June 4, 2009

Memorandum for: The Federal Co-Chair
ARC Executive Director

Subject: OIG Report 09-01
Fiscal Years 2007 and 2008 Financial Statement Audits

The enclosed report presents the results of the audit of the Commission's financial statements for the fiscal years ended September 30, 2007 and 2008. The report should be read in conjunction with the Commission's financial statements and notes to fully understand the context of the information contained therein.

The Appalachian Regional Commission (ARC) contracted with the independent certified public accounting firm of WithumSmith+Brown (WSB) to audit the financial statements of the Commission as of and for the fiscal years ended September 30, 2007 and 2008. The contracts required that the audits be conducted in accordance with U.S. generally accepted government auditing standards and OMB audit guidance. ARC's Office of Inspector General monitored audit activities to help ensure audit quality.

The following results were noted from WSB's audit of ARCs financial statements for the Fiscal Year Ended, September 30, 2008.

- WSB expressed a qualified opinion on ARC's financial statements and noted that except for its inability to satisfy itself as to the amounts reported in the financial statements related to the U.S. Department of Transportation (DOT) grants, the financial statements were properly stated in all material respects, in accordance with U.S. generally accepted accounting principles.

- WSB did not provide an opinion on the effectiveness of ARC's internal controls over financial reporting and did note improvements in meeting Parent-Child (agency funds allocated to other federal agencies for which the grantor agency has financial reporting responsibility) reporting requirements; however, as summarized in the paragraph above, because of problems related to verifying DOT's general ledger balances, the auditor continued to consider Parent-Child reporting a material weakness (discussed below). From errors occurring in Parent-Child reporting for FY 2007, ARC was forced restate its financial statements and are provided in this audit report.

- WSB identified, in addition to a material weakness, three other matters it considers to be significant deficiencies. Further discussion is provided below.

- WSB did not express an opinion on compliance with laws and regulations but did cite Anti-Deficiency Act (AD) violations occurring during the first quarter of FY 2007 and three other AD violations occurring during FY 2008.

For FY 2007, because of the implementation of OMB Circular A-136, which required Parent-Child reporting, and the related adoption of federal reporting requirements, which was more complex than ARC's previous financial statement presentation requirements, ARC was unable to issue timely financial statements and obtain an audit opinion. For FY 2008, many of the same problems inhibited timely completion of the financial statements and the reporting problem remains classified by the auditor as a material weakness. However, because of ARC's continuing efforts and improved data flow from child agencies, ARC was able to receive an opinion, although with a qualification for DOT grant amounts. The auditor continued to recommend vigilance to ensure timely financial information is received, identified issues resolved, and that ARC procedures enable management to make appropriate representations about child agencies' financial data.

In addition, ARC restated its 2007 financial statements, the balance sheet and the statement of changes in net position, because of errors recording ARC's child agency financial activity. The total cumulative change in the results of operations was approximately $8.9 million with no effect on net position. The effected financial statement line items were: cumulative results of operations, unexpended appropriations, appropriations used, and the change in accounting principles line item. The specific dollar amounts affecting each of these accounts are detailed in the Notes to Financial Statements (Note 11).

Aside from the material weakness in reporting for Parent-Child activities, three other issues, described below, were identified by the auditor as significant deficiencies impacting ARC's ability to present financial data reliably, in accordance with generally accepted accounting principles.

- Meeting federal reporting requirements.

  A required footnote disclosure, the "Reconciliation of Net Cost to Budget," formerly a part of the federal financial statements, could not be prepared for the FY 2007 financial statements, but for fiscal year 2008, the disclosure was completed but remains un-reconciled in the amount of $1.2 million. The problem resulted from ARC not processing budgetary accounting information properly and the financial system not requiring entry of budgetary data which should relate/equate to its proprietary counterpart. WSB recommended ongoing training in federal reporting requirements, the development and implementation of policies and procedures, and the adoption of an alternate financial system which will facilitate proper recording of proprietary and budgetary information.

  Note: Compliance with federal reporting requirements was a material weakness for FY 2007, but because ARC was able to prepare its Required Supplementary Stewardship Information the associated recommendation was closed and the classification changed to a significant deficiency.

- Properly accruing grant obligations.

  ARC has not developed an estimation methodology for accurately recognizing expenses incurred but not yet reported by its grantees as of September 30. The auditor recommended development of a system to obtain the necessary grant information and a methodology to properly record grant accruals.

- Properly managing the security of the financial and grant management systems.

  The auditor noted deficiencies in security management, access control, configuration/change management, segregation of duties, and contingency planning. WSB recommendations were for performance of a detailed risk assessment to be evaluated in terms of likelihood and magnitude of risk related to the deficiencies cited, and for an appropriate corrective action plan and rationale for not addressing identified risks. Continued implementation of corrective action for previously identified weaknesses and the replacement of ARC's unsupported financial accounting system were also recommended.

The FY 2007 recommendation relating to accounting for grant advances was closed and a material weakness in accounting for revenue exists only as a continuing recommendation under a WSB letter to management. The recommendation was for training and resources.

In connection with the contract, we reviewed WithumSmith+Brown's report and related documentation and inquired of its representatives. Our involvement in the audit process consisted of monitoring of audit activities, reviewing auditor independence and qualifications, attending meetings, participating in discussions, and reviewing audit planning and conclusion workpapers and reports. Our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, opinions on the Appalachian Regional Commission's financial statements, conclusions about the effectiveness of internal control, or conclusions about compliance with laws and regulations. WithumSmith+Brown is responsible for the attached auditor's report dated March 23, 2009 and the conclusions expressed in the report. However, our review disclosed no instances where WithumSmith+Brown did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Clifford H. Jennings
Inspector General

Attachment

cc: Director, Finance and Administration Division

WithumSmith+Brown
A Professional Corporation
Certified Public Accountants and Consultants

APPALACHIAN REGIONAL COMMISSION

Financial Statements

September 30, 2008 (Audited) and 2007 (Unaudited)

With Independent Auditors' Report

Appalachian Regional Commission
Table of Contents
September 30, 2008 (Audited) and 2007 (Unaudited)

	Page(s)
Independent Auditors' Report	2-12
Financial Statements	
Balance Sheets	13
Statements of Net Cost	14
Statements of Changes in Net Position	15-16
Statements of Budgetary Resources	17
Notes to the Financial Statements	18-28

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INDEPENDENT AUDITORS' REPORT

To the Commission Members
Appalachian Regional Commission
Washington, D.C.

In our audit of the Appalachian Regional Commission ("ARC") for the fiscal year ("FY") 2008, we found:

- except for the effects of such adjustments as might have been determined to be necessary had the grant balances of an ARC child agency been available for audit, the FY 2008 ARC financial statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States;
- ARC made significant progress in addressing FY 2007 issues and accordingly only one material weakness in internal control over financial reporting was identified in FY 2008;
- four significant deficiencies in internal control over financial reporting (including the one material weakness); and
- no instances of non-compliance with laws and regulations except for violations with respect to the Anti-Deficiency Act.

The following sections discuss each of these conclusions in more detail.

Qualified Opinion on FY 2008 Financial Statements

We have audited the accompanying balance sheets of ARC as of September 30, 2008 and 2007, and the related statements of net cost, changes in net position, and budgetary resources for the years then ended in accordance with U.S. generally accepted auditing standards, *Government Auditing Standards*, and OMB Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. The financial statements are the responsibility of ARC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits 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. 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 audits provide a reasonable basis for our opinion.

We were unable to obtain sufficient evidential support for the amounts presented in the FY 2007 financial statements because ARC was unable to fully implement the new Parent/Child reporting requirements for its seven child agencies, and the agency was unable to perform a reconciliation of its proprietary accounting activity with its budgetary activity. ARC's change of its financial statement presentation to be in compliance with the Federal Accounting Standards Advisory Board and OMB Circular A-136 *Financial Reporting Requirements* in FY 2007 gave rise to these issues. Because of these matters, we were unable to satisfy ourselves as to the amounts reported in the financial statements related to the child agency financial information and ARC's budgetary data by means of other auditing procedures.

ARC, a parent agency, was unable to obtain documentation supporting the funds transferred to the U.S. Department of Transportation ("DOT"), its child agency. DOT was unable to provide a detailed schedule supporting its ARC grant balances as of September 30, 2008. As a result, we were not able to satisfy ourselves as to the amounts reported in the financial statements related to DOT grants.

Because of the matter discussed in the third paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the FY 2007 financial statements.

In our opinion, except for the effects on the FY 2008 financial statements of the matters discussed in the fourth paragraph in this section, the FY 2008 financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Appalachian Regional Commission as of September 30, 2008, and its net costs, changes in net position, and budgetary resources for the year then ended in conformity with U.S. generally accepted accounting principles.

The information in Management's Discussion and Analysis and Required Supplementary Stewardship Information sections are not a required part of the financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular A-136. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the information. However, we did not audit the information and express no opinion on it.

The information in the Message from the Federal Co-Chair, Performance Report, Other Accompanying Information and Appendices are presented for purposes of additional analysis and are not required as part of the financial statements. This information has not been subjected to auditing procedures, and accordingly, we express no opinion on it.

Report on Internal Control over Financial Reporting

In planning and performing our work, we considered ARC's internal control over financial reporting as a basis for developing our audit procedures for the purpose of expressing an opinion on the financial statements but not for the purpose of expressing an opinion on the effectiveness of ARC's internal control over financial reporting. Accordingly, we do not provide an opinion on the effectiveness of ARC's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles, such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by ARC's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described above and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. In our FY 2008 audit, we consider the deficiencies, Nos. 1-4 described in Exhibit I, to be significant deficiencies in internal control over financial reporting. However, of the significant deficiencies described above, we consider deficiency No. 1 to be a material weakness.

Report on Compliance and Other Matters

ARC management is responsible for complying with laws and regulations applicable to the agency. We are responsible for performing tests of its compliance with certain provisions of laws and regulations that have a direct and material effect on the financial statements and certain other laws and regulations specified in OMB Bulletin No. 07-04. 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 of compliance with laws and regulations disclosed one instance of non-compliance, No. 5 described in Exhibit I, that is required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04.

Management's responses to the findings identified in our audit are presented for each finding as Management's Response, herein. We did not audit ARC's response and, accordingly, we express no opinion on it.

We noted certain additional matters that we have reported to the Commission Members and management of ARC in a separate letter dated March 23, 2009.

This report is intended solely for the information and use of ARC's management, the Office of Management and Budget, the Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Withum Smith + Brown, PC

March 23, 2009

1. Child Agency Reporting Requirements

ARC has made progress in addressing child agency reporting deficiencies noted in the prior year. In FY 2008, ARC was able to obtain internal control and financial information from their child agencies; however, ARC's review of this information was not sufficient to enable ARC to identify improper balances or to explain the transactions recorded by some of the agencies. For example, during our review we found that the grant schedules of undelivered order (UDO) balances provided by Rural Development (RD) and the Department of Housing and Urban Development (HUD) did not reconcile to the UDO balances in the general ledger by $46,803 and $38,335, respectively. Since ARC is ultimately responsible for the child agency balances as the parent agency, we questioned ARC about the differences, but ARC was unable to provide an explanation. After forwarding our question to the child agencies, ARC did receive an explanation from RD for the difference, but never received an explanation from HUD. Furthermore, we noted that HHS recorded $1.6 million in the cumulative results of operation; however since all the funds received from ARC are appropriated funds, the $1.6 million should have been recorded properly as appropriated capital.

ARC has ongoing issues with financial information provided by the Department of Transportation (DOT). During our audit we requested a detailed schedule of open grant undelivered order (UDO) balances, but DOT was unable to provide a detailed schedule of grant balances supporting the total recorded in the general ledger. Additionally, DOT records show a $1.2 million liability which DOT acknowledged is an error. Furthermore, DOT also recorded $7.3 million in the cumulative results of operation that should have been recorded properly as appropriated capital. The errors were corrected on ARC's records through our audit, but the inability of DOT to properly support all of the recorded general ledger balances caused a scope limitation in the current year which resulted in a qualified opinion on the financial statements.

Recommendations

We recommend that the Executive Director and the Director of Finance and Administration ensure that complete, timely financial information is received from ARC's child agencies and ensure that appropriate controls and procedures have been implemented to enable management to make representations that the child agencies' financial information is fairly presented in ARC's financial statements.

We further recommend that the Executive Director and the Director of Finance and Administration ensure that an adequate review of ARC's child agencies internal controls be completed, and that the review be detailed enough to enable ARC to explain the child agency systems and the activity recorded by the child agencies. Additionally, ARC should resolve issues with the child agencies that are identified in the review and establish timeframes for resolution of the issues in order to ensure that the child agencies' financial information is fairly presented in ARC's financial statements.

Management Response

ARC agrees that reconciliation of the Child Agency trial balance reports and the project detail reports is necessary. During the fourth quarter of fiscal 2008 ARC created a tab within ARC.net, its grant management system, to input the financial transactions from the Child Agency project detail reports as well as from TVA. This will enable ARC to reconcile the two reports. ARC will establish procedures for reconciling the Child Agency trial balance reports and the project detail reports, the reconciliation of the Child Agency project detail reports and ARC.net grant data for all Child Agencies except DOT. DOT has informed ARC that a team is working on its FMIS system now in order to produce a project detail report that will agree to its general ledger. No timeline has yet been provided by DOT.

ARC will regularly obtain descriptions of each Child Agencies financial processes to review their internal controls. When necessary, ARC will conduct site visits to further review and understand each Child Agency's systems.

Auditor Response

ARC's proposed action if properly implemented will adequately address these recommendations.

2. Federal Reporting Requirements

ARC continues to have difficulty preparing the "Reconciliation of the Net Cost to Budget" footnote disclosure. In FY 2007 ARC was unable to prepare the disclosure and therefore left it out of the financial statements which contributed to the disclaimer of opinion. Because ARC does not have the in-house expertise, ARC hired a firm to assist with the preparation of the financial statements and disclosure notes for FY 2008. Although ARC made a lot of progress in FY 2008 reducing their initial difference of $4.6M to $1.2M, they were still unable to fully reconcile the difference. As a result, ARC reported an unexplained difference of $1.2 million as a reconciling item in the footnote disclosure. This difference occurred because ARC's accounting software does not require simultaneous entry of budgetary and proprietary transactions that resulted in some proprietary entries being posted without the proper budgetary equivalent. In addition, there are no written policies and procedures in place to ensure that budgetary and proprietary activity is recorded correctly. Unless ARC finance staff are adequately trained in federal accounting standards and management implements controls to off-set the inherent weaknesses in the accounting system, ARC will have an on-going challenge performing this reconciliation in a timely fashion each year.

OMB Circular A-136 *Financial Reporting Requirements* states:

> SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, "requires a reconciliation of proprietary and budgetary information in a way that helps users relate the two."
>
> " ...The objective of this information is to provide an explanation of the differences between budgetary and financial (proprietary) accounting. This is accomplished by means of a reconciliation of budgetary obligations and non-budgetary resources available to the reporting entity with its net cost of operations."

Recommendation

We recommend that the Executive Director and the Director of Finance and Administration ensure the finance staff receive on-going training in federal reporting requirements and federal accounting standards, and that written policies and procedures are developed and implemented to ensure ARC is in full compliance with OMB Circular A-136 requirements and federal accounting standards. ARC should develop detailed written reconciliation procedures to assist in preparing the disclosure note to ensure all proprietary and budgetary amounts are properly recorded. Additionally, ARC should aggressively pursue moving its accounting function to a Financial Management Line of Business or replacing the GLOWS accounting system with a system that will facilitate the proper recording of budgetary and proprietary transactions.

Management Response

ARC has approved moving its accounting from in-house to GSA's full service shared services. GSA will execute ARC's payments, enter its financial transactions in their accounting system, submit the SF-224, FACTS II Reports, generate the financial statements, and provide ARC with view only access to the system. ARC is the final stage of signing an agreement with GSA and the implementation will occur October 1, 2009 dependent on GSA's time schedule.

ARC hired an outside accounting firm to assist in the preparation of its financial reports and provide necessary SGL Analysis. In the interim before converting to GSA's shared services, this firm will continue to provide needed assistance. ARC has prepared the mid-year financial statements that included the Reconciliation of the Net Cost to Budget. Through this process ARC staff is becoming more knowledgeable of federal financial reporting. ARC will contract for training tailored to ARC's needs and has also identified appropriate US Treasury FMS courses to which it will send staff.

ARC has implemented a monthly reconciliation of its proprietary and budgetary accounting. This procedure will be documented.

Auditor Response

ARC's proposed action if properly implemented will adequately address these recommendations.

3. <u>Grant Accrual Methodology</u>

Accrual accounting records all transactions that arise from an Agency's operations. Under accrual accounting, transactions are recorded in the period to which they relate, even though no cash may have been received or paid. Accrual accounting takes into account transactions where no cash is exchanged, such as transactions involving the creation of obligations to pay (payables) or rights to receive cash at future dates (receivables). ARC incurs an obligation to pay its grantees as soon as the grantee has expended grant funds.

In order to fully comply with generally accepted accounting principles and Federal requirements, ARC must record an accrual for its grant activity quarterly to prepare proper interim financial statements. OMB Circular A-136, *Financial Reporting Requirements*, states that "agencies shall submit unaudited interim financial statements to OMB 21 days after the end of each of the first three quarters of the fiscal year. Agencies should include management's explanation of significant variances in types or amounts of assets, liabilities, costs, revenues, obligations and outlays along with the submitted statements."

Currently, ARC grantees are required to submit grant reports on a 120-day cycle, based on the first day of the period of performance per the grant agreement. Grant expenses are recorded by the finance department on a cash basis when the grantee submits an SF-270 Request for Advance or Reimbursement. The reimbursement request is submitted by the grantee when funds are required and does not necessarily coincide with the 120-day reporting cycle. Additionally, because ARCs 120-day reporting cycle also does not coincide with a quarterly financial reporting cycle, ARC does not have the necessary financial data to facilitate development of a grant accrual methodology or to record a quarterly grant accrual based on actual data.

To record a grant accrual as of September 30, 2008, ARC collected all the financial reports received from the grantees from October 1, 2008 through February 15, 2009 (4 ½ months after the end of the fiscal year). ARC's analysis of this data resulted in recording a grant accrual totaling $1.6 million. Therefore, ARC does not have an effective process to record grant accruals on a quarterly basis. This results in an understatement of its liabilities and expenses on the interim and year-end financial statements provided to OMB.

Recommendation

We recommend that the Executive Director ensure that ARC develops a system to obtain the necessary grant financial information to assist them in properly developing and supporting a grant accrual methodology which can be recorded on a quarterly basis.

Management Response

ARC agrees on the need for a more precise and auditable grant accrual methodology for its quarterly and year-end financial reports. For fiscal 2008, ARC followed advice given to send grant confirmations to all open grantees. Unfortunately, this methodology did not result in an accurate and auditable accrual amount.

ARC will develop a methodology to calculate its grant accruals. Before this is implemented, ARC will review each grant payment request in order to determine the necessary accrual starting the 3rd quarter of 2009. The new methodology will be based on the historical grant payment information entered into ARC.net, the grant management system. ARC will review grantee reimbursement payments for the four months after each calendar quarter. Based on this review the payments will be prorated to the appropriate quarters. The prorated payments applicable to the prior quarter will be totaled and then divided by the amount of open grants to give a percentage upon which to base the accrual.

This quarterly calculation will be conducted for 3 fiscal years. An average percentage will be calculated for each quarter with this percentage applied to the subsequent fiscal year to calculate the grant accrual. If there is a discernable pattern to the grant accrual percentage, then in succeeding years the quarterly calculations will be calculated on just two quarters, which will change each year.

Auditor Response

The reasonableness and completeness of ARC's proposed grant accrual methodology will be examined in conjunction with the audit of its FY 2009 financial statements.

4. Weaknesses in IT General Controls

ARC has made significant progress in the past several years to improve and upgrade the management of its information systems, despite lacking adequate staff and sufficient resources. In recent years, various OIG audit reports have identified weaknesses in ARC's controls over its information systems. Management has implemented plans to work to resolve those deficiencies. Some of these have been completed, and some are still in process.

During our FY 2008 testwork, we noted that ARC has not yet performed a detailed risk assessment, which would help ARC assess the likelihood and impact of potential vulnerabilities, so that ARC can better determine how to allocate and prioritize its limited resources. This risk assessment should then drive how ARC will address the control weaknesses we identified in our audit, and help decide the most cost effective ways to reduce the associated risks.

Also, during FY 2008, we performed certain tests over ARCs IT general controls impacting its key financial and support systems, using the guidance in GAO's FISCAM (Federal Information System Control Audit Manual). The two primary systems we focused on are the GLOWS accounting system and the ARCNET grants management system. We identified the following specific areas where the controls are not in place or not operating effectively: 1) security management; 2) access controls; 3) configuration/change management; 4) segregation of duties; and 5) contingency planning.

We evaluated these systems using the criteria in NIST (National Institute of Standards and Technology), Federal Information Processing Standards 200 "Minimum Security Requirements for Federal Information and Information Systems", as well as GAO's "Standards for Internal Control in the Federal Government".

As a result of these control weaknesses, ARC is subject to the risk that data could be accessed, transmitted or manipulated by unauthorized personnel and the risk that systems could become unstable or unavailable.

These issues are caused primarily because ARC had not previously devoted the resources necessary to prevent or correct these weaknesses, or in some cases may not have been aware that the specific weakness existed.

The specific nature of these weaknesses and the associated details has been communicated in a separate letter to the Commission Members and management.

During the year and subsequent to our audit, ARC had begun implementing certain corrective actions. The implementation of these and any additional corrective actions will be evaluated in the FY 2009 audit.

Recommendations

We recommend the Federal Co-Chair ensure that ARC:

- Perform a detailed risk assessment so that the weaknesses related to security management, access controls, configuration/change management, segregation of duties, and contingency planning, can be evaluated in terms of likelihood and magnitude.
- Develop written corrective actions plans with timeframes for completion to resolve the weaknesses identified in the audit, or document the rationale why corrective action is not needed (based on the completion of the risk assessment).
- Continue to implement corrective actions to weaknesses previously identified.
- Aggressively pursue outsourcing the accounting function to a Financial Management Line of Business, or replacing the GLOWS accounting system so ARC will not be at risk if GLOWS fails.

Management Response

<u>Security Management</u>
ARC agrees to develop an entity-wide security management program. This program will be developed based on a risk assessment to be performed by the end of the fiscal 3rd quarter. ARC is contacting potential companies to perform the risk assessment. The security management will include policies on staff and contractor screening, confidentiality and non-disclosure statements. ARC currently performs background investigations through OPM on all employees. The security management program will also address assessment of security controls and obtaining SAS70 reports from vendors.

ARC implemented Security Awareness Training for staff during the second quarter of fiscal 2009. This is included in the Information Technology Security Policy that was issued in February 2009.

<u>Access Controls</u>
- ARC has taken the decision to move its accounting function to GSA's Financial Management Line of Business. The Commission is currently in discussions with GSA to determine the time period for the transition.
- ARC.net passwords were encrypted during the 2nd quarter of fiscal 2009. A tool was developed to allow view access privileges in ARC.net. These privileges were reviewed,

approved, and updated. A formal approval process will be included in the security management.

- ARC has developed and implemented an IT Exit Checklist to ensure timely termination of access and document IT related access termination issues.
- SSL Certificates were implemented for ARC.net during the 2nd quarter of fiscal 2009 and WebTA will be completed during the 3rd quarter of fiscal 2009.
- An incidence response plan will be included in the security management program
- Intrusion detection is included in the new firewall scheduled for installation early in the 3rd quarter of fiscal 2009.
- ARC will prepare an inventory of key financial reporting spreadsheets and with appropriate access restrictions.
- ARC is not able to restrict access to the building. The server room will remain restricted with additional security options explored.

<u>Configuration Management</u>
ARC will develop configuration management to include software, hardware, peripherals, and network infrastructure. This shall be completed by fiscal year end on September 30, 2009.

ARC agrees to the necessity of a more formal change management program. In developing such a program, the design should be one that is not overly burdensome. ARC was created to be a flexible agency that could adapt and change quickly as conditions require. Because of its size, most decisions at ARC do not require an elaborate process and the number of people involved is limited. ARC will implement a change management program once its risk management assessment and entity wide security program is completed and evaluated.

<u>Segregation of Duties</u>
As a micro agency of the US Government, the wide range of IT duties and responsibilities do not justify multiple full time positions as would be found in larger agencies. Accordingly, ARC has taken the decision to have one full-time IT staff position and outsource other functions. This decision was implemented at the beginning of fiscal 2009. Currently, ARC has a part time help desk assistant, a part time software developer, a contractor performing monthly network maintenance, and contracts to configure and install major network upgrades. Within the risk assessment and an entity-wide security management program, ARC will explore and implement additional safeguards against errors and wrongful acts.

<u>Contingency Planning</u>
Once the risk assessment and security management program are completed ARC will develop a Continuity of Operations Plan (COOP). In preparation for this plan ARC will develop a critical operations list by the fiscal year end. Given the complexity of developing a COOP this task normally takes one to two years. ARC's goal is to complete and implement its COOP within this timeframe.

ARC has contacted and obtained a quote for a waterless fire detection and suppression system. More quotes will be obtained prior to making a final decision. ARC will install this system prior to fiscal year end.

ARC has taken the decision to move to GSA's Financial Services Line of Business. In the interim, ARC has already put into place a process that would restore GLOWS within 15 minutes using the installed virtual server environment. The virtual server environment was installed during the 2nd quarter of fiscal year 2009.

Auditor Response

Based on management's response, the recommendations cited above are resolved and open pending review of the implementation of the corrective action plan in FY 2009.

5. Anti-Deficiency Act Violations

During FY 2008, ARC management disclosed that several Anti-Deficiency Act violations had occurred. In the first quarter of FY 2007 the violation totaled $521,288, the first quarter of FY 2008 the violation totaled $7,819, the second quarter of FY 2008 the violation totaled $333,988, and the third quarter of FY 2008 the violation totaled $213,288. The ARC Federal Co-Chair reported the violations along with all relevant facts and a statement of actions to the OMB and is waiting for OMB guidance prior to reporting the violations to the President of the United States, Congress and the Comptroller General of the United States as required by 31 U.S.C. §1351.

These violations involved the obligation of budgetary resources in excess of FY 2007 and FY 2008 apportionments, but did not involve expenditures or obligations in excess of ARC's appropriation. These violations occurred because ARC relied on OMB procedures to ensure that obligations did not exceed apportionments. When OMB eliminated the signature apportionment certification requirement, ARC did not have their own internal control procedures in place to ensure that obligations did not exceed the apportionments.

Status of Prior Year Significant Deficiencies and Non-Compliance with Significant Laws and Regulations

Prior Year Condition	As Reported at September 30, 2007	Status as of September 30, 2008
Lack of Full Implementation of Parent/Child Reporting Requirements	**Material Weakness:** ARC's was unable to verify the integrity of the child agency data or gain an understanding of the internal controls in place related to these allocated funds. Because of ARC's inability to verify the integrity of the data, ARC management was not in a position to take responsibility for and to make representations concerning the fair presentation of the child agency data.	**Remains a material weakness:** Although ARC has been able to obtain financial information from its child agencies and to verify the data, DOT's inability to provide detailed support for its grants balances resulted in a qualified opinion on ARC's FY 2008 financial statements.
Controls Over Compliance with Federal Reporting Requirements Not Fully Implemented	**Material Weakness:** There were certain control weaknesses related to reporting information required by OMB Circular A-136. 1) ARC did not have policies and procedures to facilitate the collection and reporting of RSSI information to ensure full compliance with federal reporting requirements; and 2) ARC accounting staff did not prepare a reconciliation of budgetary and proprietary data due to time constraints, errors identified in child agency data, and other challenges in implementing federal reporting requirements.	**Changed to significant deficiency:** ARC was able to prepare a RSSI in compliance with A-136. Therefore, this recommendation has been closed. However, ARC still has difficulty reconciling its proprietary with its budgetary data which resulted in a $1.2 million unexplained difference at year-end. In FY 2008 ARC made substantial progress toward resolving this issue. This weakness has been changed to a significant deficiency in FY 2008.
Weakness Noted over Accounting for Grant Advances	**Material Weakness:** There was inconsistent accounting for intra-governmental agreements due to the lack of policies and procedures to ensure that new grants, contracts and agreements are reviewed when approved to determine the appropriate accounting treatment for the underlying financial relationship.	**This finding is closed.**
Weakness Noted over Accounting for Revenue	**Material Weakness:** The implementation of the FASAB accounting principles resulted in significant accounting errors in recording revenue and equity under federal accounting standards.	**No longer considered a significant deficiency.** This issue has been moved to the Management Letter.

Appalachian Regional Commission
Balance Sheets
September 30, 2008 (Audited) and 2007 (Unaudited)

		Restated
	2008	**2007**
Assets		
Intragovernmental		
Fund balance with U.S. Treasury (*Note 1 & 2*)	$ 155,078,061	$ 156,202,406
Advances (*Note 1 & 3*)	11,850,630	15,585,780
Total intragovernmental	166,928,691	171,788,186
Cash in commercial institutions (*Note 1*)	87,820	94,838
Advances (*Note 1 & 3*)	30,868,453	30,992,116
Accounts receivable *(Note 1)*	-	46,076
Equipment, net (*Note 1 & 4*)	-	44,563
	$ 197,884,964	$ 202,965,779
Liabilities and Net Position		
Intragovernmental		
Accounts payable (*Note 1 & 5*)	$ 658,072	$ 638,302
Total intragovernmental	658,072	638,302
Accounts payable (*Note 1 & 5*)	3,620,067	5,732,595
Benefits due and payable (*Note 1, 5 & 6*)	2,374,812	2,986,099
Other	75,304	93,574
	6,070,183	8,812,268
Total liabilities	6,728,255	9,450,570
Unexpended appropriations	108,140,376	110,644,441
Cumulative results of operations-earmarked fund (*Note 8*)	(398,346)	(1,156,994)
Cumulative results of operations	83,414,679	84,027,762
Total net position	191,156,709	193,515,209
	$ 197,884,964	$ 202,965,779

The Notes to Financial Statements are an integral part of these statements.

Appalachian Regional Commission
Statements of Net Cost
Years Ended September 30, 2008 (Audited) and 2007 (Unaudited)

	2008	Restated 2007
Net cost of operations:		
Program costs	$ 74,981,260	$ 68,136,744
Less: earned revenues	4,636,738	3,924,645
Net cost of operations	$ 70,344,522	$ 64,212,099

The Notes to Financial Statements are an integral part of these statements.

Appalachian Regional Commission
Statement of Changes in Net Position
Year Ended September 30, 2008 (Audited)

	2008		
	Earmarked Fund	**All Other Funds**	**Consolidated Total**
Cumulative results of operations, beginning	$ (1,156,994)	$ 84,027,762	$ 82,870,768
Adjustments:			
Changes in accounting principles (*Note 1 & 11*)	-	-	-
Beginning balance, adjusted	(1,156,994)	84,027,762	82,870,768
Budgetary financing sources:			
Appropriations used	3,608,000	66,882,087	70,490,087
Transfers in/out without reimbursement	-	-	-
Total financing sources	3,608,000	66,882,087	70,490,087
Net cost of operations	(2,849,352)	(67,495,170)	(70,344,522)
Net change	758,648	(613,083)	145,565
Cumulative results of operations, ending	**$ (398,346)**	**$ 83,414,679**	**$ 83,016,333**
Unexpended appropriations, beginning	$ -	$ 110,644,441	$ 110,644,441
Adjustments:			
Changes in accounting principles (*Note 1 & 11*)	-	-	-
Beginning balance, adjusted	-	110,644,441	110,644,441
Budgetary financing sources:			
Appropriations received	3,608,000	69,424,000	73,032,000
Appropriations transferred in/out	-	-	-
Other adjustments	-	(5,045,978)	(5,045,978)
Appropriations used	(3,608,000)	(66,882,087)	(70,490,087)
Total budgetary financing sources	-	(2,504,065)	(2,504,065)
Total unexpended appropriations	-	108,140,376	108,140,376
Net position	**$ (398,346)**	**$ 191,555,055**	**$ 191,156,709**

The Notes to Financial Statements are an integral part of these statements.

Appalachian Regional Commission
Statement of Changes in Net Position
Year Ended September 30, 2007 (Unaudited)

	Restated 2007		
	Earmarked Fund	**All Other Funds**	**Consolidated Total**
Cumulative results of operations, beginning	$ (1,177,430)	$ 80,648,215	$ 79,470,785
Adjustments:			
Changes in accounting principles (*Note 1 & 11*)	-	(244,369)	(244,369)
Beginning balance, adjusted	(1,177,430)	80,403,846	79,226,416
Budgetary financing sources:			
Appropriations used	3,478,000	64,378,451	67,856,451
Transfers in/out without reimbursement	-	-	-
Total financing sources	3,478,000	64,378,451	67,856,451
Net cost of operations	(3,457,564)	(60,754,535)	(64,212,099)
Net change	20,436	3,623,916	3,644,352
Cumulative results of operations, ending	**$ (1,156,994)**	**$ 84,027,762**	**$ 82,870,768**
Unexpended appropriations, beginning	$ -	$ 7,315,477	$ 7,315,477
Adjustments:			
Changes in accounting principles (*Note 1 & 11*)	-	106,321,927	106,321,927
Beginning balance, adjusted	-	113,637,404	113,637,404
Budgetary financing sources:			
Appropriations received	3,478,000	61,380,559	64,858,559
Appropriations transferred in/out	-	4,929	4,929
Other Adjustments	-	-	-
Appropriations used	(3,478,000)	(64,378,451)	(67,856,451)
Total budgetary financing sources	-	(2,992,963)	(2,992,963)
Total unexpended appropriations	-	110,644,441	110,644,441
Net position	**$ (1,156,994)**	**$ 194,672,203**	**$ 193,515,209**

The Notes to Financial Statements are an integral part of these statements.

Appalachian Regional Commission
Statements of Budgetary Resources
Years Ended September 30, 2008 (Audited) and 2007 (Unaudited)

	2008	Restated 2007
Budgetary Resources		
Unobligated balance brought forward October 1	$ 24,875,320	$ 19,451,138
Recoveries of prior year unpaid obligations	8,083,423	14,644,027
Budget authority		
Appropriation	80,248,000	72,174,971
Spending authority from offsetting collections		
Earned		
Collected	1,767,181	2,446,062
Nonexpenditure transfers, net, actual	-	4,929
Total budgetary resources	114,973,924	108,721,127
Status of Budgetary Resources		
Obligations incurred	86,176,980	83,835,618
Unobligated balance available	25,496,404	23,474,476
Unobligated balance not available	3,300,540	1,411,033
Total status of budgetary resources	114,973,924	108,721,127
Change in Obligated Balance		
Unpaid obligated balance, net brought forward October 1	131,317,085	144,098,073
Obligations incurred, net	86,176,980	83,835,618
Less: Gross outlays	(83,175,715)	(81,926,833)
Less: Recoveries of prior year unpaid obligations, actual	(8,083,422)	(14,644,027)
Less: Uncollected customer payments from federal sources	46,189	(45,934)
Unpaid obligated balance, net end of period	126,281,117	131,316,897
Net Outlays		
Gross outlays	83,175,460	81,926,834
Less: offsetting collections	(1,813,371)	(2,002,957)
Plus: offsetting receipts	(4,720,177)	(3,924,645)
Net outlays	$ 76,641,912	$ 75,999,232

The Notes to Financial Statements are an integral part of these statements.

1 Summary of Significant Accounting Policies

Reporting entity
The ARC was established under the Appalachian Regional Development Act of 1965, as amended; the Appalachian Regional Development Reform Act of 1998; and the Appalachian Regional Development Act Amendments of 2002. ARC is a regional development agency designed to function as a federal, state, and local partnership. ARC is not a federal executive branch agency (as defined in Title 5 and 31 of the United States Code and by the Department of Justice).

Commission members are comprised of a federal member (Federal Co-Chair), who is appointed by the President, and the governors of each of the thirteen states in the Appalachian Region. The state members elect a State Co-Chair from their members. There is an Executive Director and Program and Administrative Offices that implement the policies and procedures established by the Federal and State Co-Chairs. ARC personnel are comprised of both federal and non-federal employees.

ARC supports economic and social development in the Appalachian Region. The Appalachian Region is a 200,000 square mile region from the Appalachian Mountains in Southern New York to Northern Mississippi. The ARC programs affect approximately 410 counties located in thirteen states including all of West Virginia and parts of Alabama, Georgia, Kentucky, Maryland, Mississippi, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, and Virginia.

Fund accounting structure
ARC's financial activities are accounted for by utilizing individual funds and fund accounts in reporting to the U.S. Treasury and the Office of Management and Budget. For financial statement purposes, these funds are classified as an earmarked fund and all other funds. Earmarked funds are financed by specifically identified revenues often supplemented by other financing sources which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits, or purposes and must be accounted for separately from the Government's general revenues. ARC's earmarked fund and all other funds are identified as follows:

- <u>Earmarked fund</u>
  A trust fund was established by the U.S. Treasury under the authority of the Appalachian Regional Development Act of 1965, to receive, hold, invest, and disburse monies collected to cover the administrative expenses of ARC. The administrative expenses are paid equally by the federal government and the states in the Appalachian Region as determined annually by ARC.

- <u>All other funds</u>
  All other funds consist of area development program funds and funding for the Office of the Federal Co-Chair and the Office of Inspector General.

Budgets and budgetary accounting
ARC programs and activities are funded through no-year appropriations and contributions from the thirteen states in the Appalachian Region. Federal funds are available without fiscal year limitation and remain available until expended. Because of the no-year status of the funds, unobligated amounts are not returned to the U.S. Treasury.

Basis of accounting and presentation
These financial statements present the financial position, net cost of operations, changes in net position, and budgetary resources of ARC in accordance with U.S. generally accepted accounting principles (GAAP) and form and content requirements of OMB Circular A-136 *Financial Reporting Requirements*. GAAP for federal entities are the standards prescribed by the Federal Accounting Standards Advisory

Board (FASAB), which is the official standard-setting body for the federal government. The financial statements have been prepared from the books and records of ARC, and include the accounts of all funds under the control of the ARC reporting entity.

U.S. generally accepted accounting principles encompass both accrual and budgetary transactions. Under accrual accounting, revenues are recognized when earned, and expenses are recognized when incurred. Budgetary accounting facilitates compliance with legal constraints on, and controls over, the use of federal funds. These financial statements are prepared by ARC pursuant to OMB directives and used to monitor ARC's use of budgetary resources.

Fund Balance with U.S. Treasury
ARC's cash receipts and disbursements are processed by the U.S. Treasury. Funds with U.S. Treasury represent obligated and unobligated no-year funds available to finance allowable current and future expenditures.

Cash in Commercial Institutions
ARC uses commercial bank accounts to accommodate collections and payments that cannot be processed by the U.S. Treasury.

Advances
ARC advances funds to other federal agencies for work performed on its behalf under various reimbursable agreements. These intragovernmental advances are recorded as an asset, which is reduced when actual expenditures or the accrual of unreported expenditures are recorded.

ARC also has advances made to grantees for revolving loan fund payments to provide pools of funds to be made available to grantees to create and retain jobs. These advance payments are recorded by ARC as an asset, which is reduced if the revolving fund is terminated.

Accounts Receivable
Accounts receivable represents dedicated collections owed to ARC by the Office of the States' Representative for the administrative costs of ARC.

Equipment
ARC's equipment is recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The capitalization threshold is $50,000.

Liabilities
Liabilities represent probable amounts to be paid by ARC as a result of past transactions. Liabilities covered by budgetary or other resources are those for which Congress has appropriated funds or funding is otherwise available to pay amounts due.

Liabilities not covered by budgetary or other resources represent amounts owed in excess of available Congressionally appropriated funds or other amounts. The liquidation of liabilities not covered by budgetary or other resources is dependent on future Congressional appropriations or other funding.

Accounts Payable
Accounts payable consists of amounts owed to grantees and amounts owed to federal and non-federal entities for goods and services received by ARC.

Accrued Benefits
Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued leave account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Benefits
ARC's federal and certain non-federal employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). FERS was established by the enactment of Public Law 99-335. Pursuant to this law, FERS and the Social Security and the Thrift Savings Plan program automatically cover most employees hired after December 31, 1983. Employees hired before January 1, 1984 elected to participate in the FERS and Social Security or to remain in CSRS.

All federal and certain non-federal employees are eligible to contribute to the Thrift Savings Plan (TSP). For those employees participating in the FERS, a TSP account is automatically established and ARC makes a mandatory one percent contribution to this account. In addition, ARC makes matching contributions, ranging from one to four percent, for FERS eligible employees who contribute to their TSP accounts. Matching contributions are not made to the TSP accounts established by CSRS employees. FERS employees and certain CSRS reinstatement employees are eligible to participate in the Social Security program after retirement. In these instances, ARC remits the employer's share of the required contribution.

The Office of Personnel Management (OPM) actuaries determine pension cost factors by calculating the value of pension benefits expected to be paid in the future and communicate these factors to ARC. OPM also provides information regarding the full cost of health and life insurance benefits. ARC does not recognize the imputed cost of pension and other retirement benefits during the employees' active years of service as this amount is considered to be immaterial. Reporting amounts such as plan assets, accumulated plan benefits, and related unfunded liabilities, if any, is the responsibility of OPM.

ARC also has a Defined Benefit Pension Plan which was open to all employees not participating in CSRS and FERS. ARC uses a July 1 measurement date for its plan.

In February 2000 ARC established a 401(k) retirement plan that mirrors FERS. The plan covers substantially all non-federal employees. Employees are eligible to participate in and are fully vested in the plan upon employment. ARC's funding policy is to make a 3% contribution of total salary and a matching 3% of the first 50% of the participants' contributions to the plan up to 6% of total salary.

Parent Child Reporting
ARC is a party to allocation transfers with other federal agencies as both a transferring (parent) entity and receiving (child) entity. Allocation transfers are legal delegations by one department of its authority to obligate budget authority and outlay funds to another department. A separate fund account (allocation account) is created in the U.S. Treasury as a subset of the parent fund account for tracking and reporting purposes. All allocation transfers of balances are credited to this account, and subsequent obligations and outlays incurred by the child entity are charged to this allocation account as they execute the delegated activity on behalf of the parent entity. Generally, all financial activity related to these allocation transfers (e.g., budget authority, obligations, outlays) is reported in the financial statements of the parent entity, from which the underlying legislative authority, appropriations and budget apportionments are derived. ARC allocates funds as the parent agency to the U.S. Departments of Transportation, Education, Health and Human Services, and Housing and Urban Development, as well as the Rural Development Agency, U.S. Army Corps of Engineers and the Economic Development Agency.

Additionally, ARC receives allocation transfers, as the child agency from the U.S. Department of Treasury to cover Appalachian Development Highway System administrative costs.

Net Position
Net position is the residual difference between assets and liabilities and is comprised of unexpended appropriations and cumulative results of operations. Unexpended appropriations represent the amount of unobligated and unexpended budget authority. Unobligated balances are the amount of appropriations or other authority remaining after deducting the cumulative obligations from the amount available for obligation. The cumulative results of operations are the net results of ARC's operations since inception.

Net Cost of Operations
Earned revenues arise from the collection of state contributions and are deducted from the full cost of ARC's major programs to arrive at net program cost. Earned revenues are recognized by ARC to the extent reimbursements are payable from the public, as a result of costs incurred or services performed on the public's behalf.

Budgetary Financing Sources
Budgetary financing sources other than earned revenues provide funding for ARC's net cost of operations and are reported on the Statement of Changes in Net Position. These financing sources include amounts received from Congressional appropriations to support its operations. A financing source is recognized for these appropriated funds received.

Use of Estimates
Management has made certain estimates when reporting assets, liabilities, revenue, and expenses, and in the note disclosures. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Tax Exempt Status
As an agency of the federal government, ARC is exempt from all taxes imposed by any governing body whether it is a federal, state, commonwealth, local, or foreign government.

2. Fund Balance with Treasury

Funds with U.S. Treasury at September 30 consisted of the following:

	2008	2007
Fund balances		
Trust fund	$ 1,923,267	$ 1,678,084
Appropriated funds	153,154,794	154,524,322
Total fund balance	$ 155,078,061	$ 156,202,406
Status of fund balance with Treasury		
Unobligated balance:		
Available	$ 25,496,437	$ 23,474,476
Unavailable	3,300,540	1,411,033
Obligated balance not yet disbursed	126,281,084	131,316,897
Total	$ 155,078,061	$ 156,202,406

3. Advances

Advances at September 30 consist of the following:

		2008		2007
Advances to the U.S. Army Corps of Engineers	$	1,652,257	$	2,327,000
Advances to the Tennessee Valley Authority		10,198,373		8,213,342
Advances to the Department of Health and Human Services				5,045,438
		11,850,630		15,585,780
Other				
Advances to grantees to finance future program expenditures		30,868,453		30,992,116
Total	$	42,719,083	$	46,577,896

4. Equipment, Net

Equipment balances as of September 30 were as follows:

		2008		2007
Equipment	$	117,616	$	162,179
Less: accumulated depreciation		(117,616)		(117,616)
Total	$	-	$	44,463

The loss on disposal for the years ended September 30, 2008 and 2007 was $44,463 and $0, respectively.

5. Liabilities

The accrued liabilities of ARC are comprised of program expense accruals, payroll accruals and unfunded annual leave earned by employees. Program expense accruals represent expenses that were incurred prior to year-end but were not paid. Similarly, payroll accruals represent payroll expenses that were incurred prior to year-end but were not paid.

Liabilities at September 30 consist of the following:

		2008		2007
Advances from the Centers for Disease Control	$	596,729	$	575,979
Advances from the National Endowment for the Arts		62,323		62,323
Total intragovernmental		659,052		638,302
Benefits due				
Accrued health & flexible spending benefits		65,977		59,958
Accrued salaries and benefits		243,385		229,094
Unfunded annual leave		467,544		370,046
Unfunded pension liability		1,576,063		2,327,001
Total benefits due		2,352,969		2,986,099
Payments due to grantees to finance program expenditures		3,620,067		5,732,595
Other agency transactions		96,167		93,574
Total liabilities	$	6,728,255	$	9,450,570

Liabilities not covered by budgetary resources consist of the following:

	2008	2007
Unfunded annual leave	$ 467,544	$ 370,046
Unfunded pension liability	1,576,063	2,327,001
Total liabilities	$ 2,043,607	$ 2,697,047

6. Retirement Plans

Federal

ARC participates in the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS) for federal and certain non-federal employees. The CSRS and FERS plans are administered by the OPM. Contributions to these plans for FY 2008 were $39,056 and $83,534 for CSRS and FERS, respectively and contributions for FY 2007 were $37,696 and $76,781 for CSRS and FERS, respectively.

Several employees also participate in the Federal Employees Health Benefit plan (FEHB) and the Federal Employees Group Life Insurance program (FEGLI), also administered by OPM. ARC pays a portion of the cost of current employees. Post-retirement benefits are paid by OPM. No amounts have been recognized in the financial statements for these imputed costs as they are not deemed material. Contributions to these plans for FY 2008 were $69,638 and $2,099 and for FY 2007 were $55,579 and $2,016 for FEHB and FEGLI, respectively

ARC does not report in its financial statements CSRS, FERS, FEHB or FEGLI assets, accumulated plan benefits or unfunded liabilities, if any, applicable to its employees.

ARC also contributed $33,977 and $32,481 to the Federal Thrift Savings plan for all eligible employees for the years ended September 30, 2008 and 2007, respectively.

Non-Federal

The following table presents the pension benefit expense for the defined benefit pension plan by component for fiscal years 2008 and 2007:

	2008	2007
Service cost	$ 553,305	$ 501,109
Interest cost	664,839	607,793
Expected return	(421,202)	(313,447)
Amortization of prior service cost	418,870	418,870
Recognized loss	37,909	122,847
Net periodic benefit expense	$ 1,253,721	$ 1,337,172

The following table presents the pension liability by component for fiscal years 2008 and 2007:

	2008	2007
Pension liability at October 1	$ 2,327,001	$ 1,934,715
Net periodic benefit expense	1,253,721	1,337,172
Contributions	(2,004,659)	(944,886)
Pension liability at September 30	$ 1,576,063	$ 2,327,001

Additional Information		2008		2007
Benefit obligation	$	(10,682,357)	$	(9,758,835)
Fair value of plan assets		5,797,033		4,809,598
Funded status	$	(4,885,324)	$	(4,949,237)
Employer contribution	$	1,985,638	$	944,886
Participant contribution		19,021		17,220
Benefits paid		4,488		1,126,098
Net periodic benefit expense		1,253,721		1,337,172

The accumulated benefit obligation was $9,460,083 and $8,468,670 at September 30, 2008 and 2007, respectively.

Weighted-average of economic assumptions used to determine benefit obligations at September 30:

	2008	2007
Discount rate	7.00%	6.25%
Rate of compensation increase	3.00%	3.00%

Weighted-average of economic assumptions used to determine net periodic benefit cost for the years ended September 30:

	2008	2007
Discount rate	6.25%	5.75%
Expected return on plan assets	7.25%	7.25%
Rate of compensation increase	3.00%	3.00%

Historical returns of multiple asset classes were analyzed to develop a risk-free real rate of return and risk premiums for each asset class. The overall rate for each asset class was developed by combining a long-term inflation component, the risk-free real rate of return, and the associated risk premium. A weighted-average rate was developed based on those overall rates and the target asset allocation plan.

Plan Assets

Pension plan weighted-average asset allocations at September 30 are as follows:

Asset Category	2008	2007
Cash	10.00%	10.00%
Bonds	31.00%	31.00%
U.S. Stocks	40.00%	40.00%
International Stocks	14.00%	14.00%
Real estate	5.00%	5.00%
Total assets	100.00%	100.00%

ARC's investment strategy is a long-term, risk-controlled approach using diversified investment options with a minimal exposure to volatile investment options like derivatives. ARC expects to contribute $1,200,000 to the plan in FY 2009.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

Fiscal Year	Pension Benefits
2009	$ 4,003,873
2010	1,260,865
2011	548,019
2012	1,771,515
2013	18,792
Years 2014 – 2018	6,169,405

ARC contributed $181,753 and $164,924 to the 401(k) plan for the years ended September 30, 2008 and 2007, respectively.

7. Operating Lease

ARC's lease for its office commenced on January 1, 2007 and extends through December 31, 2016. It provides for increases in annual base rent of 2 percent per year beginning January 1, 2008, and every year thereafter for the remainder of the lease term. The future minimum lease payments required under this lease are as follows:

Fiscal Year		Amount
2009	$	754,957
2010		770,056
2011		785,458
2012		823,509
2013		847,426
Thereafter		2,871,265
Total	$	6,852,671

Rent expense for the years ended September 30, 2008 and 2007 was $707,726 and $705,414, respectively.

8. Earmarked Fund

Condensed financial information for the ARC trust fund for the years ended September 30 is:

		2008		2007
Assets				
Fund balance with U.S. Treasury	$	1,923,267	$	1,678,084
Cash in commercial institutions		87,820		94,838
Accounts receivable		-		46,076
Total assets		2,011,087		1,818,998
Liabilities and Net Position				
Accounts payable		217,477		176,216
Benefits due and payable		2,191,956		2,799,776
Cumulative results of operations-earmarked funds		(398,346)		(1,156,994)
Total liabilities and net position	$	2,011,087	$	1,818,998

STATEMENT OF NET COST				
Program costs		6,785,916	$	7,318,539
Less: earned revenues		3,936,564		3,860,975
Net cost of operations	$	2,849,352	$	3,457,564
STATEMENT OF CHANGES IN NET POSITION				
Cumulative results of operations, beginning	$	(1,156,994)	$	(1,177,430)
Budgetary financing sources:				
Appropriations used		3,608,000		3,478,000
Net cost of operations		(2,849,352)		(3,457,564)
Net change		758,648		20,436
Cumulative results of operations, ending	$	(398,346)	$	(1,156,994)
Unexpended appropriations, beginning				
Budgetary financing sources:				
Appropriations received	$	3,608,000	$	3,478,000
Appropriations used		(3,608,000)		(3,478,000)
Total budgetary financing sources		-		-
Total unexpended appropriations		-		-
Net position	$	(398,346)	$	(1,156,994)

9. Status of Budgetary Resources

A. Apportionment Categories of Obligations Incurred

Obligations incurred reported on the Statement of Budgetary Resources consist of the following:

		2008		2007
Direct obligations				
Category A	$	5,237,449	$	14,111,260
Category B		73,709,286		57,969,341
Exempt		7,230,245		11,755,017
Total direct obligations	$	86,176,980	$	83,835,618

B. Permanent Indefinite Appropriations

The Commission's permanent indefinite appropriations include the trust fund. These funds are described in Note 8.

C. Explanation of Differences between the Statement of Budgetary Resources and the Budget of the U.S. Government

Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, calls for explanations of material differences between amounts reported in the Statement of Budgetary Resources (SBR) and the actual balances published in the Budget of the U.S. Government (President's Budget). The Budget of the U. S. Government, with the Actual column completed for 2007 and 2006, was reconciled to the Statement of Budgetary resources as follows:

2007

(Dollars in Millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Statement of Budgetary Resources	$ 109	$ 84	$ 2	$ 80
No Reconciling Items				
Budget of the U.S. Government	$ 109	$ 84	$ 2	$ 80

2006

(Dollars in Millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Statement of Budgetary Resources	$ 98	$ 79	$ 1	$ 78
Reconciling Items:				
Recoveries of prior year obligations	(2)			
Budget of the U.S. Government	$ 96	$ 79	$ 1	$ 78

10. Undelivered Orders at the End of the Period

The amount of budgetary resources obligated for undelivered orders are $122,343,662 and $125,970,613 as of September 30, 2008 and 2007, respectively.

11. Restatements

In FY 2007 ARC received a disclaimer of opinion on its financial statements due in part to the inability of ARC to fully implement the new Parent/Child requirements. During the FY 2008 audit, ARC was made aware of a material error affecting its FY 2007 financial statements related to the improper recording of child agency financial activity by two of ARC's child agencies. Specifically, Unexpended Appropriations and the Cumulative Results of Operations were reported incorrectly because ARC funding was not properly recorded in the Appropriations Used account.

The total amount of the error to the Cumulative Results of Operations was $8,938,471 on the balance sheet and statement of changes in net position causing the Change in Accounting Principles line item to be adjusted from $3,403,821 to $244,369 and the Appropriations Used line to be adjusted from $58,599,432 to $64,378,451 on the statement of changes in net position. In addition, the total error to the total Unexpended Appropriations was $8,938,471 on the balance sheet and statement of changes in net position causing the Change in Accounting Principles line item to be adjusted from $109,481,379 to $101,275,949 and the Appropriations Used line to be adjusted from $58,599,432 to $64,378,451. These changes had no effect on the net position of ARC as of September 30, 2007.

The FY 2007 statements *were not audited*, but rather ARC received a disclaimer of opinion on the FY 2007 financial statements by ARC's independent public accountants (IPA). This restatement does not affect the disclaimer of opinion issued by the IPA.

Because ARC did not issue audited financial statements in FY 2007 and the financial statements could not be relied upon by outside parties, ARC did not implement the communication requirements in OMB Circular A-136 which relate to audited financial statements with concurrence by OMB. ARC has determined that correcting the error with the next issuance of financial statements is the appropriate treatment since the issuance of subsequent period audited financial statements was imminent.

12. Reconciliation of Net Cost to Budget

	2008	2007
Resources Used to Finance Activities:		
Budgetary resources obligated		
Obligations incurred	$ 86,176,947	$ 83,835,618
Less: spending authority from offsetting collections and recoveries	9,850,604	17,090,089
Obligations net of offsetting collections and recoveries	76,326,343	66,745,529
Less: offsetting receipts	4,636,738	3,924,645
Obligations net of offsetting collections and recoveries	71,689,605	62,820,884
Net obligations	71,689,605	62,820,884
Total resources used to finance activities	71,689,605	62,820,884
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered by not yet provided	38,445,601	(17,275,474)
Resources that fund expenses recognized in prior periods	(750,938)	(14,799)
Total resources used to finance items not part of the net cost of operations	37,694,663	(17,290,273)
Total resources used to finance the net cost of operations	33,994,942	80,111,157
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components requiring or generating resources in future periods		
Increase in annual leave liability	(97,498)	-
Increase in exchange revenue recievable from the public	-	41,856
Other	(684)	(392,286)
Total components of net cost of operations that will require or generate resources in future periods	(98,182)	(350,430)
Components requiring or generating resources:		
Depreciation	44,563	-
Reconciling Items:		
4902 adjustments	41,408,796	-
4902 trust fund eliminating entry	(3,608,000)	-
HHS budgetary adjustment	(105,908)	
Other	(1,291,689)	(15,548,628)
Net components of net cost of operations that will not require or generate resources in the current period	36,447,762	(15,548,628)
Net Cost of Operations	$ 70,344,522	$ 64,212,099