WithumSmith+Brown
A Professional Corporation
Certified Public Accountants and Consultants

APPALACHIAN REGIONAL COMMISSION

Financial Statements

September 30, 2007

With Independent Auditors' Report

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

In our audit of the Appalachian Regional Commission (ARC) for the fiscal year (FY) 2007 we found:

- the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the balance sheet of ARC as of September 30, 2007 and the related statements of net cost, changes in net position, and budgetary resources for the year then ended;
- material weaknesses in internal control over financial reporting and compliance with laws and regulations; and
- reportable noncompliance with laws and regulations tested.

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

Disclaimer of Opinion on Financial Statements

We were engaged to audit the balance sheet of ARC as of September 30, 2007 and the related statements of net cost, changes in net position, and budgetary resources for the year 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.

ARC was unable to fully implement the new FY 2007 Parent/Child Reporting requirements in compliance with OMB Circular A-136 due to the lack of timely, complete financial information received from the child agencies which diminished ARC's ability to verify the integrity of the data or gain an understanding of the internal controls in place at the child agencies related to these allocated funds. ARC transferred (allocated) budget authority to seven child agencies in FY 2007. The reporting associated with these transfers in ARC's financial statements resulted in an eighty-eight percent increase in ARC's net cost of operations from FY 2006 to FY 2007. As a result of these challenges, management could not provide written representations concerning the fair presentation of the child agency financial information or represent to implementing adequate controls to ensure these amounts are fairly presented in all material respects.

In addition, ARC was unable to successfully perform a reconciliation of its proprietary accounting activity as reflected in the Statement of Net Cost with the budgetary activity as reported in the Statement of Budgetary Resources. The reconciliation is designed to show the relationship between ARC's use of budgetary resources with its cost of program operations. Had ARC been able to perform the reconciliation, other adjustments may have been required to ensure that ARC financial information is complete and recorded correctly.

As a result of these limitations, we were unable to obtain sufficient evidential support for the amounts presented in the balance sheet as of September 30, 2007 and the related statements of net cost, changes in net position, and budgetary resources.

Because of the matters discussed in the preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to in the paragraph above.

As a state-federal partnership, ARC prepared their financial statements in the prior fiscal year in accordance with the standards issued by the Financial Accounting Standards Board. In FY 2007 ARC changed its financial statement presentation to comply with standards issued by the Federal Accounting Standards Advisory Board and OMB Circular A-136, *Financial Reporting Requirements* in order to more easily incorporate all the child agency data now required to be included in its financial statements.

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.

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, which we were ultimately not able to do, and 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. However, we consider the deficiencies Nos. 1 – 4, described in Exhibit I, to be material weaknesses.

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 two instances of noncompliance, Nos. 2 and 5 described in Exhibit I, that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04.

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.

WithumSmith+Brown, PC

June 24, 2008

1. Lack of Full Implementation of Parent/Child Reporting Requirements

In FY 2007 a new requirement referred to as Parent/Child Reporting became effective under OMB Circular A-136. Each year ARC receives a Congressional appropriation to fund its programs in support of its mission. ARC (the "parent" agency) is authorized to allocate budget authority to another federal agency (the "child" agency) to assist ARC in performing its mission. The funds are transferred to an allocation account at the U.S. Treasury from which the child agency can obligate and expend the funding on a project by project basis. For FY 2006 and prior, the financial activity related to these allocated funds was reported in the financial statements of the child agencies. Under the new requirements, ARC is now required to report this financial activity in its financial statements and in its FACTS I submission to the U.S. Treasury.

In FY 2007 ARC transferred $29 million of its $65 million budget to seven child agencies:

- U.S. Department of Transportation,
- U.S. Department of Health and Human Services,
- U.S. Department of Housing and Urban Development,
- U.S. Department of Commerce, Economic Development Agency
- U.S. Department of Agriculture, Rural Development Agency
- U.S. Department of Education, and
- U.S. Army Corps of Engineers.

In order to maintain accountability for these funds and to properly record and report this information, ARC must obtain detailed financial data relating to these funds from the seven child agencies. ARC began planning and contacting the child agencies early in FY 2007 to arrange for the financial information to be submitted within twelve days after the end of each quarter, as required by OMB Circular A-136. Because it was the implementation year for these new requirements, and because these ARC funds represent such a small portion of each of the child agency's funding, the initial response from almost all of the agencies was to provide no financial data, partial data, or data that was not in a usable form. ARC requested OMB's assistance and finally received complete, usable financial information from most of the child agencies by late October 2007. However, ARC only received partial data from U.S. Department of Health and Human Services which was subsequently found to contain errors.

The time and effort required to get the child financial information diminished ARC's ability to verify the integrity of the data or gain an understanding of the internal controls in place at the child agencies related to these allocated funds. Because the ARC funding is so small relative to each child agency's total funding, ARC funding is less likely to be subject to internal or external reviews or audits, therefore ARC will have to do more on its own to verify the integrity of the data. Because of the timing issues and 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 which resulted in a disclaimer of opinion on ARC's FY 2007 financial statements.

Recommendation

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.

Management Response

Management will assign staff to contact its child agencies to obtain a written description of how each agency processes ARC's grant projects. ARC will review these descriptions and follow up with any agency where there are questions or incomplete information.

It is ARC's goal to eliminate its Parent/Child reporting requirements; instead ARC will control and obligate the funding and let agencies providing services draw funds via IPAC as needed. In the future ARC would obligate funding to projects with the agencies providing services.

Auditor Response

ARC's proposed action will adequately address this recommendation in FY 2008 if it provides management with sufficient assurance to enable them to make representations that the child agencies' financial information is fairly presented in ARC's financial statements.

2. Controls Over Compliance with Federal Reporting Requirements Not Fully Implemented

OMB Circular A-136 provides guidance on the form and content of agency Performance and Accountability Reports (PAR) which includes agency financial statements and disclosures. In FY 2007 due to the change in Parent/Child Reporting requirements, ARC management made the decision to adopt federal accounting and reporting standards to facilitate implementation of the new requirements. Because of the lack of sufficient understanding of these new requirements in this first year of implementation, ARC did not fully comply with the provisions of OMB Circular A-136 in preparing the Required Supplementary Stewardship Information (RSSI) and did not prepare the "Reconciliation of Net Cost of Operations to Budget" footnote disclosure to the financial statements.

The purpose of the RSSI is to report on stewardship investments including non-federal physical property, certain education and training programs, and federally-financed research and development. The substantial investment of resources in these areas is for the long-term benefit of the nation which cannot be measured in traditional financial reports. Minimum requirements under OMB Circular A-136 include reporting the full cost of the investments for the current year and the preceding four years, if the information is available. ARC did not have policies and procedures to facilitate the collection and reporting of this information to ensure full compliance with federal reporting requirements.

Prior to FY 2007, federal financial statements included a Statement of Financing which was designed to reconcile proprietary accounting activity as reflected in the Statement of Net Cost with budgetary activity as reported in the Statement of Budgetary Resources. Beginning in FY 2007 the Statement of Financing is no longer considered a Basic Statement, but the information is still required to be reported in a footnote disclosure to the financial statements. ARC accounting staff did not prepare the reconciliation due to time constraints, errors identified in child agency data, and other challenges in implementing federal reporting requirements. Due in part to this non-compliance, ARC received a disclaimer of opinion on its FY 2007 financial statements.

Recommendation

We recommend that the Executive Director ensure that ARC finance staff receive 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.

Management Response

Management agrees and will pursue training for appropriate finance staff in federal reporting requirements and begin developing policies and procedures to be in compliance with OMB Circular

A-136 requirements. ARC has set in place procedures to fully comply with the Required Supplementary Stewardship Information for its fiscal 2008 financial reporting.

Auditor Response

ARC's proposed corrective action concerning training will adequately address this recommendation. The implementation of ARC's corrective action related to development of its RSSI will be reviewed during the FY 2008 audit.

3. Weakness Noted over Accounting for Grant Advances

ARC currently has Memorandum of Agreements (MOAs) with the Tennessee Valley Authority (TVA) and the U.S. Army Corps of Engineers (USACE) to provide services on a project-by-project basis. Once individual projects are approved, disbursements of funds are processed through the Intra-Governmental Payment and Collection System (IPAC). The MOAs require that monthly status reports on the projects be submitted back to ARC (most are construction related).

The reports sent by TVA include a status of funds reporting the amounts received, the total expenditures to date, and any excess funds refunded to ARC. ARC recorded in the general ledger an expense at the time the funds were disbursed to TVA, rather than when the services were received (based on the TVA reporting of expenditures), resulting in an overstatement of expenses and an understatement of advances. We proposed an audit adjustment of $8 million based on our testing to accrue for the funds advanced to TVA but not yet spent as of September 30, 2007.

For financial reporting purposes, the USACE is both a child agency receiving allocation transfers from ARC and also a service provider with three MOAs under which additional projects are carried out. During our audit we found that $2.3 million advanced to USACE under the MOAs had been properly recorded as an advance in the general ledger, but no status reports had been received to provide a current status of funds to liquidate the advance. As a result, the advance balance is overstated by an undeterminable amount. The program manager indicated he has had great difficulty getting information from USACE as required under their agreements.

It appears the inconsistent accounting for these agreements is 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.

Recommendation

We recommend that the Director of Finance and Administration work with program and finance staff to develop written policies and procedures to ensure that contractual relationships between ARC and other entities are properly reviewed and set up in the general ledger. We also recommend that additional resources be applied to ensure USACE complies timely with MOA reporting requirements.

Management Response

Management will set up in the accounting system advance accounts for each child agency, plus TVA and USACE. In ARC.net, the grant management system, a separate data page will be inserted to track reported grant expenses from the child agencies. On a quarterly basis, the advance accounts will be adjusted.

Management will make its best effort to establish a liaison contact with USACE to obtain the reporting requirements under the MOA and to address future communication needs by requesting a single liaison contact be established with USACE.

Auditor Response

ARC's proposed action if implemented will adequately address this recommendation.

4. Weakness Noted over Accounting for Revenue

As explained in Note 1 to the financial statements, in FY 2007 ARC changed its financial reporting policies to follow federal accounting standards promulgated by the Federal Accounting Standards Advisory Board. The implementation of the new accounting principles resulted in significant accounting errors in recording revenue and equity under federal accounting standards. We proposed two adjustments to revenue totaling $40.1 million to properly state the Expended Appropriations account as of September 30, 2007. The first error was the result of not properly recording revenue at the same time expenditures of appropriated funds were recorded, resulting in an understatement of revenue by $33.3 million. The second error occurred because non-expenditure transfers out were improperly recorded as a reduction of revenue rather than to an appropriate equity account. Although the recording error for the non-expenditure transfers was identified and correctly entered in the fourth quarter of the fiscal year, the first three quarters' of activity were overlooked and not adjusted for the error. An additional adjustment for $6.8 million was required to properly state revenue as of September 30, 2007.

It appears that these errors were due to the impact of implementing in the same fiscal year both the federal financial reporting model under OMB Circular A-136 and the new Parent/Child Reporting requirements. The timing of when these changes took effect at ARC exposed a lack of knowledge of federal accounting principles and a lack of resources to adequately handle the challenges that arose from the implementation of Parent/Child reporting.

Recommendation

We recommend that the Director of Finance and Administration ensure that all accounting staff receive training in federal accounting principles and financial reporting and that sufficient resources are available to ensure the agency is compliant with all federal financial reporting requirements.

Management Response

Management agrees with this recommendation and will take steps to insure that the correct entries are entered according to the federal accounting standards and that training and/or assistance is obtained.

Auditor Response

ARC's proposed action if implemented will adequately address this recommendation.

5. Noncompliance with Federal Information Security Management Act (FISMA)

A report issued by ARC's Office of Inspector General identified significant noncompliance with FISMA requirements. ARC is in the process of building a systems security program to protect the integrity of its data and systems. Risks to mission-critical data will remain until this program is fully developed, documented, and implemented.

We are reporting this deficiency as required by the guidance issued by OMB. However, because this deficiency was addressed in a prior OIG audit report, we are not making any recommendations in this report.

Appalachian Regional Commission
Balance Sheet
September 30, 2007

		2007
ASSETS		
Intragovernmental		
Fund balance with U.S. Treasury (*Note 1 & 2*)	$	156,202,406
Advances (*Note 1 & 3*)		15,585,780
Total intragovernmental		171,788,186
Cash in commercial institutions (*Note 1*)		94,838
Advances (*Note 1 & 3*)		30,992,116
Accounts receivable		46,076
Equipment, net (*Note 1 & 4*)		44,563
	$	**202,965,779**
LIABILITIES AND NET POSITION		
Intragovernmental		
Accounts payable (*Note 1 & 5*)	$	638,302
Total intragovernmental		638,302
Accounts payable (*Note 1 & 5*)		5,732,595
Benefits due and payable (*Note 1, 5 & 6*)		2,986,099
Other		93,574
		8,812,268
Total liabilities		9,450,570
Unexpended appropriations		119,582,912
Cumulative results of operations-earmarked fund (*Note 9*)		(1,156,994)
Cumulative results of operations		75,089,291
Total net position		193,515,209
	$	**202,965,779**

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

Appalachian Regional Commission
Statement of Net Cost
Year Ended September 30, 2007

		2007
Net cost of operations:		
Program costs	$	68,136,744
Less: earned revenues		3,924,645
Net cost of operations	**$**	**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, 2007

	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*)		(3,403,821)	(3,403,821)
Beginning balance, adjusted	(1,177,430)	77,244,394	76,066,964
Budgetary financing sources:			
Appropriations used	3,478,000	58,599,432	62,077,432
Transfers in/out without reimbursement	-	-	-
Total financing sources	3,478,000	58,599,432	62,077,432
Net cost of operations	(3,457,564)	(60,754,535)	(64,212,099)
Net change	20,436	(2,155,103)	(2,134,667)
Cumulative results of operations, ending	**$ (1,156,994)**	**$ 75,089,291**	**$ 73,932,297**
Unexpended appropriations, beginning	$ -	$ 7,315,477	$ 7,315,477
Adjustments:			
Changes in accounting principles (*Note 1*)		109,481,379	109,481,379
Beginning balance, adjusted	-	116,796,856	116,796,856
Budgetary financing sources:			
Appropriations received	3,478,000	61,380,559	64,858,559
Appropriations transferred in/out		4,929	4,929
Appropriations used	(3,478,000)	(58,599,432)	(62,077,432)
Total budgetary financing sources	-	2,786,056	2,786,056
Total unexpended appropriations	-	119,582,912	119,582,912
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
Statement of Budgetary Resources
Year Ended September 30, 2007

		2007
Budgetary Resources		
Unobligated balance brought forward October 1	$	19,451,138
Recoveries of prior year unpaid obligations		14,644,027
Budget authority		
Appropriation		72,174,971
Spending authority from offsetting collections		
Earned		
Collected		2,446,062
Nonexpenditure transfers, net, actual		4,929
Total budgetary resources		108,721,127
Status of Budgetary Resources		
Obligations incurred		83,835,618
Unobligated balance available		23,474,476
Unobligated balance not available		1,411,033
Total status of budgetary resources		108,721,127
Change in Obligated Balance		
Unpaid obligated balance, net brought forward October 1		144,098,073
Obligations incurred, net		83,835,618
Less: Gross outlays		(81,926,834)
Less: Recoveries of prior year unpaid obligations, actual		(14,644,027)
Less: Uncollected customer payments from federal sources		(45,934)
Unpaid obligated balance, net end of period		131,316,896
Net Outlays		
Gross outlays		81,926,834
Less: offsetting collections		(2,002,957)
Net outlays	$	79,923,877

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

1 Summary of Significant Accounting Policies

Reporting entity

The Appalachian Regional Commission ("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 U.S. Treasury and the Office of Management and Budget. For financial statement purposes, these funds are classified as earmarked funds 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:

- Earmarked fund

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.

- All other funds

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. ARC made the decision to change its basis of presentation in FY 2007 to facilitate implementation of the new Parent/Child Reporting requirements.

FY 2006 ARC's financial statements were prepared in accordance with accounting principles promulgated by the Financial Accounting Standards Board. Budgetary information, not a required part of the basic financial statements, was presented in supplemental information not subjected to the auditing procedures applied in the audits of the basic financial statements. As a result, the financial statements for FY 2006 have not been restated to conform with OMB Circular A-136 guidance.

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 their 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 Social Security program automatically cover most employees hired after December 31, 1983. Employees hired before January 1, 1984 elected to participate in either 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 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 ARCs net cost of operations and are reported on the Statement of Changes in Net Position. These financing sources include appropriations 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.

2. Fund Balance with Treasury

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

		2007
Fund balances		
Trust fund	$	1,678,084
Appropriated funds		154,524,322
Total fund balance	$	156,202,406
Status of fund balance with Treasury		
Unobligated balance:		
Available	$	23,474,476
Unavailable		1,411,033
Obligated balance not yet disbursed		131,316,897
Total	$	156,202,406

3. Advances

Advances at September 30, 2007 consist of the following:

		2007
Intragovernmental		
Advances to the U.S. Army Corps of Engineers	$	2,327,000
Advances to the Tennessee Valley Authority		8,213,342
Advances to the Department of Health and Human Services		5,045,438
		15,585,780
Other		
Advances to grantees to finance future program expenditures		30,992,116
Total	$	46,577,896

4. Equipment, Net

Equipment balances as of September 30, 2007 were as follows:

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

5. Liabilities

The accrued liabilities for 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:

		2007
Intragovernmental		
Advances from the Centers for Disease Control	$	575,979
Advances from the National Endowment for the Arts		62,323
Total intragovernmental		638,302
Benefits due		
Accrued health & flexible spending benefits		59,958
Accrued salaries and benefits		229,094
Unfunded annual leave		370,046
Unfunded pension liability		2,327,001
Total benefits due		2,986,099
Payments due to grantees to finance program expenditures		5,732,595
Other agency transactions		93,574
Total liabilities	$	9,450,570

Liabilities not covered by budgetary resources consist of the following:

		2007
Unfunded annual leave	$	370,046
Unfunded pension liability		2,327,001
Total liabilities	$	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 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 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 2007 were $55,579 and $2,016 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 $32,481 to the Federal Thrift Savings plan for all eligible employees for the years ended September 30, 2007.

Non-Federal

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

		2007
Service cost	$	501,109
Interest cost		607,793
Expected return		(313,447)
Amortization of prior service cost		418,870
Recognized loss		122,847
Net periodic benefit expense	$	1,337,172

The following table presents the pension liability by component for fiscal year 2007:

		2007
Pension liability at October 1, 2006	$	1,934,715
Net periodic benefit expense		1,337,172
Contributions		(944,886)
Pension liability at September 30, 2007	$	2,327,001

Additional Information

		2007
Benefit obligation	$	(9,758,835)
Fair value of plan assets		4,809,598
Funded status	$	(4,949,237)

		2007
Employer contribution	$	944,886
Participant contribution		17,220
Benefits paid		1,126,098
Net periodic benefit expense		1,337,172

The accumulated benefit obligation was $8,468,670 at September 30, 2007.

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

	2007
Discount rate	6.25%
Rate of compensation increase	3.00%

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

	2007
Discount rate	5.75%
Expected return on plan assets	7.25%
Rate of compensation increase	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, 2007 are as follows:

Asset Category	2007
Equity securities	34.00%
Debt securities	61.00%
Real estate	5.00%
Total assets	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 $1,585,000 to the plan in FY2008.

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

		Pension Benefits
2008	$	2,723,150
2009		1,399,207
2010		1,221,183
2011		553,871
2012		1,769,757
Years 2013 – 2017		5,291,232

ARC contributed $164,924 to the 401(k) plan for the year ended September 30, 2007.

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 August 1, 2003, 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
2008	$	740,154
2009		754,957
2010		770,056
2011		785,458
2012		823,509
Thereafter		3,718,691
Total	$	7,592,825

Rent expense for the year ended September 20, 2007 was $705,414.

8. Earmarked Fund

Condensed financial information for the ARC Trust Fund for the year ended September 30, 2007 is:

BALANCE SHEET		2007
ASSETS		
Fund balance with U.S. Treasury	$	1,678,084
Cash in commercial institutions		94,838
Accounts receivable		46,076
Total assets		1,818,998
LIABILITIES AND NET POSITION		
Accounts payable		176,216
Benefits due and payable		2,799,776
Cumulative results of operations-earmarked funds		(1,156,994)
Total liabilities and net position	$	1,818,998

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

9. Status of Budgetary Resources

A. Apportionment Categories of Obligations Incurred

Obligations incurred reported on the Statement of Budgetary Resources in 2007 consisted of the following:

		2007
Direct obligations		
Category A	$	14,111,260
Category B		57,969,341
Reimbursable obligations		11,755,017
Total direct obligations	$	83,835,618

B. Permanent Indefinite Appropriations

The Commission's permanent indefinite appropriations include the trust fund. These funds are described in Note 9.

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 United States Government (President's Budget). The Budget of the United States Government, with the Actual column completed for 2006, was reconciled to the Statement of Budgetary resources below.

(Dollars in Millions)	2006 Budgetary Resources	2006 Obligations Incurred	2006 Distributed Offsetting Receipts	2006 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 is $125,970,613 as of September 30, 2007.