



November 30, 2015

Memorandum for: The Federal Co-Chair
ARC Executive Director

Subject: OIG Report 16-04
Fiscal Year 2015 Financial Statement Audit

The enclosed report presents the results of the audit of the Commission's financial statements for the fiscal year ended September 30, 2015. 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 Chortek, LLP, to audit the financial statements of the Commission as of and for the fiscal year ended September 30, 2015. The contract required that the audit 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 Chortek's audit of ARC's financial statements for the fiscal year ended September 30, 2015.

- Chortek stated it was their opinion that ARC's financial statements were presented fairly in all material respects, in accordance with U.S. generally accepted accounting principles.
- Chortek was not contracted for and did not provide an opinion on the effectiveness of ARC's internal controls over financial reporting. However, Chortek did state that they did not identify any deficiencies in internal control that were considered to be material weaknesses, relative to their expressing an opinion on ARC's financial statements.
- No significant deficiencies were reported.
- Chortek did not express an opinion on compliance with laws and regulations, but noted no instances of non-compliance with laws or regulations required to be reported under the provisions of OMB audit guidance.

In connection with the contract, we reviewed Chortek'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. Chortek is responsible for the attached auditor's report dated November 12, 2015 and the conclusions expressed in the report. However, our review disclosed no instances where Chortek did not comply, in all material respects, with U.S. generally accepted government auditing standards.

A handwritten signature in cursive script that reads "Hubert Sparks".

Hubert Sparks
Inspector General

Attachment

cc: Director, Finance and Administration Division
Chortek LLP



November 12, 2015

Independent Auditor's Report

Executive Director
Appalachian Regional Commission
Washington, DC

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of the Appalachian Regional Commission (ARC), which comprise the consolidated balance sheets as of September 30, 2015 and 2014, and the related consolidated statements of net cost, changes in net position, and combined budgetary resources for the years then ended, and the related notes to the financial statements (hereinafter referred to as "financial statements").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 15-02 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risk of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ARC's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and

the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion on the Financial Statements

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, 2015 and 2014, and its net costs, changes in net position, and budgetary resources, for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the information in the Management's Discussion and Analysis section be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on the basic financial statements as a whole. The Co-Chair's message, performance, and other information sections of ARC's *Performance and Accountability Report* are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements as of and for the year ended September 30, 2015, we considered ARC's internal control over financial reporting (internal control) as a basis for designing the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of ARC's internal control. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described in Exhibit I to be a significant deficiency.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, as described in accompanying Exhibit I, we identified certain deficiencies in internal control that we consider to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ARC's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of compliance disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 15-02.

Purpose of the Other Reporting Required by Government Auditing Standards

The purpose of the communication described in the Other Reporting Required by *Government Auditing Standards* section is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of ARC's internal control or compliance. Accordingly, this communication is not suitable for any other purpose.

Chortek LLP

Chortek LLP
November 12, 2015

1. Review of Financial Transactions Needs Improvement

A. Recording and Reviewing of Advances Related to Local Development Districts Grants

The Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, states the following related to advances and prepayments:

- Advances are cash outlays made by a federal entity to its employees, contractors, grantees, or others to cover a part or all of the recipients' anticipated expenses or as advance payments for the cost of goods and services the entity acquires.
- Advances and prepayments should be recorded as assets. Advances and prepayments are reduced when goods or services are received, contract terms are met, progress is made under a contract, or prepaid expenses expire.

ARC provides advances on a quarterly basis to Local Development Districts (LDD) grant recipients. Generally, the funds are provided to the grantees at the beginning of each quarter, causing a reduction to Fund Balance with Treasury and a correlating expense for the amount disbursed. According to ARC management, rather than recording numerous entries between the time of the advance and the end of the quarter, ARC has elected to record the advances as expenses at the time of disbursement. Due to the nature of the spending patterns associated with these funds, by September 30th of each fiscal year, any advanced funds are immaterial and the associated expense is reasonably stated within the financial records.

On September 11, 2015 ARC made an advance of approximately \$1.8 million to LDD grant recipients. The advance was made for expenditures related to October 1, 2015 through December 31, 2015. Management stated that the advance was made to the LDD grantees earlier than usual due to the uncertainty surrounding the FY 2016 budget process. Management also indicated, as we observed, that payment prior to the beginning of a new fiscal year is not typical.

In recording the disbursement of \$1.8 million to the LDD grant recipients, ARC did not modify its current procedures as it related to advances, given that advance payment prior to the start of a fiscal year is not common practice. Accordingly, as of September 30, 2015, expenses were overstated and advances were understated by \$1.8 million, as the funds pertained to FY 2016 expenditures. Although this matter was identified by management, the misstatement in the financial records was not determined through the standard financial reporting procedures or related internal controls. It should be noted that there was no impact on Fund Balance with Treasury, as a result of the manner in which ARC processed disbursements to the LDD grant recipients.

Consistent with accounting standards, ARC should have debited the Advance account rather than expenses and credited Fund Balance with Treasury (FBWT). As expenses are incurred, ARC should debit the appropriate expense account and credit the advance to recognize the expenditures in the period incurred. This is consistent with accrual accounting. Under the current method, there is a risk that the financial records may not accurately reflect the position of the entity at a specific period of time. Furthermore, bypassing use of the advance account for transactions of this nature causes ARC to not fully comply with accounting standards.

B. Review of Unexpended Appropriations and Cumulative Results of Operations

Internal control is a process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of operations, reporting and compliance of an entity will be achieved. Internal control is not one event, but a series of actions that occur throughout an entity's operations. Internal control is recognized as an integral part of the operational processes management uses to guide its operations rather than as a separate system within an entity.

During our review of the FY 2015 financial statements, we noted a variance of \$936,000 between the financial statements and ARC's year-end trial balance as it related to Unexpended Appropriations and Cumulative Results of Operations. Specifically, line items of Unexpended Appropriation and Cumulative Results of Operations reflected on the Balance Sheet and the Statement of Changes in Net Position did not agree with the supporting documentation.

Management indicated that an on-top adjustment was posted to the trial balance of ARC's child agencies at year-end was posted to the incorrect general ledger account. In addition, the on-top adjusting entries posted to the child agency accounts were not included in the supporting schedule of adjusting entries. Paragraph OV4.08 of the *Federal Internal Control Standards*, published by the Government Accountability Office states:

Documentation is a necessary part of an effective internal control system. The level and nature of documentation vary based on the size of the entity and the complexity of the operational processes the entity performs. Management uses judgment in determining the extent of documentation that is needed. Documentation is required for the effective design, implementation, and operating effectiveness of an entity's internal control system.

Therefore, financial statement line items did not materially agree to the supporting documentation. Furthermore, account balances for Unexpended Appropriation and Cumulative Results of Operations were misstated; however, total Net Position was accurately reflected.

C. Recording and Reviewing Obligations Related to Grants

The Statement of Budgetary Resources includes a line item for the Status of Budgetary Resources which displays the disposition of the budgetary resources made available. It consists of obligations incurred; the unobligated balances that are available; and the unobligated balances with lapsed budget authority. Obligations incurred are amounts of new orders placed, contracts awarded, services received, and other similar transactions during the period that will require payments during the same or a future period.

GAO Appropriations Law Volume II, Chapter 7 Section B, *Criteria for Recording Obligations*, discusses recording obligations for grants, and it references 31 U.S.C. § 1501 (a) (5) which requires that a grant obligation be supported by documentary evidence of a grant or subsidy

payable from appropriations made under formulas prescribed by law; or under an agreement authorized by law; or under plans approved consistent with or authorized by law.

During the financial statement audit, ARC discovered a grant in the amount of \$273,000 that was approved in August 2015, but not recorded as an obligation in its accounting system. This resulted in obligations incurred being understated, as well as unexpended appropriations to be misstated. Accordingly, the Balance Sheet and the Statements of Changes in Net Position and the Budgetary Resources included certain lines items that were misstated by the \$273,000.

Upon discovery in November 2015, management immediately notified the auditors and recorded the obligation in its accounting system. However, initially, the grant was recorded as a FY 2016 transaction rather than a FY 2015 obligation. Therefore, an adjustment was necessary to the FY 2015 financial statements, in the amount of \$273,000 to properly reflect obligations incurred.

Paragraph 10.03 of the *Federal Internal Control Standards*, published by the Government Accountability Office, outlines common control activity categories that are useful to management, which may include:

- Reviews by management at the functional or activity level. Management compares actual performance to planned or expected results throughout the organization and analyzes significant differences.
- Controls over information processing. A variety of control activities are used in information processing. Examples include edit checks of data entered; accounting for transactions in numerical sequences; comparing file totals with control accounts; and controlling access to data, files, and programs.
- Accurate and timely recording of transactions. Transactions are promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from its initiation and authorization through its final classification in summary records. In addition, management designs control activities so that all transactions are completely and accurately recorded.
- Appropriate documentation of transactions and internal controls. Management clearly documents internal control and all transactions and other significant events in a manner that allows the documentation to be readily available for examination. The documentation may appear in management directives, administrative policies, or operating manuals, in either paper or electronic form. Documentation and records are properly managed and maintained.

Management is ultimately responsible for its financial operations and reports. Inaccurate or untimely posting of transactions may lead to the reporting and presenting of inaccurate information.

Recommendations:

We recommend that ARC management review and update, as necessary, its financial management policies and procedures. In particular, management should review the current policies and procedures as they relate to the following:

1. Recording of advances;
2. Reconciliation procedures for financial data obtained from its financial management service provider to ensure all transactions are captured as ARC management intended; and
3. Reconciliation of obligations to supporting documentation to ensure completeness in its financial records.

Management's Response :

Management concurs with the recommendations outlined above.