



November 9, 2004

Memorandum for The Federal Co-Chair
 ARC Executive Director

Subject: OIG report 05-05
 FY 2004 Financial Statement Audit
 and Accompanying Documents

The enclosed report presents the results of the audits of the Commission's financial statements for the fiscal years ended September 30, 2004 and 2003. 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 contracted with the independent certified public accounting firm of M.D. Oppenheim & Company, P.C. to audit the financial statements of the Commission as of and for the years ended September 30, 2004 and 2003. In its audit, M.D. Oppenheim & Company, P.C. found the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles.

The Accountability of Tax Dollars Act of 2002 requires ARC to prepare and submit audited financial statements and to consolidate the audited financial statements and other financial and performance reports into a combined Performance and Accountability Report in accordance with OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*.

However, because the Commission is a regional development agency designed to function as a federal, state, and local partnership and is not a federal entity, the Commission concluded that the reporting formats established by the Financial Accounting Standards Board (FASB) would provide more meaningful information to users of ARC's financial statements than would be available if standards recommended by the Federal Accounting Standards Advisory Board (FASAB) were followed. Under either set of standards, the Commission determined that the financial condition and results of operations would not result in a significant difference in the recognition and measurement of ARC's accounting transactions and events. Therefore, the Commission's financial statements have been prepared in accordance with standards set by FASB.

The audit was conducted in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States. The results of the audit were discussed with Commission officials and the OIG throughout the audit. Commission officials responded to the

finding and recommendation on compliance presented in draft report and management's response has been included in the final report.

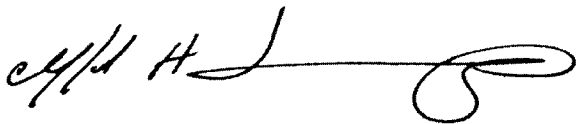
M.D. Oppenheim & Company, P.C., also identified two additional matters presenting opportunities for strengthening internal controls and operating efficiency. They are communicated in a separate letter dated October 25, 2004 for management's consideration and is attached under separate cover.

M.D. Oppenheim & Company, P.C is responsible for the attached auditors' report dated October 25, 2004 and the conclusions expressed in the report. We do not express opinions on the Appalachian Regional Commission's financial statements or internal controls.

In connection with the contract, we reviewed M.D. Oppenheim & Company's report and related documentation and inquired of its representatives. Our review, as differentiated from an audit in accordance with U.S. generally accepted auditing standards, was not intended to enable us to express, and we do not express, opinions on the Appalachian Regional Commission's financial statements or internal control. M.D. Oppenheim & Company, P.C is responsible for the attached auditors' report dated October 25, 2004 and the conclusions expressed in the report. However, our review disclosed no instances where M.D. Oppenheim & Company, P.C did not comply, in all material respects, with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States.

As noted in the letter, the consideration of internal controls was for the limited purpose of auditing the financial statements. My office is currently performing a more comprehensive audit of the internal controls.

I appreciate the cooperation given by the Finance and Administration Division to my office and M.D. Oppenheim & Company, P.C., during the audit.

A handwritten signature in black ink, appearing to read "Clifford H. Jennings", with a large, stylized flourish at the end.

Clifford H. Jennings
Inspector General

Attachments

cc: Director, Finance and Administration Division

Appalachian Regional Commission

Financial Statements and
Independent Auditors' Report

September 30, 2004 and 2003

APPALACHIAN REGIONAL COMMISSION

SEPTEMBER 30, 2004 and 2003

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To the Commission Members
Appalachian Regional Commission
Washington, DC

Independent Auditors' Report

We have audited the accompanying balance sheets of the Appalachian Regional Commission ("ARC") as of September 30, 2004 and 2003, and the related statements of operations and changes in net position and cash flows for the years then ended. These financial statements are the responsibility of ARC's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Appalachian Regional Commission as of September 30, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental information on pages 14 and 15 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we express no opinion on it.

In accordance with Government Auditing Standards, we have also issued our report dated October 25, 2004 on our consideration of ARC's internal controls

The Commission Members
Appalachian Regional Commission
Washington, DC

over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of the audit.

M.D. Copenhein & Company, P.C.

Silver Spring, Maryland
October 25, 2004

APPALACHIAN REGIONAL COMMISSION
Balance Sheets
September 30, 2004 and 2003

	2004	2003
ASSETS		
Current assets		
Fund balance with Treasury	\$ 59,904,165	\$ 57,222,347
Cash	88,026	59,981
Total cash	59,992,191	57,282,328
Accounts receivable	-	400,000
Business development revolving loan funds	26,541,791	26,510,471
Advances to grantees	864,383	1,042,266
Total current assets	87,398,365	85,235,065
Equipment and software (net)	13,394	39,292
TOTAL ASSETS	\$ 87,411,759	\$ 85,274,357
LIABILITIES AND NET POSITION		
Current liabilities		
Accounts payable	\$ 1,949,420	\$ 2,513,036
Center for Disease Control and Prevention grants	-	523,053
Accrued pension liability	985,567	574,422
Accrued leave	353,589	324,639
Accrued payroll and taxes payable	211,355	175,160
Other accrued liabilities	92,469	39,553
Total current liabilities	3,592,400	4,149,863
Net position	83,819,359	81,124,494
TOTAL LIABILITIES AND FUND BALANCE	\$ 87,411,759	\$ 85,274,357

See accompanying notes and Independent Auditors' Report.

APPALACHIAN REGIONAL COMMISSION
Statements of Operations and Changes in Net Position
Years ended September 30, 2004 and 2003

	2004	2003
REVENUES		
Appropriations	\$ 65,610,600	\$ 70,826,675
Less: Allocation transfer out	(20,206,551)	(26,854,510)
Appropriations (net)	45,404,049	43,972,165
Appalachian Development Highway System administrative revenue	691,194	612,804
State contributions	3,111,000	2,959,000
Other revenue	196,819	418,279
Total revenues	49,403,062	47,962,248
EXPENSES		
Area development grants	36,856,758	37,710,957
Office of the Federal Co-Chair and Inspector General	1,759,893	1,383,780
Commission management and administration	8,091,546	7,040,681
Total expenses	46,708,197	46,135,418
NET INCOME	2,694,865	1,826,830
Net position, beginning of period	81,124,494	79,297,664
NET POSITION, END OF PERIOD	\$ 83,819,359	\$ 81,124,494

See accompanying notes and Independent Auditors' Report.

APPALACHIAN REGIONAL COMMISSION
Statements of Cash Flows
September 30, 2004 and 2003

	2004	2003
Cash flows from operating activities:		
Net income	\$ 2,694,865	\$ 1,826,830
Adjustments to reconcile income to net cash provided by operating activities:		
Depreciation	25,898	29,980
Changes in assets and liabilities:		
Accounts receivable	400,000	(397,414)
Business development revolving loan fund	(31,320)	(22,092)
Advances to grantees	177,883	1,894,067
Accounts payable	(563,616)	1,264,349
Center for Disease Control and Prevention grants	(523,053)	123,053
Accrued pension liability	411,145	574,422
Accrued leave	28,950	(55,589)
Accrued payroll and taxes payable	36,195	40,462
Other accrued liabilities	52,916	4,290
Net cash provided by operating activities	2,709,863	5,282,358
Net increase in cash	2,709,863	5,282,358
Cash at beginning of year	57,282,328	51,999,970
CASH AT END OF YEAR	\$ 59,992,191	\$ 57,282,328
Supplemental disclosures:		
Income taxes paid	\$ 0	\$ 0
Interest paid	\$ 0	\$ 0

See accompanying notes and Independent Auditors' Report.

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Years ended September 30, 2004 and 2003

Note A – Organization and Mission

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.

Note B – Summary of Significant Accounting Policies

1. **Major Programs** – ARC is authorized to fund area and other development programs including education, workforce training, water and sewer construction, housing, leadership development, small business start-ups and expansions and development of health care resources. In executing its programs, local communities and federal agencies provide administrative and technical services. ARC utilizes approximately 10 federal departments and agencies to administer, disburse funds, and account for its infrastructure and other programs including the Department of Housing and Urban Development, Environmental Protection Agency, Rural Development Agency, and the Department of Health and Human Services. ARC is responsible for allocating funds to the projects and for the management and administration of all projects.

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Years ended September 30, 2004 and 2003

Note B – Summary of Significant Accounting Policies (continued)

2. **Basis of Accounting** – The accompanying financial statements have been prepared using the accrual method of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when incurred. Appropriations are recognized as revenue when appropriated and available.
3. **Financing Sources** – ARC receives annual no-year federal appropriations to provide grants to the entities within the Appalachian Region and to fund its operations. The state members also contribute funds to ARC operations. Funds are allocated to thirteen states and are available until expended. States can generally decide how their allocations will be used for ARC programs.
4. **Fund Balance with Treasury** – Cash receipts and disbursements for operations and the area development programs are processed by the Department of Treasury. Funds held by the Department of Treasury represent funds available for operations.
5. **Cash** – ARC uses commercial bank accounts to accommodate collections and payments that cannot be processed by the Department of Treasury.
6. **Accounts Receivable** – Management considers all receivables to be fully collectible at year-end. Accordingly, no allowance for doubtful accounts has been recorded.
7. **Advances to grantees** – Material amounts of unexpended grant funds in the hands of grantees at the end of the fiscal year are reclassified as advances.
8. **Equipment and Software** – Capital assets are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets of three to five years.
9. **Accrued Leave** – Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year the balance in the accrued annual leave account is adjusted to reflect current accrual at current pay rates.
10. **Retirement Plans** – ARC federal employees participate in federal retirement plans. ARC non-federal employees participate in the ARC Pension and 401(k) plan.

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Years ended September 30, 2004 and 2003

Note B – Summary of Significant Accounting Policies (continued)

11. **Accrued Pension Liability** – ARC recognizes and records a liability for post-retirement benefits other than pension in accordance with the Statement of Financial Accounting Standards (SFAS) No. 106, *Employer's Accounting for Post-retirement Benefits Other Than Pensions*.
12. **Use of Estimates** – The preparation of the accompanying financial statements requires management to make estimates and assumptions about certain estimates included in the financial statements. Actual results will invariably differ from those estimates.
13. **Reclassifications** – Certain accounts in the prior-year financial statements have been reclassified for comparative purposes to conform to the presentation in the current-year financial statements.
14. **Income Tax Status** – ARC is exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code and is classified as other than a private foundation.

Note C – Business Development Revolving Loan Funds

ARC established Business Development Revolving Loan Fund (RLF) grants to provide pools of funds to be made available to grantees to create and retain jobs. Various entities (grantees) within the thirteen states were provided with loan capitalization funds. These funds are loaned to borrowers who qualify with program objectives. The earnings (interest and fees) net of expenses (including bad debt) are available to the grantees to make additional loans.

Grantees return the funds to ARC when they terminate the RLF. Grantees that have income in excess of expenses (net income) return the excess funds to ARC and ARC deposits the net income funds in the U.S. Treasury general fund. Grantees that have net losses return the funds to ARC net of the losses. Grant balances that are returned are added back to the state allocation.

The following summarizes the RLF balances at September 30:

	2004		2003
RLF Funds Obligated	\$ 31,838,321	\$	31,322,784
RLF Funds Advanced	\$ 26,541,791	\$	26,510,471
RLF Loans Outstanding	\$ 31,139,964	\$	31,374,838

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Year ended September 30, 2004 and 2003

Note D – Equipment and Software

Equipment and software consists of the following at September 30:

	<u>2004</u>		<u>2003</u>
Equipment	\$ 69,194	\$	69,194
Software	48,422		48,422
Subtotal	<u>117,616</u>		<u>117,616</u>
Less: Accumulated depreciation	<u>(104,222)</u>		<u>(78,324)</u>
Equipment and software (net)	<u>\$ 13,394</u>	\$	<u>39,292</u>

Depreciation expense for the years ended September 30, 2004 and 2003 are \$25,898 and \$29,980, respectively.

Note E – Grant Transfers to Other Federal Agencies

ARC transfers funds to basic agencies to oversee economic and social development projects in the Appalachian Region. ARC records the funds transferred as contra revenue at the time the transfer is made. ARC transferred funds as follows:

	<u>2004</u>		<u>2003</u>
Department of Transportation	\$ 450,000	\$	473,686
Department of Education	-		576,805
Economic Development Agency	2,434,102		2,384,540
Environmental Protection Agency	60,000		-
Department of Energy	-		(46,811)
Department of Agriculture	15,700,000		15,633,968
Department of Housing and Urban Development	1,414,290		6,893,076
Department of Health & Human Services	148,159		939,246
	<u>\$ 20,206,551</u>	\$	<u>26,854,510</u>

Note F – Retirement and Other Post-Employment Benefit 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 United States Office of Personnel Management (OPM). ARC makes contributions at rates applicable to agencies of the federal government. The contributions do not equal the full service cost of the pension expense, which is the actuarial present value of benefits attributed to services rendered by covered employees during the accounting period. The measurement of service

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Year ended September 30, 2004 and 2003

Note F – Retirement and Other Post Employment Benefit Plans (continued)

costs requires the use of actuarial cost methods to determine the percentage of the employees' basic compensation sufficient to fund their projected pension benefit. These percentages (cost factors) are provided by OPM.

The excess of total pension expense over the amount contributed by ARC and ARC employees represents the amount which must be financed directly by OPM. ARC does not recognize in its financial statements these excess amounts as they are deemed to be immaterial.

Contributions to these plans for FY 2004 were \$47,094 and \$63,580 for CSRS and FERS, respectively, and contributions for FY 2003 were \$45,358 and \$44,809 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 2004 were \$54,466 and \$3,187 and for FY 2003 \$42,437 and \$2,437 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 \$18,390 and \$9,987 to the Federal Thrift Savings plan for all eligible employees for the years ended September 30, 2004 and 2003, respectively.

Non-Federal

ARC has a Defined Benefit Pension Plan which was open to all employees not participating in CSRS and FERS. The plan was closed in February 2000 to further entry. The Commission uses a July 1 measurement date for its plan. Plan information at September 30 consists of the following:

		<u>2004</u>		<u>2003</u>
Benefit obligation	\$	(8,298,531)	\$	(9,927,601)
Fair value of plan assets		2,719,287		3,523,136
Funded status	\$	<u>(5,579,244)</u>	\$	<u>(6,404,465)</u>
Accrued benefit cost recognized in the balance sheet	\$	985,567	\$	574,422

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Year ended September 30, 2004 and 2003

Note F – Retirement and Other Post-Employment Benefit Plans (continued)

	<u>2004</u>	<u>2003</u>
Employer contribution	\$ 1,164,693	\$ 421,214
Participant contribution	22,700	39,392
Benefits paid	4,487	788,761
Net periodic benefit costs	1,575,838	995,636

The accumulated benefit obligation was \$6,498,195 and \$7,930,284 at September 30, 2003 and 2004, respectively.

Additional Information

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

	<u>2004</u>	<u>2003</u>
Discount rate	5.75%	5.25%
Rate of compensation increase	4.08	4.08

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

	<u>2004</u>	<u>2003</u>
Discount rate	5.25%	6.25%
Expected return on plan assets	7.50	7.50
Rate of compensation increase	4.08	4.08

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, 2004 and 2003 are as follows:

<u>Asset Category</u>	<u>2004</u>	<u>2003</u>
Equity securities	31.00%	40.00%
Debt securities	64.00	54.00
Real estate	5.00	6.00
Total assets	<u>100.00%</u>	<u>100.00%</u>

APPALACHIAN REGIONAL COMMISSION
Notes to Financial Statements
Year ended September 30, 2004 and 2003

Note F – Retirement and Other Post-Employment Benefit Plans (continued)

The Commission's investment strategy is a long-term, risk-controlled approach using diversified investment options with a minimal exposure to volatile investment options like derivatives.

The Commission expects to contribute \$757,459 to the plan in FY2004.

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

	Pension Benefits
2005	\$ 1,590,000
2006	900,000
2007	11,000
2008	4,000
2009	2,330,000
Years 2010 – 2014	1,540,000

ARC also maintains a 401(k) plan covering substantially all non-federal employees. ARC contributed \$150,637 and \$134,219 for the years ended September 30, 2004 and 2003, respectively.

Note G – Lease

ARC's lease for its office space provides for increases in annual base rent based on consumer price index increases, and payment of a portion of the increases in building operating expenses and real estate taxes. The lease commenced on April 30, 1996 and extends through December 31, 2007. Future minimum lease payments required under this non-cancelable lease are as follows:

<u>Year Ended September 30,</u>	<u>Amount</u>
2005	\$ 570,000
2006	570,000
2007	142,500
Total	\$ <u>1,282,500</u>

Rent expense for the years ended September 30, 2004 and 2003 was \$686,556 and \$629,793, respectively.

Additional Information

APPALACHIAN REGIONAL COMMISSION
Additional Information
Years ended September 30, 2003 and 2004

Appalachian Development Highway System
(Appropriated Funds held by the U.S. Department of Transportation)

Congress authorized approximately \$8.6 billion for the construction of the Appalachian Development Highway System (ADHS) through fiscal year 2004. When it is complete, there will be a 3,090 mile regional system. The purpose of the ADHS is to generate economic development in previously isolated areas, supplement the national interstate system, connect Appalachia to the interstate system, and provide access to the Appalachian Region.

The U.S. Department of Transportation (USDOT) funds the ADHS primarily through the Highway Trust Fund, from which Congress authorizes annual obligation ceilings for the program. Periodically, additional funds may be provided by direct appropriation to the DOT. ARC exercises policy and programmatic control over the ADHS, including the responsibility to set policy for allocating funds to the states, and DOT is accountable for the funds. The program includes flexibility for states to use some highway funds for access road development, and ARC exercises approval for such projects.

The following is a summary of the balances and activity related to the ADHS for FY 2004:

	Unexpended Authority as of 10/1/2003	FY 2004 Authorizations	FY 2004 Expenditures	Unexpended Authority as of 9/30/2004
DOT				
Appropriations	\$ 186,778,000	\$ 124,262,500	\$ (28,318,996)	\$ 282,721,504
Highway Trust Fund Obligation Ceiling	938,457,954	484,830,284	(229,524,359)	1,193,763,879
Total	\$ 1,125,235,954	\$ 609,092,784	\$ (257,843,355)	\$ 1,476,485,383

Status of budgetary resources as of September 30, 2004:

	Obligated Balance	Unobligated Balance	Total
DOT Appropriations	\$ 135,940,317	\$ 146,781,187	\$ 282,721,504
Highway Trust Fund Obligation Ceiling	491,202,508	702,561,371	1,193,763,879
	\$ 627,142,825	\$ 849,342,558	\$ 1,476,485,383

APPALACHIAN REGIONAL COMMISSION
Additional Information
Years ended September 30, 2003 and 2004

Federal Budgetary Data

The following summarizes the budgetary data related to ARC's federal appropriations for the year ended September 30:

BUDGETARY RESOURCES	<u>2004</u>	<u>2003</u>
Budget authority – appropriation	\$ 66,000,000	\$ 71,290,000
Net transfers	(20,206,551)	(26,854,510)
Unobligated balance brought forward October 1	6,153,777	6,768,028
Spending authority from offsetting collections	466,209	1,134,720
Advance received	-	150,000
Recoveries of prior year obligations	2,241,564	2,278,322
Permanently not available	(389,400)	(463,385)
Total budgetary resources	<u>54,265,599</u>	<u>54,303,175</u>

STATUS OF BUDGETARY RESOURCES

Obligations incurred	45,697,887	48,149,398
Unobligated balance	8,567,712	6,13,777
Total budgetary resources	<u>\$ 54,265,599</u>	<u>\$ 54,303,175</u>

To the Commission Members
Appalachian Regional Commission
Washington, DC

Report on Compliance and Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

We have audited the financial statements of the Appalachian Regional Commission as of and for the year ended September 30, 2004, and have issued our report thereon dated October 25, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether ARC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance as reported in the accompanying Finding and Recommendation on Compliance, that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered ARC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal

The Commission Members
Appalachian Regional Commission
Washington, DC

control over financial reporting, which we have reported to the management of ARC in a separate letter dated October 25, 2004.

This report is intended solely for the information and use of the Inspector General, the Commission Members, management and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

M.D. Openheim & Company, P.C.

October 25, 2004

APPALACHIAN REGIONAL COMMISSION
Finding and Recommendation on Compliance
Years ended September 30, 2003 and 2004

Grant Reporting

Our audit testing of ARC grants files found a lack of timely submission of grant progress and final reports. We sampled a total of 40 grant files for compliance with ARC's grant provisions and found that in 24 (60%) of the files, progress reports were not submitted on time or at all. In 14 (35%) of the files where the grant period had expired, a final report was not submitted by the grantee within one month after the period of performance.

Part II of the Appalachian Regional Commission's grant agreement general provisions states that:

- 1) Progress Reports - Grantee shall prepare and submit to the ARC Project Coordinator, progress reports indicating the work accomplished under the agreement to date, any problems encountered and ameliorative actions taken, and a forecast of work for the next report period.
- 2) Final Report
 - (a) Draft Contents – Within one (1) month after the period of performance, Grantee shall prepare and submit to the ARC Project Coordinator for approval, a draft final report of all work accomplished under this Agreement including recommendations and conclusions based on the experience and results obtained.
 - (b) Review – After ARC review of the draft final report, which will be completed within 15 days after submission by the Grantee, the Commission will either (a) return to the Grantee the approved draft with such comments, including any requirements or suggestions for modifications as deemed necessary, or (b) require resubmission of the draft report if it is deemed necessary, in which case Grantee shall, within 15 days, submit another draft for review and comment.
 - (c) Final Submission – Within 15 days after receipt of the approved draft final report, the Grantee will prepare and submit to the Commission, 2 copies of the approved report and a reproducible master.

There was evidence in some grant files that ARC had requested the overdue reports, and the grantee filed late or still had not yet submitted the report. In other files, however, there appears to be a lack of follow-up by ARC to ensure that grantees complied with grant reporting requirements. Without timely, complete reports which provide ARC with information about the status of its grant projects and funding, ARC cannot adequately manage its grant programs or ensure that grant funds are used for their intended purpose. In addition, failure to submit final reports as required contributes to the inability of ARC to close its grants timely.

APPALACHIAN REGIONAL COMMISSION
Finding and Recommendation on Compliance
Years ended September 30, 2003 and 2004

Recommendation

We recommend that ARC develop policies and procedures to effectively monitor grantee compliance with grant reporting requirements and to promptly follow-up when any instances of non-compliance are noted.

Management's Comment

Management concurs with the finding that additional follow-up is required to ensure that grant reporting requirements are met in all cases. ARC will build the capability in the grant information system to provide automated reports to staff program managers to alert them to the need for follow-up action with grantees who are delinquent.

APPALACHIAN REGIONAL COMMISSION

Follow-up of Prior Audit Finding

Grant Advances

Condition: During our prior year audit we noted that the grant advance balance as reported in the accounting system did not reflect the current status of those funds. Information to properly adjust the advance balance to actual was not readily available and required the efforts of the Finance and Administration Division and ARC program personnel, as well as follow-up with grantees, to update the amounts. Based on the additional information obtained, the grant advance balance was reduced by \$3 million.

Recommendation: We recommended ARC develop policies and procedures to accurately record the status of grant funds held by grantees at fiscal year-end in order to facilitate preparation of the financial statements in compliance with federal reporting requirements.

Current Status: Our testing found that grant advances as of September 30, 2004 appear to more accurately reflect the current status of funds. ARC has added the submission dates of the last SF270 and Progress Reports to their Project Information System report. Also, the advance report was reviewed for accuracy prior to year-end which resulted in a balance reduction. Due to the efforts of the Commission in the current year, this finding is closed.