

STATE OF CONNECTICUT



*AUDITORS' REPORT
STATE TREASURER
STATE FINANCIAL OPERATIONS
FOR THE FISCAL YEAR ENDED JUNE 30, 2010*

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

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AUDITORS OF PUBLIC ACCOUNTS

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September 1, 2011

AUDITORS' REPORT STATE TREASURER STATE FINANCIAL OPERATIONS FOR THE FISCAL YEAR ENDED JUNE 30, 2010

We have made an examination of the financial records of the Treasurer of the State of Connecticut as they pertain to state financial operations for the fiscal year ended June 30, 2010. Throughout this report, we will refer to various financial statements and schedules contained in the Annual Report of the Treasurer, State of Connecticut, including its statutory appendix (Annual Report) for the fiscal year ended June 30, 2010.

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 Treasury.

COMMENTS

FOREWORD:

The State Treasurer operates primarily under the provisions of Article Fourth of the State Constitution and Title 3, Chapter 32 of the General Statutes. Major duties include responsibilities for the receipt and investment of state 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, the Cash Management Division, the Debt Management Division, the Second Injury Fund and administrative requirements for the Connecticut Higher Education Trust. Comments on some of the major functions of these divisions are presented in various sections of this report.

Officers and Officials:

The officers and officials of the Treasury as of June 30, 2010, were as follows:

State Treasurer: *

Denise L. Nappier

Deputy Treasurer:

Howard G. Rifkin

Assistant Deputy Treasurer:

Linda Hershman

Assistant Deputy Treasurer, Second Injury Fund and Unclaimed Property:

Maria M. Greenslade

Chief Investment Officer:

M. Timothy Corbett

Assistant Treasurer, Cash Management:

Lawrence A. Wilson

Assistant Treasurer, Debt Management:

Sarah K. Sanders

Assistant Treasurer, Policy:

Meredith A. Miller

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

Investment Advisory Council:

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

- Review trust fund investments by the State Treasurer (Section 3-13b, subsection (c) (2)).
- Review the Investment Policy Statement which shall set forth the standards governing investment of trust funds by the State Treasurer. Any revisions to the Investment Policy Statement shall be made in consultation with and with the approval of the Investment Advisory Council. (Section 3-13b, subsection (c) (1)).
- Give its advice and consent to the appointment of a Chief Investment Officer and other personnel for the retirement, pension and trust funds (Section 3-13a, subsection (a)).

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

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

Council Members:

Pursuant to Section 3-13b of the General Statutes, the Investment Advisory Council, as of June 30, 2010, should consist of 12 members. The State Treasurer is an ex-officio member who also serves as Secretary of the Council. Members of the Investment Advisory Council, as of June 30, 2010, were as follows:

Ex-officio members:

Denise L. Nappier - State Treasurer and Secretary of the Investment Advisory Council
Brenda L. Sisco - Acting 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 10-11, effective May 5, 2010, corrected Section 31-354 of the General Statutes and returned the “whichever is greater” clause to the provision requiring either a penalty of fifteen percent or fifty dollars to employers or insurance companies paying assessments to the Second Injury Fund.

Public Act 09-7 of the September Special Session, effective October 5, 2009, amended Section 3-13a of the General Statutes, and states that “the Treasurer may, with the advice and consent of the Investment Advisory Council, appoint...principal investment officers, investment officers and other personnel.”

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 2009-2010 fiscal year, the Treasury incurred \$3,803,227 of bank service fees, of which \$399,192 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-50 and pages O-13 to O-15 of the Annual Report deal with the Civil List Funds, which are the responsibility of the Cash Management Division.

Short-Term Investment Fund (STIF):

STIF was established and is operated under Sections 3-27a through 3-27i of the General Statutes. It provides state agencies, funds, political subdivisions and others with a mechanism for investing at a daily-earned rate with interest from day of deposit to day of withdrawal. STIF also provides participants with daily access to their account balances. Investments are mainly in money market instruments. Money market instruments are short-term debt and monetary instruments that mature in less than one year and are usually very liquid. The administrative functions and the actual investing of cash are the responsibility of the Cash Management Division. STIF maintained its AAAM rating by Standard and Poor's throughout the audited period.

The Treasurer's office holds an annual meeting for STIF shareholders, where information such as fiscal year performance of STIF, investment strategies and administrative enhancements are discussed. The latest meeting was held March 24, 2011.

As of June 30, 2010, STIF had total net assets of \$4,581,589,015. Participant distributions paid and payable during the 2009-2010 fiscal year were \$15,572,194 and STIF's expenses were \$1,213,495. According to the annual report, STIF reported an annual total return of 0.34 percent, exceeding its main benchmark, the MFR (First Tier Institutions-Only Money Fund Report) index, by .25 percent.

Statements and notes on pages F-37 through F-44 of the annual report deal with the Short Term Investment Fund. STIF Schedules of Rates of Return are included on pages F-47 and F-48 of the annual report.

Medium-Term Investment Fund:

Section 3-28a of the General Statutes authorizes a medium-term investment fund to be administered by the State Treasurer. During the 2008-2009 fiscal year, the Treasurer's office established client accounts for the Medium-Term Investment Fund. The Medium-Term Investment Fund includes both the Extended Investment Portfolio and the Short-Term Plus Investment Fund programs. The Extended Investment Portfolio had net assets of \$600,704,493 as of June 30, 2010.

As of June 30, 2010, the Short-Term Plus Investment Fund had net assets of \$52,566,866. Participant distributions paid and payable during the 2009-2010 fiscal year were \$636,452 and the Short-Term Plus Investment Fund's expenses were \$22,426.

Statements and notes on pages F-49 through F-55 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 \$34,000,000 as of June 30, 2010.

Pension Funds Management Division:

In general, the Pension Funds Management Division (PFMD) operates under the provisions contained primarily in Part I, Chapter 32, of the General Statutes, particularly Sections 3-13a, 3-13b, 3-13d, 3-31a and 3-31b. The division's responsibilities include the development, execution and management of investment programs of the pension and trust funds. The division is also charged with the responsibility of making sure that pension and trust fund investments are made in compliance with state statutes and guidelines. This includes administering state law regarding corporations doing business in Northern Ireland or Iran. In addition, Public Act 06-51, effective May 8, 2007, calls for the State Treasurer to review and determine to what extent the investment holdings of the state are invested in companies doing business in Sudan and consider divestment of such holdings.

The Pension Funds Management Division is responsible for managing the assets of six pension funds and eight trust funds having total net assets of \$21,869,590,362, as of June 30, 2010. The division invests the assets of these funds in accordance with an investment program through the purchase of ownership interests in a Combined Investment Fund. Each asset class within the fund holds investments of the Combined Investment Fund. As of June 30, 2010, the Combined Investment Fund (CIF) consisted of the Mutual Equity (MEF), Developed Market International Stock (DMISF), Emerging Market International Stock (EMISF), Core Fixed Income (CFIF), Inflation Linked Bond (ILBF), Emerging Market Debt (EMDF), High Yield Debt (HYDF), Real Estate (REF), Private Investment (PIF), Commercial Mortgage (CMF), and the Liquidity (LF) Funds. Record keeping and custody of most assets is provided by a master custodian (State Street Bank). As of June 30, 2010, the division employed 151 external advisors to manage and invest the assets of the Combined Investment Fund.

The cost of operating the Treasury's Pension Funds Management Division, including the cost of personnel and professional investment advisors retained, is charged against the investment income of the Combined Investment Fund. 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 \$6,500,000 for the 2009-2010 fiscal year and \$5,900,000 for the 2008-2009 fiscal year.

During the fiscal years ended June 30, 2010 and 2009, 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 2009-2010 and 2008-2009 fiscal years are summarized below:

<u>CIF</u>	<u># of Advisors- June 30, 2010</u>	<u>Expenses 2009-2010</u>	<u># of Advisors- June 30, 2009</u>	<u>Expenses 2008-2009</u>
CFIF	5	3,499,757	6	4,595,441
ILBF	2	901,014	2	944,154
EMDF	5	4,544,477	5	3,241,988
HYDF	4	2,544,771	4	2,321,899
MEF	9	10,744,251	10	7,729,408
DMISF	14	22,085,148	14	18,200,409
EMISF	4	12,333,677	2	6,970,008
LF	6	2,892,287	4	571,942
CMF	1	37,125	1	73,500
PIF	66	38,755,761	66	36,390,493
REF	<u>35</u>	<u>17,417,848</u>	<u>34</u>	<u>13,395,391</u>
Total	<u>151</u>	<u>\$115,756,116</u>	<u>148</u>	<u>\$ 94,434,633</u>

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), and the Real Estate (REF) 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:

Investment Class	As of June 30, 2010			
	TRF		SERF	
	Target Upper Range	Actual Holdings	Target Upper Range	Actual Holdings
<i>U.S. Equity</i>				
Mutual Equity Fund	35%	24.4%	35%	25.3%
<i>International Equity</i>				
Developed Markets International Stock	27%	20.7%	27%	20.9%
Emerging Markets International Stock	12%	9.5%	12%	9.7%
<i>Fixed Income</i>				
Liquidity Investment	10%	8.0%	7%	6.3%
Core Fixed Income	20%	11.6%	20%	11.8%
Inflation Linked Bond	8%	4.5%	8%	4.5%
Emerging Markets Debt	5%	5.3%	5%	5.4%
High Yield Bond	3%	3.1%	3%	3.2%
<i>Real Estate and Alternative</i>				
Private Investment	14%	9.3%	14%	9.3%
Real Estate	7%	3.6%	7%	3.6%
Hedge Funds	8%	0	8%	0

Asset allocations are reviewed monthly to determine whether a rebalancing of investments is necessary to maintain the desired allocation levels. During the 2007-2008 fiscal year, substantial changes were made to the asset allocation policy to reflect a restructuring of some asset classes and changes in investment strategy. A new Hedge Funds asset class was also added during the 2008-2009 fiscal year although no investment commitments had been made to this class of assets during the audited period.

During the fiscal year ended June 30, 2010, the Combined Investment Funds realized a net total return of 12.88 percent. During the previous fiscal year ended June 30, 2009, the Combined Investment Funds realized an annual total return of (17.32) 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, 2010 and 2009 are presented below:

<u>Combined Investment Funds:</u>	<u>Percentage Return</u>	
	<u>2009-2010</u>	<u>2008-2009</u>
Net Total Combined Investment Funds	12.88 %	(17.32) %
Mutual Equity (MEF)	14.01 %	(28.36) %
Developed Market International Stock (DMISF)	11.03 %	(27.98) %
Emerging Market International Stock (EMISF)	25.23 %	(30.90) %
Real Estate (REF)	(20.18) %	(28.66) %
Core Fixed Income (CFIF)	11.81 %	2.84 %
Emerging Market Debt (EMDF)	23.02 %	(3.62) %
High Yield Debt (HYDF)	24.54 %	(4.59) %
Inflation Linked Bond (ILBF)	9.48 %	(0.20) %
Commercial Mortgage (CMF)	6.75 %	(3.14) %
Private Investment (PIF)	17.32 %	(16.36) %
Liquidity (LF)	0.98 %	1.54 %
 <u>Retirement and Trust Funds:</u>		
Net Total Return Retirement and Trust Funds	12.88 %	(17.32) %
Teachers' Retirement Fund (TRF)	12.87 %	(17.14) %
State Employees' Retirement Fund (SERF)	12.93 %	(18.25) %
Municipal Employees' Retirement Fund (MERF)	12.57 %	(14.90) %
Probate Court Retirement Fund (Probate)	12.53 %	(15.11) %
Judges' Retirement Fund (Judges')	12.73 %	(14.82) %
State's Attorneys' Retirement Fund (St. Atty.)	10.34 %	(6.82) %
Trust Funds	13.26 %	(3.46) %

Investment performance for individual retirement funds varies based on the mixture of asset class types held by each. The investment performance for trust funds is a composite of returns earned by eight trust funds that participate in the Treasurer's Combined Investment Funds. During the fiscal year, Trust Funds included the School and Agricultural College Funds, The Soldiers' Sailors' and Marines' Fund, the Police and Fireman's Survivors' Benefit Fund, Endowment for the Arts, Hopemead Fund, Ida Eaton Cotton Fund and the Andrew Clark Fund.

A more thorough discussion of the Combined Investment Funds, including performance during the 2009-2010 fiscal year, can be found on pages 16 through 76 of the annual report.

Statements and notes on pages F-14 through F-33 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-41 of the annual report.

Investment Mix:

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

Participant Funds	6/30/09	Share Transactions				Gain on	Change	6/30/10	Percent Holdings	Inv. Income
	Market Values	Purch	Redemp	Net	Redemp	in Mkt. Value	Market Values			
	\$	\$	\$	\$	\$	\$	\$		\$	
TRF	11,397	2,253	2,527	(274)	502	648	12,273	56 %	321	
SERF	7,321	1,154	1,433	(279)	346	401	7,789	36 %	208	
MERF	1,345	199	201	(2)	50	78	1,471	7 %	41	
Probate	66	10	10	0	3	3	72	0 %	2	
Judges'	148	26	38	(12)	6	8	150	1 %	4	
St. Atty.	1	0	0	0	0	0	1	0 %	0	
Trust Funds	104	5	6	(1)	0	11	114	0 %	5	
Totals	<u>\$20,382</u>	<u>\$3,647</u>	<u>\$4,215</u>	<u>\$(568)</u>	<u>\$907</u>	<u>\$1,149</u>	<u>\$21,870</u>	<u>100%</u>	<u>\$581</u>	

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

Combined Investment Funds	6/30/09	Participant Fund Activity					6/30/10
	Net Assets	Purch	Redemp	Distrib	Net Contrib	Invest Return	Net Assets
LF	\$2,171	\$ 3,309	\$ 3,263	\$ 17	\$ 29	\$ 19	\$2,219
MEF	5,590	0	985	93	(1,078)	778	5,290
DMISF	4,416	0	420	84	(504)	523	4,435
EMISF	1,147	575	2	26	547	378	2,072
CFIF	3,160	0	651	137	(788)	329	2,701
ILBF	837	163	0	21	142	83	1,062
EMDF	1,132	0	152	47	(199)	243	1,176
HYDF	733	0	150	57	(207)	167	693
REF	770	202	0	14	188	(174)	784
CMF	5	0	1	0	(1)	0	4
PIF	1,627	180	0	92	88	299	2,014
Elim. Entry*	(1,206)	(782)	(1,409)	(7)	634	(8)	(580)
Totals	<u>\$20,382</u>	<u>\$3,647</u>	<u>\$4,215</u>	<u>\$581</u>	<u>\$(1,149)</u>	<u>\$2,637</u>	<u>\$21,870</u>

*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, 2009 and June 30, 2010 were \$16,249 and \$8,978 respectively. Amounts were for meeting costs, travel, postage and other expenses.

Debt Management Division:

The Treasurer is responsible for managing the debt of the state and administering 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 2009-2010 fiscal year and the obligations outstanding, as of June 30, 2010, is presented in the schedule entitled Changes in Debt Outstanding shown on page S-42 of the annual report, while additional information is contained in the annual report, pages S-43 and O-1 through O-12. A brief summary follows:

Bonds Outstanding June 30, 2009	\$17,886,038,772
Add- Issuances	3,430,935,000
Deduct - Payments at maturity	1,672,394,243
- Bonds refunded or defeased	<u>469,940,000</u>
Bonds Outstanding June 30, 2010	<u>\$19,174,639,529</u>

Interest paid	<u>\$966,892,078</u>
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Bonds and Notes issued in 2009-2010 by type are shown below:

General Obligation - Tax Supported	\$1,363,235,000
General Obligation – Bond Anticipation Notes	353,085,000
Economic Recovery Notes	915,795,000
Special Tax Obligation – Transportation Fund	549,775,000
Clean Water Fund	115,835,000
UCONN 2000	<u>133,210,000</u>
Total Bonds Issued, 2009-2010	<u>\$3,430,935,000</u>

True interest cost rates for new bonds issued during the 2009-2010 fiscal year ranged from 0.58 percent for bond anticipation notes with a one year average life to 3.64 percent for taxable bonds with an average life of sixteen years. Bonds issued during the 2009-2010 fiscal year were comprised of new money issues amounting to \$2,970,995,000 and refunding issues amounting to \$459,940,000.

In addition to the interest paid totaling \$966,892,078, during the 2009-2010 fiscal year, the Treasury also made arbitrage rebate payments to the federal government totaling \$198,120. Such rebates represent the excess earnings of nontaxable bond proceeds that were invested in STIF prior to project disbursement.

Economic Recovery Notes in the principal amount of \$915,795,000 were issued pursuant to Public Act 09-2, of the June 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. The amount of the General Fund deficit for the fiscal year ended June 30, 2009 was certified by the State Comptroller on December 3, 2009 to be \$947,578,504. Proceeds available to the state from the sale of Economic Recovery Notes including premiums amounted to \$991,928,023. Of this amount, \$947,578,504 was deposited with the State General Fund, \$626,271 was used to pay costs of issuance and \$43,723,248 was deposited with the Debt Service Fund to cover interest payable on the notes.

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 in the amount of \$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 will mature in June 2011.

Bonds outstanding at June 30, 2010 include \$11,275,000 of Certificates of Participation for the Middletown Courthouse and \$16,080,000 of Certificates of Participation for the Connecticut Juvenile Training School Energy Center project. These certificates are not bonded debt of the state. However, the state is obligated to pay a base rent under leases for these facilities, subject to the annual appropriation of funds or the availability of other funds. The base rent is appropriated as debt service. The Certificates of Participation are included on the Treasurer's Debt Management System for control purposes.

Further, the Connecticut Development Authority issued \$9,275,000 of its lease revenue bonds for the New Britain Government Center in the 1994-1995 fiscal year, of which \$2,915,000 is outstanding at June 30, 2010. The state is obligated to pay the base rent subject to the annual appropriation of funds. These payments are budgeted in the Treasurer's debt service budget as lease payments and are included in the above summary.

Section 32-607 of the General Statutes authorizes the board of directors of the Capital City Economic Development Authority to issue bonds and notes in such principal amounts necessary to carry out the authority's purposes. Pursuant to Section 32-608 of the General Statutes, the state has entered into 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. As of June 30, 2010, outstanding bonds subject to this state assistance contract totaled \$102,680,000.

The Connecticut Child Care Facilities Program is established pursuant to Section 10a-194c of the General Statutes to finance low interest rate loans for child care and child development centers. This statute also authorizes the Connecticut Health and Educational Facilities Authority to issue bonds in order to fund the loans. Further, 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. As of June 30, 2010, Child Care Facilities Bonds outstanding totaled \$68,240,000.

In accordance with Section 17a-485e of the General Statutes, the State Treasurer and the Office of Policy and Management entered into a contract to provide state assistance to the Connecticut Housing Finance Authority (CHFA) for the payment of debt service on authority bonds issued for the purpose of providing mortgage loans under the Supportive Housing Initiative program. The statute allows state assistance for such bonds in an aggregate principal amount not to exceed \$70,000,000. As of June 30, 2010, outstanding CHFA Special Needs Housing Bonds totaled \$61,775,000.

Tax Exempt Proceeds Fund (TEPF):

The Tax Exempt Proceeds Fund, codified as Sections 3-24a through 3-24h of the General Statutes, serves as a vehicle to allow the State Treasurer to comply with arbitrage requirements of the Tax Reform Act of 1986 with regard to the proceeds of nontaxable bond issues passed through to municipalities, nonprofit organizations and others as grants and loans. The arbitrage provision of the Tax Reform Act requires that any earnings on bond proceeds in excess of the interest rate on the bonds be rebated to the federal government unless those proceeds are invested in other tax-exempt securities. Under the Tax Reform Act, such pass-throughs are not considered expended when the state advances the funds to the recipient. Accordingly, without TEPF, the state would have to track the investment of proceeds of some bond issues until they are ultimately disbursed to contractors and vendors. Proceeds deposited into the fund can leave it only for a payment to a contractor, a vendor, or as a reimbursement.

The TEPF was incorporated as a regulated investment company and is managed by a firm retained by the State Treasurer. In addition to state agencies, TEPF may be used by authorities, municipalities and others. The TEPF was audited by a firm of independent public accountants for the 2009-2010 fiscal year.

According to the Annual Report of the TEPF, net assets of the fund totalled \$125,158,971 at June 30, 2010. The fund had net investment income of \$2,777 during the 2009-2010 fiscal year. Participants in the fund at June 30, 2010 included civil list funds and recipients of state agency grant and loan programs as well as others.

At June 30, 2010, a total of \$16,202,610 of state funds was invested in the TEPF as shown below:

<u>Fund Classification</u>	<u>Amounts</u>	<u>Annual Report Page No.</u>
Special Revenue	\$11,219,876	O-13
Capital Projects	12,080	O-14
Enterprise	4,970,654	O-14
Total	<u>\$16,202,610</u>	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 \$30,130,839 for the 2009-2010 fiscal year.

Second Injury Fund claim payments amounted to \$38,144,132 for the 2009-2010 fiscal year. A comparison of claim expenditures by category follows:

	<u>2009-2010</u>	<u>2008-2009</u>
Stipulations	\$ 10,782,487	\$ 10,117,350
Indemnity (lost wages)	22,056,446	21,269,642
Medical	5,305,199	6,964,852
Totals	<u>\$38,144,132</u>	<u>\$ 38,351,844</u>

The number of stipulated agreements to settle claims increased during the current audited period. According to the Treasurer's annual reports, the number of settled claims totaled 180 and 181 for the fiscal years ended June 30, 2009 and 2010, 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-insurers report directly to the State Treasury. A list of such companies is supplied by the Workers' Compensation Commission. (Certificates of Solvency are issued by that Commission.) By far, the greater portion of assessments is levied against insurance companies rather than self-insured employers.

Under Section 31-345 of the General Statutes, the Treasurer must assess and collect from the

above insurance carriers and self-insurers amounts to reimburse state expenses incurred by the WCC in the administration of workers' compensation benefits. In accordance with Section 31-345, the WCC's chairman notified the Treasurer of the amount needed to meet the expenses of the WCC for the fiscal year. Based on the projection, less the balance in the WCC account, the Treasurer assessed insurance companies and self-insured employers during the audited period at a rate based on their preceding fiscal year's payments for workers' compensation benefits. Collections of these assessments are deposited into the Workers' Compensation Administration Fund.

Workers' Compensation Administration Fund assessment collections amounted to \$30,315,007 for 2009-2010 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 shall not be construed to be a department, institution or agency of the state. CHET is a qualified state tuition program in accordance with guidelines contained in Section 529 of the Internal Revenue Service code. While money is invested in CHET, there are no taxes (federal or state) on the earnings. Amounts can be withdrawn to pay for tuition, room and board, or other qualified higher education expenses. There are no state taxes paid on qualified withdrawal earnings.

The Connecticut Higher Education Trust was audited by a firm of independent public accountants for the 2009-2010 fiscal year.

As of June 30, 2010, the CHET program had net assets of \$1,265,851,220, and 94,886 participant accounts. Operating results for the 2009-2010 fiscal year taken from the annual report were as follows:

Net assets at June 30, 2009	\$1,049,268,106
Net participant contributions	113,741,658
Net decrease from operations	<u>102,841,456</u>
Net assets at June 30, 2010	<u>\$1,265,851,220</u>

Financial statements and notes for CHET are presented on pages F-68 through F-74 of the Annual Report.

Trust Funds:

In addition to investment-type trust funds of the Pension Funds Management Division (described earlier in this report) and those in CHET, the Treasurer is also responsible for the administration of certain other trust funds which fall within her statutory jurisdiction. Some of these funds are described in the ensuing section.

School and Agricultural College Funds:

The administration of these two trust funds is provided for in Sections 3-40 through 3-55 of the General Statutes. Under Article Eighth, Section 4 of the Constitution of the State of Connecticut, the School Fund is a perpetual fund whose interest is to be used in support of state assistance to public schools. Annually, fund earnings are transferred to the General Fund from which public education grants are made. Under Section 10a-115 of the General Statutes, net income of the Agricultural College Fund is transferred to the University of Connecticut.

Investments consisted of participation in the Treasurer's major asset classes. No direct individual investments were held by the two trust funds. Total fund balances, at cost, on June 30, 2010, amounted to \$7,040,170 for the School Fund and \$465,691 for the Agricultural College Fund. The total fund balances on June 30, 2010, at fair value, amounted to \$9,129,205 for the School Fund and \$602,953 for the Agricultural College Fund. Statements and notes for these two funds and other non-civil list trust funds are included on pages F-57 through F-60 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, 2010, 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:

During the fiscal year ended June 30, 2010, the Treasurer named five hedge fund-to-fund managers as preferred vendors. Contracts for the five managers were in negotiations subsequent to June 30, 2010.

CONDITION OF RECORDS

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

Unreconciled Cash Account within Cash Management Division:

Criteria: The state's Core-CT accounting system has the potential to perform automated bank reconciliations, which would identify all outstanding items as to date and amount. It is the responsibility of the Cash Management Division (CMD) to research and resolve unidentified variances when reconciling the bank accounts.

Condition: During our audit of the CMD, we noted the state's payroll bank account was not completely and accurately reconciled directly to the general ledger cash account in the Core-CT accounting system. This reconciliation was not conducted in a manner which resolves all variances between the bank records and the Core-CT accounting records. As of June 30, 2010, the unexplained variance in the payroll account is \$540,120. In addition, we found adjustments totaling \$228,703 processed in prior fiscal years by the Comptroller that had not been resolved and continued to be carried forward in the payroll account as a reconciling item during the 2009-2010 fiscal year.

The CMD continues to rely on a manual reconciliation process to reconcile to the state's payroll accounts. Current manual procedures are not sufficient to identify and explain all variances in the payroll account. During the period under review, cleared payroll checks were not identified in the Core-CT accounting system. The monthly bank reconciliation report from Core-CT provides an end of the month net change in account balance by state agency but does not provide detailed information on individual bank transactions.

The Comptroller and agencies journalize recovery of payroll overpayments as adjustments in the payroll account in Core-CT. These adjustments are not cleared directly through the payroll bank account and daily downloads from the bank only reflect cash transactions that have been cleared. The Comptroller does not maintain an accounts receivable balance that would track payroll overpayments that are due to the state. An accounts receivable amount for payroll overpayments would assist in reconciling the adjustments in the payroll account.

Cause: The agencies may not have journalized the reclassification of these deposits or the Comptroller may not have processed the entries to offset the agencies' adjusted entries in the payroll account. Errors in the recording of the

adjustments made to the payroll account may not be detected in a timely manner if deposit information is not coded correctly in Core-CT by the agencies.

The Comptroller processed adjustments totaling \$228,703 in fiscal years 2008 and 2009 without having deposits to offset the processed adjustments.

Effect: The CMD cannot accurately and completely reconcile the payroll account ledger balance to the bank statement with the current manual procedures due to the lack of a net payroll adjustments figure with supporting details.

The payroll account has unresolved non-banking transactions that have been carried forward from prior fiscal years.

Recommendation: The CMD 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. (See Recommendation 1.)

Agency Response: "We concur with the Auditors' recommendation. In April 2010, the Comptroller's Office established a new account to track and book payroll recoveries. The Comptroller's Office issued Memorandum 2010-13, informing agencies that effective immediately, payroll recoveries were to be coded to the newly created account "Salary and Workers' Comp Recoveries," and not the payroll account. While this new process has been most beneficial, the Comptroller's Office does not believe that the establishment of an "Accounts Receivable" account for payroll recoveries is appropriate due to the extended timeframe for completing some of the recoveries."

Informal Monetary Settlement Between Second Injury Fund and Employer:

Criteria: According to Section 31-349, of General Statutes, only claims with an injury date prior to July 1, 1995 were entitled to transfer to the Second Injury Fund as long as all requirements for transfer were completed on or before July 1, 1999. Section 31-349 states that, as a condition precedent to the liability of the fund, the employer or its insured shall notify the custodian of the fund by certified mail of its intent to transfer claim liability to the fund and include with the notification copies of all medical records, an accounting of all benefits paid, copies of all findings, awards and approved voluntary agreement, the employer's estimate reserve amount for ultimate claim value, and a \$2,000 fee to cover the expenses and any other materials required by the custodian.

Section 31-353 of the General Statutes states generally that if the Second Injury Fund and an injured employee's representative reach an agreement in regard to compensation payable, such agreement shall be submitted in writing to the Workers' Compensation Commissioner for approval.

Condition: It appears that the Second Injury Fund settled with an employer for a claim that had not been transferred into the fund and the settlement was reached 11 years after the last hearing in front of a Workers' Compensation Commissioner. The settlement involved a payment of \$500,000 to the employer and was done primarily to prevent the claim from being transferred to the fund. The statutory criteria required as a precedent to the liability of the fund had not been met. The employer failed to provide complete medical records and acceptable verification of payment required to complete the transfer of the injury that took place in 1991.

The employer that received the \$500,000 settlement was represented by a law firm that has represented the majority of clients that were able to reach negotiated settlements with the fund when statutory requirements were missing. The law firm was able to negotiate a \$500,000 award with the fund without providing any of the prerequisite items listed in Section 31-349 of the General Statutes as conditions precedent to the liability of the fund. The \$500,000 settlement was just below the dollar threshold that would cause it to be subject to the State Treasurer's review and approval.

Cause: A previous court decision had ruled that if the eligibility of a claim was in dispute as of July 1, 1999, then the transfer of the claim is not barred after the dispute is resolved. The claim that was settled with the employer was never transferred to the fund because disputes over the adequacy of claim documentation had not been resolved.

Section 31-353 of the General Statutes was cited by agency management as the statutory authority for settling this matter before it became a liability of the fund. However, this statute refers to agreements between the Treasury and an injured employee, not between the Treasury and an employer.

Effect: The fund paid \$500,000 that it might not have been obligated to pay.

Recommendation: 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. (See Recommendation 2.)

Agency Response: "In 2009, the Fund was notified by the Workers' Compensation Commission that the injured employee was interested in settling the case. The Fund, Workers' Compensation Commission and Attorney General's representatives attended three hearings regarding transfer/settlement of this case. The full value of past and future benefits, if transferred to the fund, was \$3.8 million.

Under the court decision correctly cited by the Auditors, it was likely that this claim was eligible for transfer to the fund.

Rather than wait for the probable transfer of a \$3.8 million liability, the fund settled the case with the employer for \$500,000. The settlement was entered in consultation with the Attorney General. The settlement was approved by the Workers' Compensation Commissioner on February 23, 2010 under Section 31-353. This section allows the Treasurer to make payment by way of final settlement in any matter concerning the fund, subject to the approval of the Commissioner, whenever it is in the best interests of the injured employee. The settlement was entered and approved in accordance with the express interest of the injured employee.

While we believe the entering of the settlement was proper under current law, we are suspending future settlements of that type pending (a) development of new procedures that will require the direct approval by the Treasurer or Deputy Treasurer of any settlements of \$500,000 or more, and (b) a review of all relevant statutes for possible legislative clarification regarding delayed transfers.”

Noncompliance with Reimbursement Requirements:

Criteria: Pursuant to Sections 31-306, subsection (a)(2)(A) and 31-307a, subsection (c), of the General Statutes, employers or insurance carriers may be reimbursed for the actual cost of living adjustments (COLAs) made on injured workers' weekly compensation payments. Reimbursements may be paid by the Second Injury Fund upon presentation of any vouchers and information that the Treasurer shall require. We found no provision within these sections that allows the fund to negotiate settlements for such reimbursement claims. No claim for payment may be reimbursed by the fund more than two years after the date on which the benefits were paid by the employer or insurance carrier.

Condition: Treasury records showed indemnity payments related to reimbursement of COLA costs amounted to \$9,423,000 for the audited period. We selected ten such payments totaling \$657,607 for review and noted three exceptions as follows:

- \$150,593 to settle an insurance carrier's reimbursement request, for which appropriate vouchers and information that the Treasurer usually requires were not present.
- \$124,089 to reimburse an insurance carrier for COLAs, despite evidence suggesting the claim may not be valid for reimbursement. In addition, the fund arranged to reimburse two thirds of any future

COLAs. Under this arrangement an additional \$7,827 was paid as of September 1, 2010.

- \$78,677 to reimburse an insurance carrier for COLAs related to survivorship benefits, of which some were beyond the two-year window and without a valid affidavit that should have indicated the beneficiary remained unmarried.

Cause: The fund did not apply the reimbursement provisions consistently and had wanted to avoid litigation for potential additional benefits.

Effect: There is less assurance that reimbursement benefit requests are administered and paid properly.

Recommendation: 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. (See Recommendation 3.)

Agency Response: “The Fund agrees with the Auditors’ recommendations that 31-306 and 31-307a be followed in reimbursing employer and carrier COLA claims and does so consistently in the ordinary course. The Fund is, however, allowed by law to settle claims under the statutes [e.g., 31-353 and 31-355(f) and (g)]. Further, according the Connecticut Supreme Court, settlements that are approved by the Workers’ Compensation Commission have the force of law. The Fund’s statutory ability to settle and the legal role of the Commission in approving settlements, enables the Fund to deal with issues that are unique and outside of the ordinary course.

However, given the difference of opinion between the Fund and the Auditors in the reading of the statutes, the Fund has consulted with the Attorney General (AG) and will now refer disputed reimbursement claims to their office for negotiation and settlement recommendation. The AG, pursuant to 3-125, has the responsibility of representing and protecting the Fund as counsel. Through this procedural change, the Fund is addressing the concern of potential risks expressed by the Auditors. The Fund also intends to clarify its statutory authority to settle claims by having legislation introduced during the 2012 legislative session.”

General Obligation Bond Tax Opinion:

Criteria: In accordance with Section 3-20, subsection (r), of the General Statutes, the bond counsel opinion(s) should provide assurance of the tax status for all series included in a bond issue. The marketing of a bond’s tax status should agree with the bond counsel’s opinion.

Auditors of Public Accounts

- Condition:* During our review of bond closing documents, we noted that a bond counsel tax opinion, for the General Obligation Bond 2010 Series B in the amount of \$200,000,000, contained an error. The opinion letter listed individual bond series amounting to \$188,400,000, but omitted one bond series in the amount of \$11,600,000. A revised tax opinion was obtained from bond counsel after our inquiry. The entire \$200,000,000 bond issue was marketed with a tax-exempt status.
- Cause:* The omission was not noticed at the time of the bond closing. The lead bond counsel provided oversight of all closing documents.
- Effect:* The state paid for a legal opinion that omitted an \$11,600,000 bond series from the list of maturities. The closing documents were updated after we noted this error. We have decreased assurance that control procedures for bond closing documents are operating as intended.
- Recommendation:* The Debt Management Division should have procedures to ensure bond counsel opinions are complete. (See Recommendation 4.)
- Agency Response:* “The Auditors are correct that the descriptive portion of the series bond counsel opinion had the incorrect amount for one of the maturities of the bond issue. While we acknowledge and regret such error, bond counsel has opined that it had no bearing on the legality or tax-exempt status to the bond issue. We will work with bond and lead counsel to improve efforts to make sure that series bond counsel do not make a similar error in the future.”

Investment Advisory Council Approval of Pension Fund Appointments:

- Criteria:* Public Act 09-7 of the September Special Session amended Section 3-13a of the General Statutes, and states that “the Treasurer may, with the advice and consent of the Investment Advisory Council, appoint...principal investment officers, investment officers and other personnel.”
- Condition:* The Treasurer did not obtain the advice and consent of the Investment Advisory Council before three employees were hired.
- Cause:* The Treasurer’s Office was unaware that the new requirement applied to all Pension Fund employees.
- Effect:* The Treasurer’s Office is not in compliance with the General Statutes.
- Recommendation:* 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. (See Recommendation 5.)

Agency Response: “The Auditors reading of 3-13a is understandable. In 2009, at the Treasurer’s request, 3-13a was amended to establish the position of Deputy Chief Investment Officer and to require any appointment to such position be with the advice and consent of the Investment Advisory Council (IAC). It was never the Treasurer’s intent to require the IAC to approve the other appointments specified in 3-13a. The manner in which the General Assembly actually amended 3-13a, however, raises an ambiguity as to the role of the IAC in the other specified appointments. There is no legislative intent, in the official record of P.A. 09-7 or otherwise, indicating that the General Assembly intended to do anything different than the Treasurer originally requested and intended.

Due to this ambiguity, and despite the intent of the legislation that would counsel in favor of reading the statute not to require IAC approval for the other specified appointments, on February 9, 2011, the IAC approved the three employees appointed subsequent to the passage of P.A. 09-7. Further, the Treasurer has a bill currently pending in the General Assembly which will eliminate the ambiguity and codify the original intent of the 2009 amendment. Until this bill is passed into law, all new appointments will be presented for approval by the IAC.”

Combined Investment Fund Accounting and Compliance with Investment Policy Statement:

Criteria: Statement on Auditing Standards No. 1 details certain responsibilities of management and states that management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will initiate, record, process and report transactions, as well as events and conditions. Proper internal controls include that reconciliations of all significant accounts be reviewed in a timely manner for errors or omissions.

Section 3-11a of the General Statutes allows for the Treasurer to enter into such contractual agreements as may be necessary and proper within established procedures. The Investment Policy Statement guidelines, Part I, Article VIII, Sections D and E, for the selection and termination of providers of investment-related services call for such contracts to be executed by the State Treasurer.

The Investment Policy Statement (IPS) sets forth the general principles that govern the investments of the state’s retirement plans and trust funds in accordance with Section 3-13b, subsection (c), of the General Statutes. Specifically, Part III, Article X, Section D., of the IPS lists investment restrictions/limitations that apply to all real estate investment managers including; (a) leverage shall not exceed 60%, and that (b) redemption provisions shall be clearly defined.

Condition: During our audit of the financial statements for the fiscal year ended June 30, 2010, we noted several errors relating to the accounting for pension funds that needed to be changed for the financial statements to be complete and accurate. In addition, monthly advisors' reconciliations for liquid fund managers were delayed significantly as all 99 liquid-fund advisors' reconciliations for the months of July and August 2009 were not completed until February and March 2010. Other months also showed delays, which generally improved prior to the end of the fiscal year ended June 30, 2010.

The Treasurer did not sign several contracts for investments, which we believe may be required in accordance with the General Statutes and the Investment Policy Statement as these call for the Treasurer to execute contracts. The investment agreements instead were signed and executed by the general partner of the partnerships pursuant to a power of attorney granted to the general partner by the Treasurer. The general partner signed each investment agreement on behalf of the investor (State Treasury) and the investment manager (general partner).

There has been no official clarification of whether the 60 percent leverage provision applies to individual investment managers or to the Real Estate fund in the aggregate and redemption provisions for the open-ended real estate investment trusts that the Treasury is invested are still not clearly defined.

Cause: Management appears to have accepted certain risks associated with accounting department deficiencies due to cost considerations. We were informed that the use of power of attorney was demanded by the general partner in order for the state to become an investor. The 60% leverage requirement did not have clearly defined applicability within the IPS and the Treasury has not clarified redemption provisions for certain investments

Effect: There are increased risks, including errors, omissions or events that may be detrimental to the state will occur and not be prevented or detected in a timely manner. There are valid business reasons to grant general partners power of attorney to sign documents on behalf of the entire partnership. However, allowing the general partners to sign on behalf of the State Treasury as an individual investor presents a risk that this power could be misused.

Recommendation: 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. (See Recommendation 6.)

Agency Response: "The errors noted by the Auditors were contained in drafts and were corrected prior to end of fiscal year. To ensure that the Auditors have the most accurate, up-to-date information, we will only provide annual report

schedules in final form. We have also upgraded a procedure to ensure improved documentation of certain transactions.

On an ongoing basis, management assesses the workload of Pension Fund Accounting and Control based upon the growth of the pension fund and makes adjustments (e.g., extra resources, streamlining processes, reallocating workload).

Management was aware of the delinquent monthly advisors' reconciliations for liquid fund managers and planned for and completed all reconciliations prior to the close of the fiscal year. Reconciliations continue to be timely completed.

The Treasurer's execution of the Subscription Agreement sets all essential terms and conditions of the deal and forms the basis of the State's investment in the limited partnerships. Accordingly, it constitutes the execution of the contract for each limited partnership investment as required by the IPS. General Partners are given a limited power of attorney only for the purpose of meeting certain necessary administrative obligations.

While the Treasury asserts this practice complies with the IPS, we will seek an opinion from the Attorney General on this matter. In the interim, the Treasurer will sign all new limited partnership agreements.

The IPS will be amended to (a) articulate the practice of requiring and documenting clearly defined redemptions for all open-end accounts, and (b) specify that leverage is calculated for the Real Estate Fund (REF) in the aggregate and not for individual investments that are held in the REF. Over the past year, the Real Estate Procedures have been updated to accurately reflect the practices that will ultimately be included in the IPS. These procedures have been shared with the Auditors."

Tax Filing Agent:

Criteria: The Investment Policy Statement requires that Emerging Market Stock Fund managers invest only in liquid stocks. Investors owning securities in the country of Taiwan must appoint a local tax filing agent in order to liquidate the investment and repatriate the income and capital gains accruing from their investments.

Condition: The Pension Funds Management Division authorized an investment manager to invest in foreign stocks from the country of Taiwan without appointing a local tax filing agent. As a result, the manager made significant investments in Taiwan stocks, many of which have increased in value, but he is unable to sell the stocks and realize any of the gains due to the inability to repatriate the income and capital gains. As of June 30, 2010, this manager was holding

Taiwan stocks with an aggregate market value of \$63,555,567. During the audited period, the state was able to repatriate the principal investment of \$50,436,369 but was unable to retrieve the capital gain of \$13,119,198 because a local tax filing agent was not appointed.

Cause: It appears that the need for a tax agent was not considered at the time the manager was given the authorization to invest in Taiwan.

Effect: Capital gains totaling \$13,119,198 were not available for distribution. The state is in effect shut off from selling stocks that normally are considered to be highly liquid. The investment manager is not able to actively manage these holdings since the proceeds from sales cannot be distributed.

Recommendation: The Treasurer's Pension Fund Management Division should appoint a local tax filing agent to expedite the repatriation of capital gains from foreign countries. (See Recommendation 7.)

Agency Response: "Tax counsel has been negotiating a contract with a national independent accounting firm to serve as tax agent, but the CRPTF has been unable to execute this agreement due to differences between Connecticut's procurement requirements and the terms offered by the accounting firm. During Fiscal Year 2011, the CRPTF is continuing to work with tax counsel to engage a local tax agent. The CRPTF is also seeking advice from the Attorney General (AG) regarding the terms and conditions of the tax agent agreement, how such terms and conditions relate to Connecticut law and the ability to contract directly with tax agents. In the event that the AG is unable to find a solution consistent with Connecticut law, we will consider introducing legislation in the 2012 session of the General Assembly to enable the CRPTF to retain local tax agents."

RECOMMENDATIONS

Status of Prior Audit Recommendations:

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

- The Cash Management Division should require that agencies make recovery of state funds adjustments in the separate payroll correction account that was created by the Comptroller's Office. The CMD should work with the Comptroller's Office to enhance the reporting capabilities of Core-CT and set up an Accounts Receivable account to track overpayment recoveries, which would also assist in reconciling the overpayment recoveries adjustments to the payroll account. This recommendation has been restated to reflect current conditions and is presented as Recommendation 1.
- The Treasurer should credit the Municipal Participant Account with interest earnings as provided by statute and disburse funds in accordance with statutory requirements. This recommendation has been resolved.
- The Second Injury Fund should submit negotiated compensation agreements to the Workers' Compensation Commissioner for approval, ensure that self-insured employer assessment rates are applied without error and contest non-qualifying COLA reimbursement requests. This recommendation has been restated to reflect current conditions and is presented as Recommendation 3.
- The State Treasury should administer its responsibility for the alternative assets with more diligence and care, improve the monitoring of advisors and its financial reporting, and be sure the guidelines are effectively applied. This recommendation has been restated to reflect current conditions and is presented as Recommendation 6.
- The Treasurer's Pension Fund Management Division should appoint a local tax filing agent to expedite the repatriation of capital gains from foreign countries. This recommendation has not yet been resolved and is repeated as Recommendation 7.

Current Audit Recommendations:

The following recommendations resulted from our current review.

- 1. 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.**

Comments:

During our audit of the Cash Management Division, we noted the state's payroll bank account was not completely and accurately reconciled directly to the general ledger cash account in the Core-CT accounting system. This reconciliation was not conducted in a manner that resolves all variances between the bank records and the Core-CT accounting records. As of June 30, 2010, the unexplained variance in the payroll account is \$540,120.

The Comptroller does not maintain an accounts receivable balance that would track payroll overpayments due to the state. An accounts receivable amount for payroll overpayments would assist in reconciling the adjustments in the payroll account.

In addition, we found adjustments totaling \$228,703 processed in prior fiscal years by the account as a reconciling item during the 2009-2010 fiscal year.

- 2. 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.**

Comments:

It appears that the Second Injury Fund settled with an employer for a claim that had not been transferred into the fund and the settlement was reached 11 years after the last hearing in front of a Workers' Compensation Commissioner. The settlement involved a payment of \$500,000 to the employer and was done primarily to prevent the claim from being transferred to the Fund. The employer failed to provide complete medical records and acceptable verification of payment required to complete the transfer of the injury that took place in 1991. Section 31-353 of the General Statutes was cited by agency management as the statutory authority for settling this matter before it became a liability of the fund. However, this statute refers to agreements between the Treasury and an injured employee, not between the Treasury and an employer.

- 3. 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.**

Comments:

The Second Injury Fund reimbursed insurance carriers for cost of living adjustments without obtaining the required payment vouchers and other information. The fund also paid a negotiated amount for a cost of living adjustment. We found no statutory provision that allows the fund to negotiate settlements for such reimbursement claims.

- 4. The Debt Management Division should have procedures to ensure bond counsel opinions are complete.**

Comments:

A series bond counsel tax opinion, for the General Obligation Bond 2010 Series B in the amount of \$200,000,000, contained an error. The opinion letter listed individual bond series amounting to \$188,400,000, but omitted one bond series in the amount of \$11,600,000. A revised tax opinion was obtained from bond counsel after our inquiry. The entire \$200,000,000 bond issue was marketed with a tax-exempt status.

- 5. 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.**

Comments:

The Treasurer did not obtain the advice and consent of the Investment Advisory Council before three employees were hired.

- 6. 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.**

Comments:

We noted several errors relating to the accounting for pension funds that needed to be changed for the financial statements to be complete and accurate. The Treasurer did not sign several contracts for investments, which we believe may be required in accordance with the General Statutes and the Investment Policy Statement. Instead, the investment agreements were signed and executed by the general partner of the partnerships pursuant to a power of attorney granted to the general partner by the Treasurer. There has been no official clarification of the application of the 60 percent leverage provision to individual investment managers and redemption provisions for the open-ended real estate investment trusts.

- 7. The Treasurer's Pension Fund Management Division should appoint a local tax filing agent to expedite the repatriation of capital gains from foreign countries.**

Comments:

The Pension Funds Management Division authorized an investment manager to invest in foreign stocks from the country of Taiwan without appointing a local tax filing agent. As a result, the manager made significant investments in Taiwan stocks, many of which have increased in value, but he is unable to sell the stocks and realize any of the gains due to the inability to repatriate the income and capital gains.

INDEPENDENT AUDITORS' CERTIFICATION

Financial Statements:

We have audited the accompanying statement of net assets of the Combined Investment Funds, as of June 30, 2010, and the related statements of changes in net assets for the fiscal years ended June 30, 2010 and 2009. We have audited the accompanying statement of net assets of the Short-Term Investment Fund, including the list of investments as of June 30, 2010, and the related statements of changes in net assets for the fiscal years ended June 30, 2010 and 2009. 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, 2010, and the related statements of changes in net assets for the fiscal years ended June 30, 2010 and 2009. We have audited the statements of condition of the other Non-Civil List Trust Funds as of June 30, 2010, 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, 2010. 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, 2010 and 2009. We have also examined the schedules of Civil List Funds investments, as of June 30, 2010, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2010, and debt outstanding, as of June 30, 2010, and changes in debt outstanding during the fiscal year ended June 30, 2010. 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, 2010, 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, 2010, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2010 and debt outstanding, as of June 30, 2010, and changes in debt outstanding during the fiscal year ended June 30, 2010, 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, 2010, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2010, the balance of bonds outstanding as of June 30, 2010, 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, 2010, the Civil List Funds cash receipts and disbursements for the fiscal year ended June 30, 2010, the balance of bonds outstanding as of June 30, 2010, 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, 2010, and the results of their operations and changes in net assets for the year then ended, and the changes in fund balance for the other Non-Civil List Trust Funds and cash flows for the Second Injury Fund and the other Non-Civil List Trust Funds for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As explained in Note 1B to the financial statements of the Combined Investment Funds, the State Treasurer's policy is to present investments at fair value. The fair value of most of the assets of the Real Estate Fund, the Commercial Mortgage Fund and the Private Investment Fund are estimated by investment advisors in the absence of readily ascertainable market values, and reviewed and adjusted, when appropriate, by the State Treasurer. The fair value of most of the assets of the Real Estate Fund and the Private Investment Fund are presented at the cash adjusted fair values, which utilize the investment advisors' March 31, 2010, quarter ending estimated values adjusted for cash flows of the Funds during the subsequent quarter that affect the value at the Funds' level. Adjustments are made for underlying investments that experienced significant changes in value during the quarter, if deemed appropriate. We have reviewed the investment advisors' values, the relevant cash flows and the procedures used by the State Treasurer in reviewing the estimated values and have read underlying documentation and, in the circumstances, we believe the procedures to be reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the investments existed, and the differences could be material.

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 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 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 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 deficiencies, described in detail in the accompanying Condition of Records and Recommendations sections of this report to be significant deficiencies: Recommendation 1 – the need to improve the cash reconciliation process and Recommendation 2 – the payment of negotiated reimbursements to insurance carriers without obtaining the required payment vouchers and other information. 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 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 Treasury management in the accompanying Condition of Records and Recommendations sections of this report.

We also noted certain matters which we reported to 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 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 State Treasurer's Office 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