-63 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, 2012, 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:

On December 3, 2012, pursuant to the Treasurer's request, the Governor provided his approval for short-term borrowing by the Treasurer on behalf of the State not to exceed $550,000,000 in the aggregate in accordance with Section 3-16 of the General Statutes. Pursuant to such approval, the Treasurer arranged a $300,000,000 364-day revolving credit facility which could be drawn upon if needed.

CONDITION OF RECORDS

Our review of the financial operations of the Office of the State Treasurer did not disclose any areas requiring additional attention.

RECOMMENDATIONS

Status of Prior Audit Recommendations:

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

- The Second Injury Fund should develop procedures for payment processing to ensure that settlement payments are fully executed within statutory timeframes to avoid penalties. During our audit testing, we did not note any late payments so this finding will not be repeated.

- 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. We did not note any payments to potential surviving spouses during this audit, the Treasury sought and received a legislative change and also strengthened its settlement review procedures. We will not repeat this recommendation.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the statement of net assets of the Combined Investment Funds, as of June 30, 2012, and the related statements of changes in net assets for the fiscal years ended June 30, 2012 and 2011. We have audited the statement of net assets of the Short-Term Investment Fund, including the list of investments as of June 30, 2012, and the related statements of changes in net assets for each of the two years in the period ended June 30, 2012 and 2011. 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, 2012, and the related statements of changes in net assets for each of the two years in the period ended June 30, 2012 and 2011. We have audited the statements of condition of the other Non-Civil List Trust Funds as of June 30, 2012, 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 then ended. We have also audited the statement of net assets of the Second Injury Fund as of June 30, 2012 and 2011, and the related statements of revenues, expenses and changes in net assets and the statements of cash flows for the Second Injury Fund, for the fiscal years then ended. We have also examined the schedule of investments, and the summary schedule of the Civil List Funds for the fiscal year ended June 30, 2012. We have examined the schedule of debt outstanding, and the changes in debt outstanding for the fiscal year ended June 30, 2012. We have issued our report thereon dated December 31, 2012.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting:

Management of the Office of the State Treasurer is responsible for establishing and maintaining effective internal control over financial operations, safeguarding of assets, and compliance with the requirements of laws, regulations and contracts.

In planning and performing our audit, we considered the Office of the State Treasurer’s internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State Treasury’s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Office of State Treasurer’s internal control over financial reporting.

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 misstatements on a timely basis. A *material weakness* is a deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the State Treasury's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting 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 reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over the State Treasury's financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters:

As part of obtaining reasonable assurance about whether the Office of the State Treasurer complied with laws, regulations, contracts, and grant agreements, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those 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 or other matters that are required to be reported under *Government Auditing Standards*.

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
Auditor of Public Accounts

Robert M. Ward
Auditor of Public Accounts