SINGLE AUDIT REPORT

For Fiscal Year Ended June 30, 2003

Commonwealth of Pennsylvania
Edward G. Rendell, Governor

Prepared By:

Office of the Budget
Michael J. Masch, Secretary

Comptroller Operations
Harvey C. Eckert, Deputy Secretary

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Commonwealth of Pennsylvania
Single Audit Report
For the Fiscal Year Ended June 30, 2003

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COMMONWEALTH OF PENNSYLVANIA
GOVERNOR'S OFFICE
HARRISBURG

MICHEAEL J. MASCH
SECRETARY
OFFICE OF THE BUDGET

To the United States Department of Health and Human Services:

It is my privilege to provide to you the Commonwealth of Pennsylvania's single audit report for the fiscal year ended June 30, 2003. This audit has been performed in accordance with auditing standards generally accepted in the United States and the standards for financial audits contained in *Government Auditing Standards* issued by the U.S. General Accounting Office, and satisfies the requirements of the U.S. Office of Management and Budget's Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. The required auditors' report on the Commonwealth's basic financial statements and the supplementary schedule of expenditures of federal awards, and the reports on compliance and internal controls are contained in this document.

BASIC FINANCIAL STATEMENTS

The Commonwealth's basic financial statements are prepared in conformity with generally accepted accounting principles, as prescribed by the Governmental Accounting Standards Board (GASB). Management's discussion and analysis, which precedes the financial statements, provides an overview of the Commonwealth's financial position and activities. We are pleased to report that the Commonwealth's Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2002 has received the Government Finance Officers Association's (GFOA's) Certificate of Achievement for Excellence in Financial Reporting. This represents the seventeenth consecutive year the Commonwealth of Pennsylvania has received this award. We are confident that the Commonwealth's CAFR for the fiscal year ended June 30, 2003 conforms to GFOA standards, and we have submitted it to the GFOA to determine its eligibility for a Certificate of Achievement for Excellence in Financial Reporting.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

The accompanying Schedule of Expenditures of Federal Awards reflects $17.9 billion of federal expenditures by the Commonwealth during the fiscal year ended June 30, 2003. For purposes of the Commonwealth's single audit, a Type A federal program is any program with federal expenditures of at least $30 million. Of the $17.9 billion expended, 93 percent, or $16.6 billion, represents expenditures under federal programs audited as major programs. The Summary of Auditors' Results lists the Commonwealth's major federal programs for the fiscal year ended June 30, 2003. Most of the $17.9 billion in federal expenditures occurred in eight state agencies, as reflected in the following table:

AGENCY NAME	FEDERAL EXPENDITURES (in thousands)
Public Welfare	$9,633,111
Labor and Industry	4,352,769
Education	1,397,870
Transportation	1,378,842
Health	276,524
Community and Economic Development	183,121
Insurance	111,326
Pennsylvania Infrastructure Investment Authority	100,461
Subtotal	$17,434,024
Other Agencies (19)	432,639
Grand Total	$17,866,663

FINDINGS AND RECOMMENDATIONS - CURRENT YEAR

The accompanying report for the fiscal year ended June 30, 2003 contains various comments and findings. Comments pertaining to the audit of the Commonwealth's basic financial statements are detailed in the Basic Financial Statement Comments. Findings pertaining to the audit of the Commonwealth's federal programs are detailed in the Federal Award Findings and Questioned Costs. The comments and findings contain detailed explanations of the compliance issues, questioned costs, the auditors' recommendations, and the agency responses. This report also includes the Commonwealth's corrective action plan for each comment and finding.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

The Summary Schedule of Prior Audit Findings reflects the current status of prior, unresolved findings and recommendations. A total of 59 findings remain unresolved from single audits for the years ended June 30, 1994 through June 30, 2002.

INDEPENDENT AUDIT

The Commonwealth's June 30, 2003 basic financial statement audit and the single audit were performed jointly by the Department of the Auditor General and the independent public accounting firm of Ernst & Young LLP. These audits were performed pursuant to the authority vested in the Auditor General and the Governor under Section 402 of the Fiscal Code of 1929, and in the Governor under Section 701 of the Administrative Code of 1929.

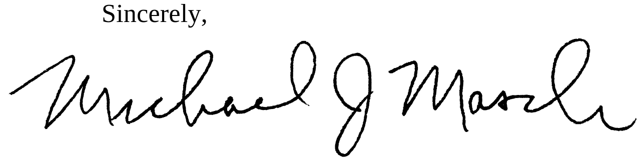
REPORTS OF OTHER INDEPENDENT AUDITORS

Other auditors performed the single audits of the Pennsylvania Higher Education Assistance Agency, the Pennsylvania Housing Finance Agency, the State System of Higher Education and the Philadelphia Shipyard Development Corporation (component units of the Commonwealth). Federal programs administered by these agencies are not included in the Commonwealth's Schedule of Expenditures of Federal Awards. These agencies will send their single audit reports directly to the Federal Audit Clearinghouse for distribution to the appropriate federal agencies.

ACKNOWLEDGMENTS

I wish to express my appreciation to the staff of the various Commonwealth agencies whose time and dedicated effort made this audit possible and, at the same time, to affirm my commitment to maintain the highest standards of accountability in the Commonwealth's management of federal funds.

Sincerely,



Michael J. Masch
Secretary
Office of the Budget

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Commonwealth of Pennsylvania

For its Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2002

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

GOVERNMENT FINANCE OFFICERS ASSOCIATION OF THE UNITED STATES AND CANADA CORPORATION SEAL CHICAGO

Edward Harrington

President

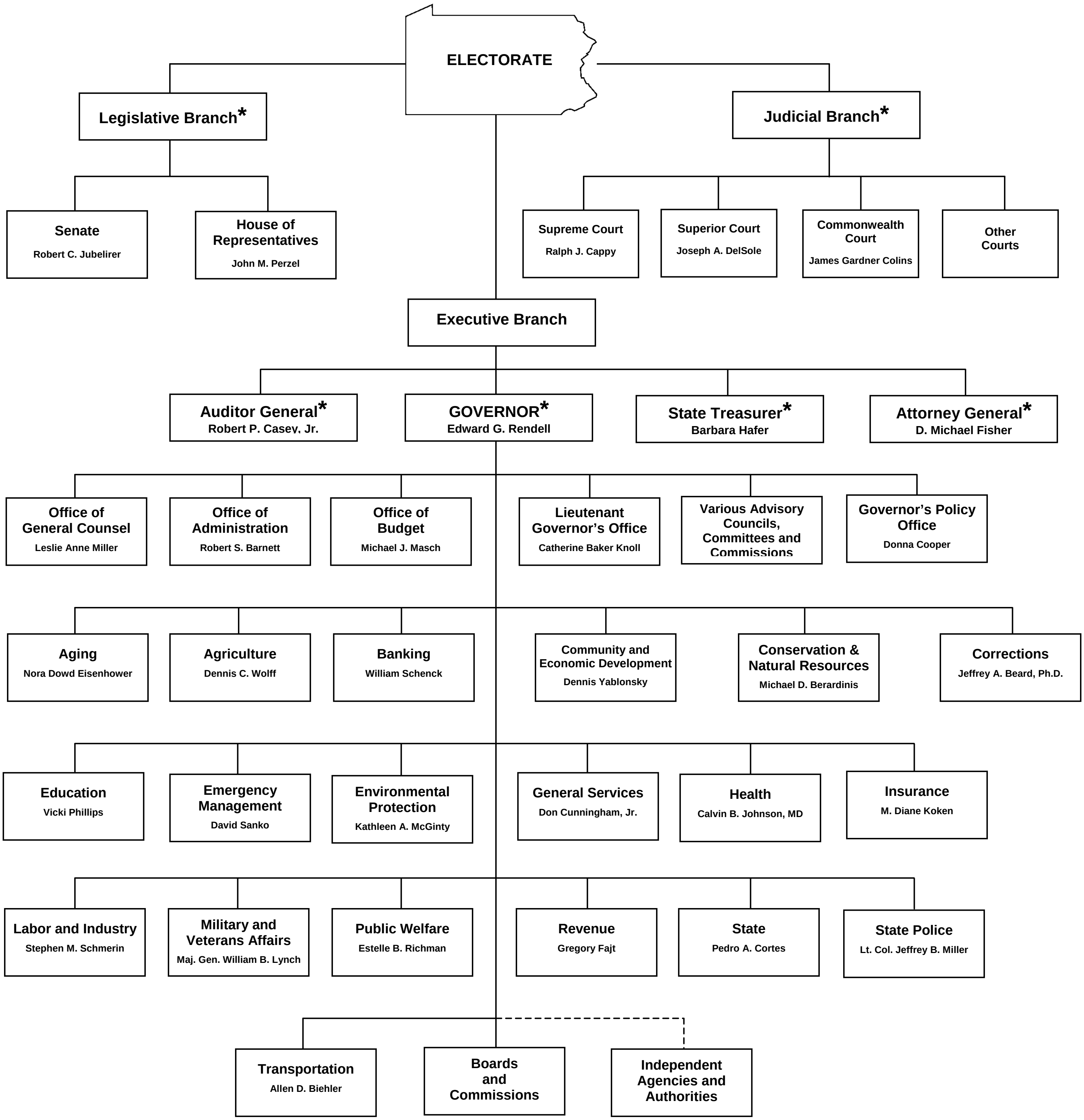
Jeffrey L. Esser

Executive Director

COMMONWEALTH OF PENNSYLVANIA

ORGANIZATION AND OFFICIALS CHART

June 30, 2003



* Independently Elected

COMMONWEALTH OF PENNSYLVANIA

Legend of Abbreviations - June 30, 2003

The following legend presents descriptions of abbreviations that appear throughout the report:

ABBREVIATION	**DESCRIPTION**
ACF	Administration for Children and Families
ADC	Average Daily Clearance
AGRI	Department of Agriculture
BFM	Bureau of Financial Management
BFS	Basic Financial Statements
BMIS	Bureau of Management Information Systems
BOA	Bureau of Audits
BWI	Bureau of Workforce Investment
CAFR	Comprehensive Annual Financial Report
CAO	County Assistance Office
CAP	Corrective Action Plan
CCDBG	Child Care and Development Block Grant
CCDF	Child Care and Development Fund
CDS	Central Drawdown System
CFDA	Catalog of Federal Domestic Assistance
CFR	Code of Federal Regulations
CHIP	State Children’s Insurance Program
CMIA	Cash Management Improvement Act of 1990
COPA	Commonwealth of Pennsylvania
CS	Central Services
CSE	Child Support Enforcement
CWSRF	Clean Water State Revolving Fund
DCED	Department of Community and Economic Development
DEP	Department of Environmental Protection
DGS	Department of General Services
DOH	Department of Health
DOI	United States Department of Interior
DOL	United States Department of Labor
DOT	United States Department of Transportation
DPW	Department of Public Welfare
DWSRF	Drinking Water State Revolving Fund
EBT	Electronic Benefits Transfer
EPA	Environmental Protection Agency
ERP	Enterprise Resource Planning
FEMA	Federal Emergency Management Agency
FFP	Federal Financial Participation
FFY	Federal Fiscal Year
FHWA	Federal Highway Administration
FNS	Food and Nutrition Service
FY	Fiscal Year
FYE	Fiscal Year Ended
GAAP	Generally Accepted Accounting Principles
GASB	Government Accounting Standards Board
HHS	United States Department of Health and Human Services
HOME	Home Investment Partnerships
HUD	United States Department of Housing and Urban Development
ICS	Integrated Central System
IES	Integrated Enterprise System
INS	Department of Insurance
JTPA	Job Training Partnership Act
L&I	Department of Labor and Industry

Legend of Abbreviations - June 30, 2003

ABBREVIATION	DESCRIPTION
LEA	Local Educational Agency
LECS	Labor, Education and Community Services
MA	Medical Assistance Program
NAFTA	North American Free Trade Agreement
OA	Office of Administration
OB	Office of the Budget
OIG	Office of Inspector General
OIM	Office of Income Maintenance
OIT	Office of Information Technology
OMB	Office of Management and Budget
OVR	Office of Vocational Rehabilitation
PACSES	Pennsylvania Child Support Enforcement System
PADOT	Pennsylvania Department of Transportation
PDA	Pennsylvania Department of Aging
PDE	Pennsylvania Department of Education
PEMA	Pennsylvania Emergency Management Agency
PENNVEST	Pennsylvania Infrastructure Investment Authority
PHHS	Public Health and Human Services
PPR	Public Protection and Recreation
RAS	Revenue Accounting System
RCIA	Revenue Collected in Advance
RESET	Road to Economic Self-Sufficiency through Employment and Training
RSBS	Rehabilitation Services - Vocational Rehabilitation Grants to States
SEFA	Schedule of Expenditures of Federal Awards
SFYE	State Fiscal Year Ended
SSA	Social Security Administration
SSBG	Social Services Block Grant
TAA	Trade Adjustment Assistance - Workers
TANF	Temporary Assistance for Needy Families
TAPR	Trade Act Participation Report
TRA	Trade Readjustment Assistance
TSF	Tobacco Settlement Fund
UC	Unemployment Compensation
UI	Unemployment Insurance
USDA	United States Department of Agriculture
USDE	United States Department of Education
VOC ED	Vocational Education
VR	Vocational Rehabilitation
WIA	Workforce Investment Act
WIC	Women, Infants, and Children

Financial Section

Commonwealth of Pennsylvania

Department of the Auditor General
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120-0018

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Independent Auditors' Report on the Basic Financial Statements and Supplementary Schedule of Expenditures of Federal Awards

The Honorable Edward G. Rendell, Governor
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania

We have jointly audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Pennsylvania, as of and for the year ended June 30, 2003, which collectively comprise the Commonwealth's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Commonwealth's management. Our responsibility is to express opinions on these financial statements based on our audit.

We did not jointly audit the financial statements of certain component units, which represent 99 percent of total assets and 98 percent of total revenues of the aggregate discretely presented component units. We did not jointly audit 100 percent of the total assets and 100 percent of the total revenues of the Pension Trust Funds. This comprises 90% of total assets and 42% of total revenues of the aggregate remaining fund information. We also did not jointly audit the financial statements of two Enterprise Funds, which represent 1 percent of total assets and 1 percent of total revenues of the aggregate remaining fund information and 4 percent of total assets and 1 percent of total revenues of the business-type activities. The financial statements of these component units, the Pension Trust Funds and the Enterprise Funds were audited by other auditors, including Ernst & Young LLP acting separately, whose reports thereon have been furnished to us, and our opinions, insofar as they relate to the amounts included for those component units, the Pension Trust Funds and Enterprise Funds, are based solely on the reports of the other auditors. Ernst & Young LLP has audited separately 21 percent of total assets and 21 percent of total operating revenues of the discretely presented component units.

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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the State Employees Retirement System, the Public School Employees Retirement System, the Deferred Compensation Fund, the PA Life and Health Insurance Guaranty Association, the PA Property and Casualty Insurance Guaranty Association, the Machinery and Equipment Loan Fund, the Small Business First Fund, the PA Industrial Development Authority, the PA Turnpike Commission, the State Public School Building Authority, the PA Higher Education Facilities Authority, the Insurance Fraud Prevention Authority, the Philadelphia Regional Port Authority, the Port of Pittsburgh Commission, the Ben Franklin Technology Development Fund, and the Patient Safety Trust Authority were not audited in accordance with *Government Auditing Standards*. 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 audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Pennsylvania as of June 30, 2003, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report as of and for the year ended June 30, 2003 dated April 9, 2004 on our consideration of the Commonwealth of Pennsylvania's internal control over financial reporting and 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 our audit.

Management's discussion and analysis and budgetary comparison information on pages 5 through 21 and 101 through 109 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Commonwealth of Pennsylvania's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U. S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. The schedule of expenditures of federal awards is prepared on the bases of accounting described in Note B to the schedule of expenditures of federal awards and excludes the expenditures associated with federal award programs for the Pennsylvania Higher Education Assistance Agency, the Pennsylvania Housing Finance Agency, the Philadelphia Shipyard Development Corporation, and the State System of Higher Education, component units that were audited in separate OMB Circular A-133 reports required to be submitted to the Federal Audit Clearinghouse. The information in the schedule of expenditures of federal awards has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

Robert P. Casey, Jr.   Ernst + Young LLP

April 9, 2004

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Management's Discussion and Analysis

Commonwealth of Pennsylvania

Overview and discussion of basic financial statements

The information included in Management's Discussion and Analysis (MD&A) supplements the basic financial statements (BFS), explains the BFS and discusses year-over-year changes in specific BFS content. The Commonwealth's June 30, 2003 BFS consist of its government-wide and fund financial statements and related note disclosures. MD&A is required supplementary information (RSI) and precedes the BFS. Other RSI is presented following the notes to the financial statements. Government-wide statements were first presented for the fiscal year ended June 30, 2002 and will be discussed first.

Government-wide financial statements

Government-wide financial statements portray the Commonwealth's overall financial position (Statement of Net Assets) at June 30, 2003 and its aggregate revenues and expenses (Statement of Activities) for the fiscal year ended June 30, 2003. The Statement of Net Assets includes an estimate of the total amount of receivables due at June 30, 2003 that is expected to be collected in the future, whereas governmental fund financial statements only include certain receivables collected within 60 days after the fiscal year end. Capital assets, such as highways, bridges, heavy equipment and buildings, are reported on the Statement of Net Assets with acquisition or construction costs being reported when the assets are placed in service. To recognize the cost of using up each capital asset, annual depreciation expense is reported over future fiscal years. Governmental fund financial statements, on the other hand, report the acquisition of capital assets as expenditures (for the entire cost of the asset) during the fiscal year the asset is acquired or constructed.

The Statement of Net Assets also includes all liabilities, regardless of when payment is due. Examples include bond principal payments which may not be due for several years and an employee disability claims liability, much of which will not be payable until future years. Likewise, employee compensated absence liabilities (such as vacation leave) are reported based on the predicted or actual cash value of leave balances at fiscal year-end. Governmental fund financial statements do not report general long-term liabilities, such as bond principal payments, employee disability claims or compensated absences.

On the Statement of Activities, both revenues and expenses are reported without considering when the related cash is received or disbursed. The reported change in net assets reveals whether the Commonwealth's overall financial position improved or deteriorated during the fiscal year. Government-wide statements do not report fund-specific information; rather, they include aggregated information that has been adjusted for specific eliminations and reclassifications. The Statement of Activities presents net program revenues/expenses by functional area as well as the total cost for providing services during the fiscal year ended June 30, 2003. These statements are on an enterprise-wide basis and classify financial activities as either governmental or business-type. Governmental activities include those traditionally provided by practically all states: public, cash, medical and other assistance; public education; correction and rehabilitation; public works projects; issuing and retiring general obligation debt; etc. Business-type activities include activities where individuals and organizations provide resources to the government in exchange for a product or service. Typical examples would be customers paying for wine or liquor, parents or others purchasing tuition credits for school-age children or lottery players purchasing game tickets. In government-wide statements, for both governmental and business-type activities, the economic resources measurement focus and accrual basis of accounting are used, meaning revenues and expenses are recognized when they occur, not when cash is received or paid.

Condensed financial statement information – government-wide financial statements

The following condensed financial statement information is derived from the Commonwealth's government-wide June 30, 2003 and 2002 financial statements and includes amounts for the primary government only. The government-wide statements include information for component units, which are organizations that are legally separate from the Commonwealth's primary government. Information related to component units is not included in MD&A. Each component unit is identified and described in Note A to the financial statements. Audited financial statements for component units are available through the Deputy Secretary for Comptroller Operations.

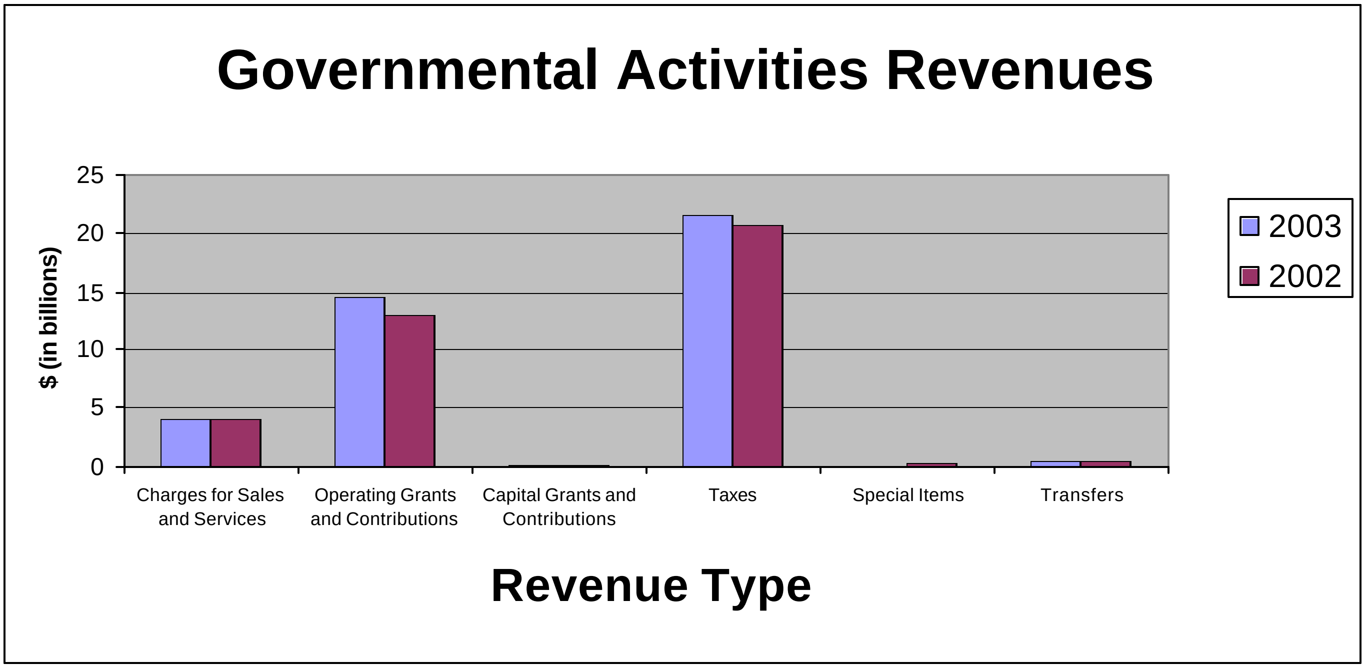
The following presents condensed financial statement information from the Statement of Net Assets (amounts in billions):

	Governmental Activities			Business-Type Activities			Total		
	2003	**2002**	**Change**	**2003**	**2002**	**Change**	**2003**	**2002**	**Change**
Assets:									
Cash and investments	$ 8.5	$ 8.1	$ .4	$4.7	$5.1	$(.4)	$ 13.2	$ 13.2	$ -
Capital assets (net)	19.8	18.5	1.3	-	-	-	19.8	18.5	1.3
All other assets	5.2	4.7	.5	1.0	.9	.1	6.2	5.6	.6
Total assets	**33.5**	**31.3**	**2.2**	**5.7**	**6.0**	**(.3)**	**39.2**	**37.3**	**1.9**
Liabilities:									
Accounts payable	3.3	3.0	.3	.5	.4	.1	3.8	3.4	.4
All other current liabilities	3.6	2.6	1.0	.9	.6	.3	4.5	3.2	1.3
Total current liabilities	**6.9**	**5.6**	**1.3**	**1.4**	**1.0**	**.4**	**8.3**	**6.6**	**1.7**
Bonds payable	6.6	5.6	1.0	-	-	-	6.6	5.6	1.0
All other long-term liabilities	2.0	2.4	(.4)	1.8	1.5	.3	3.8	3.9	(.1)
Total long-term liabilities	**8.6**	**8.0**	**.6**	**1.8**	**1.5**	**.3**	**10.4**	**9.5**	**.9**
Total liabilities	**15.5**	**13.6**	**1.9**	**3.2**	**2.5**	**.7**	**18.7**	**16.1**	**2.6**
Net assets:									
Invested in capital assets, net of related debt	16.1	14.8	1.3	-	-	-	16.1	14.8	1.3
Restricted	2.5	1.6	.9	2.5	3.5	(1.0)	5.0	5.1	(.1)
Unrestricted/(deficit)	(.6)	1.3	(1.9)	-	-	-	(.6)	1.3	(1.9)
Total net assets	**$18.0**	**$17.7**	**$ .3**	**$2.5**	**$3.5**	**$(1.0)**	**$20.5**	**$21.2**	**$ (.7)**

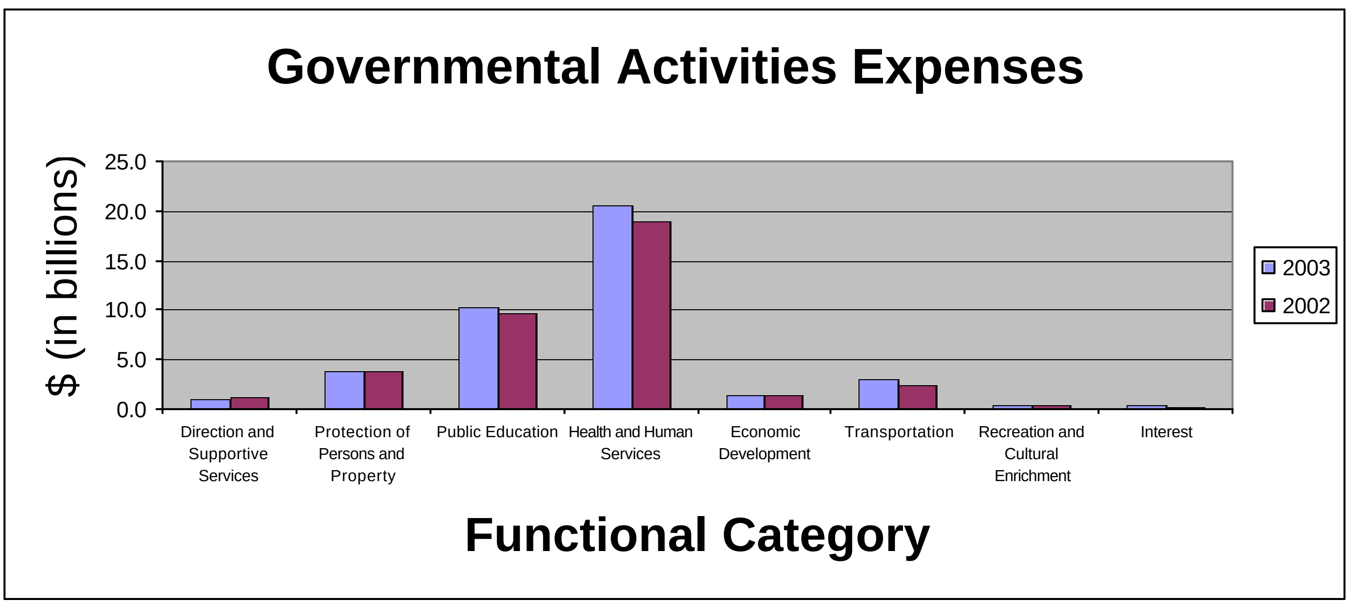
The following presents condensed financial statement information from the Statement of Activities (amounts in billions):

	Governmental Activities			Business-Type Activities			Total		
	2003	**2002**	**Change**	**2003**	**2002**	**Change**	**2003**	**2002**	**Change**
Revenues:									
Program revenues:									
Charges for sales and services	$ 4.2	$ 4.2	$ .0	$ 5.1	$ 5.1	$ .0	$ 9.3	$ 9.3	$ .0
Operating grants and contributions	14.6	13.1	1.5	1.2	.5	.7	15.8	13.6	2.2
Capital grants and contributions	.1	.1	-	-	-	-	.1	.1	-
Total program revenues	**18.9**	**17.4**	**1.5**	**6.3**	**5.6**	**.7**	**25.2**	**23.0**	**2.2**
General revenues:									
Taxes	21.6	20.6	1.0	-	-	-	21.6	20.6	1.0
Total general revenues	**21.6**	**20.6**	**1.0**	**-**	**-**	**-**	**21.6**	**20.6**	**1.0**
Total revenues	**40.5**	**38.0**	**2.5**	**6.3**	**5.6**	**.7**	**46.8**	**43.6**	**3.2**
Expenses:									
Governmental activities:									
Direction and supportive services	1.0	1.3	(.3)	-	-	-	1.0	1.3	(.3)
Protection of persons and property	3.9	3.8	.1	-	-	-	3.9	3.8	.1
Public education	10.2	9.7	.5	-	-	-	10.2	9.7	.5
Health and human services	20.5	18.9	1.6	-	-	-	20.5	18.9	1.6
Economic development	1.4	1.4	-	-	-	-	1.4	1.4	-
Transportation	3.0	2.5	.5	-	-	-	3.0	2.5	.5
Recreation and cultural enrichment	.4	.5	(.1)	-	-	-	.4	.5	(.1)
Interest	.4	.3	.1	-	-	-	.4	.3	.1
Business-type activities:									
State lottery	-	-	-	1.8	1.7	.1	1.8	1.7	.1
Unemployment compensation	-	-	-	3.5	2.8	.7	3.5	2.8	.7
Liquor control	-	-	-	.9	.9	-	.9	.9	-
Workmen's compensation	-	-	-	.2	.2	-	.2	.2	-
Tuition payment	-	-	-	.3	.2	.1	.3	.2	.1
Total expenses	**40.8**	**38.4**	**2.4**	**6.7**	**5.8**	**.9**	**47.5**	**44.2**	**3.3**
Excess/(deficiency) before special item and transfers	(.3)	(.4)	.1	(.4)	(.2)	(.2)	(.7)	(.6)	(.1)
Special item - component unit revenues	-	.3	(.3)	-	-	-	-	.3	(.3)
Transfers	.6	.5	.1	(.6)	(.5)	(.1)	-	-	-
Increase (decrease) in net assets	.3	.4	$(.1)	(1.0)	(.7)	$(.3)	(.7)	(.3)	$(.4)
Net assets, beginning	17.7	17.3		3.5	4.2		21.2	21.5	
Net assets, ending	**$18.0**	**$ 17.7**		**$2.5**	**$ 3.5**		**$20.5**	**$ 21.2**	

The following chart provides a graphic comparison of government activities revenues:



Below is a graph comparing governmental activities expenses by fiscal year:



Overall analysis and discussion of condensed financial statements

During the fiscal year ended June 30, 2003, the overall financial position (net assets) of the Commonwealth, including both governmental and business-type activities, decreased by $.7 billion or 3.3 percent of total beginning net assets. For governmental activities, the net increase in net assets was $.3 billion or 1.7 percent of beginning net assets of $17.7 billion. Total investments, not counting the State Employees Retirement Fund or other fiduciary funds, were over $11.7 billion and total cash balances were over $1.5 billion. These amounts represent considerable liquidity for the current and future fiscal years. The governmental change in net assets is very comparable to the prior year change, where revenues, transfers and special items also slightly exceeded expenses. These increases represent a year-over-year improvement in the Commonwealth's overall financial position during each of the fiscal years ended June 30, 2003 and 2002. On the other hand, the $1.0 billion decrease in total net assets for **business-type activities** follows a $.7 billion decrease during the prior fiscal year. Both decreases can be attributed to unemployment compensation benefit payments that exceeded employer/employee assessments during each of the fiscal years ended June 30, 2003 and 2002.

Business-type activities revenues were over $.4 billion ($.2 billion in the prior year) less than expenses. Including net transfers to other funds of $.6 billion ($.5 billion in the prior year), business-type activities net assets decreased by over $1 billion ($.7 billion in the prior year). The primary reason for this decrease was that Unemployment Compensation Fund expenses exceeded revenues by $.9 billion ($.6 billion in the prior year). A $.3 billion increase in revenues was far less than a $.7 billion increase in expenses during the fiscal year ended June 30, 2003.

Fund financial statements – governmental funds

Governmental fund financial statements provide fund-specific information about the General Fund, the Motor License Fund, and the Tobacco Settlement Fund, which are treated as major funds; whereas nonmajor funds are presented in the aggregate. Fund statements differ from government-wide statements in a few fundamental ways:

1) While the government-wide statements focus on the government taken as a whole (including governmental and business type activities), the fund statements reveal fund-specific information for major governmental and proprietary funds while nonmajor fund information is aggregated.
2) Unlike the aggregated columns for governmental and business-type activities in government-wide statements, individual funds are established by state law and are used to account for specific, mandated activities. Two examples of specific funds are the Motor License Fund, a special revenue fund where gasoline taxes and motor vehicle registration fees are collected and used to repair and build highways, and the Unemployment Compensation Fund, an enterprise fund, used to collect amounts from employers to pay for unemployment compensation to workers.
3) For governmental fund statements, the current financial resources measurement focus is used, along with the modified accrual basis of accounting. This means that balances and transactions are reported as cash is received and paid, plus certain accrued revenues received within 60 days of fiscal year end, minus amounts representing accrued expenditures that are paid for with currently available revenues. Long-term receivables, for amounts earned or billed but not available at fiscal year end, and capital assets are not reported in the governmental fund financial statements. Nor are long-term liabilities reported. The governmental fund Balance Sheet reports far fewer assets and liabilities than the government-wide Statement of Net Assets. The Statement of Revenues and Expenditures for governmental funds reports only those cash transactions that occurred during the fiscal year or specific cash transactions that occurred within 60 days of fiscal year end.

Budgetary Comparison

Budgetary Comparison Schedules are included as required supplementary information immediately following the Notes to the Financial Statements. These schedules provide a measurement of compliance with legally adopted budgets.

General Fund – economic factors during the fiscal year ended June 30, 2003

Although the recession technically ended in November 2001, the pace of economic activity in the US and in Pennsylvania during the months following the recession's end was slow and uneven. Concerns about falling equity prices, businesses' caution in making investments and their reluctance to add to payrolls, weakness in exports, and the war in Iraq all served to restrain economic growth. An indication of the continuing economic malaise was the continued rise of the Pennsylvania unemployment rate through 2002 to its peak of 5.9 (seasonally adjusted) from December 2002 through February 2003. The federal government, through its fiscal and monetary policies, attacked the weak economic recovery. Measures such as income tax cuts with immediate rebates and continued downward pressure on interest rates were instituted to encourage an economic turn-around. However, their effect will take months to be felt.

This prolonged period of slow economic growth through the fiscal year means that tax and other revenues to the Commonwealth failed to grow sufficient to meet budgets. Pennsylvania, along with many other states and local governments struggled to cope with expenditures growing faster than revenues.

General Fund – budgetary basis - comparison between original budget and final budget

The Budgetary Comparison Schedule for the General Fund for the fiscal year ended June 30, 2003 is presented immediately following the Notes to the Financial Statements. Final budgeted revenues for departmental services exceed the original budget by $884 million. This difference resulted primarily from transfers of $372 million in augmenting revenues from the Motor

License Fund for State Police protection of Commonwealth highways (in this case there is no true increase in funds available to the State Police), net intergovernmental revenues of $282 million, and $259 million in augmenting revenues for general obligation bond debt service that were not reflected in the original budget for departmental services revenues. The General Fund Schedule also discloses that the final budget included $1.02 billion more expenditures than the original budget. The $1.02 billion increase includes $929 million in state program expenditure increases and $89 million of increased Federal participation related to the specific state program expenditure increases. Of the $929 million state program difference, $372 million (40%) relates to increased spending authority for State Police protection of Commonwealth highways, $283 million (30%) relates to increased spending authority for medical assistance and other human services benefits, and $259 million (28%) relates to increased spending for general obligation bond debt service.

General Fund – budgetary basis - comparison between final budget and actual results

Actual budgetary results included tax collection revenues, which were lower than the final budgeted revenue estimate (from June 2002) by $513 million. Also, during the fiscal year, budgetary lapses, for a variety of specific appropriations and executive authorizations amounting to $315 million, were posted to reduce state program spending authority. Actual Federal revenues were $470 million lower than budget because of lower Federal participation than original estimates. Actual Federal revenues were lower than budgeted for the following departments: Public Welfare, $177 million; Labor and Industry, $100 million; Education, $86 million; Environmental Protection, $33 million; Transportation, $27 million; Executive Offices, $16 million; and all other affected departments, $31 million.

Measurement focus and basis of accounting – governmental funds

The General Fund, special revenue, debt service and capital projects funds are reported using the current financial resources measurement focus and modified accrual basis of accounting. Under this measurement focus, only current assets and current liabilities are normally included on the balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets. Unreserved fund balance represents a measure of available, spendable resources. Under the modified accrual basis of accounting, governmental funds recognize revenue in the year that it becomes susceptible to accrual (both measurable and available) to pay current fiscal year liabilities. Grant revenues, including Federal government grant revenues, are recognized when earned. Revenue recognition from most other sources occurs at receipt. Recognition of expenditures generally occurs in the fiscal year the goods or services are received and the related fund liability is incurred. Debt service expenditures for principal and interest on general long-term obligations are recognized when due. Prepaid items and inventory purchases are reported as current fiscal year expenditures, rather than allocating a portion of related cost to the fiscal year when the items are actually used.

Expenditures for claims, judgments, compensated absences and employer pension contributions are reported as the amount accrued during the fiscal year that normally would be liquidated with expendable available financial resources.

Discussion of individual funds, balances, and transactions

General Fund

Condensed General Fund balance sheets at June 30, 2003 and 2002 are as follows (amounts in millions):

	June 30, 2003	June 30, 2002	Change
Assets:			
Cash and investments	$ 4,131	$ 4,088	$ 43
Receivables, net	2,772	2,676	96
Due from other funds/governments/advances/other	1,622	1,373	249
Total assets	**$ 8,525**	**$ 8,137**	**$ 388**
Liabilities:			
Accounts payable and tax refunds payable	$ 2,996	$ 2,680	$ 316
Securities lending obligations	757	255	502
Due to other funds/governments/advances/other	918	764	154
Deferred revenue	1,496	1,415	81
Total liabilities	**6,167**	**5,114**	**1,053**
Fund Balance:			
Reserved	773	795	(22)
Unreserved:			
Designated	270	624	(354)
Undesignated	1,315	1,604	(289)
Total fund balance	**2,358**	**3,023**	**(665)**
Total liabilities and fund balance	**$ 8,525**	**$ 8,137**	**$ 388**

Cash and investments increased on a net basis by $43 million due to a $459 million decrease in cash balances, more than offset by a $502 million increase in the Treasury Department securities lending program at June 30, 2003. Taxes receivable increased by $102 million and other receivables decreased by $6 million (net). Amounts due from the Federal government increased by $172 million; advances to other funds increased by $85 million and net other assets decreased by $8 million. Liabilities increased by $1,053 million to $6,167 million largely because of a $383 million increase in accounts payable; the aforementioned $502 million increase in securities lending program; a $81 million increase in deferred revenue; and a $100 million increase in advances from other funds; offset by a $63 million decrease in tax refunds payable at June 30, 2003.

Fund balance designations declined by $354 million because a $300 million designation for the Budget Stabilization Reserve Fund (newly established at June 30, 2002) decreased to a zero balance at June 30, 2003 and other fund balance designations decreased by $54 million during the fiscal year, principally a $58 million decrease for group medical and life insurance, a $3 million increase for a judicial computer system, a $15 million increase for agency construction projects and a $14 million decrease in job creation tax credits and other designations.

Condensed General Fund operating statements for the fiscal years ended June 30, 2003 and 2002 follow (amounts in millions):

	June 30, 2003	June 30, 2002	Change
Revenues:			
Taxes, net of refunds	$ 19,554	$ 18,650	$ 904
Intergovernmental	12,944	11,652	1,292
Charges for sales and services	1,797	2,272	(475)
Licenses/fees/investment and other income	766	469	297
Total revenues	**35,061**	**33,043**	**2,018**
Expenditures:			
Direction and supportive services	855	910	(55)
Protection of persons and property	2,941	3,104	(163)
Health and human services	19,549	18,222	1,327
Public education	10,175	8,813	1,362
Recreation and cultural enrichment	324	326	(2)
Economic development	984	825	159
Transportation	407	316	91
Capital outlay	18	51	(33)
Total expenditures	**35,253**	**32,567**	**2,686**
Revenues over expenditures	**(192)**	**476**	**(668)**
Other financing sources (uses):			
Transfers in	426	213	213
Transfers out	(903)	(1,528)	625
Transfers from component units	-	256	(256)
Transfers to component units	-	(1,043)	1,043
Capital lease and installment purchase obligations	4	4	-
Net other financing sources (uses)	**(473)**	**(2,098)**	**1,625**
Net change in fund balance	**(665)**	**(1,622)**	**$ 957**
Fund balance, beginning	**3,023**	**4,645**	
Fund balance, ending	**$ 2,358**	**$ 3,023**	

A large part of the $665 million net decrease in General Fund fund balance was because the General Fund transferred $903 million to other Funds and provided $1,037 million to component units. Without these items, the General Fund would have actually increased by $1,275 million. Total General Fund expenditures increased by 8.2 percent during the fiscal year ended June 30, 2003, on a reported basis, largely because of a sharp increase in expenditures for medical and other assistance (reported as part of health and human services) and a change in classification for component unit subsidies. Year-over-year expenditures for the health and human services function increased by 7.3 percent; otherwise, all other expenditures increased by 2 percent, largely as a result of executive spending controls during the fiscal year, before the change in component unit subsidy treatment. General Fund tax revenues increased by 4.9 percent, due to economic growth and, to a large degree, by increases in cigarette tax rates. Intergovernmental revenues increased by 11.1 percent due to increases in Federally-funded programs, particularly medical and other assistance. Total General Fund revenues increased by 6.1 percent during the fiscal year. The overall decrease in fund balance ($665 million) during the fiscal year was an improvement of $957 million over the prior year fiscal year decrease in fund balance ($1,622 million). On an overall basis, during periods of declining or slow economic growth, it is common for the fund balance of the General Fund to decline.

Motor License Fund

Comparative financial statement information for the Motor License Fund is as follows (amounts in millions):

	2003		2002	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Investments	$ 1,151	76%	$ 899	$ 252	28%
Other Assets	364	24%	372	(8)	-2%
Total Assets	**1,515**	**100%**	**1,271**	**244**	**19%**
Accounts Payable	346	56%	423	(77)	-18%
Securities Lending Obligations	205	33%	58	147	253%
Other Liabilities	71	11%	77	(6)	-8%
Total Liabilities	**622**	**100%**	**558**	**64**	**11%**
Total Fund Balance	**893**	**100%**	**713**	**179**	**25%**
Tax Revenues	1,705	42%	1,694	11	1%
License and Fees	842	21%	839	3	0%
Federal Revenues	1,380	34%	1,403	(23)	-2%
Other Revenues	125	3%	94	31	33%
Total Revenues	**4,052**	**100%**	**4,030**	**22**	**1%**
Direction and Supportive Services	48	1%	49	(1)	-2%
Protection of Persons and Property	514	13%	493	21	4%
Transportation	3,206	84%	3,369	(163)	-5%
Capitol Outlay	39	1%	46	(7)	-15%
Other Expenditures	5	0%	3	2	67%
Total Expenditures	**3,812**	**100%**	**3,960**	**(148)**	**-4%**
Net Transfers Out	(60)	102%	(87)	27	-31%
Other Financing Sources (Uses)	1	-2%	(23)	24	-104%
Net Other Financing Sources (Uses)	**(59)**	**100%**	**(110)**	**51**	**-46%**
Net Change in Fund Balances	**$ 181**	**100%**	**$ (40)**	**$ 221**	**-553%**

Revenues for the Motor License Fund are derived primarily from driver and vehicle licenses, motor fuel taxes and Federal funding; whereas expenses are primarily for the construction and maintenance of Pennsylvania's transportation infrastructure. Although revenues were relatively flat from 2002 to 2003, transportation expenditures were down $163 million, or 5%, as a result of lower enacted appropriations. This resulted in a $252 million, or 28%, increase in cash and investment balances as well as a corresponding $147 million, or 253%, increase in securities lending liabilities. Increased patrolling by the Pennsylvania State Police resulted in 4% higher protection of persons and property expenditures.

Tobacco Settlement Fund

Comparative financial statement information for the Tobacco Settlement Fund is as follows (amounts in millions):

	2003		2002	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Investments	$ 959	89%	$ 1,053	$ (94)	-9%
Other Assets	119	11%	74	45	61%
Total Assets	**1,078**	**100%**	**1,127**	**(49)**	**-4%**
Accounts Payable	139	54%	192	(53)	-28%
Securities Lending Asset/Liability	84	32%	0	84	0%
Other Liabilities	36	14%	0	36	0%
Total Liabilities	**259**	**100%**	**192**	**67**	**35%**
Total Fund Balance	**819**	**100%**	**712**	**107**	**15%**
Intergovernmental	108	19%	76	32	42%
Investment Income	37	6%	7	30	429%
Other Revenues	427	75%	433	(6)	0%
Total Revenues	**572**	**100%**	**516**	**56**	**11%**
Protection of Persons and Property	80	12%	0	80	
Health and Human Services	474	73%	331	143	43%
Economic Development	100	15%	0	100	0%
Total Expenditures	**654**	**100%**	**331**	**323**	**98%**
Net Transfers In (Out)	(36)	100%	758	(794)	-105%
Other Financing Sources (Uses)	0	0%	(8)	8	-100%
Net Other Financing Sources (Uses)	**(36)**	**100%**	**750**	**(786)**	**-105%**
Net Change in Fund Balances	**$ (118)**	**100%**	**$ 935**	**$ (1,053)**	**-113%**

Intergovernmental revenues increased by $32 million during the fiscal year ended June 30, 2003, from $76 million to $108 million, because of net increased Federal participation and because of Federally-funded program expansion during the fiscal year. Investment income increased by $30 million during the fiscal year because of increasing investment fair value during the fiscal year ended June 30, 2003. Other revenues, consisting of Master Settlement Agreement (MSA) receipts, decreased by $6 million. MSA receipts are directly related to tobacco product sales. Those sales decreased during the MSA measurement period. Fund expenditures grew nearly 98 percent because of greatly increased and expanded programs funded through MSA receipts. New programs for protection of persons and property expenditures and economic development, respectively, increased by $80 million and $100 million and health and human services expenditures increased by $143 million during the fiscal year ended June 30, 2003. Year-over-year statutory net transfers to/from the Fund decreased by $794 million, largely because of the one-time transfer of cumulative MSA receipts and related investment income, amounting to $854 million, from the General Fund to the Tobacco Settlement Fund during the fiscal year ended June 30, 2002.

Measurement focus and basis of accounting – proprietary funds

The enterprise funds and internal service funds (proprietary funds) are reported using the economic resources measurement focus and the accrual basis of accounting. Under this measurement focus all assets and liabilities associated with the operations of these funds are included on the statement of net assets. Under the accrual basis of accounting, revenues are recognized in the fiscal year earned and expenses are recognized in the fiscal year incurred. Enterprise funds that report loan, insurance and tuition payment programs report all revenues as operating revenues; non-operating revenues are reported for other programs and include investment income and grant revenues. Under the Governmental Accounting Standards Board's (GASB) Statement 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting," the Commonwealth has elected not to adopt the Financial Accounting Standards Board pronouncements issued after November 30, 1989. Four enterprise funds are reported as major funds and are discussed below (amounts in millions).

Unemployment Compensation Fund

	2003		2002	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Investments	$ 1,379	74%	$ 2,351	$ (972)	-41%
Other Assets	496	26%	402	94	23%
Total Assets	**1,875**	**100%**	**2,753**	**(878)**	**-32%**
Accounts Payable	206	97%	156	50	32%
Other Liabilities	6	3%	6	0	0%
Total Liabilities	**212**	**100%**	**162**	**50**	**31%**
Net Assets	**1,663**		**2,591**	**(928)**	**-36%**
Sales and Services	1,532	60%	1,761	(229)	-13%
Investment Income	103	4%	156	(53)	-34%
Other Revenues	907	36%	343	564	164%
Total Revenues	**2,542**	**100%**	**2,260**	**282**	**12%**
Cost of Sales and Services	3,470	100%	2,820	650	23%
Total Expenses	**3,470**	**100%**	**2,820**	**650**	**23%**
Decrease in Net Assets	**$ (928)**		**$ (560)**	**$ (368)**	**66%**

Decreases in cash/investments, total assets and net assets during the fiscal year were attributable to increases in expenses which were not offset by higher revenues. During the fiscal year ended June 30, 2003, unemployment compensation benefit claims continued at high levels. Incoming revenues from employer contributions and Federally funded programs, while $282 million higher than the previous fiscal year, were not sufficient to fully fund higher June 30, 2003 benefit payments and other expenses ($650 million higher) and, as a result, cash and investment balances decreased significantly. This same situation has resulted in decreases in reported total assets and increases in liabilities at June 30, 2003. During the fiscal year, statutory contribution increases were triggered for employers and employees in an effort to improve the Fund's continuing ability to make benefit payments. The Temporary Extended Unemployment Compensation Program, established by Federal legislation during the fiscal year ended June 30, 2002, also continued to provide an additional 13 weeks of benefit payments for qualified claimants. This program is supported by Federal funding and resulted in increases in Fund revenues and expenses.

State Workmen's Insurance Fund (December 31, 2002)

	2003		2002	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Short-term Investments	$ 589	30%	$ 536	$ 53	10%
Long-Term Investments	1,318	68%	1,235	83	7%
Other Assets	38	2%	34	4	12%
Total Assets	**1,945**	**100%**	**1,805**	**140**	**8%**
Securities Lending Obligations	510	31%	469	41	9%
Deferred Revenue	0	0%	35	(35)	-100%
Insurance Loss Liability	1,040	63%	1,033	7	1%
Other Liabilities	94	6%	22	72	327%
Total Liabilities	**1,644**	**100%**	**1,559**	**85**	**5%**
Net Assets	**301**	**100%**	**246**	**55**	**22%**
Sales and Services	181	65%	100	81	81%
Investment Income	97	35%	50	47	94%
Other Revenues	0	0%	0	0	0%
Total Revenues	**278**	**100%**	**150**	**128**	**85%**
Cost of Sales and Services	212	94%	168	44	26%
Interest Expense	6	3%	5	1	20%
Provision for Uncollectible Accounts	8	3%	2	6	300%
Other Expenses	0	0%	0	(0)	-100%
Total Expenses	**226**	**100%**	**175**	**51**	**29%**
Increase (Decrease) in Net Assets	**$ 52**		**$ (25)**	**$ 77**	**-307%**

Cash, investments and other assets of the State Workmen's Insurance Fund increased during calendar year 2002 because of a year-over-year increase in policies. Similarly, revenues increased during 2002. Investment income increased by $47 million due to increased policies and better investment results. Total expenses increased by $51 million due to increased claim expenses. Overall net assets increased by $52 million during 2002, compared to a decrease of $25 million during the prior year, for a year-over-year increase in the change in total net assets of $77 million during calendar year 2002.

State Lottery Fund

	2003		2002	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Short-term Investments	$ 406	92%	$ 340	$ 66	19%
Long-Term Investments	14	3%	14	0	1%
Other Assets	24	5%	22	2	9%
Total Assets	**444**	**100%**	**376**	**68**	**18%**
Accounts Payable	219	73%	187	32	17%
Securities Lending Obligations	76	25%	0	76	--
Other Liabilities	7	2%	8	(1)	-13%
Total Liabilities	**302**	**100%**	**195**	**107**	**55%**
Net Assets	**142**	**100%**	**181**	**(39)**	**-22%**
Sales and Services	2,100	97%	1,933	167	9%
Other Revenues	69	3%	66	3	5%
Total Revenues	**2,169**	**100%**	**1,999**	**170**	**9%**
Cost of Sales and Services	1,762	96%	1,614	148	9%
Other Expenses	65	4%	68	(3)	-4%
Total Operating Expenses	**1,827**	**100%**	**1,682**	**145**	**9%**
Operating Income (Loss)	**342**		**317**	**25**	**8%**
Nonoperating Revenues	**15**		**23**	**(8)**	**-35%**
Income (Loss) Before Transfers	**357**		**340**	**17**	**5%**
Transfers	**(395)**		**(359)**	**(36)**	**10%**
Decrease in Net Assets	**$ (38)**		**$ (19)**	**$ (19)**	**100%**

State Lottery Fund cash and investments increased due to an expansion in the Treasury Department securities lending program during the fiscal year. Revenues and expenses increased primarily due to the Commonwealth's participation in the Powerball game during the fiscal year. The current year statutory transfer from the Fund for the payment of benefits to the elderly that the Fund subsidizes amounted to $395 million, an increase of $36 million over the prior fiscal year.

Tuition Payment Fund

	2003		2002	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Short-term Investments	$ 194	28%	$ 143	$ 51	36%
Long-Term Investments	504	72%	267	237	89%
Other Assets	2	0%	2	0	0%
Total Assets	**700**	**100%**	**412**	**288**	**70%**
Securities Lending Obligations	87	12%	34	53	156%
Tuition Benefits Payable	658	87%	399	259	65%
Other Liabilities	7	1%	5	2	40%
Total Liabilities	**752**	**100%**	**438**	**314**	**72%**
Net Assets	**(52)**	**100%**	**(26)**	**(26)**	**100%**
Sales and Services	234	89%	157	77	49%
Investment Income	28	11%	(6)	34	-
Total Revenues	**262**	**100%**	**151**	**111**	**74%**
Cost of Sales and Services	288	100%	191	97	51%
Total Expenses	**288**	**100%**	**191**	**97**	**51%**
Decrease in Net Assets	**$ (26)**		**$ (40)**	**$ 14**	**-35%**

The Tuition Payment Fund cash and investments balance increased during the fiscal year due to an expansion in the Treasury Department securities lending program. The total tuition benefits payable liability, which incorporates a variety of actuarial assumptions, increased by $259 million, from $399 million at June 30, 2002 to $658 million at June 30, 2003. The 49 percent increase in sales and services is attributable to increases in the number of tuition credit purchasers as well as increases in the per-credit tuition price charged to purchasers, while investment income increased due to much more favorable year-over-year investment returns. Year-over-year expenses increased by $97 million, largely as a result of tuition cost increases. Fund net assets decreased by $26 million during the current fiscal year, while total net assets decreased by $40 million during the prior fiscal year, resulting in a year-over-year decrease of $14 million in the change in total net assets.

Capital asset activity during the fiscal year ended June 30, 2003

Throughout the fiscal year, Commonwealth agencies acquire or construct capital assets. In governmental fund statements, expenditures for capital assets are typically reported as capital outlay. Funding for a significant portion of capital asset acquisition is provided by proceeds of general obligation bonds issued; such proceeds are generally accounted for in the capital projects funds in the funds financial statements as an other financing source. In the government-wide statements, bond proceeds are reported as additions to long-term bond liabilities and completed project expenditures and construction in progress at fiscal year end are reported as part of general capital assets. Construction in progress for Department of General Services (public works) and Department of Transportation (highway and bridge) projects at June 30, 2003 amounted to $1.2 and $1.9 billion, respectively. Authorized but unissued general obligation bonds at June 30, 2003 totaled $33.5 billion.

General capital assets of the Commonwealth are those used in the performance of specific governmental functions during more than one fiscal year. Capital assets of the proprietary funds are reported in both fund statements and in government-wide statements. Fiduciary fund capital assets are reported in fund statements; fiduciary funds are not included in government-wide statements. General capital assets as of June 30, 2003 amounted to $19.7 billion at actual or estimated historical cost, net of accumulated depreciation of $9.1 billion. In the government-wide statements, depreciation expense for all capital assets is reported to recognize the cost of "using up" capital assets over their estimated useful lives. This treatment differs from reporting capital outlay as a current year expenditure in governmental funds. Highway and bridge infrastructure assets are typically funded by Motor License Fund taxes, license and registration fees and Federal revenues. The Motor License Fund reports transportation and capital outlay expenditures in fund statements; a portion of such expenditures is reported as additions to capital assets in government-wide statements. Depreciation of highway and bridge infrastructure assets is not related to the quality or relative value of these assets; rather, it is a specific accounting treatment to recognize the cost of "using up" the Assets over long periods of time (25 years for highways and 50 years for bridges.) Depreciation is an allocation of an asset's cost over its estimated useful life and is reported in government-wide statements. Note E to the financial statements provides more information on capital asset activities during the fiscal year ended June 30, 2003.

Long-term debt activity during the fiscal year ended June 30, 2003

The constitution of the Commonwealth of Pennsylvania permits the incurrence of debt, without approval of the electorate, for capital projects specifically authorized in a capital budget. Capital project debt outstanding cannot exceed one and three quarters (1.75) times the average of the annual tax revenues deposited in all funds during the previous five fiscal years. The certified constitutional debt limit at August 31, 2003 was $42.5 billion. Outstanding capital project debt at August 31, 2003 amounted to $6.0 billion, for a remaining legal debt margin of $36.5 billion. In addition to constitutionally authorized capital project debt, the Commonwealth may incur debt for electorate-approved programs, such as economic revitalization, land and water development, and water facilities restoration; and for special purposes approved by the General Assembly, such as disaster relief.

Total general obligation bond indebtedness outstanding at June 30, 2003 was $7.031 billion. Total debt service transfers paid from General Fund, Motor License Fund and Capital Facilities Fund appropriations to make principal and interest payments to bondholders during the fiscal year ended June 30, 2003 amounted to $715 million. The table that follows shows total outstanding long-term indebtedness for general obligation bonds at the end of the eight most recent fiscal years (expressed in billions).

At June 30	Outstanding Bond Indebtedness
1996	$ 5.062
1997	4.842
1998	4.841
1999	5.254
2000	5.367
2001	5.545
2002	6.072
2003	7.031

Note K to the financial statements provides more specific details on long-term debt balances and activity during the fiscal year ended June 30, 2003.

Debt administration – fiscal year ending June 30, 2004

During the fiscal year ending June 30, 2004 the Office of the Budget currently plans general obligation bond issuances amounting to $1.0345 billion, a decrease of $934.2 million when compared to actual bond issuances of $1.969 billion during the fiscal year ended June 30, 2003. This plan reflects the need to make investments in the Commonwealth's capital infrastructure, particularly prisons, highways, bridges, mass transportation and water supply systems. Debt principal retirements of $455.9 million are currently planned for the fiscal year ending June 30, 2004.

In addition to general obligation bonds, the Commonwealth may issue tax anticipation notes to meet operating cash needs during certain months of the fiscal year. Tax anticipation notes may be issued only for the General Fund and the Motor License Fund. They may not exceed 20 percent of the funds' estimated revenues for the year, and must mature during the fiscal year in which they are issued. Cash shortages may occur during the fiscal year because tax receipts, unlike cash disbursements, are concentrated in the last four months of the fiscal year. The Commonwealth has not issued tax anticipation notes during the past five fiscal years and has no plans to issue any during the 2004 fiscal year. There were no changes in credit ratings and there were no debt limitations during the fiscal year ended June 30, 2003 that might affect the Commonwealth's plans during the fiscal year ending June 30, 2004.

Legislative changes during fiscal year 2003-2004

During the fiscal year that began July 1, 2003, the legislature passed several laws that are expected to have an effect on financial position or changes in financial position the most significant of which was Act 46 of 2003. This act increases the Personal Income Tax from 2.8 percent to 3.07 percent beginning January 1, 2004; imposes a gross receipts tax on interstate calls and cellular communications, effective December 31, 2003; increases the cigarette tax from $1.00 to $1.35 per pack and delays the Capital Stock and Franchise Tax phase-out. Overall the act is expected to generate annual revenues of $1.3 billion.

Fiscal year 2003-2004 tax collections

The initial fiscal year 2004 budget estimate for Commonwealth revenues was prepared in March 2003 at the time of budget enactment based upon a "low growth" economic forecast for national real gross domestic product during the second quarter of 2003 to the second quarter of 2004. The forecast anticipated that growth in the national economy would be below average due to uncertainties at that time, particularly regarding the potential for war with Iraq, an increase in the unemployment rate, and sluggish growth in personal income and personal consumption. Performance of the Pennsylvania economy was anticipated to follow closely the national rate. However, more recent economic indicators at the national level portray a more robust and sustainable recovery that has been taking shape. As result, the original 2004 budget estimate of certified revenues was increased by $630 million, or 3.0 percent, to reflect improving economic conditions since March 2003. Further, certain Commonwealth taxes and fees were increased to provide $794 million of additional fiscal year 2004 revenues. The combination of these two revisions resulted in a final revised official revenue estimate of $22,191.3 million for fiscal year 2004. Actual General Fund revenues (budgetary basis) for the fiscal year through April 2004 are $368 million (2%) over estimate. Most major revenue sources show receipts above estimate for the fiscal year-to-date period. Based on improved national economic data, the Commonwealth now anticipates that revenues will be at least $368 million (2%) over estimate for the fiscal year ending June 30, 2004.

Management's discussion and analysis is intended to enhance the reader's understanding of the basic financial statements, which immediately follow. This supplementary information should be read in conjunction with the government-wide financial statements, the fund financial statements and the notes to financial statements.

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Basic Financial Statements – Government-Wide

Commonwealth of Pennsylvania

COMMONWEALTH OF PENNSYLVANIA

(Expressed in Thousands)

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
ASSETS				
Current assets:				
Cash—Note D	$ 94,395	$ 20,234	$ 114,629	$ 372,308
Cash with fiscal agents—Note D	-	1,378,778	1,378,778	-
Temporary investments—Note D	6,717,547	1,444,072	8,161,619	2,036,723
Receivables (net):				
Taxes—Note G	2,070,663	-	2,070,663	-
Unemployment assessments	-	388,341	388,341	-
Accounts	252,224	74,770	326,994	88,067
Accrued interest	10,247	13,755	24,002	102,158
Loans—Note G	20,555	41,601	62,156	937,084
Lease rentals—Note G	1,334	-	1,334	634
Other	9,429	35	9,464	20,323
Due from pension trust funds—Note H	869	5	874	-
Due from primary government—Note H	-	-	-	7,522
Due from component units—Note H	18,651	374	19,025	76
Due from Federal government	1,774,116	57,077	1,831,193	7,233
Due from political subdivisions	6,664	7,629	14,293	-
Due from other governments	-	17,644	17,644	7,387
Inventory	80,241	161,649	241,890	24,582
Prepaid and deferred expenses	-	1,772	1,772	78,567
Total current assets	11,056,935	3,607,736	14,664,671	3,682,664
Noncurrent assets:				
Long-term investments—Note D	1,683,989	1,833,570	3,517,559	2,314,072
Advances to other funds—Note H	117,108	-	117,108	-
Receivables (net):				
Taxes—Note G	764,771	-	764,771	-
Loans—Note G	27,180	192,322	219,502	7,830,631
Lease rentals—Note G	-	-	-	18,151
Non-depreciable capital assets—Note E:				
Land	1,325,661	323	1,325,984	141,328
Construction in progress	3,035,078	6,708	3,041,786	540,219
Depreciable capital assets—Note E:				
Land improvements	413,071	-	413,071	169,026
Buildings and building improvements	3,953,134	25,727	3,978,861	1,518,380
Machinery and equipment	678,120	71,243	749,363	500,602
Library books and other	-	-	-	147,253
Turnpike infrastructure	-	-	-	3,749,954
Highway infrastructure	13,814,760	-	13,814,760	-
Bridge infrastructure	5,758,394	-	5,758,394	-
Waterway infrastructure	1,700	-	1,700	-
Infrastructure-other	8,614	-	8,614	-
Less: accumulated depreciation	(9,197,837)	(61,580)	(9,259,417)	(3,099,949)
Net depreciable capital assets	15,429,956	35,390	15,465,346	2,985,266
Other assets	3,097	375	3,472	168,372
Total non-current assets	22,386,840	2,068,688	24,455,528	13,998,039
TOTAL ASSETS	$ 33,443,775	$ 5,676,424	$ 39,120,199	$ 17,680,703

- The notes to the financial statements are an integral part of this statement. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
LIABILITIES				
Current liabilities:				
Accounts payable and accrued liabilities	$ 3,277,934	$ 535,949	$ 3,813,883	$ 296,450
Tax refunds payable	576,000	-	576,000	-
Tuition benefits payable	-	48,800	48,800	-
Securities lending obligations	1,406,337	718,533	2,124,870	1,070
Internal balances—Note H	(527)	22,776	22,249	-
Due to pension trust funds—Note H	8,601	72	8,673	-
Due to primary government—Note H	-	-	-	5,016
Due to component units—Note H	7,523	-	7,523	22
Due to political subdivisions	789,488	2,478	791,966	-
Due to other governments	28,697	6,652	35,349	6
Interest payable	88,090	-	88,090	110,883
Deferred revenue	86,553	77,196	163,749	50,369
Notes payable—Note J	-	-	-	210,708
Bonds payable—Note K	458,017	-	458,017	20,327
Revenue bonds payable—Note K	-	-	-	163,521
Self insurance liabilities—Note M	18,500	-	18,500	-
Compensated absence liability—Note K	106,523	7,066	113,589	34,434
Other liabilities	30,978	11,707	42,685	62,879
Total current liabilities	6,882,714	1,431,229	8,313,943	955,685
Noncurrent liabilities:				
Tuition benefits payable—Note F	-	609,341	609,341	-
Deferred revenue	-	-	-	1,253
Advances from other funds—Note H	112,508	86,626	199,134	-
Demand revenue bonds payable—Note J	-	-	-	3,471,000
Insurance loss liability—Note F	-	1,040,265	1,040,265	-
Notes payable—Note J	-	-	-	551,718
General obligation bonds payable—Note K	6,572,601	-	6,572,601	-
Bonds payable—Note K	-	-	-	505,333
Revenue bonds payable—Note K	-	-	-	6,181,858
Capital lease/installment purchase obligations—Note K	62,131	-	62,131	32,000
Compensated absence liability—Note K	633,733	27,087	660,820	70,019
Self insurance liabilities—Note M	650,578	14,693	665,271	-
Other liabilities—Note K	530,420	-	530,420	928,857
Total non-current liabilities	8,561,971	1,778,012	10,339,983	11,742,038
TOTAL LIABILITIES	15,444,685	3,209,241	18,653,926	12,697,723
NET ASSETS—Note C				
Invested in capital assets, net of related debt	16,106,064	42,421	16,148,485	897,569
Restricted for:				
Transportation	553,212	31,742	584,954	-
Capital projects	301,628	-	301,628	732,575
Debt service	32,685	-	32,685	320,512
Unemployment/worker's compensation	48,847	1,960,499	2,009,346	-
Elderly programs	111,659	142,284	253,943	-
Environmental and conservation programs	445,350	-	445,350	-
Other purposes	1,003,117	361,993	1,365,110	2,755,518
Unrestricted (deficit)	(603,472)	(71,756)	(675,228)	276,806
TOTAL NET ASSETS	$ 17,999,090	$ 2,467,183	$ 20,466,273	$ 4,982,980

- The notes to the financial statements are an integral part of this statement. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

		Program Revenues			Net (Expense) Revenue and Changes in Net Assets			
					Primary Government			
Functions/Programs	Expenses	Charges for Sales and Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-Type Activities	Total	Component Units
Primary government:								
Governmental activities:								
Direction and supportive services	$ 1,024,071	$ 347,910	$ 212,487	$ -	$ (463,674)	$ -	$ (463,674)	$ -
Protection of persons and property	3,921,413	627,529	567,027	17,693	(2,709,164)	-	(2,709,164)	-
Public education	10,219,211	-	1,345,932	-	(8,873,279)	-	(8,873,279)	-
Health and human services	20,454,323	2,049,640	10,553,837	-	(7,850,846)	-	(7,850,846)	-
Economic development	1,455,272	142,914	432,942	106,922	(772,494)	-	(772,494)	-
Transportation	2,998,824	914,129	1,429,181	11,124	(644,390)	-	(644,390)	-
Recreation and cultural enrichment	435,864	143,221	32,877	401	(259,365)	-	(259,365)	-
Interest	370,284	-	-	-	(370,284)	-	(370,284)	-
Total governmental activities	40,879,262	4,225,343	14,574,283	136,140	(21,943,496)	-	(21,943,496)	-
Business-type activities:								
State lottery	1,827,306	2,103,644	80,113	-	-	356,451	356,451	-
State workmen's insurance	225,483	180,664	97,023	-	-	52,204	52,204	-
Tuition payment	288,118	234,460	27,311	-	-	(26,347)	(26,347)	-
Unemployment compensation	3,470,257	1,532,213	1,010,443	-	-	(927,601)	(927,601)	-
Liquor control	954,763	1,025,813	3,739	-	-	74,789	74,789	-
Economic development and other	12,663	15,878	4,962	6,706	-	14,883	14,883	-
Total business-type activities	6,778,590	5,092,672	1,223,591	6,706	-	(455,621)	(455,621)	-
Total primary government	$ 47,657,852	$ 9,318,015	$ 15,797,874	$ 142,846	(21,943,496)	(455,621)	(22,399,117)	-
Component units:								
Total component units	$ 3,467,699	$ 1,775,517	$ 1,692,029	$ 144,453	-	-	-	144,300
General revenues:								
Taxes:								
Personal income					6,691,957	-	6,691,957	-
Sales and use					7,511,233	-	7,511,233	-
Corporation					3,418,599	-	3,418,599	-
Liquid fuels and motor carriers					1,666,795	-	1,666,795	46,288
Inheritance					634,365	-	634,365	-
Other					1,616,368	-	1,616,368	-
Total taxes					21,539,317	-	21,539,317	46,288
Investment income					115,829	-	115,829	-
Other					-	-	-	417
Total general revenues					21,655,146	-	21,655,146	46,705
Transfers—Note H					551,807	(551,807)	-	-
Net general revenues and transfers					22,206,953	(551,807)	21,655,146	46,705
Change in net assets					263,457	(1,007,428)	(743,971)	191,005
Net assets, July 1, 2002—Note B					17,735,633	3,474,611	21,210,244	4,791,975
Net assets, June 30, 2003—Note C					$ 17,999,090	$ 2,467,183	$ 20,466,273	$ 4,982,980

- The notes to the financial statements are an integral part of this statement. -

Basic Financial Statements – Fund Statements

Commonwealth of Pennsylvania

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	General Fund	Motor License Fund	Tobacco Settlement Fund	Nonmajor Funds	Total
ASSETS					
Assets:					
Cash—Note D	$ 43,155	$ 18,219	$ 10,479	$ 20,569	$ 92,422
Temporary investments—Note D	3,468,263	829,198	628,646	1,732,497	6,658,604
Long-term investments—Note D	619,218	304,020	319,566	441,185	1,683,989
Receivables, net:					
Taxes—Note G	2,673,101	144,785	-	17,548	2,835,434
Accounts	85,431	-	609	18,767	104,807
Accrued interest	3,947	1,711	-	4,589	10,247
Loans—Note G	9,691	-	-	38,265	47,956
Lease rentals—Note G	-	-	-	1,334	1,334
Other	-	7,418	-	3	7,421
Due from other funds—Note H	46,333	14,854	6,167	66,357	133,711
Due from pension trust funds—Note H	838	-	-	13	851
Due from component units—Note H	1,341	-	-	4,814	6,155
Due from Federal government	1,453,149	191,451	112,887	16,630	1,774,117
Due from political subdivisions	3,199	3,207	-	-	6,406
Advances to other funds—Note H	114,108	-	-	3,000	117,108
Other assets	3,000	-	-	-	3,000
TOTAL ASSETS	$ 8,524,774	$ 1,514,863	$ 1,078,354	$ 2,365,571	$ 13,483,562
LIABILITIES AND FUND BALANCES					
Liabilities:					
Accounts payable and accrued liabilities	$ 2,420,906	$ 345,855	$ 139,240	$ 334,419	$ 3,240,420
Tax refunds payable	575,108	892	-	-	576,000
Securities lending obligations	757,308	205,181	84,368	348,666	1,395,523
Due to other funds—Note H	90,304	21,563	19,535	23,013	154,415
Due to component units—Note H	-	7,522	-	-	7,522
Due to pension trust funds	4,421	4,128	-	52	8,601
Due to political subdivisions	691,881	19,558	16,602	61,447	789,488
Due to other governments	16,085	11,819	-	744	28,648
Deferred revenue	1,495,387	3,037	-	34,943	1,533,367
Advances from other funds—Note H	100,000	2,175	-	10,333	112,508
Other liabilities	15,661	-	-	1,017	16,678
TOTAL LIABILITIES	6,167,061	621,730	259,745	814,634	7,863,170
Fund balances:					
Reserved for:					
Encumbrances	341,881	456,015	-	712,520	1,510,416
Advances—Note C	114,108	-	-	3,000	117,108
Loans receivable	9,470	-	-	38,186	47,656
Other—Note C	307,974	-	388,527	56,884	753,385
Unreserved:					
Designated for:					
Capital projects	-	-	-	54,026	54,026
Debt service:					
Retirement of general obligation bonds	-	-	-	32,685	32,685
Highways	-	215,946	-	-	215,946
Other—Note C	269,775	-	-	-	269,775
Undesignated (deficit)-reported in:					
General Fund	1,314,505	-	-	-	1,314,505
Special Revenue Funds	-	221,172	430,082	1,052,280	1,703,534
Capital Projects Funds	-	-	-	(398,644)	(398,644)
TOTAL FUND BALANCES	2,357,713	893,133	818,609	1,550,937	5,620,392
TOTAL LIABILITIES AND FUND BALANCES	$ 8,524,774	$ 1,514,863	$ 1,078,354	$ 2,365,571	$ 13,483,562

- The notes to the financial statements are an integral part of this statement. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

The governmental funds balance sheet reports total fund balance for all governmental funds. In the governmental activities column in the Statement of Net Assets, amounts are reported for all governmental funds and are adjusted to account for specific items that are treated differently on the Statement of Net Assets than on the governmental funds Balance Sheet. Under the modified accrual basis of accounting, numerous governmental assets are not reported because they may not be "available," (that is, they are not current financial resources) and, similarly, numerous governmental liabilities are not reported because they are not due and payable until after fiscal year end. The following reconciliation begins with total governmental funds fund balance and ends with total net assets for governmental activities. It includes all of the adjustments made to "convert" governmental fund information in the fund financial statements to governmental activities information in the Statement of Net Assets.

Total Fund Balances--Governmental Funds		$ 5,620,392
General capital assets used in governmental activities are not financial resources and are therefore not reported in the governmental funds balance sheet. (Refer to Note E.) These assets consist of:		
Land	$ 1,325,655	
Land improvements	412,780	
Buildings and building improvements	3,949,138	
Machinery and equipment	583,085	
Infrastructure	19,583,468	
Construction in progress	3,035,078	
Accumulated depreciation	(9,147,291)	
Net general capital assets		19,741,913
Certain revenues are earned but not available at fiscal year-end and therefore are reported as deferred revenues in the governmental funds balance sheet		1,446,822
Certain receivables are not reported as governmental fund assets because they are not collected during the availability period under the modified accrual basis of accounting		159,609
Internal service funds are proprietary in nature and charge the costs of certain goods and services to governmental funds. Therefore, the assets and liabilities of the internal service funds are included in the Statement of Net Assets as governmental activities		89,958
The Statement of Net Assets includes inventories that are not reported in the governmental funds balance sheet because they are not current financial resources		69,006
Certain general long-term liabilities are not due and payable at fiscal year-end and therefore are not reported in the governmental funds balance sheet. (Refer to Note K.) These liabilities are:		
Bonds payable	$ (7,030,618)	
Accrued bond interest payable	(88,090)	
Capital lease and installment purchase obligations	(62,131)	
Compensated absence liability	(740,256)	
Self-insurance liabilities	(669,078)	
Other liabilities	(530,420)	
Accounts payable	(8,017)	
		(9,128,610)
Total Net Assets---Governmental Activities		$ 17,999,090

- The notes to the financial statements are an integral part of this statement. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	General Fund	Motor License Fund	Tobacco Settlement Fund	Nonmajor Funds	Total
REVENUES:					
Taxes, net of refunds	$ 19,553,998	$ 1,705,082	$ -	$ 210,090	$ 21,469,170
Licenses and fees	250,264	842,466	-	257,286	1,350,016
Intergovernmental	12,943,624	1,379,786	108,312	143,994	14,575,716
Charges for sales and services	1,796,974	95,911	-	126,957	2,019,842
Investment income	114,990	26,500	37,319	70,982	249,791
Lease rental principal and interest	-	-	-	329	329
Other	401,219	2,455	426,545	7,370	837,589
TOTAL REVENUES	35,061,069	4,052,200	572,176	817,008	40,502,453
EXPENDITURES:					
Current:					
Direction and supportive services	854,434	48,400	543	11,417	914,794
Protection of persons and property	2,941,339	514,100	79,960	347,444	3,882,843
Health and human services	19,549,141	-	473,801	487,907	20,510,849
Public education	10,174,386	1,068	-	22,622	10,198,076
Recreation and cultural enrichment	324,186	3,504	-	144,230	471,920
Economic development	984,334	-	100,000	423,250	1,507,584
Transportation	407,328	3,205,830	-	322,627	3,935,785
Capital outlay	17,698	39,154	-	350,228	407,080
Debt service:					
Principal retirement	-	-	-	998,396	998,396
Interest and fiscal charges	-	-	-	313,681	313,681
TOTAL EXPENDITURES	35,252,846	3,812,056	654,304	3,421,802	43,141,008
REVENUES OVER (UNDER) EXPENDITURES	(191,777)	240,144	(82,128)	(2,604,794)	(2,638,555)
OTHER FINANCING SOURCES (USES):					
Bonds issued	-	-	-	1,324,167	1,324,167
Refunding bonds issued	-	-	-	837,991	837,991
Transfers in—Note H	425,875	-	-	1,303,664	1,729,539
Transfers out—Note H	(903,078)	(60,243)	(34,682)	(179,730)	(1,177,733)
Payment to refunded bond escrow agent	-	-	-	(837,991)	(837,991)
Capital lease and installment purchase obligations	3,851	805	-	-	4,656
NET OTHER FINANCING SOURCES (USES)	(473,352)	(59,438)	(34,682)	2,448,101	1,880,629
NET CHANGE IN FUND BALANCES	(665,129)	180,706	(116,810)	(156,693)	(757,926)
FUND BALANCES, JULY 1, 2002	3,022,842	712,427	935,419	1,707,630	6,378,318
FUND BALANCES, JUNE 30, 2003	$ 2,357,713	$ 893,133	$ 818,609	$ 1,550,937	$ 5,620,392

- The notes to the financial statements are an integral part of this statement. -

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES-GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES

For the Fiscal Year Ended June 30, 2003

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

The governmental funds Statement of Revenues, Expenditures and Changes in Fund Balances reports events and activities that affect, on a current financial resources basis, fund balance changes during the fiscal year. The governmental activities column on the government-wide Statement of Activities conveys information on an economic basis. In effect, the government-wide statement demonstrates all expenses and revenues related to the operation of the government for the fiscal year ended June 30, 2003. Expenses such as depreciation and certain claims and judgments and revenues that may not be collected for several months after fiscal-year end are included in the government-wide statement but are not included in the governmental funds statement. This reconciliation reports all economic events during the fiscal year that appear on the government-wide Statement of Activities but are not included in the governmental funds statement.

Net change in total fund balances of governmental funds...		$ (757,926)
Amounts reported for governmental activities in the statement of activities are different because:		
Capital outlays are reported as expenditures in governmental funds; however, in the government-wide statements capital outlays are reported as increases in capital assets (not expenses) and the cost of general capital assets is allocated over their estimated useful lives and reported as depreciation expense. All depreciation is reported as part of functional program expenses. (Refer to Note E) The current amounts were:		
Capital asset acquisitions (net)..	$ 2,052,376	
Depreciation expense...	(804,176)	
Capital lease, installment purchase and related payments...............	562,650	
Net excess of capital asset additions/installment purchase payments over depreciation expense..		1,810,850
Bond proceeds provide current financial resources to governmental funds; however, issuing bonds increases general long-term liabilities in the statement of net assets. During the current fiscal year, proceeds were received from:		
General obligation bonds, including a premium of $107,848...........	$ (1,324,167)	
Refunding bonds, including a premium of $87,059.........................	(837,991)	
Total bond proceeds..		(2,162,158)
Repayment of general long-term liabilities is reported as an expenditure in governmental funds, but the repayment reduces general long-term liabilities in the statement of net assets. During the current fiscal year, these amounts consisted of:		
Bond principal retirement..	$ 468,391	
Payments to the refunded bond escrow agent..................................	837,991	
Total long-term debt repayment...		1,306,382
Internal service funds charge the costs of certain goods and services to individual funds. The net loss of the internal service funds is reported as part of governmental activities expenses...		2,818
Certain tax and other revenues due by fiscal year end will not be collected for several months or years after fiscal year end; they are not considered available revenues in the governmental funds, but they are reported as revenues in the statement of activities.		85,429
Certain additional expenses are reported in the statement of activities because they are due and payable and are funded with future economic resources rather than current available financial resources..		(21,938)
Net change in governmental net assets in the statement of activities...............................		$ 263,457

- The notes to the financial statements are an integral part of this statement. -

STATEMENT OF NET ASSETS
Proprietary Funds *June 30, 2003*

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Enterprise Funds						
	Unemployment Compensation Fund	State Workmen's Insurance Fund (Dec. 31, 2002)	State Lottery Fund	Tuition Payment Fund	Nonmajor Funds	Total	Internal Service Funds
ASSETS							
Current assets:							
Cash	$ -	$ 3,274	$ 235	$ 915	$ 15,810	$ 20,234	$ 1,974
Cash with fiscal agents—Note D	1,378,778	-	-	-	-	1,378,778	-
Temporary investments—Note D	163	585,292	405,769	193,300	259,548	1,444,072	58,943
Receivables (net):							
Unemployment assessments	388,341	-	-	-	-	388,341	-
Accounts	22,556	25,326	23,647	-	3,241	74,770	5
Accrued interest	-	10,537	-	1,827	1,391	13,755	-
Loans—Note G	-	-	-	-	41,601	41,601	-
Other	-	-	13	-	22	35	652
Due from other funds—Note H	3,104	200	-	-	2,475	5,779	21,612
Due from pension trust funds	5	-	-	-	-	5	18
Due from component units—Note H	371	-	-	-	3	374	1,432
Due from Federal government	56,639	-	433	-	5	57,077	-
Due from political subdivisions	7,629	-	-	-	-	7,629	258
Due from other governments	17,644	-	-	-	-	17,644	-
Inventory	-	-	-	-	161,649	161,649	11,235
Prepaid expenses	-	-	-	-	1,772	1,772	-
Total current assets	1,875,230	624,629	430,097	196,042	487,517	3,613,515	96,129
Noncurrent assets:							
Long-term investments	-	1,315,687	13,873	504,010	-	1,833,570	-
Receivables (net):							
Loans—Note G	-	-	-	-	192,322	192,322	-
Non-depreciable capital assets—Note E:							
Land	-	-	-	-	323	323	6
Construction in progress	-	-	-	-	6,708	6,708	-
Depreciable capital assets—Note E:							
Land improvements	-	-	-	-	-	-	291
Buildings and building improvements	-	-	-	-	25,727	25,727	3,996
Machinery and equipment	-	2,758	424	-	68,061	71,243	95,035
Less: accumulated depreciation	-	(1,256)	(336)	-	(59,988)	(61,580)	(50,546)
Net depreciable capital assets	-	1,502	88	-	33,800	35,390	48,776
Other assets	-	375	-	-	-	375	97
Total noncurrent assets	-	1,317,564	13,961	504,010	233,153	2,068,688	48,879
TOTAL ASSETS	1,875,230	1,942,193	444,058	700,052	720,670	5,682,203	145,008
LIABILITIES							
Current liabilities:							
Accounts payable and accrued liabilities	206,119	8,351	219,382	7,491	94,606	535,949	29,495
Tuition benefits payable—Note F	-	-	-	48,800	-	48,800	-
Securities lending obligations	30	510,162	75,662	86,695	45,984	718,533	10,814
Due to other funds—Note H	2	3,948	284	20	24,301	28,555	383
Due to pension trust funds	-	-	-	-	72	72	-
Due to component units	-	-	-	-	-	-	1
Due to political subdivisions	-	-	2,478	-	-	2,478	-
Due to other governments	5,452	53	650	2	495	6,652	49
Deferred revenue	-	71,665	3,230	-	2,301	77,196	8
Compensated absences	-	-	-	6	7,060	7,066	-
Other liabilities	-	8,482	-	-	3,225	11,707	14,300
Total current liabilities	211,603	602,661	301,686	143,014	178,044	1,437,008	55,050
Noncurrent liabilities:							
Advances from other funds—Note H	-	1,626	-	-	85,000	86,626	-
Self insurance	-	-	-	-	14,693	14,693	-
Tuition benefits payable—Note F	-	-	-	609,341	-	609,341	-
Insurance loss liability—Note F	-	1,039,532	-	-	733	1,040,265	-
Compensated absences	-	-	-	49	27,038	27,087	-
Total noncurrent liabilities	-	1,041,158	-	609,390	127,464	1,778,012	-
TOTAL LIABILITIES	211,603	1,643,819	301,686	752,404	305,508	3,215,020	55,050
NET ASSETS							
Invested in capital assets, net of related debt	-	1,502	88	-	40,831	42,421	48,781
Restricted for:							
Transportation	-	-	-	-	31,742	31,742	-
Unemployment/worker's compensation	1,663,627	296,872	-	-	-	1,960,499	-
Elderly programs	-	-	142,284	-	-	142,284	-
Other purposes—Note C	-	-	-	-	361,993	361,993	41,177
Unrestricted (deficit)	-	-	-	(52,352)	(19,404)	(71,756)	-
TOTAL NET ASSETS	$ 1,663,627	$ 298,374	$ 142,372	$ (52,352)	$ 415,162	$ 2,467,183	$ 89,958

- The notes to the financial statements are an integral part of this statement.

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
Proprietary Funds

For the Fiscal Year Ended June 30, 2003

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Enterprise Funds						
	Unemployment Compensation Fund	State Workmen's Insurance Fund (Dec. 31, 2002)	State Lottery Fund	Tuition Payment Fund	Nonmajor Funds	Total	Internal Service Funds
OPERATING REVENUES:							
Sales and services	$ 1,532,213	$ 180,593	$ 2,100,096	$ 234,334	$ 1,031,561	$ 5,078,797	$ 216,023
Investment income	103,601	97,023	-	27,311	4,463	232,398	-
Interest on loans	-	-	-	126	8,296	8,422	-
Other	906,842	71	68,522	-	1,015	976,450	-
TOTAL OPERATING REVENUES	2,542,656	277,687	2,168,618	261,771	1,045,335	6,296,067	216,023
OPERATING EXPENSES:							
Cost of sales and services	3,470,257	211,806	1,762,311	288,118	957,831	6,690,323	203,704
Interest expense	-	5,096	-	-	(73)	5,023	-
Depreciation	-	359	20	-	4,619	4,998	12,196
Provision for uncollectible accounts	-	8,222	-	-	4,915	13,137	221
Other	-	-	64,975	-	-	64,975	-
TOTAL OPERATING EXPENSES	3,470,257	225,483	1,827,306	288,118	967,292	6,778,456	216,121
OPERATING INCOME (LOSS)	(927,601)	52,204	341,312	(26,347)	78,043	(482,389)	(98)
NONOPERATING REVENUES (EXPENSES):							
Investment income	-	-	15,139	-	4,070	19,209	840
Other revenues	-	-	-	-	7,693	7,693	1
Other expenses	-	-	-	-	(134)	(134)	(3,561)
NONOPERATING REVENUES, NET	-	-	15,139	-	11,629	26,768	(2,720)
INCOME (LOSS) BEFORE TRANSFERS	(927,601)	52,204	356,451	(26,347)	89,672	(455,621)	(2,818)
TRANSFERS:							
Transfers out—Note H	-	-	(395,000)	-	(156,807)	(551,807)	-
TOTAL TRANSFERS	-	-	(395,000)	-	(156,807)	(551,807)	-
INCREASE/(DECREASE) IN NET ASSETS	(927,601)	52,204	(38,549)	(26,347)	(67,135)	(1,007,428)	(2,818)
TOTAL NET ASSETS, JULY 1, 2002 (restated)—Note B	2,591,228	246,170	180,921	(26,005)	482,297	3,474,611	92,776
TOTAL NET ASSETS, JUNE 30, 2003	$ 1,663,627	$ 298,374	$ 142,372	$ (52,352)	$ 415,162	$ 2,467,183	$ 89,958

- The notes to the financial statements are an integral part of this statement. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Enterprise Funds						
	Unemployment Compensation Fund	State Workmen's Insurance (Dec. 31, 2002) Fund	State Lottery Fund	Tuition Payment Fund	Nonmajor Funds	Total	Internal Service Funds
CASH FLOWS FROM OPERATING ACTIVITIES:							
Receipts from employers	$ 1,455,651	$ 201,981	$ -	$ -	$ -	$ 1,657,632	$ -
Receipts from customers		-	2,099,463	234,550	1,038,334	3,372,347	231,182
Receipts from borrowers		-	-	-	7,455	7,455	-
Payments to programs for the elderly		-	(497,481)	-	-	(497,481)	-
Payments to prize winners		-	(1,124,598)	-	-	(1,124,598)	-
Payments to participants		-	-	(26,489)	-	(26,489)	-
Payments to claimants	(3,420,318)	(205,747)	-	-	(2,273)	(3,628,338)	-
Payments to borrowers		-	-	-	4,409	4,409	-
Payments to suppliers		-	(174,115)	-	(970,887)	(1,145,002)	(202,231)
Other receipts	888,484	71	68,522	-	953	958,030	-
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	(1,076,183)	(3,695)	371,791	208,061	77,991	(422,035)	28,951
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES							
Net borrowings (repayments) under advances from other funds	-	(177)	-	(50)	82,000	81,773	-
Transfers out	-	-	(395,000)	-	(156,808)	(551,808)	-
NET CASH USED FOR NON-CAPITAL FINANCING ACTIVITIES	-	(177)	(395,000)	(50)	(74,808)	(470,035)	-
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:							
Acquisition and construction of capital assets	-	(532)	-	-	(16,595)	(17,127)	(15,870)
Loss on disposition of capital assets					136	136	3,560
NET CASH USED FOR CAPITAL AND RELATED FINANCING ACTIVITIES	-	(532)	-	-	(16,459)	(16,991)	(12,310)
CASH FLOWS FROM INVESTING ACTIVITIES:							
Purchase of Investments	(5,604)	(1,027,530)	(1,073,293)	(13,205,133)	(899,346)	(16,210,906)	(271,936)
Sales and maturities of investments	5,647	929,125	1,012,890	12,931,995	865,756	15,745,413	245,066
Investment income	103,601	61,029	10,077	12,665	7,706	195,078	1,061
Change in securities lending obligations	30	41,108	73,738	52,356	41,090	208,322	10,814
NET CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	103,674	3,732	23,412	(208,117)	15,206	(62,093)	(14,995)
NET INCREASE (DECREASE) IN CASH	(972,509)	(672)	203	(106)	1,930	(971,154)	1,646
CASH AT JULY 1, 2002	2,351,285	3,946	32	1,021	13,880	2,370,164	328
CASH AT JUNE 30, 2003	$ 1,378,777	$ 3,274	$ 235	$ 915	$ 15,810	$ 1,399,010	$ 1,974
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES							
Operating income (loss)	$ (927,601)	$ 52,203	$ 341,311	$ (26,335)	$ 78,039	$ (482,383)	$ (98)
Depreciation and amortization	-	359	20	-	4,620	4,999	12,196
Provision for uncollectible accounts	-	8,222	-	-	4,915	13,137	221
Non-operating revenues (expenses)	-	-	-	-	7,558	7,558	(3,560)
Reclassification of investment income	(103,601)	(97,022)	-	(27,311)	(4,462)	(232,396)	-
Change in assets and liabilities:							
Accounts receivable	(5,477)	(15,192)	(6,017)	80	(1,913)	(28,519)	(657)
Unemployment compensation assessments receivable	(69,086)	-	-	-	-	(69,086)	-
Inventory	-	-	-	-	(22,011)	(22,011)	412
Due from other funds	(441)	(70)	-	-	(91)	(602)	16,655
Due from component units	28	-	-	-	57	85	(1,094)
Due from other governments	(19,944)	-	3,505	-	64	(16,375)	(75)
Other current assets	-	3,524	-	-	2,118	5,642	(90)
Accounts payable and accrued liabilities	50,514	3,259	32,676	2,520	(2,736)	86,233	5,018
Tuition benefits payable	-	-	-	259,050	-	259,050	-
Due to other funds	2	1,311	242	4	3,493	5,052	8
Due to political subdivisions	-	-	(2,475)	-	-	(2,475)	7
Due to component units	(577)	53	650	(2)	102	226	7
Due to other governments		-	-	-	(141)	(141)	1
Deferred revenue	-	36,651	1,879	-	118	38,648	-
Insurance loss liability	-	7,026	-	-	733	7,759	-
Other liabilities	-	(4,019)	-	55	7,528	3,564	-
Total Adjustments	(148,582)	(55,898)	30,480	234,396	(48)	60,348	29,049
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	$ (1,076,183)	$ (3,695)	$ 371,791	$ 208,061	$ 77,991	$ (422,035)	$ 28,951
Increase (decrease) in fair value of investments during the fiscal year	$ -	$ 88,292	$ 1,484	$ 15,605	$ (716)	$ 104,665	$ (222)

There were no other material investing, capital or financing activities that did not result in cash receipts or cash payments during the fiscal year.

- The notes to the financial statements are an integral part of this statement. -

STATEMENT OF FIDUCIARY NET ASSETS
Fiduciary Funds and Similar Component Units *June 30, 2003*

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Pension (and Other Employee Benefit) Trust Funds	Investment Trust Fund: INVEST Program for Local Governments (December 31, 2002)	Private Purpose Trust Fund: Tuition Account Investment Program	Agency Funds
ASSETS				
Cash—Note D	$ 5,866	$ -	$ 22	$ 9,232
Cash with fiscal agents—Note D	-	-	-	66,017
Temporary investments—Note D	7,386,768	1,034,837	1,421	1,420,189
Long-term investments—Note D	63,333,401	-	48,135	1,042,126
Receivables, net:				
Taxes—Note G	-	-	-	23,911
Accounts	-	-	178	446,644
Accrued interest	246,457	377	18	819
Loans—Note G	-	-	-	4,909
Pension contributions	235,613	-	-	-
Investment proceeds	1,271,083	-	23	-
Other	4	-	-	139,595
Due from other funds—Note H	3,280	-	-	-
Due from political subdivisions	361	-	-	-
Due from other governments	3,871	-	-	-
Advances to other funds—Note H	-	-	-	100,000
Depreciable capital assets:				
Capital assets—Note E	11,349	-	-	-
Less: accumulated depreciation	(8,921)	-	-	-
Net depreciable capital assets	2,428	-	-	-
Other assets	-	-	-	587,486
TOTAL ASSETS	72,489,132	1,035,214	49,797	3,840,928
LIABILITIES				
Liabilities:				
Accounts payable and accrued liabilities	78,088	915	59	22,798
Investment purchases payable	3,185,080	-	176	-
Securities lending obligations	4,706,928	-	-	104,150
Due to other funds—Note H	1,091	-	-	-
Due to political subdivisions	-	-	-	294,957
Due to other governments	-	-	-	17
Deferred revenue	-	-	-	1,149
Other liabilities	188,349	-	-	3,417,857
TOTAL LIABILITIES	8,159,536	915	235	3,840,928
NET ASSETS:				
Held in trust for:				
Pension and other employee benefits	63,195,938	-	-	-
Healthcare benefits	171,539	-	-	-
Employee salary deferrals	962,119	-	-	-
INVEST Program participants	-	1,034,299	-	-
Tuition Accounts Program participants	-	-	49,562	-
TOTAL NET ASSETS	$ 64,329,596	$ 1,034,299	$ 49,562	$ -

- The notes to the financial statements are an integral part of this statement. -

STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS
Fiduciary Funds and Similar Component Units *For the Fiscal Year Ended June 30, 2003*

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Pension (and Other Employee Benefit) Trust Funds	Investment Trust Fund — INVEST Program for Local Governments (December 31, 2002)	Private Purpose Trust Fund — Tuition Account Investment Program
ADDITIONS:			
Pension contributions:			
Employer	$ 167,287	$ -	$ -
Employee	1,324,133	-	-
Total contributions	1,491,420	-	-
Investment income:			
Net depreciation in fair value of investments	(3,507,056)	-	-
Interest income	1,007,383	21,264	3,982
Dividend income	592,750	-	-
Rental and other income	415,977	-	-
Total investment activity income	(1,490,946)	21,264	3,982
Less: investment expenses			
Investment activity expense	(333,329)	-	(131)
Net investment earnings	(1,824,275)	21,264	3,851
Securities lending activities:			
Income	70,746	-	-
Expenses	(47,310)	-	-
Total securities lending income	23,436	-	-
Total net investment income	(1,800,839)	21,264	3,851
Share transactions (at net asset value of $1.00 per share):			
Shares purchased	-	2,623,913	48,485
Shares issued in lieu of cash distributions	-	20,043	35
Shares redeemed	-	(2,935,996)	(2,771)
Net increase in net assets from share transactions	-	(292,040)	45,749
TOTAL ADDITIONS	(309,419)	(270,776)	49,600
DEDUCTIONS:			
Benefit payments	4,534,110	-	-
Refunds of contributions	18,103	-	-
Transfers to other plans	27,543	-	-
Administrative expenses	62,322	676	-
Other expenses	14,151	-	-
Distributions to participants	-	21,500	38
TOTAL DEDUCTIONS:	4,656,229	22,176	38
CHANGE IN PLAN NET ASSETS HELD IN TRUST FOI			
Pension and other employee benefits	(5,013,786)	-	-
Healthcare benefits	48,138	-	-
INVEST program participants	-	(292,952)	-
Tuition Account Program participants	-		49,562
Net assets, July 1, 2002	69,295,244	1,327,251	-
Net assets, June 30, 2003	$ 64,329,596	$ 1,034,299	$ 49,562

- The notes to the financial statements are an integral part of this statement. -

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STATEMENT OF NET ASSETS

Discretely Presented Nonfiduciary Component Units

COMMONWEALTH OF PENNSYLVANIA

(Expressed in Thousands)

	State Public School Building Authority	Philadelphia Shipyard Development Corporation (Dec. 31, 2002)	Ben Franklin/ IRC Partnership	Ben Franklin Technology Development Fund	Insurance Fraud Prevention Authority	Pennsylvania Higher Educational Facilities Authority	Patient Safety Trust Authority
ASSETS							
Current assets:							
Cash—Note D	$ -	$ 26,702	$ -	$ -	$ 231	$ -	$ -
Temporary investments—Note D	17,623	-	-	19,661	3,012	-	5,832
Receivables:							
Accounts	2	-	-	-	161	-	-
Accrued interest	221	26	-	-	-	-	-
Loans—Note G	2,367	-	-	11,328	-	-	-
Lease rentals—Note G	-	-	-	-	-	-	-
Other	-	-	-	-	14	-	-
Due from primary government—Note H	-	-	-	-	-	-	-
Due from component units—Note H	-	-	-	-	-	-	-
Due from Federal government	-	-	-	-	-	-	-
Due from other governments	-	7,259	-	-	128	-	-
Inventory	-	-	-	-	-	-	-
Prepaid and deferred expenses	-	38	-	-	12	-	-
Total current assets	20,213	34,025	-	30,989	3,558	-	5,832
Noncurrent assets:							
Long-term investments—Note D	8,867	-	-	-	-	-	-
Receivables (net):							
Loans—Note G	4,814	30,000	-	8,600	-	-	-
Lease rentals—Note G	-	-	-	-	-	-	-
Non-depreciable capital assets—Note E:							
Land	-	161	-	-	-	-	-
Construction in progress	-	-	-	-	-	-	-
Depreciable capital assets—Note E:							
Land improvements	-	-	-	-	-	-	-
Buildings and building improvements	-	-	-	-	-	-	-
Machinery and equipment	544	-	-	-	67	-	-
Infrastructure	-	-	-	-	-	-	-
Library books	-	-	-	-	-	-	-
Other capital assets	-	-	-	-	-	-	-
Less: accumulated depreciation	(379)	-	-	-	(33)	-	-
Net depreciable capital assets	165	-	-	-	34	-	-
Other assets	-	-	-	-	2	-	-
Total noncurrent assets	13,846	30,161	-	8,600	36	-	-
TOTAL ASSETS	34,059	64,186	-	39,589	3,594	-	5,832
LIABILITIES							
Current liabilities:							
Accounts payable and accrued liabilities	586	3,875	-	2,297	73	-	114
Securities lending obligations	-	-	-	-	-	-	1,070
Due to primary government—Note H	-	-	-	-	-	-	-
Due to component units—Note H	-	-	-	-	-	-	-
Due to other governments	-	-	-	-	-	-	1
Interest payable	-	-	-	-	-	-	-
Deferred revenue	-	-	-	-	-	-	-
Notes payable—Note J	-	-	-	-	-	-	-
Bonds payable—Note K	-	-	-	-	-	-	-
Revenue bonds payable—Note K	-	-	-	-	-	-	-
Compensated absences	41	-	-	-	-	-	-
Other liabilities	76	-	-	-	-	-	-
Total current liabilities	703	3,875	-	2,297	73	-	1,185
Non-current liabilities:							
Deferred revenue	-	-	-	-	-	-	-
Demand revenue bonds payable—Note J	-	-	-	-	-	-	-
Notes payable—Note J	-	-	-	-	-	-	-
Bonds payable—Note K	-	-	-	-	-	-	-
Revenue bond payable—Note K	-	-	-	-	-	-	-
Capital lease obligation	-	30,000	-	-	-	-	-
Compensated absences	295	-	-	-	-	-	-
Other liabilities	769	-	-	-	-	-	-
Total non-current liabilities	1,064	30,000	-	-	-	-	-
TOTAL LIABILITIES	1,767	33,875	-	2,297	73	-	1,185
NET ASSETS—Note C:							
Invested in capital assets, net of related debt	165	161	-	-	34	-	-
Restricted for:							
Capital projects	-	-	-	-	-	-	-
Debt service	-	-	-	-	-	-	-
Other purposes	32,127	30,150	-	37,292	3,487	-	4,647
Unrestricted	-	-	-	-	-	-	-
TOTAL NET ASSETS	$ 32,292	$ 30,311	$ -	$ 37,292	$ 3,521	$ -	$ 4,647

- The notes to the financial statements are an integral part of this statement. -

Port of Pittsburgh Commission	Pennsylvania Turnpike Commission (May 31, 2003)	Pennsylvania Industrial Development Authority	Pennsylvania Housing Finance Agency	Pennsylvania Higher Education Assistance Agency	Pennsylvania Infrastructure Investment Authority	State System of Higher Education	Philadelphia Regional Port Authority	Total
$ 3	$ 131,761	$ 2,543	$ 96,726	$ 69,179	$ 6,446	$ 33,424	$ 5,293	$ 372,308
1,811	173,705	121,027	807,935	155,865	403,560	326,692	-	2,036,723
60	21,737	-	-	9,531	-	55,637	939	88,067
7	5,427	3,578	-	90,943	1,956	-	-	102,158
109	-	80,129	71,683	670,587	93,986	6,895	-	937,084
-	-	634	-	-	-	-	-	634
-	-	-	20,309	-	-	-	-	20,323
-	7,522	-	-	-	-	-	-	7,522
-	-	-	-	-	76	-	-	76
-	-	-	-	6,504	729	-	-	7,233
-	-	-	-	-	-	-	-	7,387
-	12,275	-	-	-	-	12,307	-	24,582
-	-	-	24,483	28,700	17,716	6,920	698	78,567
1,990	352,427	207,911	1,021,136	1,031,309	524,469	441,875	6,930	3,682,664
-	665,313	157,843	470,369	432,237	-	579,443	-	2,314,072
-	-	462,221	2,500,461	3,554,300	1,239,999	30,236	-	7,830,631
-	-	18,151	-	-	-	-	-	18,151
-	123,955	-	-	2,946	-	14,266	-	141,328
-	431,702	-	-	-	-	97,695	10,822	540,219
-	53,486	-	-	-	-	115,540	-	169,026
-	588,153	-	-	63,097	-	761,179	105,951	1,518,380
2,108	271,279	-	-	20,298	-	187,085	19,221	500,602
-	3,749,954	-	-	-	-	-	-	3,749,954
-	-	-	-	-	-	75,901	-	75,901
-	-	-	-	69,188	-	-	2,164	71,352
(326)	(2,510,943)	-	-	(81,449)	-	(441,960)	(64,859)	(3,099,949)
1,782	2,151,929	-	-	71,134	-	697,745	62,477	2,985,266
-	67,158	14,277	-	53,460	-	25,852	7,623	168,372
1,782	3,440,057	652,492	2,970,830	4,114,077	1,239,999	1,445,237	80,922	13,998,039
3,772	3,792,484	860,403	3,991,966	5,145,386	1,764,468	1,887,112	87,852	17,680,703
59	47,963	1,609	2,686	91,280	5,822	136,719	3,367	296,450
-	-	-	-	-	-	-	-	1,070
-	4,893	7	-	-	116	-	-	5,016
-	-	-	-	-	22	-	-	22
-	-	-	-	-	5	-	-	6
-	34,829	15,118	43,977	16,959	-	-	-	110,883
-	12,549	-	-	4,032	-	33,778	10	50,369
-	-	-	-	210,708	-	-	-	210,708
-	-	-	-	-	-	20,327	-	20,327
-	42,370	22,120	78,385	1	18,415	155	2,075	163,521
47	11,893	-	-	5,010	-	17,443	-	34,434
-	-	-	887	-	-	61,617	299	62,879
106	154,497	38,854	125,935	327,990	24,380	270,039	5,751	955,685
-	-	-	-	-	-	944	309	1,253
-	-	-	-	3,471,000	-	-	-	3,471,000
-	-	-	-	548,569	-	-	3,149	551,718
-	-	-	-	-	-	505,333	-	505,333
-	2,084,936	529,029	2,960,289	376,529	113,375	69,170	48,530	6,181,858
2,000	-	-	-	-	-	-	-	32,000
-	-	-	-	6,944	-	62,228	552	70,019
-	19,049	15,714	303,512	114,863	-	469,130	5,820	928,857
2,000	2,103,985	544,743	3,263,801	4,517,905	113,375	1,106,805	58,360	11,742,038
2,106	2,258,482	583,597	3,389,736	4,845,895	137,755	1,376,844	64,111	12,697,723
(218)	580,280	-	-	($2,160)	-	301,686	17,621	897,569
-	700,913	-	-	-	-	31,662	-	732,575
-	-	-	82,938	231,844	-	-	5,730	320,512
1,884	252,809	-	519,292	69,807	$1,626,713	176,920	390	2,755,518
-	-	276,806	-	-	-	-	-	276,806
$ 1,666	$ 1,534,002	$ 276,806	$ 602,230	$ 299,491	$ 1,626,713	$ 510,268	$ 23,741	$ 4,982,980

- The notes to the financial statements are an integral part of this statement. -

STATEMENT OF ACTIVITIES
Discretely Presented Nonfiduciary Component Units

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	State Public School Building Authority	Philadelphia Shipyard Development Corporation (Dec. 31, 2002)	Ben Franklin/ IRC Partnership	Ben Franklin Technology Development Fund Fund	Insurance Fraud Prevention Authority	Pennsylvania Higher Educational Facilities Authority	Patient Safety Trust Authority	Port of Pittsburgh Commission
Expenses	$ 2,449	$ 46,135	$ 16	$ 50,368	$ 10,772	$ 1,053	$ 214	$ 931
Program revenues:								
Charges for goods and services	1,372	-	-	709	9,606	1,053	-	30
Operating grants and contributions	736	22,995	-	53,397	280	-	4,861	1,016
Capital grants and contributions	-	-	-	-	-	-	-	-
Total program revenues	2,108	22,995	-	54,106	9,886	1,053	4,861	1,046
Net (expense) revenue	(341)	(23,140)	(16)	3,738	(886)	-	4,647	115
General revenues:								
Taxes and other general revenues	2	-	-	-	-	-	-	-
Change in net assets	(339)	(23,140)	(16)	3,738	(886)	-	4,647	115
Net assets, July 1, 2002 (restated)—Note B	32,631	53,451	16	33,554	4,407	-	-	1,551
Net assets, June 30, 2003	$ 32,292	$ 30,311	$ -	$ 37,292	$ 3,521	$ -	$ 4,647	$ 1,666

- The notes to the financial statements are an integral part of this statement. -

Pennsylvania Turnpike Commission (May 31, 2003)	Pennsylvania Industrial Development Authority	Pennsylvania Housing Finance Agency	Pennsylvania Higher Education Assistance Agency	Pennsylvania Infrastructure Investment Authority	State System of Higher Education	Philadelphia Regional Port Authority	Total
$ 573,550	$ 35,182	$ 472,565	$ 757,399	$ 49,421	$ 1,442,108	$ 25,536	$ 3,467,699
411,888	20,848	202,831	349,608	23,408	750,046	4,118	1,775,517
90,787	7,522	293,136	440,245	21,078	747,330	8,646	1,692,029
7,135	-	-	-	118,074	7,251	11,993	144,453
509,810	28,370	495,967	789,853	162,560	1,504,627	24,757	3,611,999
(63,740)	(6,812)	23,402	32,454	113,139	62,519	(779)	144,300
46,288	-	-	-	-	-	415	46,705
(17,452)	(6,812)	23,402	32,454	113,139	62,519	(364)	191,005
1,551,454	283,618	578,828	267,037	1,513,574	447,749	24,105	4,791,975
$ 1,534,002	$ 276,806	$ 602,230	$ 299,491	$ 1,626,713	$ 510,268	$ 23,741	$ 4,982,980

- The notes to the financial statements are an integral part of this statement. -

INDEX TO NOTES

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The basic financial statements of the Commonwealth of Pennsylvania have been prepared in accordance with accounting principles generally accepted in the United States applicable to governments. The Governmental Accounting Standards Board (GASB) establishes accounting and financial reporting requirements for governments.

Government-Wide Financial Statements: Government-wide financial statements report financial position and results of activities for the Commonwealth of Pennsylvania as a whole. Amounts are separated between governmental and business-type activities within the primary government (defined below) and nonfiduciary component units. The Statement of Net Assets reports all economic resources (assets) and all liabilities for the primary government of the Commonwealth. The Statement of Activities reports the total cost of providing governmental services, by function, net of related program revenues, and, after including general revenues, reports whether the total net assets of the government increased or decreased during the fiscal year ended June 30, 2003. The government-wide financial statements do not include any fiduciary fund assets, liabilities or activities for the primary government or component units (defined below) that are fiduciary in nature. Governmental activities within government-wide financial statements include specific balances and transactions related to Internal Service Funds that are reported as proprietary funds in fund financial statements. Business-type activities include information for all Enterprise Funds.

Financial Reporting Entity: Government-wide financial statements include separate columns and/or rows for the primary government and discretely presented nonfiduciary component units. Fiduciary component unit balances are reported in the Statement of Fiduciary Net Assets and combining statements for all nonfiduciary component units are presented following fund financial statements as a Statement of Net Assets and a Statement of Activities.

Primary Government: For financial reporting purposes, the Commonwealth of Pennsylvania is a primary government (PG). The PG includes all publicly elected members of the executive, legislative and judicial branches of the Commonwealth. The PG also includes all Commonwealth departments, agencies, boards and organizations that are not legally separate.

Component Units: In addition to the PG, the financial reporting entity includes blended and discretely presented component units. Component units include all legally separate organizations for which the PG is financially accountable, and other organizations for which the nature and significance of their relationship with the PG are such that exclusion would cause the financial statements to be misleading or incomplete. The criteria used to define financial accountability include appointment of a voting majority of an organization's governing body and (1) the ability of the PG to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the PG. Fiscal dependency is also considered. The following organizations are included in the financial reporting entity as component units:

Blended Component Unit

State Employees' Retirement System (SERS) (Fiduciary Funds) **—** The SERS is a public employee retirement system that covers Commonwealth employees. The PG appoints all voting board members and, on a very limited basis, imposes its will on the SERS. The PG uses the SERS to provide pension benefits to PG employees. The PG makes essentially all employer contributions to the SERS; PG employees make almost all of the employee contributions to the SERS (virtually all PG employees are required to join the SERS). The PG is responsible for all of the SERS pension obligations. The SERS is a blended component unit because it provides services and benefits almost exclusively to the PG.

Discretely Presented Component Units

State Public School Building Authority (SPSBA) and Pennsylvania Higher Educational Facilities Authority (PHEFA) - The SPSBA and the PHEFA issue limited obligation revenue bonds, the proceeds of which are used to finance the construction of facilities for school districts and public/ private colleges and universities. These bonds are repaid solely from lease/loan payments from the schools. The PG appoints all nine voting members of the SPSBA and the HEFA governing boards; nine high-ranking members of the PG serve as ex-officio members of each board. As a result, the PG is able to impose its will. The PG Department of Education approves the SPSBA projects (which indicates imposition of will and fiscal dependency). Neither the PG nor the Authorities are obligated for debt service payments (beyond lease/loan payments from schools).

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Ben Franklin/IRC Partnership (Partnership) — The Partnership assists business through interaction of technology development, modernization and training programs. Industrial resource centers and technology centers, established through the Partnership, also increase the competitiveness of businesses. Operations of the Partnership are funded by state appropriations and private contributions; the Partnership may not issue debt. The Partnership works closely with the Department of Community and Economic Development (DCED). The PG appoints all 15 voting members of the governing board. All Partnership expenditures must be appropriated annually by the General Assembly. State law abolished the Partnership effective June 30, 2003.

Ben Franklin Technology Development Authority (PTDA) - The PTDA is very similar to the Ben Franklin/IRC Partnership (above) and superseded and replaced it as of June 30, 2003. The PTDA includes a PTDA Revolving Loan Program. The PG appoints all 21 voting members of the governing board. The PG may appropriate funding for the PTDA from the General Fund.

Port of Pittsburgh Commission (PPC) – The PPC promotes economic development throughout waterways in southwestern Pennsylvania by constructing and/or financing transportation and recreation facilities. The PG appoints all 15 voting members of the governing board and can remove board members at will. The PG provides funding for the PPC but is not required to do so.

Insurance Fraud Prevention Authority (IFPA) **-** The IFPA assists in the prevention, discovery, investigation and prosecution of insurance fraud. The IFPA is funded through assessments paid by the insurance industry and through certain criminal and civil fines, penalties and awards. The PG appoints six of seven voting members of the IFPA governing board; the Attorney General serves ex-officio as one of these six members. A significant portion of IFPA expenditures funds the Section on Insurance Fraud in the Office of Attorney General; this indicates a financial benefit/burden. The IFPA is not fiscally dependent on the PG.

Philadelphia Shipyard Development Corporation (PSDC) **-** The PSDC was created as a nonprofit corporation to assist the PG and other governmental entities in financing a shipbuilding facility at the former Philadelphia Naval Shipyard. The PSDC obtains funding from the PG and a variety of other governmental sources to fund development, construction and job recruitment and training costs. The PG appoints three of five voting board members and provides a significant portion of funding for the PSDC. For the purposes of this report, the PSDC has a December 31, 2002 fiscal year end.

Philadelphia Regional Port Authority (PRPA) **–** The PRPA operates a port facility and manages port-related activities to promote commerce and economic development in southeastern Pennsylvania. The PRPA charges rental and other fees to port users and obtains other funding from the PG. The PRPA also issues revenue bonds to finance its activities. The PG appoints all eleven voting board members and can remove board members at will. The PG provides operating and capital subsidies and pays rent in amounts equal to PRPA debt service requirements. The PRPA is fiscally dependent on the PG, as the Governor must approve the issuance of its debt.

Pennsylvania Higher Education Assistance Agency (PHEAA) - The PHEAA makes grants and loans to students to help fund the cost of higher education. Lending institutions and post-secondary schools are involved in the loan program. The PG funds the PHEAA grant program; the PHEAA issues revenue bonds to fund the student loan program. Revenue bonds are repaid from student loan repayments. The PHEAA also services student loan portfolios for lending institutions. The PG appoints all voting board members but does not significantly impose its will on the PHEAA. A significant PG financial burden exists through subsidizing the grant program; also, although the PG is not obligated for the PHEAA revenue bonds, the PG could take certain actions to satisfy bondholders. The PHEAA is fiscally dependent, as the Governor must approve the issuance of its debt.

Pennsylvania Housing Finance Agency (PHFA) - The PHFA makes loans to eligible individuals and organizations to purchase or construct housing. The loans benefit low and moderate-income individuals and families. The PG appoints all voting board members; four of the fourteen members may be removed at will. The Governor is required to request an appropriation from the General Assembly for the PHFA whenever a deficiency exists in the capital reserve account or if additional funds are needed to avoid a default on the PHFA debt. This represents a PG moral obligation for the PHFA debt. The Governor must approve the issuance of the PHFA debt.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Pennsylvania Industrial Development Authority (PIDA) - The PIDA collaborates with local industrial development corporations to make loans that help preserve or expand the work force, assist targeted economic areas or assist specific companies. Loans are made at lower-than-market interest rates; the interest rates are based on local unemployment and other economic conditions. The PIDA issues revenue bonds to finance the loan program. Loan repayments are used for debt service payments. The PIDA operates closely with the DCED. The PG appoints all voting board members and is able to impose its will on the PIDA. The PG has provided contributed capital; "excess" PIDA funds are transferred to the **General Fund**. The PG is not obligated for the PIDA debt, but the PG could take certain actions to satisfy bondholders.

Pennsylvania Infrastructure Investment Authority (PENNVEST) - PENNVEST makes grants and low-interest loans to local governments and authorities, businesses and nonprofit organizations for the construction, improvement, repair or rehabilitation of drinking and waste water systems. The PENNVEST obtains funds through Commonwealth general obligation bond proceeds (approved by referendum), revenue bonds, the Federal government and contributed amounts from Commonwealth funds. Loan repayments finance the PENNVEST debt service costs. PENNVEST operates closely with the Department of Environmental Protection. The PG appoints all voting board members; there are limitations on three of the thirteen appointments. By issuing general obligation debt and providing the proceeds to the PENNVEST as contributed capital, the PG creates a significant financial burden. The PG is not obligated for the PENNVEST debt, but the PG could take certain actions to satisfy bondholders. Upon dissolution, the assets of the PENNVEST revert to the Commonwealth.

Pennsylvania Turnpike Commission (PTC) - The PTC was created to construct, maintain and operate a turnpike system in the Commonwealth. Activities are financed through user tolls and the issuance of revenue bonds. Debt service payments are funded through user tolls. The PTC works closely with the Department of Transportation. The PG appoints all voting members. When all the PTC bondholders have been satisfied, the PTC assets revert to the Department of Transportation. The Governor must approve the issuance of all PTC debt. The PG is not obligated for PTC debt, but the PG could take certain actions to satisfy bondholders. The PTC is included for its fiscal year ended May 31, 2003.

State System of Higher Education (SSHE) - The SSHE was created to provide instruction for postsecondary students. The SSHE is composed of fourteen universities and an administrative headquarters. Resources are provided by student tuition, grants and PG subsidies. The PG appoints all voting board members. Five of the sixteen appointments must be trustees of universities; three must be students. The PG provides significant operating and capital subsidies to the SSHE. The PG is not obligated for the SSHE debt, but the PG could take certain actions to satisfy bondholders.

Pennsylvania Life and Health Insurance Guaranty Association (PLHIGA) (Fiduciary Funds) - The PLHIGA was created to protect insurance policy owners, insured persons, beneficiaries annuitants, payees and assignees of direct non-group life, health, annuity and supplemental policies or contracts from potential insurer failure due to the impairment or insolvency of the insurer. The PLHIGA guarantees the payment of insurance benefits and continuation of coverage by assessing member insurers. The PLHIGA is also authorized to assist the Pennsylvania Insurance Commissioner in the prevention and detection of insurer impairments or insolvencies. The PG has appointment approval authority for all governing board members and the Insurance Commissioner has broad authority to impose will on the PLHIGA. There is a minor financial burden on the PG.

Pennsylvania Property and Casualty Insurance Guaranty Association (PPCIGA) (Fiduciary Funds) - The PPCIGA was created to provide for the payment of insured property and casualty policy claim losses and to avoid losses to claimants or policyholders as a result of insurer insolvency. The PPCIGA guarantees the payment of insurance benefits and continuation of coverage by assessing member insurers. The PG has appointment approval authority for all governing board members and the Insurance Commissioner has broad authority to impose will on the PPCIGA. There is a minor financial burden on the PG.

Public School Employees' Retirement System (PSERS) (Fiduciary Funds) - The PSERS was created to administer and provide pension benefits to public school employees in Pennsylvania. The PSERS covers almost all such employees. Covered elementary and secondary school employers make employer contributions with the PG reimbursing each employer at least half their required annual contribution. Employer contributions for covered employees of higher education institutions and covered employers and the PG share state-owned schools equally; all covered public school employees also contribute. The PG appoints eight of fifteen voting board members; the seven other members are appointed by active or retired public school employees or are appointed by public school boards. In addition to making significant contributions to the PSERS, the PG guarantees the payment of all annuities and other pension benefits. This represents a compelling PG financial burden.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Pennsylvania Economic Development Financing Authority (PEDFA) - The PEDFA was created to lend money primarily to businesses to promote economic development in the Commonwealth. The PEDFA issues revenue bonds to fund specific projects only and repayments are derived solely from project revenues. The debt is considered non-recourse, as the Authority is not obligated to bondholders beyond amounts received by the Authority from the funded projects. Financial statement information for the PEDFA is not reported because its only activity involves conduit debt. The PG appoints all sixteen board members; five members are ex-officio. The PG is not obligated for the PEDFA debt, but the PG could take certain actions to satisfy bondholders. Upon dissolution, the assets of PEDFA revert to the Commonwealth.

Pennsylvania Energy Development Authority (PEDA)—The PEDA was created to promote the development of energy sources within the Commonwealth. The PEDA issued revenue bonds and lent the proceeds to fund three specific projects. Loan repayments are derived solely from project revenues. The debt is considered non-recourse, as the PEDA is not obligated to bondholders beyond amounts received from the funded projects. The PEDA has not issued any debt since 1990. Financial statement information for the PEDA is not reported because its only activity involves conduit debt. The PG appoints all nineteen board members; six members are ex-officio. The Governor must approve the issuance of Authority debt. The PG is not obligated for the PEDA debt, but the PG could take certain actions to satisfy bondholders.

The **Pennsylvania Life and Health Insurance Guaranty Association** and the **Pennsylvania Property and Casualty Insurance Guaranty Association**, discretely presented component units, are included for their fiscal years ended December 31, 2002.

Financial Statements for Component Units and Investment Trust Fund

Audited financial statements for component units are available by writing to the Deputy Secretary for Comptroller Operations, Room 207 Finance Building, Harrisburg, PA 17120. The Commonwealth sponsors the INVEST Program for Local Governments, an external investment pool, which is reported as an Investment Trust Fund. Audited financial statements for that Program are also available through the Deputy Secretary for Comptroller Operations.

Related Organizations

The Commonwealth created the **Pennsylvania Municipal Retirement System** (PMRS). The PG appoints all eleven governing board members but is not financially accountable, as there is no imposition of will, no financial benefit/burden, nor fiscal dependency associated with the PMRS. Local governments are the only participants in the PMRS. Participation is voluntary and there are variations among different municipal pension plans. Local participating governments are financially responsible only for their own plan obligations. The Commonwealth provides accounting services to the PMRS on a cost reimbursement basis.

The Commonwealth also created the **Automotive Theft Prevention Authority** (ATPA). The PG appoints all seven governing board members but is not financially accountable due to a lack of imposition of will and no financial benefit/burden. The ATPA is not fiscally dependent on the PG. The operation of the ATPA is funded by an annual assessment paid by companies providing automobile insurance in the Commonwealth. The PG processes cash receipts and disbursements for the ATPA.

The **Philadelphia Parking Authority** (Authority) is financially reported as a discretely presented component unit in the City of Philadelphia's (City) financial reporting entity. During 2001, the General Assembly passed Senate Bill 780 that provided, in part, for the Commonwealth to appoint a voting majority of the Authority's governing board. The law provided for an increase from five to eleven board members; the Commonwealth appointed six new members by June 30, 2001. Through June of 2006, existing members' (appointed by the City) terms are to expire and neither the Commonwealth nor the City are to appoint replacements for the five current members. Beginning June 1, 2006 the board is to consist of six members. Subsequent to passage of the 2001 law, the Authority and the City pursued several legal actions contesting, among other things, the constitutionality of the new law.

The **Philadelphia School District** (School District) is financially reported as a discretely presented component unit in the City of Philadelphia's (City) financial reporting entity. During 2001, the General Assembly passed Senate Bill 640 that provided, in part, for several changes to the Public School Code. Among other things, the changes provide for the Commonwealth to appoint a voting majority of the School Reform Commission that now governs the School District. Despite these changes, the School District remains fiscally dependent on the City.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Joint Venture

The Commonwealth, through its Office of Administration, created the Pennsylvania Employees Benefit Trust Fund (PEBTF) using a contractual agreement with various Commonwealth employee labor unions. The PEBTF establishes and provides Commonwealth employee health and welfare benefits. A governing board administers the PEBTF; one-half of the board is appointed by the Commonwealth and one-half is appointed by the various unions. Neither the Commonwealth nor the unions control the governing board or the PEBTF; administration is jointly and equally shared. The Commonwealth unilaterally pays for the cost of providing benefits. Contribution amounts are based on the terms contained in collective bargaining agreements. Employee unions are not financially responsible for making contributions. Neither the Commonwealth nor the employee unions have an equity interest or any ongoing financial interest in the PEBTF. Aside from its obligation to make periodic, established contributions, the Commonwealth is not responsible for any obligations of the PEBTF.

Excluded Organizations

School districts, local governments and counties are considered separate, stand-alone primary governments because they are governed by popularly elected officials. Secondary vocational-technical schools, intermediate units and community colleges were considered as potential component units, but have been excluded from the financial reporting entity. These schools may receive significant PG operating and/or capital subsidies, but the PG does not appoint a voting majority of governing board members, nor does the PG impose its will on these organizations. Although various Commonwealth laws affect or strongly influence these organizations, the PG does not control day-to-day operating decisions. These organizations are not fiscally dependent. The PG appoints a portion, but not a voting majority, of the governing boards at the following four universities (commonly referred to as state related): Pennsylvania State University, University of Pittsburgh, Lincoln University and Temple University. The PG provides significant subsidies; however, given the absence of PG appointment of a governing board voting majority and the lack of fiscal dependency, these universities are excluded from the financial reporting entity.

Primary Government – Fund Structure

Fund Accounting: In governmental accounting, a fund is defined as an independent fiscal and accounting entity, with a self-balancing set of accounts, recording cash and/or other resources together with all related liabilities and equities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with the fund's special regulations, restrictions or limitations. In the Commonwealth, funds are established by legislative enactment or, in certain rare cases, by administrative action.

The fund financial statements include: three major governmental funds and total nonmajor governmental funds; and four major enterprise funds and total nonmajor enterprise funds and all fiduciary funds. The Commonwealth uses the following fund categories to account for each fund included in the primary government:

Governmental Funds

General Fund—Accounts for all financial resources except those required to be accounted for in another fund.

The **General Fund** is the Commonwealth's main operating fund and is reported as a Major Fund.

Special Revenue Funds—Account for the proceeds of specific revenue sources (other than debt service or capital projects funds) that are legally restricted to expenditure for specified purposes. The **Motor License Fund** and the **Tobacco Settlement Fund** are reported as Major Funds.

The **Motor License Fund** receives revenues from liquid fuels taxes, licenses and fees on motor vehicle registrations and operating privileges, aviation fuel taxes, federal aid for highway and aviation purposes, contributions from local subdivisions for highway projects and other miscellaneous revenues. The Fund makes expenditures for highway and bridge improvement, design, maintenance, and purchases of rights-of-way, as well as aviation activities and Transportation licensing and safety activities. It also finances State Police highway patrol operations and pays subsidies to local subdivisions for construction and maintenance of roads.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The **Tobacco Settlement Fund** was established to deposit all payments received by the Commonwealth pursuant to the Master Settlement Agreement with tobacco product manufacturers. Deposits into this fund include: jurisdictional payments received by the Commonwealth from the master agreement; strategic contribution payments from the master agreement and earnings from investments. Expenditures from this fund are determined by the annual budget appropriated to each program distributed as follows: 8 percent to the Health Account; 13 percent for Home and Community Based Services; 12 percent for Tobacco Use Prevention and Cessation; 19 percent for Health Related Research; 10 percent for Uncompensated Care; 30 percent for Health Investment Insurance; and 8 percent for the expansion of the PACENET Program.

Debt Service Funds—Account for the accumulation of resources, principally transfers from other funds, for the payment of general long-term debt principal and interest. There are no major debt service funds.

Capital Projects Funds—Account for financial resources to be used for the acquisition or construction of major capital facilities, including those provided to political subdivisions and other public organizations (other than those financed by Proprietary or Fiduciary Funds). There are no major capital projects funds.

Proprietary Funds

Enterprise Funds—Account for operations that are financed and operated in a manner similar to private business enterprises. Costs of providing goods and services to the general public on a continuing basis, including depreciation, are financed or recovered primarily through user charges. The **State Lottery Fund, State Workmen's Insurance Fund, Unemployment Compensation Fund** and **Tuition Payment Fund** are all reported as Major Funds.

The **State Lottery Fund** provides for the operation of the Pennsylvania State Lottery and for programs to support older Pennsylvanians. Revenues are derived from the sale of lottery tickets, interest earned on securities and deposits, unclaimed prize monies and Federal grants. Fund expenses pay for prizes to holders of winning lottery tickets and commissions to local lottery agents. Amounts remaining after payment of lottery prizes and commissions are used to fund programs benefiting older Pennsylvanians including PENNCARE, PACE, free mass transit and reduced fare shared-ride programs, and property tax and rent rebates.

The **State Workmen's Insurance Fund** (SWIF) was created by legislation on June 2, 1915 and operates within the Department of Labor and Industry. It is a self-sustaining fund providing workers' compensation insurance to employers, including those who are refused policies by private insurance firms. SWIF is subject to underwriting rules, classifications and rates promulgated by rating bureaus authorized by the Commonwealth Insurance Commissioner. Premium rates are established by the bureaus based on the history of accidents by industry classification. Revenues are generated by premiums charged to policyholders plus investment income. Workers' compensation payments and administration costs are paid from the Fund. The **State Workmen's Insurance Fund** is included for its fiscal year ended December 31, 2002.

The **Unemployment Compensation Fund** is comprised of four basic components: the 63 Employer Contribution Fund, 64 UC Benefit Payment Fund, 21 Special Administration Fund, and the UC Trust Fund in Washington, D.C. The purpose of these funds is to collect employer assessments for UC (63 Fund) and transfer the assessments to the Federal government for deposit in the UC Trust Fund. As needed, these funds are drawn back to pay unemployment compensation payments to claimants (64 Fund). The 21 Special Administration Fund is used to isolate penalty and interest charges from employers and claimants. It is used to supplement grant-funding shortfalls and pay audit disallowances with any remaining amounts over $200 thousand being transferred to the UC Trust Fund in Washington, D.C. each June 30. The 64 UC Benefit Payment Fund also receives amounts from the Federal government to reimburse Pennsylvania for those Federal workers who collected UC benefits from Pennsylvania.

The **Tuition Payment Fund** offers a college savings program with a guaranteed rate of return based on increases in the cost of tuition. The program is administered by the Tuition Account Program Bureau within the Treasury Department with oversight by the Tuition Account Program Advisory Board. Revenue is derived primarily from application fees, participant contributions and investment income. Fund expenses consist mainly of payments to educational institutions and administrative costs.

The State Stores Fund is reported for its fiscal year ended June 24, 2003.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Internal Service Funds—Account for the financing of goods or services provided by one department or agency to other departments or agencies of the Commonwealth, or to other governmental units, on a cost-reimbursement basis. The Purchasing Fund is used to purchase materials, supplies, services, and equipment for use by departments, agencies, boards, and commissions of state government, and to pay costs associated with administering the fund. The fund receives reimbursements from the various Commonwealth departments, boards, and commissions for the materials, services, and supplies they obtain, from appropriations and periodic loans from the **General Fund**, from the sale of vehicles and unserviceable property and from interest earned on securities. The Manufacturing Fund is a fund that uses inmate labor to produce items for the Department of Corrections and other state agencies. The revenue source is the sale of items produced or services provided. Expenditures are for raw materials, inmate labor, and general and administrative costs.

Fiduciary Funds

Trust and Agency Funds—Account for assets held by the Commonwealth in a trustee capacity or as an agent for individuals, private organizations, other governmental units and/or other funds. These include Pension (and other employee benefit) Trust Funds, an Investment Trust Fund, a Private Purpose Trust Fund and Agency Funds. The State Employees' Retirement System, a pension trust fund, is a component unit and accounts for the payment of retirement, disability and death benefits to members of the State Employees' Retirement System and their beneficiaries. The Deferred Compensation Fund is an other employee benefit pension trust fund that collects and administers amounts contributed by Commonwealth employees who are deferring a portion of their income until future years, in accordance with Internal Revenue Code Section 457. The INVEST Program for Local Governments is an Investment Trust Fund that invests amounts owned by local governments and school districts. The Tuition Account Investment Program is a Private Purpose Trust Fund that invests amounts on behalf of participants who are saving for college tuition costs.

The State Employees' Retirement System, a pension trust fund, the Deferred Compensation Fund, an other employee benefit trust fund, and the INVEST Program for Local Governments, an Investment Trust Fund, are included for their fiscal years ended December 31, 2002.

Measurement Focus and Basis of Accounting - Government-Wide Financial Statements

The government-wide financial statements are reported using the economic resources measurement focus and accrual basis of accounting. This means that the Statement of Net Assets reports all assets (including receivables regardless of when collected and capital assets, such as heavy trucks, highways and bridges) and liabilities regardless of when payment is due. The Statement of Activities includes all revenues and expenses, regardless of when cash is respectively received or paid. The Statement of Activities reports program revenues, which are revenues derived directly from a specific governmental function and are reported by the function which generates the revenue. Charges for goods or services, most investment income, grant revenues and fines are reported as program revenues. Neither program revenues nor expenses are reported for donated works of art, historical treasures or similar assets received during the fiscal year because such donations are not material. Except for unemployment compensation tax revenues, which are reported as charges for sales and services program revenues, all tax revenues are classified as general revenues in the Statement of Activities. The Statement of Activities also reports governmental activities expenses that include governmental fund expenditures (which are not eliminated or reclassified) and current year depreciation on capital assets, which recognizes the cost of ordinary use of the assets over their estimated useful lives. The costs of most employee benefits earned during the fiscal year (such as vacation time earned) and increases in self-insurance liabilities are also reported as expenses in the statement, regardless of when the benefits are used or the liabilities are paid.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Measurement Focus and Basis of Accounting – Fund Financial Statements

Governmental Funds

The **General Fund**, special revenue, debt service and capital projects funds (governmental funds) are reported using the current financial resources measurement focus and modified accrual basis of accounting. Under this measurement focus, only current assets and current liabilities are normally included on the balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets. Unreserved fund balance represents a measure of available, spendable resources. Under the modified accrual basis of accounting, revenues of governmental funds are recognized in the year that they become susceptible to accrual (both measurable and available) to pay current fiscal year liabilities. The Commonwealth accrues the following major revenue sources that are both measurable and available (available is treated as being received within 60 days of fiscal year end for these revenues): sales and use taxes, cigarette taxes, corporation taxes, personal income taxes, liquid fuels taxes, inheritance taxes, liquor taxes, investment income, institutional revenues and sales of goods and services.

Grant revenues, including Federal government grant revenues, are recognized when earned. Revenues from most other sources are recognized when received. Expenditures are generally recognized in the fiscal year the goods or services are received and the related fund liability is incurred. Debt service expenditures for principal and interest on general long-term obligations are recognized when due. Prepaid items and inventory purchases are reported as current fiscal year expenditures, rather than allocating a portion of related cost to the fiscal year when the items are actually used. Expenditures for claims, judgments, compensated absences and employer pension contributions are reported as the amount accrued during the fiscal year that normally would be liquidated with expendable available financial resources.

Proprietary Funds, Pension (and other employee benefit) Trust Funds and Investment Trust Fund

The enterprise, internal service (proprietary funds), pension (and other employee benefit) trust funds and the investment trust fund are reported using the economic resources measurement focus and the accrual basis of accounting. Under this measurement focus all assets and liabilities associated with the operations of these funds are included on the statement of net assets. Under the accrual basis of accounting, revenues are recognized in the fiscal year earned and expenses are recognized in the fiscal year incurred.

Enterprise funds that report unemployment compensation, insurance, tuition payment and loan programs report all revenues as operating revenues; non-operating revenues are reported for other programs, such as lottery and liquor control, and primarily include investment income and grant revenues. Under the Governmental Accounting Standards Board's (GASB) Statement 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting," the Commonwealth has elected not to adopt the Financial Accounting Standards Board pronouncements issued after November 30, 1989.

Agency Funds

Assets and liabilities of agency funds are reported using the accrual basis of accounting.

Significant Accounting Policies

Pooled Cash: In accordance with the Fiscal Code, cash balances of most Commonwealth funds are pooled by the Treasury Department. Cash balances are segregated by fund, but accounted for centrally for receipt and disbursement purposes. The law requires that collateral be pledged by banks and other financial institutions to guarantee the Commonwealth's cash on deposit.

Cash Equivalents: No investments that could be defined as cash equivalents have been treated as such on the Statement of Cash Flows; therefore, only net changes in cash are displayed.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Investment Pools: The Fiscal Code provides the Treasury Department with investment control over most Commonwealth funds. The Treasury Department uses a variety of sophisticated internal investment pools to ensure preservation of principal, liquidity, diversification and income for Commonwealth funds. All participating funds report amounts invested in such pools as temporary and/or long-term investments; the pools themselves are not financially reported. The Treasury Department maintains an external investment pool, the INVEST Program for Local Governments, which separately issues audited financial statements, and is reported as an Investment Trust Fund. Financial statements for the INVEST Program include a statement of net assets and a statement of changes in net assets prepared using the economic resources measurement focus and the accrual basis of accounting.

Temporary Investments: The Treasury Department manages the Treasury Investment Program (TIP); practically all individual funds that are part of primary government are participants in the TIP. The Treasury Department accounts for each participating fund's equity (considered "shares") in the TIP on a daily basis. "Share" balances of participating funds fluctuate considerably during the fiscal year, based on the timing of cash receipts and disbursements in the participating fund, and are reported as temporary investments. The TIP is considered an internal investment pool. Periodic TIP earnings are allocated to specific participating funds based on either the weighted daily average share balance or the net asset value on redemption date combined with share balances on declaration date.

Several individual funds may directly own investments in specific securities. Such investments, which are expected to be realized in cash within twelve months or less, are reported as temporary investments. Temporary investments are reported at fair value (typically using published market prices) except for nonparticipating interest-bearing contracts, which are reported at amortized cost.

Long-Term Investments: Investments expected to be realized in cash after more than twelve months from fiscal year end are reported as long-term investments. Long-term investments are reported at fair value, except for certain nonparticipating interest-bearing contracts, which are reported at amortized cost. Fair values are based on published market prices, quotations from national securities exchanges and securities pricing services, or by the respective fund managers for securities that are not actively traded. Certain pension trust fund investments, including real estate, venture capital, private equity, private placements and alternative investments, are valued based on appraisals, independent advisors or the present value of projected future income.

Investment Income: Investment income includes interest, dividends, realized gains and losses and the change in the fair value of investments, if any, during the fiscal year. Certain investment income from specific funds' investments is assigned to another fund and is reported by the receiving fund if the income is transferred for legal or contractual reasons; otherwise, the investment income is reported as a transfer by the receiving fund. Specific fund disclosures for assigned investment income are provided in Note H.

Grants: Federal grants and assistance awards made on the basis of entitlement periods are recorded as intergovernmental revenues when entitlement occurs. Federal reimbursement-type grant revenues are recorded when the related expenditures or expenses are incurred.

Inventories: Inventories of operating materials and supplies are reported by certain governmental activities and operating and merchandise inventories are reported by Proprietary Funds and the State System of Higher Education, a discretely presented component unit. These inventories are valued at the lower of cost or market (first-in, first-out) by governmental activities and Proprietary Funds, and lower of cost or market by the State System of Higher Education, with cost determined principally using weighted average. In the governmental fund financial statements, inventories are accounted for using the purchases method.

Capital Assets and Depreciation: General capital assets (including infrastructure) and other capital assets are reported at cost or estimated historical cost in the Statement of Net Assets. Donated capital assets are reported at fair market value at the time of donation. The cost of all land is reported; for other types of capital assets the following minimum dollar reporting thresholds are used:

Land improvements, buildings and building improvements….	$25,000
Machinery and equipment	$25,000
Highway and bridge infrastructure..	$100,000
All other infrastructure	$25,000

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Commonwealth agencies maintain inventories of all their respective capital assets, including assets acquired for less than the above minimum amounts, which are not reported in the BFS. Certain waterway and other non-highway institutional infrastructure acquired prior to July 1, 2001 is not reported in the Statement of Net Assets. The Pennsylvania Historical and Museum Commission (PHMC) owns diverse collections of historical, architectural, prehistoric and artistic artifacts; archives and manuscripts; and scientific specimens. The Commonwealth does not capitalize these collections as they meet the following criteria: PHMC's mission in acquiring these collections is for the purpose of preservation, education, research and exhibition; PHMC secures and preserves all collections in order to adequately preserve Commonwealth history; and all acquisitions and deaccessions must be approved by the PHMC Collections Committee and the PHMC Executive Director. All amounts received from the deacessioning of artifacts/collections are placed in a restricted account that can only be used for the purchase of new artifacts/collections. The Commonwealth does not capitalize expenditures for software or expenditures to protect farmland under the Agricultural Area Security Law. Capital assets (excluding land and construction in progress) are depreciated over the estimated useful lives of major capital asset classes using the straight-line method. Depreciation expense is reported in the Statement of Activities as part of direct functional expenses; all depreciation is allocated to a specific function. Capital assets reported by proprietary funds are reported in those funds at cost or estimated historical cost. Depreciation is reported on the straight-line basis over the capital assets' estimated useful lives. The following useful lives are used for primary government governmental activities:

Buildings and building improvements	40 years
Improvements other than buildings	30 years
Machinery and equipment	10 years
Highway heavy equipment	15 years
Highway infrastructure	25 years
Bridge infrastructure	50 years
Dams, dikes and pier infrastructure	50 years
Other infrastructure	20 years

Primary government business-type activities report depreciation expense using useful lives that are very similar to the above and do not report any infrastructure. Certain land, buildings and improvements owned by the Commonwealth and used by the State System of Higher Education (SSHE), a discretely presented component unit, which were acquired or constructed before July 1, 1983 (the inception date for the SSHE), are financially reported as governmental activities general capital assets. All general capital assets acquired or constructed for the SSHE subsequent to June 30, 1983 without the use of university funds or incurrence of SSHE debt are also reported as governmental activities general capital assets. This reporting treatment is used to conform to the enabling legislation for the SSHE, which includes the vesting of title for the SSHE-used property. Capital assets reported by the SSHE are stated at cost. Depreciation of SSHE capital assets is recognized over the estimated useful life of the assets.

Self-Insurance: The Commonwealth is uninsured for property losses and self-insured for annuitant medical/hospital benefits, employee disability and tort claims. Note M provides disclosures for self-insurance liabilities.

Compensated Absences: Employees earn annual leave based on 2 percent to 10 percent of regular hours paid. A maximum of 45 days may be carried forward at the end of each calendar year. Employees are paid for accumulated annual leave upon termination or retirement.

Employees earn sick leave based on 5 percent of regular hours paid. A maximum of 300 days may be carried forward at the end of each calendar year. Retiring employees that meet service, age or disability requirements are paid in accordance with the following schedule:

Days Available at Retirement	Percentage Payment	Maximum Days Paid
0-100	30%	30
101-200	40%	80
201-300	50%	150
over 300 (in last year of employment)	100% of days over 300	13

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Accumulated annual and sick leave liabilities payable with expendable available financial resources are reported by Governmental Funds; all compensated absences payable are reported by governmental activities and Proprietary Funds and Pension Trust Funds.

Liabilities: In the Statement of Net Assets, governmental activities liabilities are presented as either "current" or "noncurrent." Liabilities are segregated into these categories by establishing an average maturity for the liability class and classifying the portion due within one year of the statement date as current and the portion due beyond one year of the statement date as noncurrent. For liabilities without specific maturity or due dates, estimates are made of maturities. Liabilities without specific due dates include those related to self-insurance and compensated absences.

Pension Costs: The Commonwealth's policy is to fund pension costs incurred and to amortize prior service costs over varying periods not exceeding 20 years.

Intergovernmental Revenues: These amounts represent revenues received principally from the Federal government.

Restricted Net Assets: These amounts were determined based on enabling legislation that provides for restrictions on how the resources of special (non-**General Fund**) funds may be used. Practically all reported restricted net assets could become unrestricted based on possible future legislative changes.

Tax Stabilization Reserve Fund: This fund, commonly referred to as the "Rainy Day Fund," was created in July of 1985 by Act 32 to provide financial assistance to minimize future revenue shortfalls and deficits, and promote greater continuity and predictability in the funding of vital government services. The tax stabilization reserve balance was not to exceed 6 percent of the estimated revenues of the **General Fund**. Revenue was provided through an executive authorization appropriated by the General Assembly for transfer to this Fund. Act 74 of 2001 provided that, for the fiscal year beginning July 1, 2001 and any fiscal year thereafter during which there is a surplus of operating funds in the **General Fund**, as certified by the Budget Secretary, ten percent of such surplus was to be deposited into this Fund. In addition, the proceeds received from the disposition of certain assets of the Commonwealth were also to be deposited into this Fund. For GAAP reporting purposes, at June 30, 2001 the fund balance in this Fund was reported as a fund balance reservation in the **General Fund**. During the fiscal year ended June 30, 2002, Act 91 of 2002 abolished this Fund and net investment assets (valued at $1.038 billion at June 30, 2002) were transferred, resulting in a decrease in fund balance reservations and an increase to unreserved/undesignated fund balance in the **General Fund**.

Budget Stabilization Reserve Fund: Act 91 of 2002 provides for this new Fund effective July 1, 2002 to eventually establish a budgetary reserve amounting to 6 percent of the revenues of the **General Fund**. For the fiscal year beginning July 1, 2002 and in any fiscal year thereafter in which the Secretary of the Budget certifies that there is a surplus in the **General Fund**, 25 percent of the surplus shall be deposited by the end of the next succeeding quarter into this Fund.

Tobacco Master Settlement Agreement Proceeds: In 1997, the Pennsylvania Attorney General began litigation in Commonwealth Court against several defendant tobacco product manufacturers to recover certain amounts the Commonwealth allegedly expended to provide health care to numerous tobacco product users. In 1998, along with many other states, the Commonwealth joined in a settlement that provided, among other things, that the Commonwealth cease its litigation against manufacturers. As part of the settlement, certain manufacturers agreed to remit periodic payments to the Commonwealth and other states (amounting to over $200 billion, according to some estimates) until 2025. Amounts remitted are calculated based on a variety of specific settlement provisions; actual tobacco product sales are one key factor used in determining periodic payment amounts. During the fiscal year ended June 30, 2003 the Commonwealth received $426.5 million from the settlement; this amount is reported as revenue in the **Tobacco Settlement Fund**.

Due From Other Governments: This receivable represents amounts due primarily from the Federal government for various department programs.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Interfund Transactions: The Commonwealth has the following types of transactions between funds, between primary government governmental activities and business-type activities and between primary government and discretely presented non-fiduciary component units:

Statutory Transfers —Legally required transfers that subsidize recipient fund programs and are reported when incurred as "Transfers in" by the recipient fund and as "Transfers out" by the disbursing fund. Legally required payments from the primary government to component unit organizations are reported when incurred as governmental activities program expenses and component unit subsidies by the recipient organization. Interfund balances (amounts due from/to other funds) are reported for unremitted transfers at fiscal year end. In the Statement of Activities, only transfers between governmental activities and business-type activities are reported as transfers.

Transfers of Expenditures (Reimbursements)—Reimbursement of expenditures made by one fund for another that are recorded as expenditures in the reimbursing fund and as a reduction of expenditures in the reimbursed fund.

Interfund Services Provided and Used—Charges or collections for services provided by one fund to another that are recorded as revenues of the recipient fund and expenditures or expenses of the disbursing fund are reclassified and treated as reimbursements (above) in fund financial statements and the Statement of Activities. Interfund balances (amounts due from/to other funds), are reported for unremitted charges or collections at fiscal year end that arise in connection with routine, ordinary governmental fund and proprietary fund operations.

The composition of the Commonwealth's interfund receivables/payables at June 30, 2003 and transfers in/out during the fiscal year ended June 30, 2003 is presented in Note H. Interfund balances between two governmental funds or two proprietary funds are not reported in the Statement of Net Assets.

New Accounting Pronouncements: Effective July 1, 2002 the Commonwealth adopted the Governmental Accounting Standards Board's (GASB's) Technical Bulletin 2003-1 "Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets." Note D includes disclosures required by this new standard. In May 2002 the GASB issued Statement No. 39, "Determining Whether Certain Organizations Are Component Units." GASB No. 39 amends GASB No. 14 and potentially affects the composition of the financial reporting entity; both the primary government and discretely presented component units may be affected. In March 2003 the GASB issued Statement No. 40, "Deposit and Investment Risk Disclosures." GASB No. 40 amends GASB No. 3 and requires additional disclosures related to concentrations of credit risk, interest rate risk and foreign currency risk. In November 2003 the GASB issued Statement No. 42, "Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries." GASB No. 42 requires ongoing evaluation of specific events or changes affecting capital assets to determine whether they are impaired. The Commonwealth must adopt the new standards as follows:

GASB No. 39	Effective July 1, 2003, for financial statements for the fiscal year ending June 30, 2004
GASB No. 40	Effective July 1, 2004, for financial statements for the fiscal year ending June 30, 2005
GASB No. 42	Effective July 1, 2005, for financial statements for the fiscal year ending June 30, 2006.

NOTE B – RESTATEMENT OF PREVIOUSLY REPORTED NET ASSETS AT JUNE 30, 2002

Primary Government

The previously-reported net assets for the Purchasing Fund and the Manufacturing Fund, Internal Service Funds, have been restated and increased, respectively, by $31,067 from $14,452 to $45,519 and by $6,003 from $41,254 to $47,257 as of July 1, 2002 to correct the treatment for eliminating governmental fund amounts owed to each Internal Service Fund. Net assets for Internal Service Funds as of July 1, 2002 amount to $92,776 (amounts in thousands).

Discretely Presented Component Units

The previously-reported net assets for the Pennsylvania Shipyard Development Corporation (PSDC) have been restated and increased by $5,374, from $48,077 to $53,451, as of January 1, 2002 to include previously-unreported grant revenues during its calendar year ended December 31, 2001. Total net assets for discretely presented component units have been restated and increased, from $4,786,601 to $4,791,975 at July 1, 2003. PSDC is reported for its year ended December 31, 2002 (amounts in thousands).

NOTE C – NET ASSETS/FUND EQUITY

Governmental Activities and Business-Type Activities Net Assets: Total Net Assets are the difference between Total Assets and Total Liabilities reported on the Statement of Net Assets. Total Net Assets are reported in three distinct components: Invested in capital assets, net of related debt; Restricted net assets; and Unrestricted net assets. Invested in capital assets, net of related debt represents total capital assets less accumulated depreciation and the outstanding liability for debt specifically related to the acquisition of the capital assets. At June 30, 2003 governmental and business-type activities, respectively, reported $16,106,064 and $42,421 in net assets invested in capital assets, net of related debt. Restricted net assets for special funds are those that are statutorily established and for which net assets may only be used for specific legislated purposes. Governmental fund balance "designations" are not treated as restricted net assets because they represent plans and can easily be changed. Restraints established by enabling legislation, on the other hand, are not easily changed. At June 30, 2003 governmental and business-type activities, respectively, reported $3,085,101 and $2,496,518 in restricted net assets. Unrestricted net assets represent total net assets minus the totals of invested in capital assets, net of related debt and restricted net assets. At June 30, 2003 governmental activities reported an unrestricted net assets deficit of $1,156,933. Business-type activities reported an unrestricted net assets deficit of $71,756 at June 30, 2003 (amounts in thousands).

Governmental Fund Balance Reservations: Fund balance reservations reported in governmental fund balance sheets represent portions of governmental fund balances that are legally segregated for a specific future use or are not available for expenditure.

The amount reserved for advances in the **General Fund**, $114.1 million, is applicable to advances as follows: $14.3 million to the Purchasing Fund, an Internal Service Fund; $2.3 million to the **State Workmen's Insurance Fund** and $85.0 million to the State Stores Fund, both Enterprise Funds; $2.2 million to the **Motor License Fund**; and $10.3 million to the Pharmaceutical Assistance Fund, both Special Revenue Funds.

The amount reserved for advances in the Hazardous Sites Cleanup Fund, a Special Revenue Fund, is applicable to a $3 million advance to the Small Business First Fund, an Enterprise Fund.

Governmental funds reported total fund balance "other" reservations of $458,981 at June 30, 2003. This amount consists of $307,974 reserved in the **General Fund**, $210,227 for restricted revenue and $97,747 for continuing programs; $351,605 reserved in the **Tobacco Settlement Fund** for various health-related programs; and $56,884 reserved in nonmajor Funds for the following programs: (amounts in thousands):

Land reclamation	$ 33,663
Pharmaceutical assistance programs	4,624
Recreation programs	1,573
Conservation, recycling and economic development programs	6,228
Worker's compensation	8,977
Total nonmajor Special Revenue programs	55,065
General State Authority maintenance in the Capital Facilities Fund	1,819
Total nonmajor funds other reservations	$ 56,884

Governmental Fund Balance Designations: Designations of unreserved fund balances reported in governmental funds balance sheets reflect managerial plans for the future use of financial resources. At June 30, 2003 the Commonwealth has included the following amounts as "Designated—Other" for the **General Fund** (amounts in thousands):

General Fund:	
Group medical and life insurance	$ 93,369
Job creation tax credits	49,778
Judicial computer system	54,902
Agency construction projects	65,382
Other	6,344
Total **General Fund**	$ 269,775

NOTE C – NET ASSETS/FUND EQUITY (continued)

Governmental Fund Balance Deficits: Individual funds have reported fund balance deficits in governmental funds balance sheets. The Workmen's Compensation Supersedeas Fund and the State Racing Fund, both Special Revenue Funds, reported a fund balance deficit of $2,414 and $382 at June 30, 2003 (amounts in thousands).

The Capital Facilities Fund, a Capital Projects Fund, reported a deficit unreserved/undesignated fund balance of $356,370 at June 30, 2003. In total, the Capital Facilities Fund reported a fund balance of $237,262 at June 30, 2003. Total Capital Projects Funds reported reservations for encumbrances of $644,428; other reservations of $1,819; designations for Capital Projects of $54,026; and an unreserved/undesignated fund balance deficit of $356,370; for total combined fund balances of $343,903 at June 30, 2003 (amounts in thousands).

Proprietary Fund Net Assets: Nonmajor funds reported total restricted net assets for "other purposes" of $361,993 at June 30, 2003 for the following programs: economic development loans, $191,137; emergency services loans, $118,509; mine subsidence insurance, $36,849; vocational rehabilitation, $8,551; and $6,947 for other programs (amounts in thousands).

The **Tuition Payment Fund**, an Enterprise Fund, reported an unrestricted net assets deficit of $52,352 at June 30, 2003 (amounts in thousands).

Component Unit Net Assets: Except for the Pennsylvania Industrial Development Authority, net assets of all component units are restricted, consistent with enabling legislation for component units. Net assets are restricted to purposes specifically identified by the legislation that created the component unit entity.

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

Authority for Deposits and Investments

The deposit and investment policies of the Treasury Department are governed by Sections 301, 301.1 and 505 of the Pennsylvania Fiscal Code (Act of 1929, P.L. 343) and Section 321.1 of the Pennsylvania Administrative Code (Act of 1929, P.L. 177, No. 175). Treasury deposits must be held in insured depositories approved by the Board of Finance and Revenue and must be fully collateralized. The Treasury Department is granted the power to invest in any deposits and investments subject, however, to the exercise of that degree of judgment and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation but in regard to the permanent disposition of the funds considering the probable income to be derived therefrom as well as the probable safety of their capital. Such deposits and investments may include equity securities and mutual funds.

The Treasury Department manages the Treasury Investment Program (TIP), which is comprised of the Common Investment Pool, Treasury Liquid Asset Pool, **General Fund** Program and **Motor License Fund** Program. As of June 30, 2003, approximately 87 percent of the amounts from practically all Commonwealth Funds are invested on a temporary basis in the TIP. The objectives of the TIP are preservation of principal, liquidity, diversification, and income and all investments are made in accordance with the preceding statutory authority. Throughout the fiscal year, the TIP participates in reverse repurchase agreements; Treasury Department policies require that the maturity date of the reverse repurchase agreements and the maturity date of the regular repurchase agreement purchased with the proceeds occur on the same date. The **General Fund** Program and **Motor License Fund** Program represent funds accumulated beyond the ordinary cash needs of these Funds. These two Programs invest in equity and intermediate-term securities.

Several Commonwealth departments have statutory authority to make their own temporary and long-term investments for the following Funds: **State Workmen's Insurance**, an Enterprise fund, Deferred Compensation, a Pension Trust fund, Workmen's Compensation Security Trust, a Special Revenue fund, and Underground Storage Tank Indemnification and Statutory Liquidator, both Agency funds.

The deposit and investment policies of certain component units are established by authority other than the Fiscal Code. Enabling statutes generally provide deposit and investment authority for component units. Further, specific bond and trust indentures, as well as formal governing board resolutions, provide deposit and investment requirements. Allowable investments of component units do not significantly differ from those investments of the Treasury Department, except that, in accordance with applicable statutory authority, the State Employees' Retirement System and the Public School Employees' Retirement System, Pension Trust funds, utilize financial instruments with off-balance sheet risk. Specific disclosures about Pension Trust fund investments are included in this Note.

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

Deposits

The Treasury Department controls the receipt and disbursement of amounts owned by agencies included in the primary government. Certain discretely presented component units, meanwhile, control receipt and disbursement of their own funds, often through a trustee. The following summaries present the amount of primary government and discretely presented component unit (Commonwealth) deposits which are fully insured or collateralized with securities held by the Commonwealth or its agent in the Commonwealth's name (Category 1), those deposits which are collateralized with securities held by the pledging financial institution's trust department or agent in the Commonwealth's name (Category 2) and those deposits which are not collateralized or are collateralized by the pledging financial institution or the pledging institution's trust department or agent, but not in the Commonwealth's name (Category 3) at June 30, 2003 (amounts in thousands).

Primary Government

	Category 1	Category 2	Category 3	Total Bank Balance	Carrying Amount
Cash	$ 373,339	-	$ 9,523	$ 382,862	$ 109,227
Cash with fiscal agents	1,423,356	-	21,439	1,444,795	1,444,795
Certificates of deposit and related items	202,704	-	13,566	216,270	216,270

The bank balance for cash does not include $134.44 million in available cash resulting from 'float' for outstanding checks at June 30, 2003 which the Treasury Department invested in overnight repurchase agreements. Pension and Other Employee Benefit Trust Funds, the Private Purpose Trust Fund and Agency Funds, all Fiduciary Funds, respectively, reported $5,866, $22 and $7,231 respectively, of cash at June 30, 2003. Agency Funds reported $66,017 of cash with fiscal agents at June 30, 2003. These amounts are not included in the Statement of Net Assets. The above-listed $216,270 in certificates of deposit and related items are reported as part of primary government temporary investments at June 30, 2003 (amounts in thousands).

Discretely Presented Component Units

	Category 1	Category 2	Category 3	Total Bank Balance	Carrying Amount
Cash	$ 7,710	$ 140,742	$ 189,213	$ 337,665	$ 374,309

Fiduciary component units reported $2,001 (in thousands) of cash at their fiscal years ended December 31, 2002. These amounts are not included in the Statement of Net Assets.

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

Investments

The Treasury Department, other agencies in the primary government and discretely presented component units (Commonwealth) categorize investments according to the level of credit risk assumed by the Commonwealth. Category 1 includes investments that are insured, registered or held by the Commonwealth or the Commonwealth's agent in the Commonwealth's name. Category 2 includes uninsured and unregistered investments held by the counterparty's trust department or agent in the Commonwealth's name. Category 3 includes uninsured and unregistered investments held by the counterparty, or by its trust department or its agent, but not in the Commonwealth's name. Certain investments have not been categorized because securities are not used as evidence of the investment. These uncategorized investments include ownership interests in mutual funds, mortgage loans, real estate and venture capital. The following summaries identify the level of custodial credit risk assumed and the related type of investment at June 30, 2003 (amounts in thousands).

Primary Government

All primary government investments susceptible to credit risk categorization are in Category 1, except for amounts in parentheses below, at June 30, 2003.

Commercial paper	$ 420,238
Common and preferred stocks ($160,465 is Category 3)	6,632,976
Corporate bonds and notes ($448,040 is Category 3)	2,481,368
International fixed income ($21,999 is Category 3)	899,752
International equities	39,083
Money market funds ($50,000 is Category 2)	50,000
Mortgage loans	29,982
Real estate	347,315
Repurchase agreements	2,650,264
State and municipal obligations ($2,788 is Category 3)	423,412
U.S. Treasury obligations ($7,085 is Category 2; $241,971 is Category 3)	726,359
U.S. Gov't agency obligations ($36,194 is Category 2; $263,022 is Category 3)	3,195,303
Total categorized investments	17,896,052
Investments not susceptible to credit risk categorization:	
Securities lent by the **State Lottery Fund** at June 30, 2003	3,136
Investments held by the **Tuition Payment Fund** at June 30, 2003:	
Mutual funds	1,101
Securities lent	90,052
Treasury Department global pool	35,901
Investments owned by the Deferred Compensation Fund at December 31, 2002:	
Money market funds	33,506
Mutual funds	916,724
Investments owned by the State Employes' Retirement System (SERS) at December 31, 2002:	
Treasury Department global pool	557,883
Mortgage loans	87,739
Mutual funds	3,860,397
Short-term investment funds	180,630
Venture capital	7,047,681
Securities lent by the SERS at December 31, 2002:	
Common and preferred stocks	321,354
Corporate bonds and notes	213,151
International fixed income	101,022
U.S. Government agency obligations	47,905
U.S. Treasury obligations	626,901
Investments owned by the Statutory Liquidator Fund at June 30, 2003:	
Annuities	2,117
Money market funds	237,990
Mortgage loans, partnership interests and subsidiaries	302
Treasury Department global pool	77,059
Subtotal forwarded to next page	$ 32,338,603

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

Subtotal forwarded from previous page	$ 32,338,603
Investments of the Underground Storage Tank Indemnification Fund at June 30, 2003:	
Securities lent	22,084
Treasury Department global pool	3,038
Investments of the Worker's Compensation Security Trust Fund at June 30, 2003:	
Mortgage loans	2,840
Securities lent	78,862
Treasury Department global pool	35,348
Investments owned by the **State Workmen's Insurance Fund** at December 31, 2002:	
Securities lent	550,581
Treasury Department global pool	26,436
Investments owned by the **General Fund** at June 30, 2003:	
Money market funds	28,296
Securities lent	172,701
Investments owned by the **Tobacco Settlement Fund** at June 30, 2003:	
Partnership interests	1,850
Short-term investment funds	62,010
Investments owned by the Treasury Common Investment Pool at June 30, 2003:	
Money market funds	314,672
Mutual funds	55,444
Securities lent	1,355,908
Investments owned by the **Motor License Fund** at June 30, 2003:	
Money market funds	17,128
Securities lent	73,762
Mutual funds owned by the Tuition Assistance Investment Fund at June 30, 2003	49,556
Subtotal	$35,189,119
Certificates of deposit and related items	216,270
Securities lending collateral held by participating Funds	3,548,258
Amount financially reported by discretely presented component units in Pennsylvania Treasury Common Investment Pool at June 30, 2003	(501,472)
Total primary government temporary and long-term investments	$ 38,452,175

The above-listed $216,270 in certificates of deposit and related items are financially reported as part of temporary investments at June 30, 2003, but are treated as deposits for a determination of the level of credit risk associated with them. Fiduciary funds reported $26,772,997 and non-fiduciary funds reported $11,679,178 of the above $38,452,175 total primary government investments at June 30, 2003. Non-fiduciary funds reported temporary and long-term investments, respectively, of $8,161,619 and $3,517,559 at June 30, 2003 (amounts in thousands). Primary government fiduciary funds investments are not reported in government-wide financial statements.

The State Employees' Retirement System, a Pension Trust Fund, owns 100 percent of the venture capital, 100 percent of the real estate, 79 percent of the Treasury Department global pool, 35 percent of the securities lending collateral, 79 percent of the mutual funds, 67 percent of the common and preferred stocks, 63 percent of the mortgage loans, 46 percent of the corporate bonds and notes and 30 percent of the U.S. Treasury obligations, reported in the above summary. The Treasury Common Investment Pool owns 100 percent of the commercial paper, 71 percent of the international fixed income, 64 percent of the repurchase agreements and 63 percent of the U.S. Government agency obligations.

Financial Instruments With Off-Balance Sheet Risk – State Employees' Retirement System (SERS)

The SERS enters into derivative and structured financial instruments primarily to enhance the performance and reduce the volatility of its investment portfolio. It enters into foreign exchange contracts to hedge foreign currency exposure, futures contracts to gain or hedge exposure to certain equity markets and manage interest rate risk, and swaps to hedge against the effects of inflation.

Foreign exchange contracts are agreements to exchange the currency of one country for the currency of another country at an agreed upon price and settlement date. The SERS uses these contracts primarily to hedge the currency exposure of its investments. To reduce the risk of counterparty nonperformance, the SERS generally enters into these contracts with institutions regarded as meeting high standards of creditworthiness. The unrealized gain/loss on contracts is included in the SERS's net assets and represents the fair value of the contract on December 31. At December 31, 2002, the SERS had contracts to purchase foreign currencies for a total notional amount of $5,240,796 and contracts to sell foreign currencies for a

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

total notional amount of $5,189,305, for a total notional amount of $10,430,101 (amounts in thousands). The net unrealized loss on foreign currency contracts was approximately $51.5 million at December 31, 2002.

Futures contracts are standardized, exchange-traded contracts to purchase or sell a specific financial instrument at a predetermined price. Gains and losses on futures contracts are settled daily based on a notional (underlying) principal value and do not involve an actual transfer of the specific instrument. Because of daily settlement, the futures contracts have no fair value.

The System has entered into certain futures contracts maturing through March 2004. The notional value of these contracts at December 31, 2002 is as follows:

	Buy Contracts	Sell Contracts
Eurodollar futures	$ 27,378	$ 47,960
Euro bond futures	49,443	41,345
Japan bond futures	51,475	-
Treasury futures	20,401	339,804
S&P futures	319,175	417

The exchange on which futures contracts are traded assumes the counterparty risk and generally requires margin payments to minimize such risk. The System pledges investment securities to provide the initial margin requirements on the futures contracts it buys. In addition to that collateral, the System also pledges securities on sales of securities that it does not presently own (short sales). The System enters into those short sales to neutralize the market risk of certain equity positions. The securities the System pledged as collateral on futures purchases and short sales at December 31, 2002 represent restricted assets.

Swap agreements provide for periodic payments between parties based on the net difference in the cash flows of underlying assets, indexes, or rates. During 2002, the System entered into swap arrangements to purchase commodity futures. Under the arrangement, the System receives the net return of the Goldman Sachs Commodity Index from the swap counterparty in return for the 90-day Treasury Bill rate, which it pays to the counterparty. The commodity swaps are used as an inflation hedge and settle on a monthly basis. In addition, during 2002, the System also entered into swap arrangements to gain equity exposure on its absolute return fund-of-fund investments. Under those arrangements, the System receives the net return of the S&P 500 Total Return Index in exchange for a short-term rate plus a spread. The System uses multiple contracts with counterparties to diversify its credit risk. The contracts have varying maturity dates ranging from March 19, 2003 through December 19, 2003.

The table below presents the System's swap exposure at December 31:

	Notional value	Receivable/(Payable)
Goldman Sachs Commodity Index	$ 324,503	$ 25,000
Interest rate	32,600	(729)
S&P 500 Total Return Index	2,378,538	(191,169)

The System generally requires collateral on these swaps based on the counterparty's credit rating in order to reduce the risk of counterparty nonperformance.

The System mitigates its legal risk on investment holdings, including the previously discussed instruments, by carefully selecting portfolio managers and extensively reviewing their documentation. It manages its exposure to market risk within risk limits set by management.

The System also indirectly holds foreign exchange contracts, futures contracts, and certain swap contracts through its investments in collective trust funds. Those collective trust funds directly and indirectly (through a securities lending collateral pool) invest in those instruments to hedge foreign exchange exposure, to synthetically create equity returns, and to manage interest rate risk by altering the average life of the portfolio.

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

Discretely Presented Component Units
(amounts in thousands)

	Category 1	Category 2	Category 3	Total
Asset backed securities	$ -	$ 116,405	$ -	$ 116,405
Commercial paper	-	198,113	154,965	353,078
Common and preferred stocks	15,081,523	580	10	15,082,113
Corporate bonds and notes	3,606,399	166,626	121,010	3,894,035
Guaranteed investment contracts	102,390	-	-	102,390
International equities	6,329,856	-	-	6,329,856
International fixed income	1,189,225	-	-	1,189,225
Mortgage-backed securities	5,510,242	33,615	-	5,543,857
Repurchase agreements	67,501	83,606	40,098	191,205
State and municipal obligations	-	63,550	9,250	72,800
U.S. Treasury obligations	-	402,581	9,564	412,145
U.S. Government agency obligations	638,180	376,400	237,858	1,252,438
Various short-term investments	1,305,656	-	-	1,305,656
Total categorized investments	$ 33,830,972	$1,441,476	$ 572,755	$ 35,845,203

Investments not susceptible to credit risk categorization:

Investments owned by the Ben Franklin Technology Development Authority in Pennsylvania Treasury Common Investment Pool at June 30, 2003	19,661
Investments owned by the Pennsylvania Housing Finance Agency at June 30, 2003:	
Investment agreements	2,908
Mutual funds	185,808
Investments owned by the Pennsylvania Higher Education Assistance Agency at June 30, 2003:	
Guaranteed investment contracts	120,604
Investment agreements	19,990
Money market funds	111,975
Pennsylvania INVEST Program	78,769
Pennsylvania Treasury Common Investment Pool	108,764
Investments owned by the Pennsylvania Infrastructure Investment Authority in Pennsylvania Treasury Common Investment Pool at June 30, 2003	363,462
Guaranteed investment contracts owned by the Pennsylvania Turnpike Commission at May 31, 2003	276,382
Investments owned by the Public School Employees' Retirement System at June 30, 2003:	
Invested with Pennsylvania Treasury Department	1,410,100
Mutual funds	920,008
Private debt	1,153,106
Private equity	2,392,040
Real estate	1,934,156
Securities lending collateral	3,387,690
Securities lending investments	3,259,282
Venture capital	191,626
Money market investments owned by the Pennsylvania Property and Casualty Insurance Guaranty Association at December 31, 2002	500
Mutual funds owned by the Pennsylvania Life and Health Insurance Guaranty Association at December 31, 2002	1,039
Investments owned by the Insurance Fraud Prevention Authority in Pennsylvania Treasury Common Investment Pool at June 30, 2003	3,012
Investments owned by the State Public School Building Authority in Treasury INVEST Program at June 30, 2003	17,623
Investments owned by the Port of Pittsburgh Commission in Pennsylvania Treasury Common Investment Pool at June 30, 2003	1,811
Mutual funds and other investments owned by the State System of Higher Education at June 30, 2003	33,324
Investments owned by the Patient Safety Trust Authority at June 30, 2003:	
Pennsylvania Treasury Common Investment Pool	4,762
Securities lending collateral	1,070
Total temporary and long-term investments	$51,844,675

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

The total amount reported by discretely presented component units in the Pennsylvania Treasury Common Investment Pool is $501,472 at June 30, 2003; Common Investment Pool disclosures are included as part of Primary Government investment disclosures. Of the $51,844,675 in total temporary and long-term investments, non-fiduciary component units reported $2,036,723 in temporary investments and $2,314,072 in long-term investments; fiduciary component units reported $5,643,516 in temporary investments and $41,850,364 in long-term investments at June 30, 2003 (amounts in thousands). Fiduciary component unit investments are not included in government-wide financial statements.

The Public School Employees' Retirement System (PSERS), a Pension Trust fund, owns nearly 100 percent of the common and preferred stocks, 91 percent of the corporate bonds and notes, 100 percent of the international equities, 100 percent of the international fixed income, over 99 percent of the mortgage-backed securities, 100 percent of the real estate and 24 percent of the U.S. Government agency investments included in the above summary. The Pennsylvania Higher Education Assistance Agency owns 42 percent of commercial paper and 24 percent of guaranteed investment contracts. The Pennsylvania Turnpike Commission owns 55 percent of the guaranteed investment contracts, 72 percent of the state and municipal obligations, 40 percent of the repurchase agreements and 96 percent of the U.S. Treasury obligations. The State System of Higher Education owns 56 percent of the commercial paper, 100 percent of the asset-backed securities and 30 percent of the U.S. Government agency obligations. There were no violations of statutory authority or contractual provisions for investments during the fiscal year ended June 30, 2003.

Financial Instruments with Off-Balance Sheet Risk

Public School Employees' Retirements System (System)
The System enters into a variety of financial contracts, which include options and futures. The System also enters into foreign exchange positions, such as forward and spot contracts to hedge foreign exposure; collateralized mortgage obligations (CMOs); other forward contracts, and U.S. Treasury STRIPS. The System is not a dealer, but an end-user of these instruments. The contracts are used primarily to enhance performance and reduce the volatility of the portfolio. Short-term investments and cash equal to or greater than performance obligations under these contracts are maintained at all times. The System is exposed to credit risk in the event of nonperformance by counterparties to financial instruments. As the System generally enters into transactions only with high quality institutions, no losses associated with counterparty nonperformance on derivative financial instruments have been incurred. Legal risk is mitigated through selection of executing brokers and review of all documentation. The System is exposed to market risk, the risk that future changes in market conditions may make an instrument less valuable. Exposure to market risk is managed in accordance with risk limits set by senior management, through buying or selling instruments or entering into offsetting positions.

The notional or contractual amounts of derivatives indicate the extent of the System's involvement in the various types and uses of derivative financial instruments and do not measure the System's exposure to credit or market risks and do not necessarily represent amounts exchanged by the parties. The amounts exchanged are determined by reference to the notional amounts and the other terms of the derivatives.
The following table summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2003 (in thousands):

Futures contracts – long	$ 5,067,677
Futures contracts – short	2,727,179
Foreign exchange forward and spot contracts, gross	2,792,438
Options – calls purchased	85,070
Options – puts purchased	66,213
Options – calls sold	96,320
Options – puts sold	1,523,489

Futures contracts are contracts in which the buyer agrees to purchase and the seller agrees to make delivery of a specific financial instrument at a predetermined date and price. Gains and losses on future contracts are settled daily based on a notional (underlying) principal value and do not involve an actual transfer of the specific instrument. Futures contracts are standardized and are traded on exchanges. The exchange assumes the risk that a counterparty will not pay and generally requires margin payments to minimize such risk. In addition, the System enters into short sales, sales of securities it does not presently own, to neutralize the market risk of certain equity positions. Initial margin requirements on futures contracts and

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

collateral for short sales are provided by investment securities pledged as collateral or by cash held in segregated accounts by the System's custodial bank or short sale broker. Although the System has the right to access individual pledged securities, it must maintain the amount pledged by substituting other securities for those accessed. The value of securities pledged and the amount of cash held at June 30, 2003 represent a restriction on the amount of assets available as of year-end to use for other purposes.

Option contracts provide the option purchaser with the right, but not the obligation, to buy or sell the underlying security at a set price during a period or at a specified date. The option writer is obligated to buy or sell the underlying security if the option purchaser chooses to exercise the option. The System generally uses exchange listed currency, index, stock, and futures options. The System has authorized an investment manager to write covered call stock index option spreads up to a notional amount of $500,000,000.

Foreign exchange contracts involve an agreement to exchange the currency of one country for the currency of another country at an agreed-upon price and settlement date. The contracts reported above primarily include forwards. The $2,792,438,000 of foreign currency contracts outstanding at June 30, 2003 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of $1,766,479,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of $1,025,959,000. The unrealized gain on contracts of $3,234,000 at June 30, 2003 is included in the System's net assets and represents the fair value of the contracts.

The System also invests in mortgage-backed securities (MBS) such as CMOs and MBS forwards to maximize yields. These securities are sensitive to prepayments by mortgagees, which may result from a drop in interest rates. The MBS forwards are subject to credit risk in the event of nonperformance by counterparties. The fair value of CMOs at June 30, 2003 is $2,325,381,000.

The System invests in U.S. Treasury STRIPS, which essentially act as zero coupon bonds and are subject to market volatility from an increase or decrease in interest rates. Through certain collective trust funds, the System also indirectly holds various derivative financial instruments. The collective trust funds invest in futures and options thereon; forward foreign currency contracts; options; interest rates, currency, equity, index, and total return swaps; interest-only STRIPS, and CMOs, to enhance the performance and reduce the volatility of their portfolios. Swap agreements are used to modify investment returns or interest rates on investments in the collective trust funds. Swap transactions involve the exchange of investment returns or interest rate payments without the exchange of the underlying principal amounts. These swaps expose the collective trust funds entering into these types of arrangements to credit risk in the event of nonperformance by counterparties.

Philadelphia Regional Port Authority (Authority)

In December 2002, the Authority entered into an interest rate swaption transaction (Swaption) with a securities investment firm (counterparty) in connection with the planned refunding of the 1993 Lease Revenue Bonds. Under the terms of the Swaption, the counterparty paid an up-front premium of $5,820,000 to the Authority and in return the Authority granted the counterparty the right, but not the obligation, to execute an interest rate swap (Swap) with the Authority. Under the Swap, the Authority will pay a fixed rate of interest of 5.19% on the notional amount of the 2003 refunding lease revenue bonds then outstanding to the counterparty, commencing on September 1, 2003 and ending on September 1, 2020, in exchange for the counterparty's payment of a floating rate of interest, which will be equal to the floating rate of interest on the 2003 refunding lease revenue bonds unless certain events occur which would permit the counterparty to pay an alternate floating rate of interest, as defined.

Upon the occurrence of certain events as described in the Swap, the Authority may be liable for the difference between a higher variable interest rate on the 2003 refunding lease revenue bonds and the interest rate payable by the counterparty. The Authority has the option, subject to certain conditions, to terminate the Swap. Additionally, the Swap provides for other Additional Termination Events, as defined, that may entitle the Authority or the counterparty to terminate the Swap. A termination of the Swap may result in the Authority making or receiving a termination payment.

The counterparty has given notice to the Authority that it intends to exercise its right under the Swaption, effective July 10, 2003.

In connection with the Swaption transaction, the Authority and the Commonwealth entered into the Second Amendment to Agreement of Lease and the First Amendment to Agreement of Sublease.

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

Pennsylvania Industrial Development Authority (Authority)
The Authority entered into a derivative financial contract on September 4, 2002 and J. P. Morgan Chase & Co. (J. P. Morgan). The contract provided the Authority with an upfront receipt of $9,525,000 in exchange for giving J. P. Morgan the option (Swaption) to require the Authority to enter into a pay fixed receive variable interest rate swap as of January 1, 2004. This transaction monetizes the call option embedded within the 1996 Economic Development Revenue Bonds as of the execution date.

The Authority's initial receipt of $9,525,000 was based on a notional amount of $98,960,000. The counterparty has the right to exercise the agreement on January 1, 2004, the Authority's 1996 Bonds' first call date. If exercised, the swap will require the Authority to pay a fixed rate of 5.12% and receive a rate equivalent to 68% of the London Interbank Offering Rate (LIBOR).

Due to decreases in interest rates by the United States Federal Reserve System, the swaption has increased in fair value causing an increased liability to the Authority. This liability is reflected in the statement of net assets at its fair value as of June 30, 2003, which is $15,713,550. The fair market value above included both the market value of the option and the present value of the future net settlements required under the swap.

Pennsylvania Turnpike Commission (Commission)
In June 2001, the Commission entered into three forward interest swap agreements on a portion of its debt to synthetically convert variable interest rates to fixed interest rates and thus hedge its variable rate exposure as well as preserve lower interest rates. These swaps were placed on the Series U Bonds of 2001, Series A Bonds of 2002 and Series B Bonds of 2002 with five different swap providers (counterparties). Based on these swap agreements, the Commission owes interest calculated at a fixed rate to the counterparties to the swaps. In return, the counterparties owe the Commission interest based on a variable rate that approximates the rate on the bonds. Only the net difference in interest payments is actually exchanged with the counterparties. The total notional amount of these swaps was approximately $602 million at May 31, 2003. The $602 million in bond principal is not exchanged, it is only the basis on which the interest payments are calculated. Additonally, the Commission continues to pay interest to the bondholders at the variable rate on the bonds.

In February 2002, the Commission entered into a swap option (swaption) related to Series A of 2002 bonds. The Commission sold its option to terminate the swaption in exchange for an upfront payment of approximately $10 million that it has recorded as deferred revenue and will amortize into income over the life of the swaption.

Following is a summary of the swaps in place as of May 31, 2003. These swap agreements contain certain risks as described below:

Swap	Notional Value	Final Maturity	Floating Rate Index (Receivable)	Fixed Rate (Payable)	Fair Value from(to) Counterparty
Series U 2001	$127,365,000	12/01/2019	67% of 1 mo. LIBOR (1)	4.21%	$ (20,771,543)
	42,455,000	12/10/2019			(7,007,448)
	72,066,250	12/01/2030	67% of 1 mo. LIBOR (1)	4.403%	(14,814,603)
Series A 2002	144,070,000	12/01/2030			(29,408,597)
	72,066,250	12/01/2030			(14,926,703)
	36,077,500	12/01/2012	BMA (2)	4.538%	(3,637,251)
Series B 2002	72,155,000	12/01/2012			(7,310,668)
	36,077,500				(3,614,136)
Total	$602,332,500				$(101,490,949)

(1) 1 month LIBOR was 1.32% at May 31, 2003
(2) BMA was 1.19% at May 31, 2003

- **Credit Risk –** As of May 31, 2003, the Commission was not exposed to credit risk because all of the swaps had negative fair values. However, should interest rates change and the fair values of the swaps become positive, the Commission would be exposed to credit risk in the amount of the derivatives' fair values. To mitigate the potential for credit risk, the swap agreements include collateral provisions in the event of downgrades to the swap counterparties' credit ratings. Collateral would be posted with a third-party custodian and would be in the form of cash, U.S. Treasury Obligations, or U.S.

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

Government Agency Securities. The credit ratings of the swap providers as of May 31, 2003 were AAA to AA- and Aaa to Aa3 to Standard and Poor's and Moody's, respectively.

- **Interest Rate Risk** – The Commission will be exposed to variable interest rates if one or more of the swap providers defaults or if a swap is terminated.

- **Basis Risk** – The underlying variable rates for the Commission's Series U and Series A bonds are based on BMA while the Series U and Series A swaps are based on a percentage of LIBOR. Therefore, the Commission is exposed to basis risk to the extent BMA exceeds 67% of one month LIBOR.

- **Termination Risk** – The swap document may be terminated due to a number of circumstances and the Commission retains the option to terminate the swap at any time. If the Commission were required to make a termination payment because of a termination event (by either party), then the Commission would have the option to enter into a new swap to match the remaining amortization of the underlying bonds and apply the payment it received toward the termination payment. It is the Commission's intent to maintain the swap transactions for the life of the financing.

Securities Lending Program

The Treasury Department provides a securities lending program authorized by the Fiscal Code, which provides the Treasury Department with numerous custodial responsibilities; the securities program is an integral part of the custodial function. A contract between the Treasury Department and its custodian, acting as lending agent, provides that the custodian lends securities owned by the participants to independent brokers, dealers and banks, acting as borrowers.

Lending agreements between the custodian and the borrowers require that the custodian receive collateral from the borrowers in exchange for the securities lent. For securities lent which are not denominated in United States dollars or whose primary trading market is located outside the United States, the fair value of the collateral received must be at least 105 percent of the fair value of the securities lent. For all other securities lent, the fair value of the collateral received must be at least 102 percent. Securities lent consist of both domestic and foreign equity securities and United States Treasury and foreign debt obligations. Almost all collateral received consists of cash; a very small portion of collateral received consists of letters of credit, United States Treasury, corporate and/or foreign debt obligations. Collateral is marked to market daily. Additional collateral from borrowers is required if the fair value of the collateral received declines below lending agreement requirements. The lending agent cannot pledge or sell collateral securities received unless the borrower defaults. Accordingly, neither collateral securities received from borrowers nor the related obligations to borrowers are reported.

To the extent collateral received consists of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the Treasury Department. Either the participant or the borrower may terminate lending agreements on demand. Lending agreements are typically of very short duration - usually overnight. Therefore, the duration of lending agreements does not generally match the maturities of the investments made with cash collateral. The resulting rate risk is mitigated by the lending agent's ability to reallocate lending agreements among program participants.

The program requires that the lending agent indemnify the Treasury Department for all claims, liabilities and costs resulting from the lending agent's negligence or intentional misconduct. During the fiscal year ended June 30, 2003 (December 31, 2002 for the **SWIF**, the SERS and the Deferred Compensation Fund), there were no failures by any borrower to return securities lent or pay distributions thereon. Also, there were no losses resulting from a lending agent or borrower default and there were no Treasury Department restrictions on the amount of the loans that could be made.

At June 30, 2003 (December 31, 2002 for the **SWIF**, the SERS and the Deferred Compensation Fund), there was no Treasury Department or participant credit risk to the borrowers because the fair value of collateral received was greater than the fair value of the securities lent, consistent with the lending agreements outstanding. The carrying amount and fair value of the securities lent, along with type of investments lent, are (amounts in thousands):

NOTE D – DEPOSITS, INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (continued)

	Securities Lent Amount	U.S. Treasury Obligations	U.S. Government Agency Obligations	Corporate Bonds and Notes	Common and Preferred Stocks
General Fund……………………………………..	$ 172,701	$ 111,354	$ 24,539	$ 28,239	$ 8,569
State Lottery Fund………………………………..	3,136	3,136	-	-	-
Motor License Fund……………………………....	73,762	43,177	14,282	9,818	6,485
State Workmen's Insurance Fund………………	550,581	428,746	87,127	32,271	2,437
Tuition Payment Fund…………………………...	90,052	48,316	17,214	5,734	18,788
Workmen's Compensation Security Trust Fund….	78,862	41,983	11,262	11,612	14,005
Deferred Compensation Fund………………………	91,986	44,139	36,735	11,112	-
State Employees' Retirement System ………………	1,310,333	626,901	47,905	314,173	321,354
Public School Employees' Retirement System…...	3,259,282	-	712,796	728,576	1,817,910
Underground Storage Tank Indemnification Fund	22,084	7,593	6,402	2,128	5,961

At June 30, 2003 the Treasury Common Investment Pool (TIP) lent $1,355,908 in securities; the related cash collateral received was $1,434,597. On a pro-rata basis, TIP participants collectively reported cash collateral of $1,306,645 as part of temporary investments and related securities lending obligation of $1,306,645 associated with TIP securities lending balances at June 30, 2003. The composition of the lent securities of $1,355,908 was: U.S. Treasury obligations, $382,560; U.S. government agencies, $721,615; corporate bonds and notes, $215,210; and common and preferred stocks, $36,523 (in thousands).

NOTE E – CAPITAL ASSETS

A summary of capital assets by category at June 30, 2003 is as follows (amounts in thousands):

	Primary Government			Discretely Presented Component Units	
	Governmental Activities		Business-Type Activities		
	General Capital Assets	Internal Service Funds	Enterprise Funds	Non-Fiduciary Funds	Fiduciary Funds
Land	$ 297,855	$ 6	$ 323	$ 141,328	$ -
Highway right-of-way	1,027,800	-	-	-	-
Buildings	3,949,138	3,996	25,727	1,518,380	-
Improvements other than buildings	412,780	291	-	169,026	-
Machinery and equipment	583,086	95,034	71,243	500,602	-
Library books and other	-	-	-	147,253	-
Turnpike infrastructure	-	-	-	3,749,954	-
Highway infrastructure	13,814,760	-	-	-	-
Bridge infrastructure	5,758,394	-	-	-	-
Waterway infrastructure	1,700	-	-	-	-
Other infrastructure	8,614	-	-	-	-
Construction in progress	1,159,378	-	6,708	540,219	-
Highway and bridge construction in progress	1,875,700	-	-		-
Total	$ 28,889,205	$ 99,327	$ 104,001	$ 6,766,762	$ -

Changes in general capital assets for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Retirements	Balance June 30, 2003
Non-Depreciable General Capital Assets:				
Land	$ 287,010	$ 11,575	$ 730	$ 297,855
Highway right-of-way	940,300	87,500	-	1,027,800
Construction in progress	1,101,165	370,231	312,018	1,159,378
Transportation construction in progress	1,522,400	1,514,700	1,161,400	1,875,700
Subtotal	3,850,875	1,984,006	1,474,148	4,360,733
Depreciable General Capital Assets:				
Buildings	3,693,636	276,930	21,428	3,949,138
Improvements other than buildings	386,556	26,300	76	412,780
Machinery and equipment	538,067	59,966	14,947	583,086
Highway infrastructure	13,025,900	788,860	-	13,814,760
Bridge infrastructure	5,369,900	388,494	-	5,758,394
Other infrastructure	8,614	-	-	8,614
Waterway infrastructure	798	902	-	1,700
Subtotal	23,023,471	1,541,452	36,451	24,528,472
Total general capital assets	$ 26,874,346	$ 3,525,458	$ 1,510,599	$ 28,889,205

NOTE E – CAPITAL ASSETS (continued)

Changes in General Capital Assets Accumulated Depreciation for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Retirements	Balance June 30, 2003
Buildings	$ 1,628,203	$ 104,585	$ 16,817	$ 1,715,971
Improvements other than buildings	158,018	13,739	32	171,725
Machinery and equipment	286,624	36,001	14,200	308,425
Highway infrastructure	5,247,500	537,206	-	5,784,706
Bridge infrastructure	1,053,600	111,262	-	1,164,862
Waterway infrastructure	-	30	-	30
Other infrastructure	219	1,353	-	1,572
Total accumulated depreciation	$ 8,374,164	$ 804,176	$ 31,049	$ 9,147,291

Depreciation expense, by function, related to General Capital Assets for the fiscal year ended June 30, 2003 is as follows (amounts in thousands):

Direction and supportive services	$ 24,245
Protection of persons and property	64,254
Public education	22,084
Health and human services	12,510
Recreation and cultural enrichment	8,484
Transportation	672,599
Total depreciation expense	$ 804,176

Changes in Internal Service fund capital assets for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Retirements	Balance June 30, 2003
Non-Depreciable Capital Assets:				
Land	$ 6	$ -	$ -	$ 6
Subtotal	6	-	-	6
Depreciable Capital Assets:				
Buildings	3,997	-	-	3,997
Improvements other than buildings	291	-	-	291
Machinery and equipment	94,527	15,824	15,317	95,034
Subtotal	98,815	15,824	15,317	99,322
Total Internal Service fund capital assets	$ 98,821	$ 15,824	$ 15,317	$ 99,328

NOTE E – CAPITAL ASSETS (continued)

Changes in Internal Service fund capital assets accumulated depreciation for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Retirements	Balance June 30, 2003
Buildings	$ 1,782	$ 114	$ -	$ 1,896
Improvements other than buildings	105	330	-	435
Machinery and equipment	48,267	11,705	11,757	48,215
Total accumulated depreciation	$ 50,154	$ 12,149	$ 11,757	$ 50,546

Changes in Enterprise fund capital assets for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Retirements	Balance June 30, 2003
Non-Depreciable Capital Assets:				
Land	$ 323	$ -	$ -	$ 323
Construction in progress	-	6,708	-	6,708
Subtotal	323	6,708	-	7,031
Depreciable Capital Assets:				
Buildings	17,265	8,462	-	25,727
Machinery and equipment	70,460	1,953	1,170	71,243
Subtotal	87,725	10,415	1,170	96,970
Total Enterprise fund capital assets	$ 88,048	$ 17,123	$ 1,170	$ 104,001

Changes in Enterprise fund capital assets accumulated depreciation for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Retirements	Balance June 30, 2003
Buildings	$ 10,284	$ 763	$ -	$ 11,047
Machinery and equipment	47,338	4,231	1,036	50,533
Total accumulated depreciation	$ 57,622	$ 4,994	$ 1,036	$ 61,580

NOTE E – CAPITAL ASSETS (continued)

Construction in progress included in general capital assets at June 30, 2003 includes project information as follows (amounts in thousands):

		Expended Through June 30, 2003		
	Project Authorization	Amounts Previously Capitalized	Amounts Not Capitalized To Date	Authorization Available
Department of Corrections Institutions	$ 851,824	$ 175,884	$ 506,751	$ 169,189
Capitol Complex	898,247	234,355	315,556	348,336
Educational Institutions	246,153	82,117	89,859	74,177
State Parks and Forests	133.554	11,586	74,898	47,070
Agriculture Facilities	104,940	89,192	2,341	13,407
State-wide Radio Project	100,243	-	95,814	4,429
Veterans Homes and Military Armories	60,999	22,526	18,398	20,075
Transportation Facilities	52,254	22,969	14,672	14,613
Department of Public Welfare Institutions	38,209	17,445	8,936	11,828
State Police Facilities	36,125	10,168	17,719	8,238
Historical and Museum Commission Facilities	34,638	10,186	13,606	10,846
Other	9,181	6,082	828	2,271
Total	$2,566,367	$ 682,510	$ 1,159,378	$ 724,479

The Pennsylvania Turnpike Commission, a discretely presented component unit, capitalized interest costs of $1.5 million during its fiscal year ended May 31, 2003.

The Commonwealth’s initial valuation of general capital assets was made as of June 30, 1986 using appraisal and historical cost reconstruction techniques. Subsequent to June 30, 1986, general capital asset acquisitions are reported at cost or, for donations or confiscations, at fair market value. At June 30, 2003 the amount of general capital assets related to the initial 1986 valuation amounts to $1,738 million and does not include highway, bridge or waterway infrastructure.

NOTE F – TUITION BENEFITS PAYABLE AND INSURANCE LOSS LIABILITY – PROPRIETARY FUNDS AND BUSINESS-TYPE ACTIVITIES

Tuition Benefits Payable

The reported liability for tuition benefits payable of $658 million of the **Tuition Payment Fund**, an Enterprise Fund, at June 30, 2003, is based on several actuarial assumptions, including those related to future sales of tuition credits, tuition cost increases, investment experience and program expenses for the Tuition Account Program. The June 30, 2003 actuarial analysis includes the effects of a minor change in assumptions for expenses from the June 30, 2002 analysis. Per-unit tuition credit expense continues to decline as the Program expands. The per-unit credit expense assumption was reduced from 54 to 38 cents. The effect of this change increased the aggregate actuarial reserve (actuarial value of assets less liabilities) by $1.8 million.

Insurance Loss Liability

The reported insurance loss liability of the **State Workmen's Insurance Fund** (SWIF), an Enterprise Fund, is primarily based on historical claims experience. One of the assumptions used to determine the reported liability amount includes using a 4.0 percent discount rate at December 31, 2002 and 2001, respectively. There is uncertainty as to whether the reported liability will be supported by future claim experience, including payments; this uncertainty must be considered when evaluating the reported insurance loss liability.

For the calendar years ended December 31, 2002 and 2001, the following summary provides information on prior year reported insurance loss liability, incurred claims and payments, and current year reported insurance loss liability (amounts in thousands):

Year Ended	Prior Year	Incurred Claims		Payments		Current Year
December 31	Liability	Current	Prior	Current	Prior	Liability
2002	$1,032,506	$ 205,952	$ (41,264)	$ 31,034	$ 126,628	$1,039,532
2001	$1,054,252	$ 127,025	$ (4,267)	$ 15,322	$ 129,182	$1,032,506

NOTE G - TAXES, LOANS AND LEASE RENTALS RECEIVABLE

Taxes Receivable: Taxes receivable at June 30, 2003 consisted of the following (amounts in thousands):

	Statement of Net Assets: Governmental Activities
Sales and use	$ 1,001,139
Personal income	492,592
Corporation	724,002
Liquid fuels	144,785
Inheritance	405,886
Other	67,030
Total	$ 2,835,434

Governmental activities taxes receivable includes $764,771 expected to be collected after June 30, 2004 (amounts in thousands).

	Fund Balance Sheets			
	General	Motor License	Nonmajor Governmental Funds	Fiduciary Funds
Sales and use	$ 1,001,139	$ -	$ -	$ -
Personal income	492,592	-	-	-
Corporation	724,002	-	-	-
Liquid fuels	-	144,785	-	1
Inheritance	405,886	-	-	-
Other	49,482	-	17,548	23,910
Total	$ 2,673,101	$ 144,785	$ 17,548	$ 23,911

General Fund taxes receivable includes $764,771 expected to be collected after June 30, 2004 (amounts in thousands).

Loans Receivable: Loans receivable at June 30, 2003 consisted of the following (amounts in thousands):

	Primary Government		
	Governmental Activities Special Revenue Funds	Business Type Activities Enterprise Funds	Discretely Presented Component Units
Mortgage loans	$ -	$ -	$ 2,724,714
Student loans	-	-	4,273,282
Economic development loans	40,808	174,197	619,403
Drinking water, storm water and sewer system loans	10,697	-	1,357,981
Volunteer fire company loans	-	112,279	-
Other notes and loans	15,835	-	7,181
	67,340	286,476	8,982,561
Less: allowance for uncollectible amounts	29,075	52,553	214,846
Loans receivable, net	$ 38,265	$ 233,923	$ 8,767,715

Special Revenue funds report $21,257 in loans due after June 30, 2004 and the Enterprise funds report $192,322 in loans due after June 30, 2004. Discretely presented component units reported $7,830,631 in loans receivable due after June 30, 2004 (amounts in thousands).

NOTE G - TAXES, LOANS AND LEASE RENTALS RECEIVABLE (continued)

The **General Fund** reported $9,691 in loans receivable for program objectives, of which $9,470 represents governmental activities lending and of which $5,923 is due after June 30, 2004. Agency Funds reported $4,909 in loans receivable to replace underground storage tanks, all of which are due after June 30, 2004 (amounts in thousands).

Lease Rentals Receivable: The Capital Facilities Fund, a Capital Projects fund, reports amounts related to construction projects for educational institutions funded through the issuance of general obligation bonds, the principal and interest of which are paid through the collection of lease rental payments and deposited in the Capital Debt Fund, a Debt Service fund. At the conclusion of the lease terms, the project facilities are conveyed to the educational institutions. Accordingly, these lease arrangements are classified as direct financing leases. Lease rental receivables and associated deferred revenue equal to the principal lease payments to be received are recorded in the Capital Debt Fund. At June 30, 2003 the total minimum lease payments to be received were $1.4 million and the present value of the lease payments was $1.3 million, the difference representing interest of $.1 million. The Pennsylvania Industrial Development Authority, a discretely presented component unit, reported a lease rental receivable with total minimum payments of $28 million, present value of $19 million and interest of $9 million at June 30, 2003. Minimum lease payments receivable for the five fiscal years succeeding June 30, 2003 are as follows (amounts in thousands):

Fiscal Year Ending June 30	Primary Government	Discretely Presented Component Units
2004	$ 193	$ 634
2005	194	634
2006	193	2,923
2007	194	5,212
2008	193	5,212

Except for $193 owed to the primary government and $634 owed to discretely presented component units, all amounts receivable under lease rentals are due after June 30, 2004 (amounts in thousands).

NOTE H – INTERNAL/INTERFUND BALANCES AND TRANSFERS

In the Statement of Net Assets, reported internal balances assets/liabilities for governmental activities differ from internal balances assets/liabilities for business-type activities because the **State Workmen's Insurance Fund**, an Enterprise Fund, and the State Employees Retirement System, a Pension Trust Fund, report for their fiscal years ended December 31, 2002.

The composition of governmental and proprietary funds interfund balances reported at June 30, 2003 is as follows, with Major Fund titles in bold. Aggregate nonmajor governmental funds receivables from other funds and from component units, respectively, amount to $66,370 and $4,814; aggregate nonmajor enterprise funds receivables amount to $2,475 and $3; aggregate internal service funds receivables amount to $21,630 and $1,432 (amounts in thousands):

FUND TYPE/FUND PRIMARY GOVERNMENT	DUE FROM		DUE TO	
	OTHER FUNDS	COMPONENT UNITS	OTHER FUNDS	COMPONENT UNITS
General Fund	$ 47,171	$ 1,341	$ 94,724	$ -
Special Revenue:				
Motor License Fund	14,854	-	25,691	7,522
Tobacco Settlement Fund	6,167	-	19,535	-
Hazardous Sites Clean-up Fund	797	-	5,114	-
State Racing Fund	-	-	6,538	-
Vocational Rehabilitation Fund	56	-	1,918	-
Pharmaceutical Assistance Fund	4,973	-	-	-
Agricultural Conservation Easement Fund	10,243	-	-	-
Public Transportation Assistance Fund	3,803	-	545	-
Other Funds	1,616	-	8,245	-
	42,509	-	67,586	7,522
Debt Service:				
Pennsylvania Infrastructure Investment Authority Redemption Fund	-	-	-	-
Other Funds	13	-	-	-
	13	-	-	-
Capital Projects:				
Capital Facilities Fund	39,681	4,814	4	-
Keystone Recreation, Park and Conservation Fund	5,188	-	700	-
	44,869	4,814	704	-
Enterprise:				
Unemployment Compensation Fund	3,109	371	2	-
State Lottery Fund	-	-	284	-
State Workmen's Insurance Fund	200	-	3,948	-
Tuition Payment Fund	-	-	20	-
State Stores Fund	359	-	21,461	-
Rehabilitation Center Fund	1,833	-	40	-
Other Funds	283	3	2,871	-
	5,784	374	28,626	-
Internal Service:				
Purchasing Fund	13,577	1,425	329	1
Manufacturing Fund	8,053	7	54	-
	21,630	1,432	383	1
Pension Trust:				
State Employees' Retirement System	1,205	-	-	-
	1,205	-	-	-
Total primary government	$ 163,181	$ 7,961	$ 192,023	$ 7,523

NOTE H – INTERNAL/INTERFUND BALANCES AND TRANSFERS (continued)

DISCRETELY PRESENTED COMPONENT UNITS	DUE FROM PRIMARY GOVERNMENT	DUE FROM COMPONENT UNITS	DUE TO PRIMARY GOVERNMENT	DUE TO COMPONENT UNITS
Non-fiduciary:				
Pennsylvania Turnpike Commission	$ 7,522	$ -	$ 4,893	$ -
Pennsylvania Infrastructure Investment Authority	-	76	116	22
Other Component Units	-	-	7	-
	7,522	76	5,016	22
Fiduciary:				
Public School Employees Retirement System	2,075	-	1,091	-
Total discretely presented component units	$ 9,597	$ 76	$ 6,107	$ 22

The amount of total reported interfund receivables of $180,815 does not agree with total reported interfund payables of $205,675 at June 30, 2003 due to different fiscal year ends and reporting differences for certain Funds included in the Fund Financial Statements at June 30, 2003. The amount reported for the Pennsylvania Turnpike Commission, a discretely presented component unit, is reported at its fiscal year ended May 31, 2003 and the amounts reported as interfund balances for the State Employees' Retirement System and the Deferred Compensation Fund, Pension Trust Funds, the INVEST Program for Local Governments, an Investment Trust Fund and the **State Workmen's Insurance Fund** and State Stores Fund, Enterprise Funds, are reported at their fiscal years ended December 31, 2002 and June 24, 2003. The following presents a reconciliation of interfund balances reported at June 30, 2003 and those amounts which would have been reported if all Funds reported at the same fiscal year end (amounts in thousands):

Due from other funds at June 30, 2003	$ 162,307
Due from fiduciary funds at June 30, 2003	874
Due from primary government at June 30, 2003	9,597
Due from component units at June 30, 2003	8,037
Reported Interfund Receivables	180,815
State Workmen's Insurance Fund increase in receivables from January 1, 2003 through June 30, 2003	198
State Employees' Retirement System increase in receivables from January 1, 2003 through June 30, 2003	2,171
Interfund receivables reported as accounts receivable by component units	2,053
Interfund receivables adjustments	(22)
Interfund receivables reported as accounts receivable by Fiduciary Funds	5,614
Reconciled Interfund Receivables	$ 190,829

Due to other funds at June 30, 2003	$ 183,350
Due to fiduciary funds at June 30, 2003	8,673
Due to primary government at June 30, 2003	6,107
Due to component units at June 30, 2003	7,545
Reported Interfund Payables	205,675
State Employees' Retirement System increase in payables from January 1, 2003 through June 30, 2003	764
State Workmen's Insurance Fund decrease in payables from January 1, 2003 through June 30, 2003	(3,605)

NOTE H – INTERNAL/INTERFUND BALANCES AND TRANSFERS (continued)

Deferred Compensation Fund increase in payables from January 1, 2003 through June 30, 2003	15
State Stores Fund decrease in payables from June 25 to June 30, 2003	(18,527)
Interfund payables reported as accounts payable by component units	6,323
Interfund payables reported as accounts payable by Fiduciary Funds	184
Reconciled Interfund Payables	$ 190,829

At June 30, 2003 the **General Fund** reported Advances to Other Funds of $114,108. Specifically, this amount has been advanced as follows: $2,300 to the **State Workmen's Insurance Fund** and $85,000 to the State Stores Fund, an Enterprise Fund, $2,175 to the **Motor License Fund**, $10,333 to the Pharmaceutical Assistance Fund, Special Revenue Funds, and $14,300 to the Purchasing Fund, an Internal Service Fund. These amounts have been reported by the respective owing Funds as Advances from Other Funds, except for the **State Workmen's Insurance Fund**, which has reported an advance of $1,626 at its fiscal year ended December 31, 2002 and the Purchasing Fund, which reports a $14,300 "other" liability (amounts in thousands). At June 30, 2003 the Hazardous Sites Cleanup Fund, a Special Revenue Fund, has reported an Advance to Other Funds of $3,000. This amount was advanced to the Small Business First Fund, an Enterprise Fund. The Underground Storage Tank Fund, an Agency Fund advanced $100,000 (amounts in thousands) to the **General Fund** at June 30, 2003.

In the Statement of Net Assets, only advances between governmental activities and business-type activities are reported.

A summary of transfers reported for the fiscal year ended June 30, 2003 is as follows, with Major Fund titles in bold. Aggregate nonmajor governmental fund transfers from other funds amount to $1,201,120 during June 30, 2003 and include a $395,000 transfer from the **State Lottery Fund** to the Pharmaceutical Assistance Fund (amounts in thousands):

PRIMARY GOVERNMENT	Transfers In	Transfers Out
General Fund	$ 425,875	$ 903,078
Special Revenue:		
Tobacco Settlement Fund	-	34,682
Motor License Fund	-	60,243
Hazardous Sites Clean-up Fund	-	26,815
State Racing Fund	-	6,515
Vocational Rehabilitation Fund	38,237	-
Pharmaceutical Assistance Fund	439,943	-
Water Facilities Loan Fund	-	-
Environmental Stewardship Fund	30,000	13,854
Other Funds	35,658	42,246
	543,838	184,355
Debt Service:		
Land and Water Development Sinking Fund	3,937	-
Water Facilities Loan Redemption Fund	8,309	-
Capital Debt Fund	715,344	-
Local Criminal Justice Sinking Fund	8,096	-
Agricultural Conservation Easement Sinking Fund	5,756	-
Keystone Recreation, Park and Conservation Fund	3,854	-

NOTE H – INTERNAL/INTERFUND BALANCES AND TRANSFERS (continued)

TRANSFERS (continued from previous page)

	Transfers In	Transfers Out
Debt Service (continued):		
Disaster Relief Redemption Fund	9,716	-
Pennsylvania Economic Revitalization Sinking Fund	1,729	-
Volunteer Company Loan Sinking Fund	2,048	-
Other Funds	1,037	-
	759,826	-
Capital Projects:		
Capital Facilities Fund	-	90,000
Keystone Parks & Recreation Fund	-	300
	-	90,300
Enterprise:		
State Lottery Fund	-	395,000
State Stores Fund	-	156,476
Coal and Clay Mine Subsidence	-	330
	-	551,806
Total primary governments	$1,729,539	$1,729,539

Total primary government governmental funds transfers between governmental funds of $1,177,733 have been eliminated in the Statement of Activities; total business-type activities transfers of $551,806 to governmental activities are reported.

Assigned Investment Income: Certain funds, as follows, receive but do not financially report investment income that is assigned to (and reported by) another fund for legal or contractual reasons. Investment income and related interfund transfers are reported by those funds which assign/receive investment income for other than legal/contractual reasons (in thousands).

Assigning Fund	Receiving Fund	Reason	Amount
Liquor License	**General**	Legal/contractual	$ 42
Liquid Fuels Tax	**Motor License**	Legal/contractual	207
Land and Water Development	Land and Water Development Sinking	Legal/contractual	33
Remining Financial Assurance	Land and Water Development Sinking	Other than legal/contractual	67
PA Economic Revitalization	PA Economic Revitalization Sinking	Other than legal/contractual	6
Fire Insurance Tax	State Insurance	Legal/contractual	458
Fire Insurance Tax	Municipal Pension Aid	Legal/contractual	191

NOTE I - RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS

Pension Systems

Commonwealth laws established contributory defined benefit pension plans covering substantially all Commonwealth and public school employees. Commonwealth employees are members of the State Employees' Retirement System (SERS), a blended component unit. The SERS is the only blended component unit in the financial reporting entity and it is the only pension trust fund included in the primary government. Public school employees are members of the Public School Employees' Retirement System (PSERS), a discretely presented component unit. The PSERS is the only Fiduciary Fund reported as a discretely presented component unit. Both the SERS and the PSERS issue stand-alone financial statements which are available to the public. Written requests for financial statements should be directed to the following addresses:

State Employees' Retirement System
30 North Third Street, Executive Office
P.O. Box 1147
Harrisburg, PA 17108

Public School Employees' Retirement System
Bureau of Communications
P.O. Box 125
Harrisburg, PA 17108

State Employees' Retirement System

Plan Description: The SERS is the administrator of a cost-sharing multiple-employer defined benefit retirement system established to provide pension benefits for employees of state government and certain other organizations. At December 31, 2002 there were 105 employer state agencies and other organizations participating in the SERS. The SERS provides retirement, death, and disability benefits. Retirement benefits vest after 5 years of credited service. Employees who retire at age 60 with three years of service, or with 35 years of service if under age 60, are entitled to a normal (unreduced) annual retirement benefit. Members of the General Assembly and certain employees classified in hazardous duty positions can retire with full benefits at age 50 with at least three years of service.

Article II of the Pennsylvania Constitution provides the General Assembly the authority to establish or amend benefit provisions. Act 2001-9, signed into law on May 17, 2001 established Class AA membership whereby, generally, annual full retirement benefits for electing active members is 2.5 percent of the member's highest three-year average salary (final average salary) multiplied by years of service. State employees hired after June 30, 2001 are Class AA members. Members hired before May 17, 2001 had the option, but were not required, to elect Class AA membership. Substantially all eligible members chose the Class AA option. For legislators in office on May 17, 2001 Act 2001-9 established Class D-4 membership whereby the general annual benefit is 3 percent of final average salary for each year of service.

The general annual benefit for full retirement for Class A members is 2 percent of the member's final average salary multiplied by years of service. State police troopers are entitled to an annual benefit equal to a percentage of their highest annual salary (excluding their year of retirement). The annual benefit is 75 percent of salary for 25 or more years of service and 50 percent of salary for 20-24 years of service. Judges are entitled to a benefit of 4 percent of final average salary for each of the first 10 years of service and 3 percent for subsequent years. District Justices are entitled to a benefit of 3 percent of final average salary for each year of service.

Funding Policy: The SERS Board has the authority to establish or amend periodic employer contributions at actuarially determined rates, expressed as a percentage of annual covered payroll. Commonwealth law determines all member contribution rates. The active plan member contribution rate is 5 percent of covered payroll for most employees in Class A; for Class AA members, the contribution rate is 6.25 percent. Higher contributions are required for certain members of the General Assembly and judges and district justices who elect higher contribution rates. Act 9 of 2001 provided that new benefits arising from Act 9 were to be funded over a ten-year period, with level dollar funding, beginning July 1, 2002. Act 9 also provided that all the existing actuarial assets and liabilities would be combined and refinanced over a ten-year period using level dollar funding and future actuarial gains and losses were to be amortized using ten-year level dollar funding.

During each of the three years ended December 31, the annual required employer contributions (amounts in thousands) and the related percentage of that amount actually contributed are as follows (amounts in thousands):

Year ended December 31	Annual Required Contribution	Percentage Contributed
2002	$ 22,906	221.9
2001	$ 52,104	147.2
2000	$ 168,002	100.0

NOTE I - RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS (continued)

At December 31, 2002, the SERS disclosed no long-term contracts for contributions to the plan.

Summary of Significant Accounting Policies: The SERS financial statements are prepared on the accrual basis of accounting, whereby expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of the related trade date. Member and employer contributions are recognized in the period in which employee salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Investment Valuation: The investment in the Commonwealth Treasury short-term investment pool is reported at cost plus allocated interest, which approximates fair value. Collateral received under the Commonwealth Treasury securities lending program is reported at cost plus accrued interest. United States government obligations, corporate and foreign bonds and notes, and common and preferred stocks are generally valued based on published market prices and quotations from national security exchanges and securities pricing services. Securities that are not traded on a national security exchange are valued by the asset manager or third parties based on similar sales. The System has entered into certain swap contracts with a notional amount equivalent to the System's original investment in the absolute return fund-of-funds limited partnerships to provide S&P 500 returns. The combination of the swaps and the underlying investments result in a return consistent with an actively managed equity portfolio. Accordingly, those investments have been classified as common stocks on the statement of net assets. Real estate is primarily valued based on appraisals performed by independent appraisers or, for properties not appraised, at the present value of the projected future net income stream. Alternative investments, which include interests in limited partnerships invested in venture capital, leveraged buyouts, private equities, and other investments are valued based on amounts established by valuation committees, which are subject to an annual independent audit. The values for real estate and alternative investments are reported on a one-quarter lag (September 30), adjusted for cash flows through December 31. Foreign exchange and futures contracts are marked-to-market daily with changes in fair value recognized as part of investments and investment income. The net values of swaps are determined no less than monthly based on the return of the underlying indices, which is generally exchanged for a short-term rate plus a spread.

The Collective Trust Funds (CTF) consist primarily of domestic and international institutional mutual and index funds. The funds do not pay interest or dividends to shareholders, and reinvest all income earned on securities held by the fund. The fair value of CTF is based on the reported share value of the respective fund.

Investment Concentration: At December 31, 2002, approximately $471 million, or 19.4 percent, of the total SERS real estate portfolio was located in the Commonwealth of Pennsylvania. Also, investments in corporate and foreign bonds and notes include approximately $767 million of high-yield bonds at December 31, 2002.

Public School Employees' Retirement System

Plan Description: The PSERS is a cost-sharing multiple-employer defined benefit retirement system established to provide pension and other benefits for public school employee members. At June 30, 2003 there were 726 participating employers, generally school districts. The PSERS provides retirement, death, disability and health care benefits. In most cases, retirement benefits vest after 5 years of credited service. Members are eligible for full monthly retirement benefits upon reaching (a) age 62 with at least one year of service, (b) age 60 with 30 or more years of service, or (c) 35 or more years of service regardless of age.

Act 9 of 2001 provided for members to elect Membership Class T-D and convert from Membership Class T-C effective July 1, 2001. Benefits for full retirement are generally equal to 2 percent (Membership Class T-C) or 2.5 percent (Membership Class T-D) of the member's final average salary multiplied by years of credited service. The Commonwealth has the authority to establish or amend benefit provisions.

Funding Policy: The Public School Employees' Retirement Code provides that the PSERS Board has the authority to establish or amend periodic employer contributions at actuarially determined rates, expressed as a percentage of annual covered payroll. The active plan member contribution rates for employees in Membership Class T-C and T-D hired before July 22, 1983 are 5.25 and 6.50 percent of covered payroll, respectively; for employees in Membership Class T-C and T-D hired after July 21, 1983, the rate are 6.25 and 7.50 percent, respectively. The increased member contribution rates for Class T-D became effective January 1, 2002. Commonwealth law determines member contribution rates.

NOTE I - RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS (continued)

Since 1995, employers defined as school entities (school districts, area vocational-technical schools, and intermediate units) are required to pay the entire employer contribution. The Commonwealth partially reimburses school entities in accordance with Act 29 of 1994. The amount of reimbursement is at least one half of the total employer contribution. For employers that are not school entities, the employer contribution is paid equally by the employer and the Commonwealth to the PSERS; no Commonwealth reimbursement occurs.

During each of the three fiscal years ended June 30, the annual required employer contributions (in thousands) and the related percentage of that amount actually contributed are as follows:

Fiscal year Ended June 30	Annual Required Contribution	Percentage Contributed
2003	$ 20,831	100
2002	$ 539	100
2001	$ 158,193	100

At June 30, 2003, the PSERS disclosed that $99,700 of $190,922 (in thousands) of member receivables for purchases of service credit are due subsequent to June 30, 2004.

Summary of Significant Accounting Policies: The PSERS financial statements are prepared on the accrual basis of accounting, whereby expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of the related trade date. Member and employer contributions are recognized in the period in which employees' salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

Investment Valuation: Investments are reported at fair value, which is the amount that the PSERS can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Short-term securities are reported at cost, which approximates fair value, unless they have a published market price or quotation from national security exchanges and securities pricing services, in which case they are reported at the published market price. Fixed income securities and common and preferred stocks are generally reported based on published market prices and quotations from national security exchanges and securities pricing services. Securities that are not traded on a national security exchange are valued by the respective fund manager or other third parties based on similar sales. Real estate is primarily valued based on appraisals performed by independent appraisers or, for properties not appraised, at cost or the present value of projected future net income. Private equity, private debt, venture capital and equity real estate are primarily valued based on amounts established by valuation committees. Futures contracts, foreign exchange contracts, and options are marked-to-market daily; changes in market value are recognized as part of net appreciation/depreciation in the fair value of investments. Initial margin requirements for such financial instruments are provided by investment securities pledged as collateral or by cash.

Investment Concentration: At June 30, 2003, there were no investments in any one organization that represented 5 percent or more of plan net assets.

Other Postemployment Benefits

The Commonwealth funds certain health care benefits for retired primary government and certain component unit employees (that meet specified length-of-service and age requirements) and their eligible dependents. These benefits are provided as a result of negotiated union contracts and through administrative policy. The Commonwealth recognizes the cost of providing these benefits as paid, which totaled $295 million for the fiscal year ended June 30, 2003. Approximately 90,000 individuals were covered by these benefits during the fiscal year.

The Commonwealth provides several other postemployment benefits, including disability life insurance and certain benefits to beneficiaries of state police officers killed in the line of duty. The amount expended for these benefits was not material during the fiscal year ended June 30, 2003.

NOTE J - NOTES AND DEMAND REVENUE BONDS PAYABLE

Primary Government

During the fiscal year ended June 30, 2003, the Commonwealth did not issue any tax or bond anticipation notes or any other short-term debt and no short-term debt was repaid. At June 30, 2003 and 2002, no short-term debt was outstanding.

Discretely Presented Component Units

The Pennsylvania Higher Education Assistance Agency (PHEAA), a discretely presented component unit, has reported $3,471 million of demand revenue bonds outstanding and $759.3 million of notes payable, consisting of student loan financing of $550.6 million, capital financing of $76.3 million, term financings of $86.4 million and other lines of credit of $46 million at June 30, 2003 as follows (amounts in thousands):

	Balance June 30, 2002	Additions	Reductions	Balance June 30, 2003
Student loan demand revenue bonds due 2018-2042, at weighted average interest rates of 1.14 and 1.58 percent at June 30, 2003and 2002, respectively ....$	2,061,000	$ 1,410,000	$ -	$ 3,471,000
Notes Payable:				
Student loan financing, due in 2002-2007, at weighted average interest rates of 1.65 and 2.33 percent at June 30, 2003 and 2002, respectively	769,959	330,135	(549,475)	550,619
Capital financings, due 2003-2010 at weighted average interest rates of 6.23 and 5.36 percent at June 30, 2003 and 2002, respectively	79,283	-	(2,691)	76,592
Term financings, due 2005-2030 at weighted average interest rates of 5.22 and 5.26 percent at June30, 2003 and 2002, respectively	91,826	-	(4,804)	87,022
Other lines of credit, due on demand at weighted average interest rates of 3.47 and 3.91 percent at June 30, 2003 2002, respectively	30,000	16,000	-	46,000
	971,068	346,135	(556,970)	760,233
Less: unamortized discount	(1,037)	0	81	(956)
Total Notes Payable ....$	970,031	$ 346,135	$(556,889)	$ 759,277

The component unit Statement of Net Assets reports current notes payable of $210,708 that relate to PHEAA notes payable. The noncurrent notes payable amount to $551,718; this amount includes noncurrent PHEAA notes of $548,569 and noncurrent Philadelphia Regional Port Authority notes of $3,149 (amounts in thousands) at June 30, 2003.

NOTE J - NOTES AND DEMAND REVENUE BONDS PAYABLE (continued)

The note and bond indentures, among other things, require PHEAA to comply with various covenants including minimum parity levels as defined, student loan and investment yields, and program expenses. The demand bonds payable are subject to purchase, at par plus accrued interest, by PHEAA on demand of the bondholders upon seven days prior irrevocable written notice. Under the irrevocable letters of credit issued by the *Student Loan Marketing Association,* the trustee is entitled to draw an amount sufficient to pay the purchase price of the bonds delivered to it. The letters of credit are valid from 2003 through 2010. The PHEAA is required to pay annual commitment fees ranging from 15 to 33 basis points on the stated amount of the letter of credit coverage. At June 30, 2003 total letter of credit coverage was $1.5 billion.

All student loan financing notes payable, demand student loan revenue bonds payable and student loan revenue bonds payable are collateralized by student loans and investments. At June 30, 2003, $4.2 billion of debt is collateralized by $4.4 billion of student loan principal and related interest receivable, and $384 million of investments and related interest receivable. Capital financings are collateralized with capital assets. Amounts due under other lines of credit are generally unsecured. At June 30, 2003 the PHEAA had $211 million of available credit under student loan financing arrangements and $9 million available under other lines of credit.

Debt service requirements subsequent to June 30, 2003, based upon stated maturities of notes payable, bonds payable and other financings and obligations are as follows (amounts in thousands):

	Student Loan Bonds And Financings		Capital and Other Financings and Obligations Under Capital Lease	
Year of Maturity	**Principal**	**Interest**	**Principal**	**Interest**
2004	$ 135,709	$ 47,107	$ 55,083	$ 8,615
2005	414,910	39,454	9,467	8,036
2006	-	39,454	5,697	7,576
2007	-	39,454	3,752	7,290
2008	-	39,454	3,235	7,115
2009-13	-	197,270	77,010	24,398
2014-18	100,000	196,774	8,380	13,116
2019-23	446,000	175,625	14,660	9,955
2024-28	475,000	159,392	18,710	5,795
2029-33	400,000	132,754	13,620	1,015
2034-38	300,000	121,952	-	-
2039-43	1,750,000	74,075	-	-
Total	$ 4,021,619	$1,262,765	$ 209,614	$ 92,911

The PHEAA has $4.0 billion of student loan bonds and financings that are variable-rate debt, of which $1.1 billion resets based upon auctions every seven days, $1.9 billion resets based upon auctions every 28 days, $450 million resets based upon auctions every 35 days, $414 million is indexed to 91-day Treasury bills, and the remaining $135.7 million is indexed to the 3-month LIBOR.

Notes and bonds payable, as well as all other debt, are limited obligations of the PHEAA. The PHEAA has no taxing power, and the Commonwealth is not obligated to pay the principal, redemption price, if any, or interest on any of the PHEAA's debt.

NOTE K – GENERAL LONG TERM OBLIGATIONS-GOVERNMENTAL ACTIVITIES AND COMPONENT UNITS

Long-term obligations of the Commonwealth's primary government at June 30, 2003 and changes for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

GENERAL LONG-TERM OBLIGATIONS	Issue Dates	Interest Rates	Maturity Dates Through	Bonds Authorized But Unissued	Balance July 1, 2002	Additions	Reductions	Balance June 30, 2003
General Obligation Bonds Payable From Tax Revenues:								
Capital Facilities	1974-03	3.12-6.60%	2023	$ 33,037,409	$ 4,170,980	$ 1,216,000	$ 775,455	$ 4,611,525
Disaster Relief	2000-01	4.60-5.56%	2021	105,908	29,755	-	8,130	21,625
Land and Water Development	1992-94	5.04-6.44%	2012	300	11,670	-	9,410	2,260
Nursing Home Loan Development	-	-	-	31,000	550	-	550	-
Volunteer Companies Loan	1992-98	4.84-6.02%	2018	-	18,005	-	8,995	9,010
Vietnam Conflict Veterans Compensation	1974	5.36%	2003	3,000	935	-	455	480
Water Facilities Loan	1992-97	5.00-6.44%	2017	11,500	79,835	-	49,110	30,725
Pennsylvania Economic Revitalization	1992-95	5.04-6.44%	2015	14,000	10,445	-	4,380	6,065
Pennsylvania Infrastructure Investment Authority	1992-01	4.62-6.44%	2021	267,000	185,850	-	104,595	81,255
Agricultural Conservation Easement Purchase	1992-98	4.47-6.60%	2018	-	44,650	-	21,245	23,405
Local Criminal Justice	1992-01	4.36-6.60%	2021	8,000	102,405	-	77,680	24,725
Keystone Recreation, Park and Conservation	1994-98	4.84-6.60%	2018	-	34,645	-	14,015	20,630
Refunding Bonds	1992-03	3.23-5.73%	2018	-	1,382,213	752,739	165,816	1,969,136
Total principal				33,478,117	6,071,938	1,968,739	1,239,836	6,800,841
Unamortized premium on bonds issued				-	66,500	194,907	7,146	254,261
Unamortized deferred net refunded loss				-	-	(27,216)	(2,733)	(24,483)
Total general obligation bonds payable				33,478,117	6,138,438	2,136,430	1,244,249	7,030,619
Other General Long-Term Obligations Payable From Tax and Other Revenues:								
Installment Purchase Obligations	-	-	-	-	14,344	805	4,700	10,449
Capital Lease Obligations	-	-	-	-	52,073	3,851	4,242	51,682
Obligations Under Master Lease—Prison Facilities	-	-	-	-	563,020	-	563,020	-
Self-Insurance—Note M	-	-	-	-	707,277	157,926	104,713	760,490
Compensated Absences	-	-	-	-	735,497	344,493	339,735	740,255
Catastrophic Motor Vehicle Losses	-	-	-	-	121,987	12,811	11,583	123,215
Other	-	-	-	-	426,271	146,046	126,965	445,352
				-	2,620,469	665,932	1,154,958	2,131,443
TOTAL GENERAL LONG-TERM OBLIGATIONS				$ 33,478,117	$ 8,758,907	$ 2,802,362	$ 2,399,207	$ 9,162,062

Proprietary funds/business-type activities have reported $18,266 (in thousands) of the self-insurance liabilities above.

Revenue bond obligations of discretely presented component units at June 30, 2003 (May 31, 2003 for the Pennsylvania Turnpike Commission) and changes for the fiscal year then ended are as follows (amounts in thousands):

Pennsylvania Higher Education Assistance Agency	1988-02	3.30%	2025	$ 537,925	$ -	$ 150,000	$ 387,925
Philadelphia Regional Port Authority	1993	2.75-6.20%	2020	52,575	-	1,970	50,605
State System of Higher Education	1992-03	3.87-5.74%	2024	15,970	53,485	130	69,325
Pennsylvania Housing Finance Agency	1982-03	1.15-10.88%	2033	2,974,119	495,545	394,353	3,075,311
Pennsylvania Industrial Development Authority	1994-02	4.00-7.00%	2021	556,625	-	24,815	531,810
Pennsylvania Turnpike Commission	1992-02	2.50-6.00%	2041	2,151,235	449,145	469,830	2,130,550
Pennsylvania Infrastructure Investment Authority	1990-98	4.10-6.45%	2011	147,315	-	14,685	132,630
				6,435,764	998,175	1,055,783	6,378,156
Less: Bond discounts/(premiums)	-	-	-	3,107	2,967	6,446	(372)
Deferred costs of refunding	-	-	-	24,071	10,073	2,563	31,581
Deferred refunding loss	-	-	-	2,129	-	561	1,568
TOTAL REVENUE BONDS PAYABLE				$ 6,406,457	$ 985,135	$ 1,046,213	$6,345,379

NOTE K – GENERAL LONG TERM OBLIGATIONS – GOVERNMENTAL ACTIVITIES AND COMPONENT UNITS (continued)

Primary Government

The Commonwealth has pledged its full faith and credit for the payment of principal and interest on its general obligation bonds. Typically only the **General Fund** and the **Motor License Fund** transfer amounts to Debt Service funds for general obligation bond principal and interest payments. During the fiscal year ended June 30, 2003, respectively, these two Funds transferred $563,820 and $61,524, along with $90,000 from the Capital Facilities Fund, to the Capital Debt fund, which reported $695,163 (over 91 percent) of total Debt Service funds principal and interest expenditures of $758,456 (amounts in thousands). Except for Catastrophic Motor Vehicle Losses, which are funded by motorist violation fines, general long-term obligations other than general obligation bonds are funded by specific Funds where capital assets are procured using long-term vendor or other financing, where employees earn compensated absences or where self-insurance claims originate.

The total "Additions" of $2,136,430 for General Obligations Bonds Payable from Tax Revenues at June 30, 2003 consists of total bond and refunding bond proceeds of $1,324,167 and $837,991, respectively, for Governmental Funds (as reported in the Statement of Revenues, Expenditures and Changes in Fund Balances), plus net principal accretion on maturing debt for capital appreciation bonds of $1,488 less deferred net refunded loss of $27,216 during the fiscal year ended June 30, 2003. Total Governmental Fund bond/refunding bond proceeds of $2,162,158 equal "Additions" of $1,968,739 plus premium on bonds issued of $194,907, less net principal accretion on maturing debt for capital appreciation bonds of $1,488. During the fiscal year ended June 30, 2003 $7,146 of bond premium was amortized and credited to bond interest expense in the Statement of Activities; unamortized premium in the Statement of Net Assets at June 30, 2003 is $254,261. Also, during the fiscal year ended June 30, 2003 $2,733 of deferred net refunded loss was amortized and charged to bond interest expense in the Statement of Activities; unamortized deferred net refunded loss in the Statement of Net Assets at June 30, 2003 is $24,483 (amounts in thousands).

The Commonwealth uses fiscal agents to process payments for the servicing of certain bond issues. Additional cash with fiscal agents is held by the Federal government for unemployment compensation claims.

The balance outstanding at June 30, 2003 for general obligation refunding bonds includes $28.2 million of accreted value for capital appreciation bonds. No principal or interest is payable on the capital appreciation bonds until maturity.

Included in "Other" for Other General Long-Term Obligations payable from workmen's compensation assessments and **General Fund** tax revenues are the following at June 30, 2003 (amounts in thousands):

Workmen's Compensation Security Trust Claims	$ 380,567
Public Utility Realty Tax Act (PURTA)	28,404
Litigation—Note N	36,298
Arbitrage Rebate Tax	83
	$ 445,352

The Workmen's Compensation Security Trust Fund provides for payment of valid claims under the Workmen's Compensation Law to individuals whose employers are insured by insolvent insurance carriers. The PURTA provides for a tax on utility realty property whereby amounts received during the fiscal year are used as a General Fund revenue source. The Act also provides for payment of a majority of the PURTA revenues as a distribution to local taxing authorities during the following fiscal year (normally in October). Such payments are appropriated for expenditure in the following fiscal year and are, therefore, not expendable during the fiscal year the related revenue is received. The other amounts included in General Long-Term Obligations at June 30, 2003 relating to Workmen's Compensation Claims, Litigation and Arbitrage Rebate Tax are not payable with currently expendable available financial resources.

NOTE K – GENERAL LONG TERM OBLIGATIONS – GOVERNMENTAL ACTIVITIES AND COMPONENT UNITS (continued)

In 1991, the Commonwealth entered into lease arrangements with five local government authorities for the rental of five new prisons. Each authority issued bonds to finance the construction of the prisons. Each lease provided for the Commonwealth to pay periodic rentals equal to debt service payments on each authority's debt obligation. On July 1, 1993 a finance corporation issued Certificates of Participation, Series 1993A to refund the authority debt obligations, to consolidate the financing of the prisons and to provide additional construction funding. As a result of the consolidated financing, the Commonwealth made lease payments equal to the finance corporation's debt service payments. Both the original and the new leases provided that the Commonwealth's obligation to make lease payments was subject to Commonwealth appropriations made to provide for these obligations. In the fiscal year ended June 30, 1994 the Commonwealth began using the new prison facilities. The finance corporation held nominal title to the facilities as security for the Commonwealth lease payments. During the fiscal year ended June 30, 2003 the Commonwealth redeemed the Certificates of Participation, Series 1993A using refunding bond proceeds. The Capital Facilities Fund, a Capital Projects Fund, reported principal and interest expenditures, respectively, of $530 million and $23.6 million during the fiscal year ended June 30, 2003 to redeem the Certificates of Participation, Series 1993A and that liability is no longer outstanding at June 30, 2003.

The Commonwealth's constitutional debt limit, which allows for the incurrence of debt to be used for capital projects without electorate approval as specifically itemized in a capital budget, was $42.5 billion as of August 31, 2003, with net debt outstanding of $6 billion.

Discretely Presented Component Units

The Pennsylvania Housing Finance Agency (PHFA), the Pennsylvania Higher Education Assistance Agency (PHEAA), the Pennsylvania Industrial Development Authority, the Pennsylvania Turnpike Commission (PTC) and the Pennsylvania Infrastructure Investment Authority, discretely presented component units, have pledged substantially all of their revenues for the redemption of revenue bonds outstanding. Revenue bonds outstanding as reported in this note disclosure for the fiscal year ended June 30, 2003 (May 31, 2003 for the PTC) include bond premiums, deferred costs of refunding, and deferred refunding losses of $372 thousand, $31.6 million, and $1.6 million, respectively.

The following table presents annual principal and interest payments for long-term debt outstanding for the primary government and discretely presented component units at June 30, 2003 (May 31, 2003 for the Pennsylvania Turnpike Commission) (amounts in thousands):

PRIMARY GOVERNMENT

	2004	2005	2006	2007	2008	2009-13	2014-18
GENERAL OBLIGATION BONDS:							
Capital Facilities	$ 472,568	$ 492,596	$ 477,146	$ 467,881	$ 448,423	$ 2,064,419	$ 1,527,701
Disaster Relief	2,735	2,656	2,577	2,494	2,412	10,784	7,177
Land and Water Development	506	264	260	260	259	1,406	-
Nursing Home Loan Development	-	-	-	-	-	-	-
Volunteer Companies Loan	1,424	928	911	899	880	4,380	3,008
Vietnam Conflict Veterans Compensation	491	-	-	-	-	-	-
Water Facilities Loan	6,438	3,727	3,597	3,565	3,537	16,096	3,155
Pennsylvania Economic Revitalization	1,667	667	663	654	652	3,167	323
Pennsylvania Infrastructure Investment Authority	15,756	9,581	9,253	9,074	8,886	37,813	15,522
Agricultural Conservation Easement Purchase	4,459	2,709	2,668	2,617	2,156	10,081	5,577
Local Criminal Justice	7,562	4,313	3,804	3,771	1,287	5,853	3,267
Keystone Recreation, Park and Conservation	3,275	3,240	3,056	3,014	2,512	7,734	3,994
Refunding Bonds	261,714	288,837	281,751	258,851	253,294	1,001,980	184,885
Total Principal and Interest	778,595	809,518	785,686	753,080	724,298	3,163,713	1,754,609
Less: Interest Payments	320,578	317,340	293,359	267,657	243,718	847,328	344,822
	458,017	492,178	492,327	485,423	480,580	2,316,385	1,409,787
Other General Long-Term Obligations	109,808	86,600	90,911	90,869	92,846	537,683	548,324
TOTAL GENERAL LONG-TERM OBLIGATIONS	$ 567,825	$ 578,778	$ 583,238	$ 576,292	$ 573,426	$ 2,854,068	$ 1,958,111

The portion of Total General Long-Term Obligations due by June 30, 2004 amounts to $567,825 (in thousands).

NOTE K – GENERAL LONG TERM OBLIGATIONS – GOVERNMENTAL ACTIVITIES AND COMPONENT UNITS (continued)

	2019-23	2024-28	2029-33	2034-38	2039-43	Total
GENERAL OBLIGATION BONDS:						
Capital Facilities	$ 726,000	$ 13,937	$ -	$ -	$ -	$ 6,690,671
Disaster Relief	397	-	-	-	-	31,232
Land and Water Development	-	-	-	-	-	2,955
Nursing Home Loan Development	-	-	-	-	-	-
Volunteer Companies Loan	-	-	-	-	-	12,430
Vietnam Conflict Veterans Compensation	-	-	-	-	-	491
Water Facilities Loan	-	-	-	-	-	40,115
Pennsylvania Economic Revitalization	-	-	-	-	-	7,793
Pennsylvania Infrastructure Investment Authority	1,559	-	-	-	-	107,444
Agricultural Conservation Easement Purchase	974	-	-	-	-	31,241
Local Criminal Justice	701	-	-	-	-	30,558
Keystone Recreation, Park and Conservation	-	-	-	-	-	26,825
Refunding Bonds	-	-	-	-	-	2,531,312
Total Principal and Interest	729,631	13,937	-	-	-	9,513,067
Less: Interest Payments	77,117	307	-	-	-	2,712,226
	652,514	13,630	-	-	-	6,800,841
Other General Long-Term Obligations	493,585	80,817	-	-	-	2,131,443
TOTAL GENERAL LONG-TERM OBLIGATIONS	$ 1,146,099	$ 94,447	$ -	$ -	$ -	$ 8,932,284

DISCRETELY PRESENTED COMPONENT UNITS

	2004	2005	2006	2007	2008	2009-13	2014-18
Pennsylvania Higher Education Assistance Agency	$ 83,272	$ 8,272	$ 8,272	$ 8,272	$ 8,272	$ 41,361	$ 178,020
Philadelphia Regional Port Authority	5,115	5,107	5,059	4,547	4,545	22,616	22,495
State System of Higher Education	2,864	3,296	3,387	3,543	3,597	20,240	21,899
Pennsylvania Housing Finance Agency	226,932	231,111	230,949	227,903	229,728	1,197,843	1,121,955
Pennsylvania Industrial Development Authority	51,956	53,491	54,239	55,697	56,889	253,908	188,546
Pennsylvania Turnpike Commission	122,761	123,161	125,702	126,177	126,677	638,677	652,633
Pennsylvania Infrastructure Investment Authority	21,768	21,388	20,493	19,446	18,076	41,815	21,265
Total Principal and Interest	514,668	445,826	448,101	445,585	447,774	2,216,460	2,206,813
Less: Interest Payments	279,338	273,471	265,992	257,773	249,188	1,100,201	815,667
TOTAL REVENUE BONDS	$ 235,330	$ 172,355	$ 182,109	$ 187,812	$ 198,586	$ 1,116,259	$ 1,391,146

	2019-23	2024-28	2029-33	2034-38	2039-43	Total
Pennsylvania Higher Education Assistance Agency	$ 19,975	$ 177,662	$ -	$ -	$ -	$ 533,378
Philadelphia Regional Port Authority	13,369	-	-	-	-	82,853
State System of Higher Education	22,158	22,488	23,994	16,408	-	143,874
Pennsylvania Housing Finance Agency	902,082	654,970	276,538	4,114	-	5,304,125
Pennsylvania Industrial Development Authority	83,864	-	-	-	-	798,590
Pennsylvania Turnpike Commission	395,267	597,336	1,649,605	53,317	188,611	4,799,914
Pennsylvania Infrastructure Investment Authority	-	-	-	-	-	164,251
Total Principal and Interest	1,436,715	1,452,456	1,950,137	73,839	188,611	11,826,985
Less: Interest Payments	491,508	259,214	1,411,482	37,179	7,816	5,448,829
TOTAL REVENUE BONDS	$ 945,207	$ 1,193,242	$ 538,655	$ 36,660	$ 180,795	$ 6,378,156

NOTE K – GENERAL LONG TERM OBLIGATIONS – GOVERNMENTAL ACTIVITIES AND COMPONENT UNITS (continued)

The Commonwealth has entered into certain agreements to lease various facilities and equipment. Such agreements are in-substance purchases (capital leases) and are reported as Capital Lease Obligations. In addition, the Commonwealth also makes purchases using installment purchase arrangements. The following is a schedule by fiscal year of future minimum payments under capital leases and installment purchase obligations, together with the present value of the net minimum lease payments as of June 30, 2003 (amounts in thousands):

	Primary Government		Discretely Presented Component Unit
	Capital Lease Obligations	Installment Purchase Obligations	State System of Higher Education
Fiscal year ending June 30			
2004	$ 9,513	$ 4,446	$ 43,638
2005	8,205	2,866	44,767
2006	7,203	1,419	44,276
2007	6,543	844	43,185
2008	6,282	536	42,579
2009-13	31,416	2,509	214,512
2014-18	18,535	747	189,298
2019-23	-	-	142,435
2024-28	-	-	21,270
Total minimum lease payments	87,697	13,367	785,960
Less: amount representing estimated executory cost included in minimum lease payments	10,532	-	-
Net minimum lease payments and Installment purchases	77,165	13,367	785,960
Less: amount representing interest	25,483	2,918	260,300
TOTAL CAPITAL LEASE AND INSTALLMENT PURCHASE OBLIGATIONS	$ 51,682	$ 10,449	$ 525,660

At June 30, 2003 general capital assets included $95.8 million of buildings and $11.3 million of equipment being procured by capital leases. A total of $30.6 million in general capital assets is being procured by vendor-financed installment purchase arrangements.

Capital lease obligations outstanding as of June 30, 2003 reported by the State System of Higher Education (SSHE), a discretely presented component unit, relate to various capital projects currently under construction for which a related public financing authority is the lessor. Revenue bonds were issued by the public financing authority to provide funding for these capital projects. SSHE capital assets include $89.7 million of construction in progress related to capital leases at June 30, 2003.

Conduit Debt

The State Public School Building Authority (SPSBA), a discretely presented component unit, finances construction and improvement projects for public schools through the issuance of tax-exempt instruments (bonds, notes or other obligations), for the purpose of making lower cost tax-exempt financing available to school districts and community colleges. The debt instruments issued by the SPSBA represent limited obligations payable solely from lease/loan payments made by the borrowing institutions and related assets held by trustees. At June 30, 2003 the SPSBA has $666.6 million of debt outstanding. Neither the SPSBA nor the Commonwealth has any obligation for this debt. Therefore, neither the financed assets nor the bonds are included in the accompanying financial statements.

The Pennsylvania Higher Educational Facilities Authority (PHEFA), a discretely presented component unit, finances projects through the issuance of tax-exempt instruments (bonds, notes and other obligations) to provide a source of tax-exempt financing for colleges and universities. The debt instruments issued by the PHEFA represent limited obligations payable solely from payments made by the related borrowing institutions and related assets held by the trustees. At June 30, 2003 the PHEFA has $4.3 billion of debt outstanding. Neither the PHEFA nor the Commonwealth has any obligation for this debt. Therefore, neither the financed assets nor the bonds are included in the accompanying financial statements.

NOTE K – GENERAL LONG TERM OBLIGATIONS –
GOVERNMENTAL ACTIVITIES AND COMPONENT UNITS (continued)

The Pennsylvania Economic Development Financing Authority (PEDFA) finances projects on behalf of local industrial and commercial development authorities to promote economic growth within the Commonwealth. Revenue bonds issued by the PEDFA represent limited obligations payable solely from Authority financed project revenues. At June 30, 2003 the PEDFA has $1,614.6 million of debt outstanding. Neither PEDFA nor the Commonwealth has any obligation for this debt. Therefore, neither the financed assets nor the bonds are included in the accompanying financial statements.

The Pennsylvania Energy Development Authority (PEDA) finances projects related to energy conservation and research. Fees are assessed to recover related processing and application costs incurred. The bonds issued by the Authority represent limited obligations payable solely from payments made by the borrowing entities. The majority of the bonds are secured by the property financed. Upon repayment of a bond, ownership of acquired property transfers from the trustees to the entity served by the bond issuance. The PEDA has $85.3 million in revenue bonds outstanding at June 30, 2003. The Commonwealth has no obligation for this debt. Accordingly, neither the financed assets nor the bonds are included in the accompanying financial statements.

NOTE L - REFUNDED DEBT

Primary Government

During the fiscal year ended June 30, 2003 the Commonwealth issued $641.2 million and $110 million in general obligation bonds, Second Refunding Series of 2002 and Second Series of 2003, respectively, with average interest rates of 4.99 percent and 5.0 percent to advance refund $662.8 million and $108.6 million of previously issued general obligation bonds with average interest rates of 5.31 percent and 5.375 percent. The net refunding bond proceeds of $712 million (including bond premium of $71 million) and $126 million (including bond premium of $16 million), respectively, after payment of underwriting fees, insurance, and other issuance costs, were deposited in irrevocable trusts to provide for all future debt service payments on the refunded bonds. As a result, the bonds refunded are considered to be defeased and have been removed from the Commonwealth's financial statements. The Commonwealth advance refunded its previously issued bonds to reduce debt service payable on its general obligation bonds by $57.1 million and $7.4 million, respectively, and to obtain economic gains of $47.7 million and $3.8 million.

Also, during the fiscal year ended June 30, 2003 the Commonwealth issued $490.7 million in general obligation bonds, Second Series of 2003, with an average interest rate of 5.04 percent to current refund $530 million of previously issued Certificates of Participation, Series 1993A with an average interest rate of 5.16 percent. The net refunding bond proceeds of $553.6 million (including bond premium of $64.5 million), after payment of underwriting fees, insurance, and other issuance costs, were deposited in irrevocable trusts to provide for all future debt service payments on the refunded debt. As a result, the Certificates of Participation, Series 1993A are considered to be defeased and have been removed from the Commonwealth's financial statements. The Commonwealth refunded its previously issued Certificates of Participation to reduce debt service payable by $57.4 million and to obtain an economic gain of $55.7 million.

In prior years, the Commonwealth defeased certain general obligation bonds by placing the proceeds of refunding bonds in irrevocable trusts to provide for all future debt service payments on the refunded bonds. At June 30, 2003, $692.6 million of general obligation bonds outstanding that were previously accounted for in the Commonwealth's financial statements have been defeased through advance refundings.

Discretely Presented Component Units

During the fiscal year ended June 30, 2003, the Pennsylvania Higher Education Assistance Agency (PHEAA) issued $225 million of student loan demand revenue bonds at a weighted average interest rate of 1.28 percent to current refund $225.0 million of outstanding student loan revenue bonds with a weighted-average interest rate of 6.22 percent. The current refunding bonds are fixed rate bonds with a mandatory tender on July 1, 2004. At that date, the bonds will be remarketed. The PHEAA expects to reduce interest payments over the next year by $11.0 million as a result of the refunding. The current refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $4.0 million. This difference, reported in the accompanying statement of net assets as a deduction from student loan revenue bonds payable, is being charged to student loan financings and bonds payable interest expense ratably over the life of the student loan revenue bonds.

During the fiscal year ended June 30, 2003 the Pennsylvania Housing Finance Agency (PHFA) redeemed prior to maturity $8.5 million of Multi-Family Residential Development Bonds and $5.4 million of Multi-Family Development Bonds, Issues 1993 and 1993A, using mortgage prepayments. An extraordinary loss of $156 thousand resulted from the redemptions as unamortized bond discounts and the related costs of issuance for the bonds were expensed. Additionally, during that year, the PHFA redeemed prior to maturity $173.1 million of Multi-Family Residential Development Bonds and $27.2 million of State Workers' Insurance Fund Bond issues 1991A, 1992, 1992A, and 1994 using bond issuance proceeds. Although a deferred loss of $5.1 million resulted from the refundings, the PHFA in effect obtained an economic gain of $32.6 million and was able to reduce its aggregate debt service payments as a result of these transactions by a total of $69.5 million over the next 30 years.

Also during the fiscal year ended June 30, 2003, the PHFA redeemed prior to maturity $108.3 million of Single Family Mortgage Revenue Bonds, Series 1992-34, 1992-35, 1994-38, 1994-41, 1994-42, 1994-43, 1995-44, 1995-45, 1995-46, 1996-47, 1996-48, 1996-50, 1996-51, 1996-52, 1996-53, 1997-54, 1997-56, 1997-57, 1997-58, 1997-59, 1997-60, 1997-61, 1998-62, 1998-64, 1999-65, 1999-66, 1999-67, 1999-68, 2000-69, 2000-70, 2001-72, and 2002-73, using mortgage prepayments. Extraordinary losses of $1.1 million resulted from the redemptions as unamortized bond discount and related costs of issuance for the bonds redeemed were expensed There were no advance refundings of Single Family Bonds from the issuance of new debt during 2003.

NOTE L - REFUNDED DEBT (continued)

At June 30, 2003, $7.1 million of bonds outstanding that were previously accounted for in the financial statements of the PHFA have been defeased through refundings.

During the fiscal year ended May 31, 2003 the Pennsylvania Turnpike Commission (PTC) issued $288.3 million in Series A Revenue Bonds and $160.9 million in Series B Revenue Bonds. The proceeds of the bonds were used to advance refund the PTC's Series O and P Revenue Bonds. As a result of the Series A and B advance refundings, the PTC incurred economic losses of $10.4 million and $5.8 million, respectively, which will be amortized over the life of the new bonds. The advance refundings resulted in a decrease in debt service requirements at May 31, 2003 of $11.8 million.

At May 31, 2003, the PTC has no bonds outstanding that were previously accounted for in their financial statements that have been defeased through refundings.

At June 30, 2003, $11.3 million of bonds outstanding that were previously accounted for in the financial statements of the Pennsylvania Infrastructure Investment Authority have been defeased through refundings.

At June 30, 2003, $2 million of bonds outstanding that were previously accounted for in the financial statements of the Pennsylvania Industrial Development Authority have been defeased through refundings.

At June 30, 2003, $89.1 million of bonds outstanding that were previously accounted for in the financial statements of the State System of Higher Education have been defeased through refundings.

NOTE M - SELF-INSURANCE

The Commonwealth is self-insured for statutory workers' compensation, which includes indemnity and medical benefits (employee disability), for its employees injured on the job. The Commonwealth is also self-insured for annuitant medical/hospital claims and for tort liability claims. Major tort risks include automobile, employee and general torts. For property losses, the Commonwealth has $1 million retention with excess commercial insurance coverage up to $134 million per occurrence. The Commonwealth is also self-insured for claims against the Department of Transportation (transportation claims). The Commonwealth has established various administrative policies that are intended to avoid or limit the aforementioned risks.

There were no reductions in commercial insurance coverage during the fiscal year ended June 30, 2003. No settlements exceeded commercial insurance coverage during any of the past three fiscal years.

The accrued liabilities for employee disability and annuitant medical/hospital claims are determined by an actuary in accordance with accepted actuarial principles. The accrued liability for employee disability was calculated including the effects of changes in statutory benefits from Act 44 of 1993 and Act 57 of 1997. Accrued liabilities for tort and transportation claims are established based on reserves computed from the Commonwealth's claim experience; such claims are not discounted. These liabilities include liabilities for allocated claim adjustment expenditures/expenses and include salvage and subrogation. Salvage and subrogation were not material for the fiscal year ended June 30, 2003. No accrued liability has been reported for property losses.

At June 30, 2003, the accrued liabilities that will be paid with current expendable available financial resources are reported in the **General Fund** ($111,592), the **Motor License Fund** ($18,500), a Special Revenue Fund, and the State Workmen's Insurance Fund ($228) and the State Stores Fund ($3,060), Enterprise Funds. The **General Fund** is reporting the annuitant medical/hospitalization liability as Accounts Payable at June 30, 2003. Those liabilities that will not be paid with current expendable available financial resources at June 30, 2003 are reported as governmental long-term obligations (GLTO) and will be funded by the **General Fund** ($379,172), the **Motor License Fund** ($271,407), a Special Revenue Fund, and as a non-current liability of the State Workmen's Insurance Fund ($1,037) and State Stores Fund ($13,941), Enterprise Funds. All accrued self-insurance liabilities at June 30, 2003 are summarized as follows (amounts in thousands):

	General Fund	Motor License Fund	State Workmen's Insurance Fund	State Stores Fund	GLTO	Total
Employee disability	$ 65,120	$ -	$228	$ 3,060	$ 308,686	$ 377,094
Annuitant medical/hospital	38,447	-	-	-	-	38,447
Automobile tort	3,375	-	-	-	17,733	21,108
Employee tort	3,050	-	-	-	25,430	28,480
General tort	1,600	-	-	-	42,301	43,901
Transportation	-	18,500	-	-	271,407	289,907
Totals	$111,592	$18,500	$228	$ 3,060	$ 665,557	$ 798,937

The following summary provides aggregated information on June 30, 2002 reported self-insurance liabilities; incurred claims and payments during the fiscal year ended June 30, 2003 and reported self-insurance liabilities at June 30, 2003 (amounts in thousands):

	June 30, 2002 Liability	Incurred Claims		Payments		June 30, 2003 Liability
-		Current	Prior	Current	Prior	
Employee disability	$ 379,248	$ 60,021	$ 6,247	$ 8,843	$ 59,579	$ 377,094
Annuitant medical/hospital	36,499	341,265	-	302,818	36,499	38,447
Automobile tort	19,676	10,484	(5,959)	1,143	1,950	21,108
Employee tort	27,631	1,085	3,090	30	3,296	28,480
General tort	41,324	9,563	(6,314)	45	627	43,901
Transportation	331,358	60,523	(90,587)	429	10,958	289,907
Totals	$ 835,736	$ 482,941	$ (93,523)	$ 313,308	$112,909	$ 798,937

NOTE M - SELF-INSURANCE (continued)

The following summary provides aggregated information on June 30, 2001 self-insurance liabilities; incurred claims and payments during the fiscal year ended June 30, 2002 and reported self-insurance liabilities at June 30, 2002 (amounts in thousands):

	June 30, 2001	Incurred Claims		Payments		June 30, 2002
-	Liability	Current	Prior	Current	Prior	Liability
Employee disability	$ 378,934	$ 44,363	$ 9,966	$ 5,965	$ 48,050	$ 379,248
Annuitant medical/hospital	36,181	314,832	-	278,333	36,181	36,499
Automobile tort	17,786	6,850	(2,054)	1,046	1,860	19,676
Employee tort	26,086	1,269	1,384	82	1,026	27,631
General tort	32,729	7,125	2,557	20	1,067	41,324
Transportation	272,815	67,050	3,642	463	11,686	331,358
Totals	$ 764,531	$ 441,489	$ 15,495	$ 285,909	$ 99,870	$ 835,736

NOTE N – COMMITMENTS AND CONTINGENCIES

Construction and Other Commitments: At June 30, 2003, the Department of Transportation and at May 31, 2003, the Pennsylvania Turnpike Commission, a discretely presented component unit, have contractual commitments of approximately $3,248.5 million and $352 million, respectively, for various highway construction and mass transit projects. Financing for these future expenditures will be primarily from approved federal grants and general obligation bond proceeds. In addition, the Commonwealth has a variety of contractual and other commitments for future subsidies and purchases of goods and services for approximately $5.5 billion at June 30, 2003. Actual expenditures are contingent upon approved spending authority and/or availability of financial resources.

Loan Commitments: At June 30, 2003, the following discretely presented component units had approved loans that had not been disbursed (amounts in millions):

Pennsylvania Housing Finance Agency	$ 38
Pennsylvania Industrial Development Authority	140
Pennsylvania Infrastructure Investment Authority	578

Operating Lease Commitments: The Commonwealth and its discretely presented component units have commitments to lease certain buildings and equipment. Future minimum rental commitments for noncancelable operating leases as of June 30, 2003 were as follows (amounts in thousands):

Fiscal year ending June 30:	Primary Government	Discretely Presented Component Units
2004	$ 224,726	$9,427
2005	156,100	6,124
2006	126,507	2,731
2007	86,069	1,808
2008	63,702	256
2009-2013	144,086	418
Total Minimum Lease Payments	$ 801,190	$20,764

Rental expenditures/expenses for all operating leases for the fiscal year ended June 30, 2003 amounted to $368.7 million ($357.9 million for primary government and $10.8 million for discretely presented component units).

Child Support Payments: At June 30, 2003, the Commonwealth is contingently liable for approximately $42 million in payments received by a contractor to be used for child support payments.

Litigation: The Commonwealth is a defendant in numerous legal proceedings pertaining to matters normally incidental to routine operations. Such litigation includes, but is not limited to, claims asserted against the Commonwealth arising from alleged torts, alleged breaches of contracts, condemnation proceedings and other alleged violations of Commonwealth and Federal laws. The Commonwealth has recorded accrued liabilities at June 30, 2003 with respect to torts as described in Note M, and other General Long-Term Obligations with respect to other matters of litigation in the amount of $36,298 thousand for which the likelihood of an unfavorable outcome is probable.

Additionally, the Commonwealth is currently involved in certain legal proceedings relative to a case concerning the distribution of certain state funding for public education in an approximate amount ranging from $200 million to $1 billion. Other cases that the Commonwealth is vigorously contesting could range from approximately $70 million to $449 million, $.2 to $372 million, $7.5 to $27.2 million, zero to $.7 million, zero to $15 million, and $.1 million to $1.1 billion of additional liabilities for the **General Fund**, Special Revenue Funds, Capital Projects Funds, Enterprise Funds, Agency Funds and the Pension Trust Funds, respectively.

Based on the current status of all these legal proceedings, for which accruals have not been made, it is the opinion of the Commonwealth's management and counsel that they will not have a material effect on the Commonwealth's financial position.

The range of potential liability for governmental and business-type activities, respectively, is between $294 million and $1.9 billion and zero to $.7 million at June 30, 2003. The range for the **Motor License Fund** and the **Unemployment Compensation Fund**, respectively, is between $200 thousand and $252 million and zero and $.7 million at June 30, 2003.

NOTE N – COMMITMENTS AND CONTINGENCIES (continued)

Federal Grants: The Commonwealth receives significant financial assistance from the Federal government in the form of grants and entitlements, including several non-cash programs (which are not included in the general purpose financial statements). Receipt of grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable Federal regulations, including the expenditure of resources for eligible purposes. Substantially all grants are subject to either the Federal Single Audit Act or to financial and compliance audits by the grantor agencies of the Federal government or their designees. Disallowances and sanctions as a result of these audits may become liabilities of the Commonwealth. The Commonwealth is currently involved in administrative and legal proceedings, with certain Federal agencies, contesting various disallowances and sanctions related to Federal Assistance Programs ranging from $40 to $139 million at June 30, 2003. The Commonwealth's management believes ultimate disallowances and sanctions, if any, will not have a material effect on the basic financial statements.

Student Loan Guarantees: The Pennsylvania Higher Education Assistance Agency (PHEAA), a discretely presented component unit, guarantees loans made by private lenders to certain resident students. Total original principal of outstanding guarantees issued by PHEAA approximated $20.5 billion at June 30, 2003. Under the Federal Family Education Loan Program, as amended, the PHEAA has entered into agreements with the U.S. Department of Education for reinsurance of death, disability, bankruptcy, default, school closure and borrower ineligibility claims paid to lenders. Pursuant to these agreements, PHEAA receives reimbursement of claims paid to lenders, provided that PHEAA is in compliance with numerous Federal requirements. Reinsurance rates vary from 75 percent to 100 percent depending upon default rates in the portfolio guaranteed by PHEAA and upon the time period when specific loans were guaranteed by PHEAA. During the fiscal year ended June 30, 2003, PHEAA's default rate was in a range that permitted the maximum reinsurance reimbursement from the U.S. Department of Education.

Lottery Prizes: The **State Lottery Fund**, an Enterprise Fund, awards a variety of prizes, including immediate, lump-sum cash prizes and certain large prizes which provide for periodic payments to winners for specific periods of time (in some cases throughout the winners' lifetimes, and to designated beneficiaries). At June 30, 2003, the amount of future payments owed to prizewinners is $1.38 billion. To satisfy its financial obligation to these prizewinners, the Fund purchases annuity contracts from insurance companies whereby the insurance companies make periodic payments to prizewinners. Generally, in the event of insurance company default, the Fund is liable for the related annuity payments. However, certain prizewinners voluntarily assign their annuity rights to other parties and receive lump-sum payments in return. In the event of insurance company default where annuity rights have been voluntarily assigned by prizewinners, the Fund is not liable for the related annuity payments. At June 30, 2003, future payments of $381 million have been voluntarily assigned by prizewinners.

NOTE O - CERTAIN AGENCY FUND CLAIMS LIABILITIES

On March 20, 2002, the Governor signed Act No. 13 of 2002, known as the Medical Care Availability and Reduction of Error (MCare) Act. The Act transferred the assets, liabilities and rights of the Medical Professional Liability Catastrophe Loss Fund, an Agency Fund, to the MCare Fund, a new Agency Fund, which was also created by the Act. The transfer was effective October 1, 2002. Prior to that date, the predecessor Fund acted as a service agent to facilitate the payment of medical malpractice claims exceeding basic liability coverage carried by healthcare providers practicing in the Commonwealth. The Fund collected healthcare provider surcharges, as a percentage of insurance premiums for basic coverage, to pay claims and other costs paid on behalf of healthcare providers during the prior year. The actuarially computed liability to the healthcare providers for claims outstanding at June 30, 2003 totals $2.2 billion. The amount of expendable financial resources available to pay claims at June 30, 2003 is $23.8 million. This amount is reported as a fund liability. The remaining claims will be funded exclusively through surcharge assessments in future years as claims are settled and paid; as a result, a financial liability for remaining claims is not reported.

The Underground Storage Tank Indemnification Fund (the Fund), an Agency Fund, is used to collect fees from underground storage tank owners and operators sufficient to pay owners and operators for costs associated with corrective actions or for bodily injury or property damage caused by underground tank leaks and other releases. Owners and operators are assessed actuarially determined amounts to accumulate sufficient assets to pay claims. The Fund actuary has estimated potential claims of $3,539 million at June 30, 2003 ($431.8 million at June 30, 2002). The increase in the current year is due to a change in the estimate period, from 10 years in 2002 to 20 years in 2003, and a change in assumptions related to tank removal. Prior year claims estimates assumed that all non-heating oil bare steel tanks would be removed by 2005, reducing claims in future years. The current rate of inspection and removal of such tanks did not support the use of this assumption in developing the 2003 estimate. There are statutory limits on the extent of the Fund’s liability to participating owners and operators; the Fund is not obligated beyond assets held at June 30, 2003. Owners and operators will be assessed for any claims exceeding Fund assets and no financial liability is reported for those claims.

NOTE P - DEFERRED COMPENSATION

The Commonwealth sponsors a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, which is administered by the State Employees' Retirement System, permits participants to defer a portion of their salary until future years. Amounts deferred under the plan are not available to employees until termination, retirement, death or unforeseeable emergency.

Of the $1,047 million in assets reported in the Deferred Compensation Fund, a Pension Trust Fund, at December 31, 2002, $1,016 million relates to primary government employees and $27 million relates to employees of discretely presented component units. The remaining balance of $4 million relates to organizations not included in the Commonwealth's financial reporting entity.

NOTE Q - JOINT VENTURE

The Commonwealth and various labor unions representing Commonwealth employees participate in a joint venture, the Pennsylvania Employees Benefit Trust Fund (PEBTF). The PEBTF establishes and provides health and welfare benefits for active Commonwealth employees and is a third party administrator for Commonwealth annuitant medical/hospital benefits. The Commonwealth is required to fund almost all necessary contributions to pay for the cost of providing benefits; the unions are not required to make contributions. Collective bargaining agreements and administrative policies establish contribution rates and/or amounts. During the fiscal year ended June 30, 2003, the Commonwealth contributed approximately $777 million to fund benefits. Neither the Commonwealth nor the unions have an equity interest in the PEBTF.

At June 30, 2003, the PEBTF reported total assets of $96 million, total liabilities and benefit obligations of $115 million, and a deficiency of net assets over benefit obligations of $19 million. The financial status of the PEBTF is monitored on an ongoing basis; financial stress is evident as a result of increasing benefit and other expenses. During the fiscal year ended June 30, 2003 the PEBTF reported a decrease in net assets available for benefits of $144 million for the Active Plan program. This was caused by a continuing increase in the cost of medical benefits incurred over an increase in contributions made by the Commonwealth. Also, investment income decreased significantly during the fiscal year due to a decrease in the average investment balance as the PEBTF liquidated certain investments to pay claims.

In August and September 2003, the PEBTF received a loan from the **Motor License Fund**, a Special Revenue Fund, to help fund the Active Plan until additional contributions could be made by the Commonwealth. The interest on the loan is calculated daily based on the daily yield of the Commonwealth's Fund 98, a short-term investment pool, and will be paid when the loan is paid off (which is expected to be on or before April 8, 2004). On December 23, 200, the General Assembly passed the 2003-2004 budget, wherein $80 million was appropriated to enable PEBTF to repay the **Motor License Fund** loan.

The PEBTF prepared an analysis that showed that, with the $80 million loan proceeds, net assets would exceed benefit obligations through June 30, 2004. However, such an analysis is based on many factors, including member utilization, medical cost inflation and administrative expense assumptions. To the extent such factors vary from actual conditions and experience, benefit obligations may exceed net assets throughout the remainder of the fiscal year ending June 30, 2004.

Effective October 1, 2003, the PEBTF changed certain benefit provisions under its current agreement with the Commonwealth and various labor unions. However, these changes in benefit provisions may not be sufficient to ensure that net assets will equal or exceed benefit obligations.

Audited financial statements for the PEBTF are available, by request, from:

William K. Schantzenbach
Chief Financial Officer
Pennsylvania Employees Benefit Trust Fund
150 South 43rd Street
Harrisburg, Pennsylvania 17111-5700

NOTE R – SUBSEQUENT EVENTS

Primary Government

On February 26, 2004, the Commonwealth issued $809.5 million of General Obligation Bonds, First Series of 2004 with an interest rate of 3.4 percent. The Commonwealth issued the bonds to refund a portion of seven separate issues of previously issued Commonwealth of Pennsylvania General Obligation Bonds in order to reduce debt service on its general obligation bonds, and to provide for the construction, acquisition and major rehabilitation of capital facilities projects and county and multi-county regional prison facility projects.

Discretely Presented Component Units

On April 10, 2003, the **Pennsylvania Property and Casualty Insurance Guaranty Association** and the Commonwealth Court of Pennsylvania approved an order of liquidation for White Hall Mutual Insurance Company.

On May 6, 2003, the **Pennsylvania Turnpike Commission (PTC)** approved a resolution for the defeasance of certain Oil Franchise Tax Revenue Senior Bonds, Series A of 1998 and Oil Franchise Tax Revenue Subordinate Bonds, Series B of 1998. The Commission will utilize both Oil Franchise Tax Revenue and Vehicle Registration Fee Revenue assets received prior to the issuance of the respective bond issues to provide sufficient funding for the defeasance. The defeasance occurred in July 2003. On May 20, 2003, the **PTC** approved resolution for the issuance of Oil Franchise Tax Revenue Bonds in an aggregate principal amount not to exceed $500 million. The proceeds from these bonds will be used to finance certain costs associated with capital projects as defined under Commonwealth of Pennsylvania Act 61.

On July 10, 2003, the **Philadelphia Regional Port Authority (PRPA)** issued Series 2003 Commonwealth Lease Revenue Bonds with a par value of $53,900,000 with a floating interest rate to refund the 1993 Lease Revenue Bonds. After Bond Insurance Premium of $171,000 and an Underwriter's Discount of $215,600, net proceeds of the issuance were $53,513,400. This was deposited with the Authority's Trustee along with $500,000 from the Authority representing the special Swap Reserve Fund and the $5,340,950 liquidated balance and investment earnings from the Debt Service Reserve Fund of the 1993 Lease Revenue Bonds. The Trustee transferred $771,224 to the Series 2003 Cost of Issuance Fund, $4,979,430 to the 2003 Debt Service Reserve Fund, $500,000 to the 2003 Swap Reserve Fund, and $53,103,676 was deposited to the Redemption Fund to pay principal, interest, and premium on the 1993 Lease Revenue Bonds that were due to mature in September 2020, rendering them no longer outstanding under the original indenture. The interest rate swap became effective on July 10, 2003. The 2003 Lease Revenue Bonds and all amounts due under the interest rate swap are payable from and secured by a pledge of and lien on all amounts received by or payable to the **PRPA** under the lease of port facilities to the Commonwealth.

On August 7, 2003, the **Pennsylvania Housing Finance Agency** issued $100 million of Single Family Mortgage Revenue Bonds, Series 2003-77 and $73.68 million of Single Family Mortgage Revenue Bonds Series 2003-78. The proceeds from these bond issuances were used to finance new loan purchases and refund existing bonds.

On July 1, 2003, variable interest rates charged to Federal Family Education Loan Program (FFELP) borrowers under loan programs administered by the **Pennsylvania Higher Education Assistance Agency (PHEAA)** decreased 0.64%, based on the 91-day U.S. Treasury Bill rate on the reset date of May 21, 2003. Under the net interest revenue section, the agency earned $4.4 million more than expected during 2003 because the borrower rate exceeded the lender rate for almost the entire year. Since July 1, 2003, the borrower rate has exceeded the lender rate, on average, by 0.20%. Changes in short-term interest rates will affect future results of operations. Since June 30, 2003 rates on 91-day U.S. Treasury Bills and rates on 3-month commercial paper have increased 0.05%. On July 1, 2003, **PHEAA** refunded $75.0 million of bonds with the proceeds from bonds issued on April 25, 2003. The bonds issued are variable-rate bonds with a weighted-average rate of 1.24% for the year ended June 30, 2003. The effective rate of the refunded bonds was 6.05%. On July 1, 2003, $312.9 million of student loan revenue bonds switched from a weighted-average fixed-rate of 2.64% to variable-rate debt. On September 5, 2003, the agency issued $300 million of student loan demand revenue bonds. The bonds issued are variable-rate debt that reset based upon auctions every 28 days and carried an initial rate of 1.15%. On October 1, 2003, the rate that the U. S. Department of Education (ED) pays for loan processing and issuance fees decreased from 65 basis points to 40 basis points. If the new rate had been in effect for the year ended June 30, 2003, federal fees would have been $5.6 million less than they were in the current year. On October 1, 2003, retention of collections on defaulted loans will decrease from 24% to 23%. If that new rate had been in effect for the year ended June 30, 2003, retention of collections on defaulted loans would have been $1.8 million less than it was in the current year. During the month of June 2003 the board of directors authorized the development of programs to deliver an additional $25 million of financial aid. As these programs are developed and implemented, net assets will be used to fund the financial aid. Finally, on December 10, 2003 **PHEAA** securitized $387.1 million of student loans.

Required Supplementary Information

Commonwealth of Pennsylvania

BUDGETARY COMPARISON SCHEDULE
Budgeted Major Funds
General Fund

For the Fiscal Year Ended June 30, 2003

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Taxes, net of refunds	$ 20,179,700	$ (98,800)	$ 20,080,900	$ (513,381)	$ 19,567,519
Liquor store profits transfer	155,000	-	155,000	-	155,000
Licenses and fees	136,700	-	136,700	(40,290)	96,410
Fines, penalties and interest	27,600	-	27,600	7,320	34,920
Investment income	90,282	-	90,282	(15,430)	74,852
Unclaimed property	50,500	-	50,500	231,799	282,299
Departmental services	2,269,652	884,483	3,154,135	-	3,154,135
Miscellaneous	341,518	-	341,518	(167,667)	173,851
TOTAL STATE PROGRAMS	23,250,952	785,683	24,036,635	(497,649)	23,538,986
Federal Programs	13,306,050	88,941	13,394,991	(469,928)	12,925,063
TOTAL REVENUES	36,557,002	874,624	37,431,626	(967,577)	36,464,049
EXPENDITURES:					
State Programs:					
Direction and supportive services	1,198,443	(15,146)	1,183,297	(37,015)	1,146,282
Protection of persons and property	2,767,348	364,676	3,132,024	(47,208)	3,084,816
Health and human services	8,689,887	282,514	8,972,401	(166,011)	8,806,390
Public education	8,956,199	40,034	8,996,233	(50,225)	8,946,008
Recreation and cultural enrichment	160,509	(2,006)	158,503	(3,375)	155,128
Debt service	349,138	259,239	608,377	(54)	608,323
Economic development	419,394	(1,984)	417,410	(7,124)	410,286
Transportation	399,484	1,628	401,112	(4,106)	397,006
TOTAL STATE PROGRAMS	22,940,402	928,955	23,869,357	(315,118)	23,554,239
Federal Programs	13,306,050	88,941	13,394,991	(469,928)	12,925,063
TOTAL EXPENDITURES	36,246,452	1,017,896	37,264,348	(785,046)	36,479,302
REVENUES OVER/(UNDER) EXPENDITURES	310,550	(143,272)	167,278	(182,531)	(15,253)
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	151,818	151,818	-	151,818
Transfer to Budget Stabilization Reserve Fund	(1,055)	1,055	-	(69,775)	(69,775)
TOTAL OTHER FINANCING SOURCES (USES)	(1,055)	152,873	151,818	(69,775)	82,043
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	309,495	9,601	319,096	(252,306)	66,790
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2002, RESTATED	142,535	-	142,535	-	142,535
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003	$ 452,030	$ 9,601	$ 461,631	$ (252,306)	$ 209,325

- The notes to required supplementary information are an integral part of this schedule. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Taxes, net of refunds	$ 1,112,200	$ -	$ 1,112,200	$ (6,739)	$ 1,105,461
Licenses and fees	829,700	-	829,700	(879)	828,821
Fines, penalties and interest	30,420	-	30,420	(203)	30,217
Investment income	26,087	-	26,087	(13,326)	12,761
Departmental services	47,970	684,454	732,424	-	732,424
Miscellaneous	30,893	-	30,893	(9,384)	21,509
TOTAL STATE PROGRAMS	2,077,270	684,454	2,761,724	(30,531)	2,731,193
Federal Programs	1,621,059	15,327	1,636,386	(354,859)	1,281,527
TOTAL REVENUES	3,698,329	699,781	4,398,110	(385,390)	4,012,720
EXPENDITURES:					
State Programs:					
Direction and supportive services	66,792	113	66,905	(6,295)	60,610
Protection of persons and property	375,775	-	375,775	-	375,775
Public education	1,230	-	1,230	-	1,230
Recreation and cultural enrichment	1,000	-	1,000	-	1,000
Debt service	42,813	(50)	42,763	(1,206)	41,557
Transportation	1,618,826	684,891	2,303,717	(3,340)	2,300,377
TOTAL STATE PROGRAMS	2,106,436	684,954	2,791,390	(10,841)	2,780,549
Federal Programs	1,621,059	15,327	1,636,386	(354,859)	1,281,527
TOTAL EXPENDITURES	3,727,495	700,281	4,427,776	(365,700)	4,062,076
REVENUES UNDER EXPENDITURES	(29,166)	(500)	(29,666)	(19,690)	(49,356)
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	23,447	23,447	-	23,447
TOTAL OTHER FINANCING SOURCES	-	23,447	23,447	-	23,447
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	(29,166)	22,947	(6,219)	(19,690)	(25,909)
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2002	56,358	-	56,358	-	56,358
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003	$ 27,192	$ 22,947	$ 50,139	$ (19,690)	$ 30,449

- The notes to required supplementary information are an integral part of this schedule. -

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Licenses and fees	$ 12,856	$ (362)	$ 12,494	$ 1,190	$ 13,684
Fines, penalties and interest	55	15	70	159	229
Investment income	1,002	(137)	865	(335)	530
TOTAL REVENUES	13,913	(484)	13,429	1,014	14,443
EXPENDITURES:					
State Programs:					
Direction and supportive services	13,722	-	13,722	(1,660)	12,062
TOTAL EXPENDITURES	13,722	-	13,722	(1,660)	12,062
REVENUES OVER (UNDER) EXPENDITURES	191	(484)	(293)	2,674	2,381
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	4	4	-	4
TOTAL OTHER FINANCING SOURCES	-	4	4	-	4
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	191	(480)	(289)	2,674	2,385
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2002	19,740	-	19,740	-	19,740
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003	$ 19,931	$ (480)	$ 19,451	$ 2,674	$ 22,125

- The notes to required supplementary information are an integral part of this schedule. -

BUDGETARY COMPARISON SCHEDULE
Budgeted Nonmajor Funds
Special Revenue Fund-Milk Marketing

For the Fiscal Year Ended June 30, 2003

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Licenses and fees	$ 2,167	$ (3)	$ 2,164	$ 27	$ 2,191
Fines, penalties and interest	10	-	10	(2)	8
Investment income	113	1	114	(62)	52
Miscellaneous	1	-	1	-	1
TOTAL REVENUES	2,291	(2)	2,289	(37)	2,252
EXPENDITURES:					
State Programs:					
Direction and supportive services	2,532	-	2,532	(19)	2,513
TOTAL EXPENDITURES	2,532	-	2,532	(19)	2,513
REVENUES UNDER EXPENDITURES	(241)	(2)	(243)	(18)	(261)
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	118	118	-	118
TOTAL OTHER FINANCING SOURCES	-	118	118	-	118
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	(241)	116	(125)	(18)	(143)
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2002	1,519	-	1,519	-	1,519
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003	$ 1,278	$ 116	$ 1,394	$ (18)	$ 1,376

- The notes to required supplementary information are an integral part of this schedule. -

BUDGETARY COMPARISON SCHEDULE
Budgeted Nonmajor Funds
Special Revenue Fund-Workmen's Compensation Administration

For the Fiscal Year Ended June 30, 2003

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Taxes, net of refunds	$ 51,635	$ -	$ 51,635	$ 3,328	$ 54,963
Fines, penalties and interest	31	-	31	(21)	10
Investment income	1,939	-	1,939	(1,317)	622
Departmental services	175	-	175	-	175
Miscellaneous	430	-	430	(293)	137
TOTAL REVENUES	54,210	-	54,210	1,697	55,907
EXPENDITURES:					
State Programs:					
Direction and supportive services	55,435	-	55,435	(94)	55,341
Economic development	175	-	175	-	175
TOTAL EXPENDITURES	55,610	-	55,610	(94)	55,516
REVENUES OVER (UNDER) EXPENDITURES	(1,400)	-	(1,400)	1,791	391
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	3,692	3,692	-	3,692
TOTAL OTHER FINANCING SOURCES	-	3,692	3,692	-	3,692
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	(1,400)	3,692	2,292	1,791	4,083
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2002	39,785	-	39,785	-	39,785
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003	$ 38,385	$ 3,692	$ 42,077	$ 1,791	$ 43,868

- The notes to required supplementary information are an integral part of this schedule. -

NOTES TO REQUIRED SUPPLEMENTARY INFORMATION

Note 1 - Budget Preparation Process

The process of preparing the General Fund Budget for the Commonwealth of Pennsylvania begins nearly one year before the new budget takes effect on July 1 each year. The budget process begins in August of the year previous to the budget year with the distribution of both the Budget Instructions and Program Policy Guidelines by the Office of the Budget and the Governor's Office, respectively. These provide detailed guidelines and define major policy issues to be considered when agencies complete their budget requests. As required by statute, agencies must prepare budgets that indicate the cost of supporting activities at the level expected in the immediate budget year and the ensuing four budget years. The five-year horizon does not include future program changes but considers the requirements and demands of current law, regulation, policy and program decisions.

Agencies submit budget requests to the Secretary of the Budget beginning in early October. From October through January, the Office of the Budget reviews these requests for accuracy and adherence to policy guidelines and prepares funding recommendations for the Secretary of the Budget and the Governor.

During December, the Governor meets with leaders of the General Assembly to inform them of anticipated spending and revenue levels and to discuss related budgetary issues. The Governor then conducts reviews to make the final budget decisions. The Governor's Executive Budget is finalized in January and is submitted to the General Assembly in early February.

After receiving the budget document, the appropriations committees of both houses of the legislature hold hearings to review agency funding requests. The General Assembly passes the budget in the form of a General Appropriations Bill and individual appropriations bills. At the time of passage of these bills and their presentation to the Governor, the official revised revenue estimates for the budget year are issued. If the combined appropriations bills passed by the legislature exceed the revenue estimates, the Governor is required and has the authority to either veto entire appropriations bills or to reduce the amount of appropriations in order to produce a budget that is in balance. The Governor also has the power to reduce or veto any specific appropriation even if the total appropriations do not exceed estimated revenues. The Governor's signing of the appropriations bills and any revenue bills is the last step in the approval stage of the budget.

Additional information regarding Pennsylvania's budgeting process may be located at: http://www.oit.state.pa.us/budget

Note 2 – Basis of Budgeting

On the budgetary basis, certain estimated tax revenue accruals are recorded at fiscal year end for the **General Fund** and the **Motor License Fund**, a Special Revenue Fund. Accruals include sales and use taxes and personal income taxes, both applicable to the General Fund, and liquid fuels taxes applicable to the **Motor License Fund**. These taxes are estimated to be owed to the Commonwealth but are not collected by fiscal year end. Also, estimated encumbrances are established for all funds at fiscal year end to pay certain direct expenditures for salaries, wages, travel, and utility costs payable against current year appropriation authority but expended in the subsequent year. Over-estimates of prior year encumbrances are lapsed in the subsequent year and under-estimates are charged to subsequent year appropriation authority.

Budgeted revenues in the Budgetary Comparison Schedules represent official estimates while expenditures represent amounts originally adopted or legally amended. Actual amounts are presented on the budgetary basis. Because the budgetary basis differs from the modified accrual basis of accounting for governmental funds, a reconciliation of the differences between budgetary basis and the modified accrual basis of reporting is presented.

Note 3 - Reconciliation of Budgetary to GAAP Basis Amounts

The Commonwealth adopts formal annual budgets for two major governmental funds (**General Fund** and **Motor License Fund**, Special Revenue Fund) and three nonmajor governmental funds (Workmen's Compensation Administration, Banking Department, and Milk Marketing, Special Revenue funds). The Budgetary Comparison Schedules for Budgeted Major and Nonmajor Funds presents comparisons of the legally adopted budget, as amended, with actual data on a budgetary basis, which differs from governmental fund statement information primarily by the omission of certain revenue and expenditure accruals.

The following presents a reconciliation of the budgetary basis to the modified accrual basis of reporting (amounts in thousands):

	Major Budgeted Funds		Nonmajor Budgeted Funds		
	General Fund	Motor License Fund	Workmen's Compensation Administration Fund	Banking Department Fund	Milk Marketing Fund
Budgetary basis — revenues and other sources over (under) expenditures and other uses…………………………	$66,790	$(25,909)	$4,083	$2,385	$(143)
Adjustments:					
To adjust revenues, other financing sources and related receivables and deferred revenue…….…………...	(1,125,072)	16,838	(6,620)	(3,220)	(106)
To adjust expenditures, other financing uses and related accounts payable and and accrued liabilities………………...	393,153	189,777	4,721	527	181
Net adjustments………………………	(731,919)	206,615	(1,899)	(2,693)	75
Modified accrual basis – net change in governmental fund balance…………	$(665,129)	$180,706	$2,184	$(308)	$(68)

The above revenue adjustments include net revenue accruals, amounts to recognize certain pass-through grants and amounts to recognize certain intergovernmental revenues that are not reported for budgetary reporting purposes. Likewise, the above expenditure adjustments include net expenditure accruals, amounts to recognize certain pass-through grants and amounts to recognize certain expenditures related to Federal and other grants that are not reported for budgetary reporting purposes.

Note 4 – Budgetary Compliance

The General Assembly passes, and the Governor approves (or reduces or vetoes), individual appropriations as part of the annual budget adoption process. Budgetary expenditure control occurs at the appropriation level; this is the lowest level of legislative spending control. Encumbrances and expenditures within individual appropriations may not exceed total amounts appropriated plus actual augmentations (certain revenues credited to specific appropriations). Also, appropriation transfers between or within departments and any supplemental appropriations require both legislative and gubernatorial approval. The legislatively adopted budget for the **General Fund** includes $41.8 million in supplemental appropriations approved during the fiscal year ended June 30, 2003.

A separately available report, the "*Status of Appropriations*," demonstrates budgetary expenditure compliance for the **General Fund** for the fiscal year ended June 30, 2003. This report includes a variety of detail information and summaries related to individual appropriations. A second "*Status of Appropriations*" report (for Special Funds) demonstrates compliance for the four budgeted Special Revenue funds: **Motor License**, Workmen's Compensation Administration, Banking Department and Milk Marketing. Both "*Status*" reports are available from the Office of the Budget. The Governor controls spending by using executive authorizations for Special Revenue funds not controlled by legislatively adopted budgets.

Total reported actual expenditures for "Total State Programs" included in the Budgetary Comparison Schedule – Major Governmental Funds are based on appropriation, augmentation and lapse amounts reported in the respective June 30, 2003 "*Status of Appropriations*" (Total All Current State Ledgers) as follows (in thousands):

	"*Status*" Page Reference	Total Approved Appropriations	+	Total Actual Augmentations	-	Total Actual Lapses	=	Actual Expenditure Amounts
General Fund amounts.............	7[1]	$ 21,644,822		$ 3,154,135		$ 315,118		$ 24,483,839
Less: tax refunds.....................	7[1]	(929,600)		-		-		(929,600)
Amount reported.....................		$ 20,715,222		$ 3,154,135		$ 315,118		$ 23,554,239
Special Revenue Funds:								
Motor License Fund................	47	$ 2,798,872		$ 2,016,040		$ 77,942		$ 4,736,970
less: reductions[2]		(739,906)		(1,283,616)		(67,101)		(1,956,421)
Amount reported.....................		$ 2,058,966		$ 732,424		$ 10,841		$ 2,780,549
Workmen's Compensation Administration Fund	242	$ 55,435		$ 175		$ 94		$ 55,516
Banking Department Fund........	85	$ 13,722		$ -		$ 1,660		$ 12,062
Milk Marketing Fund................	91	$ 2,532		$ -		$ 19		$ 2,513

Total actual expenditures for "Federal Programs" for the **General Fund** are derived from the **General Fund** "*Status*," pkt page 225, page no. 225 "Summary of All Current Federal Ledgers by Character of Expenditure" as follows (in thousands): Commitments of $850,294 and Expenditures of $11,075,820, for a total of $11,926,114.

Total actual expenditures for "Federal Programs," Special Revenue funds, are derived from the Special Funds "*Status*" as follows (in thousands): **Motor License** - $1,090,124 (calculated in footnote 3 below).

[1] Pkt page 7, page no. 7, "Summary of All Current State Ledgers by Character of Expenditure," **General Fund** "*Status of Appropriations*."

[2] Excludes the following appropriation symbols, beginning on page 50, Special Funds "*Status of Appropriations*:" 010-78-571-02-10; 010-78-572-02-10; 010-78-579-02-10; 010-73-132-02-20; 010-38-226-02-20; 010-78-172-02-20; 010-78-173-02-20; 010-78-174-02-20; and 010-78-177-02-20 through 010-78-185-02-20.

[3] Consists of $1,281,527 in Year-to-Date "Total Federal Funds" on pages 113 and 114 of the "*Report of Revenues and Receipts*" less $191,403 in Year-to-Date Federal Funds amounts for the following revenue codes (also on pages 113 and 114 of the "*Report*"): 010811-008051-101; 010811-008181-101; 010811-008181-106; 010811-008181-108; 010811-008232-101; 010811-008284-101; 010811-008289-101; and 010811-008289-102.

Note 5 – Restatement of June 30, 2002 Unreserved/Undesignated General Fund Fund Balance (Budgetary Basis)

The Budgetary Comparison schedule reflects a restatement of minus $300 thousand to the June 30, 2002 budgetary basis Unreserved/Undesignated fund balance. The restatement includes in fund balance the result of a transfer of spending authority from the current year Department of Public Welfare Long-Term Care appropriation to a prior year Pennsylvania Emergency Management Agency appropriation created in the 2001-2002 fiscal year. This appropriation was created to provide emergency and disaster relief as a result of the airplane crash in Somerset County and catastrophic events in New York City, New York and Washington D.C. on September 11, 2001.

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Schedule of Expenditures of Federal Awards

Commonwealth of Pennsylvania

CFDA #	CFDA Program Name		Federal Expenditures (000's)
10.551	Food Stamps	748,313	
10.561	State Admin Matching Grants for Food Stamp Program	130,174	
	Total Food Stamp Cluster		878,487
10.553	School Breakfast Program	40,416	
10.555	National School Lunch Program	182,596	
10.556	Special Milk Program for Children	729	
10.559	Summer Food Service Program for Children	12,645	
	Total Child Nutrition Cluster		236,386
10.568	Emergency Food Assistance Program (Admin Costs)	2,946	
10.569	Emergency Food Assistance Program (Food Commodities)	12,480	
	Total Emergency Food Assistance Cluster		15,426
10.025	Plant & Animal Disease, Pest Control & Animal Care		972
10.064	Forestry Incentives Program		5
10.156	Federal-State Marketing Improvement Program		61
10.162	Inspection Grading and Standardization		157
10.250	Agricultural and Rural Economic Research		40
10.450	Crop Insurance		270
10.550	Food Donation		29,153
10.557	Special Supplemental Nutrition Program for WIC		117,388
10.558	Child and Adult Care Food Program		45,481
10.560	State Administrative Expenses for Child Nutrition		3,291
10.565	Commodity Supplemental Food Program		294
10.570	Nutrition Services Incentive		6,467
10.572	WIC Farmers' Market Nutrition Program (FMNP)		3,707
10.574	Team Nutrition Grants		98
10.664	Cooperative Forestry Assistance		831
10.665	Schools and Roads - Grants to States		3,665
	Total - Department of Agriculture		**$1,342,179**
11.407	Interjurisdictional Fisheries Act of 1986		12
11.419	Coastal Zone Management Administration Awards		2,076
11.450	Integrated Flood Observing and Warning System (IFLOWS)		103
11.457	Chesapeake Bay Studies		10
11.474	Atlantic Coastal Fisheries Cooperative Management Act		141
	Total - Department of Commerce		**$2,342**
12.112	Payments to States in Lieu of Real Estate Taxes		79
12.401	National Guard Military Operations and Maintenance Projects		22,031
12.999	Miscellaneous		2,000
	Total - Department of Defense		**$24,110**
14.228	Community Development Block Grants/State's Program		54,017
14.231	Emergency Shelter Grants Program		3,052
14.239	HOME Investment Partnerships Program		13,137

- See Notes to Schedule of Expenditures of Federal Awards -

CFDA #	CFDA Program Name		Federal Expenditures (000's)
14.241	Housing Opportunities for Persons with AIDS		1,474
14.401	Fair Housing Assistance Program - State & Local		1,216
	Total - Department of Housing and Urban Development		**$72,896**
15.605	Sport Fish Restoration	6,040	
15.611	Wildlife Restoration	6,611	
	Total Fish and Wildlife Cluster		12,651
15.250	Regulation of Surface Coal Mining		11,504
15.252	Abandoned Mine Land Reclamation Program		22,616
15.612	Endangered Species Conservation		17
15.616	Clean Vessel Act		30
15.625	Wildlife Conservation and Restoration		608
15.808	U.S. Geological Survey - Research & Data Collection		10
15.810	National Cooperative Geologic Mapping Program		78
15.904	Historic Preservation Fund Grants-In-Aid		739
15.916	Outdoor Recreation - Acquisition, Development and Planning		1,716
	Total - Department of the Interior		**$49,969**
16.004	Law Enforce Asst - Narcotics & Dangerous Drugs Training		128
16.007	State Domestic Preparedness Equipment Support Program		2,306
16.523	Juvenile Accountability Incentive Block Grants		6,866
16.540	Juvenile Justice & Delinquency Prevention - Allocation to States		2,495
16.548	Title V - Delinquency Prevention Program		1,345
16.549	Part E - State Challenge Activities		365
16.550	State Justice Statistics Program for Statistical Analysis Centers		46
16.554	National Criminal History Improvement Program (NCHIP)		995
16.572	State Criminal Alien Assistance Program		4,221
16.574	Byrne Evaluation Partnership Program		7,603
16.575	Crime Victim Assistance		16,863
16.576	Crime Victim Compensation		3,415
16.579	Byrne Formula Grant Program		22,837
16.580	Ed Byrne Mem State & Local Law Enforce Asst/Disc Grants		224
16.582	Crime Victim Assistance/Discretionary Grants		583
16.588	Violence Against Women Formula Grants		3,330
16.592	Local Law Enforcement Block Grants Program		3,119
16.607	Bulletproof Vest Partnership Program		191
16.727	Enforcing Underage Drinking Laws Program		1,121
16.999	Miscellaneous		1,076
	Total - Department of Justice		**$79,129**
17.207	Employment Service	31,753	
17.801	Disabled Veterans' Outreach Program (DVOP)	3,055	
17.804	Local Veterans' Employment Representative Program	3,590	
	Total Employment Services Cluster		38,398

CFDA #	CFDA Program Name		Federal Expenditures (000's)
17.258	WIA Adult Program	38,344	
17.259	WIA Youth Activities	46,838	
17.260	WIA Dislocated Workers	71,738	
	Total WIA Cluster		156,920
17.002	Labor Force Statistics		2,834
17.005	Compensation and Working Conditions		48
17.203	Labor Certification for Alien Workers		802
17.225	Unemployment Insurance		3,807,224
17.235	Senior Community Service Employment Program		4,874
17.245	Trade Adjustment Assistance – Workers		39,790
17.246	Employment & Training Assistance - Dislocated Workers		1,400
17.253	Welfare-to-Work Grants to States and Localities		14,080
17.255	Workforce Investment Act		10,584
17.257	One-Stop Career Center Initiative		468
17.262	Employment and Training Administration Evaluations		53
17.600	Mine Health and Safety Grants		685
17.802	Veterans' Employment Program		561
	Total - Department of Labor		**$4,078,721**
20.205	Highway Planning and Construction	1,300,916	
23.003	Appalachian Development Highway System	21,662	
	Total Highway Planning and Construction Cluster		1,322,578
20.600	State and Community Highway Safety	9,892	
20.601	Alcohol Traffic Safety & Drunk Driving Prev Grants	1,448	
	Total Highway Safety Cluster		11,340
20.005	Boating Safety Financial Assistance		1,399
20.006	State Access to the Oil Spill Liability Trust Fund		170
20.106	Airport Improvement Program		16,001
20.218	National Motor Carrier Safety		5,878
20.219	Recreational Trails Program		1,316
20.308	Local Rail Freight Assistance		1
20.500	Federal Transit - Capital Investment Grants		3,171
20.505	Federal Transit - Metropolitan Planning Grants		2,750
20.509	Formula Grants for Other Than Urbanized Areas		11,031
20.513	Capital Assistance Program for Elderly & Disabled Persons		4,348
20.514	Transit Planning and Research		831
20.700	Pipeline Safety		389
20.703	Interagency Hazardous Matl Public Sector Training Grants		330
20.999	Miscellaneous		36
	Total - Department of Transportation		**$1,381,569**
23.002	Appalachian Area Development		83
23.008	Appalachian Local Access Roads		304
23.011	Appalachian State Research, Tech Asst & Demo Projects		229
	Total - Appalachian Regional Commission		**$616**

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2003

CFDA #	CFDA Program Name	Federal Expenditures (000's)
30.002	Employment Discrim – State & Local Fair Empl Practice	1,695
	Total - Equal Employment Opportunity Commission	**$1,695**
39.003	Donation of Federal Surplus Personal Property	11,043
39.011	Election Reform Payments	116
	Total - General Services Administration	**$11,159**
45.025	Promotion of the Arts - Partnership Agreements	763
45.026	Promotion of the Arts - Leadership Initiatives	36
45.310	State Library Program	6,510
	Total - National Foundation on the Arts and Humanities	**$7,309**
59.999	Miscellaneous	1,472
	Total - Small Business Administration	**$1,472**
64.010	Veterans Nursing Home Care	485
64.014	Veterans State Domiciliary Care	3,210
64.015	Veterans State Nursing Home Care	15,843
64.111	Veterans Education Assistance	815
	Total - Department of Veterans Affairs	**$20,353**
66.001	Air Pollution Control Program Support	4,504
66.032	State Indoor Radon Grants	293
66.419	Water Pollution Control - State & Interstate Program Support	4,330
66.432	State Public Water System Supervision	3,177
66.438	Construction Management Assistance	353
66.454	Water Quality Management Planning	677
66.458	Capitalization Grants for Clean Water State Revolving Funds	86,545
66.460	Nonpoint Source Implementation Grants	4,952
66.461	Wetland Program Grants	59
66.463	Water Quality Cooperative Agreements	313
66.466	Chesapeake Bay Program	2,624
66.467	Wastewater Operator Training Grant Program (Tech Assistance)	10
66.468	Capitalization Grants for Drinking Water State Revolving Funds	19,822
66.472	Beach Monitoring & Notification Program Implementation Grants	35
66.474	Water Protection Grants to the States	2
66.606	Surveys, Studies, Investigations and Special Purpose Grants	768
66.608	State Information Grants	66
66.700	Consolidated Pesticide Enforcement Coop Agreements	763
66.707	TSCA Title IV State Lead Grants Cert of Lead-Based Paint	351
66.708	Pollution Prevention Grants Program	26
66.801	Hazardous Waste Management State Program Support	4,341

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2003

CFDA #	CFDA Program Name		Federal Expenditures (000's)
66.802	Superfund State, Political Subdiv - Cooperative Agreements		(2)
66.804	State and Tribal Underground Storage Tanks Program		187
66.805	Leaking Underground Storage Tank Trust Fund Program		1,346
	Total - Environmental Protection Agency		**$135,542**
81.041	State Energy Program		1,142
81.042	Weatherization Assistance for Low-Income Persons		14,478
81.105	Natl Industrial Competitiveness through Energy, Envir & Econ		475
81.117	Energy Efficiency & Renewable Energy Info Dissemination		21
81.119	State Energy Program Special Projects		157
81.999	Miscellaneous		113
	Total - Department of Energy		**$16,386**
83.010	National Fire Academy Educational Program		12
83.105	Community Asst Program – State Support Services Element		16
83.536	Flood Mitigation Assistance		697
83.543	Individual and Family Grants		(88)
83.544	Public Assistance Grants		8,108
83.547	First Responder Counter-Terrorism Training Assistance		45
83.548	Hazard Mitigation Grant		3,563
83.550	National Dam Safety Program		26
83.551	Project Impact Building Disaster Resistant Communities		(7)
83.552	Emergency Management Performance Grants		4,745
83.563	Emergency Operations Centers		2
83.999	Miscellaneous		4,527
	Total - Federal Emergency Management Agency		**$21,646**
84.027	Special Education - Grants to States	287,914	
84.173	Special Education - Preschool Grants	13,779	
	Total Special Education Cluster		301,693
84.002	Adult Education - State Grant Program		24,517
84.010	Title I Grants to Local Educational Agencies		382,625
84.011	Migrant Education - State Grant Program		7,403
84.013	Title I Program for Neglected and Delinquent Children		737
84.048	Vocational Education - Basic Grants to States		44,384
84.063	Federal Pell Grant Program		571
84.126	Rehabilitation Services - Vocational Rehab Grants to States		102,636
84.162	Immigrant Education		55
84.169	Independent Living - State Grants		1,331
84.177	Rehab Serv - Independent Living Services for Older Blind Indiv		1,362
84.181	Special Educ - Grants for Infants & Families with Disabilities		13,807
84.184	Safe & Drug-Free Schools & Communities - National Programs		1,564
84.186	Safe & Drug-Free Schools & Communities - State Grants		16,358
84.187	Supported Employ Serv for Individuals with Severe Disabilities		1,012

Schedule of Expenditures of Federal Awards - June 30, 2003

CFDA #	CFDA Program Name		Federal Expenditures (000's)
84.194	Bilingual Education Support Services		48
84.196	Education for Homeless Children and Youth		1,588
84.206	Javits Gifted & Talented Students Education Grant Program		230
84.213	Even Start - State Educational Agencies		8,694
84.215	Fund for the Improvement of Education		20,028
84.216	Capital Expenses		369
84.243	Tech-Prep Education		4,961
84.265	Rehab Training - State Voc Rehab Unit In-Service Training		301
84.276	Goals 2000 State & Local Educ System Improvement Grants		6,310
84.281	Eisenhower Professional Development State Grants		8,066
84.282	Charter Schools		2,766
84.287	Twenty-First Century Community Learning Centers		73
84.298	Innovative Education Program Strategies		15,950
84.314	Even Start - Statewide Family Literacy Program		201
84.318	Education Technology State Grants		18,561
84.323	Spec Educ – State Program Improve Grants for Child with Disab		1,500
84.330	Advanced Placement Program		106
84.331	Grants to States for Incarcerated Youth Offenders		137
84.332	Comprehensive School Reform Demonstration		9,420
84.336	Teacher Quality Enhancement Grants		596
84.338	Reading Excellence		6,795
84.340	Class Size Reduction		21,144
84.346	Voc Ed - Occupational & Employment Info State Grants		216
84.348	Title I Accountability Grants		4,637
84.352	School Renovation Grants		28,268
84.357	Reading First State Grants		22,038
84.358	Rural Education		618
84.365	English Language Acquisition Grants		946
84.367	Improving Teacher Quality State Grants		72,887
84.369	Grants for State Assessments and Related Activities		60
84.999	Miscellaneous		23
	Total - Department of Education		**$1,157,592**
89.003	National Historical Publications and Records Grants		114
	Total National Archives and Records Administration		**$114**
93.044	Special Programs for the Aging - Title III Part B	26,264	
93.045	Special Programs for the Aging - Title III Part C	22,752	
	Total Aging Cluster		49,016
93.575	Child Care and Development Block Grant	161,269	
93.596	Child Care Mandatory & Matching Funds - Child Care & Dev Fund	105,031	
	Total Child Care Cluster		266,300

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2003

CFDA #	CFDA Program Name		Federal Expenditures (000's)
93.775	State Medicaid Fraud Control Units	3,501	
93.777	State Survey & Cert of Health Care Providers & Suppliers	7,693	
93.778	Medical Assistance Program	7,177,729	
	Total Medicaid Cluster		7,188,923
93.003	Public Health and Social Services Emergency Fund		4,758
93.041	Special Programs for the Aging - Title VII Chapter 3		148
93.042	Special Programs for the Aging - Title VII Chapter 2		601
93.043	Special Programs for the Aging - Title III Part D		1,026
93.048	Special Programs for the Aging - Title IV and Title II		26
93.052	National Family Caregiver Support		6,319
93.053	Nutrition Services Incentive Program		377
93.103	Food and Drug Administration - Research		32
93.116	Project Grants & Coop Agreements for Tuberculosis Control		655
93.127	Emergency Medical Services for Children		157
93.130	Primary Care Services - Resource Coordination & Development		224
93.136	Injury Prev & Control Research & State & Comm Based Programs		1,804
93.150	Projects for Assistance in Transition from Homelessness (PATH)		1,552
93.162	National Health Service Corps Loan Repayment Program		42
93.165	Grants for State Loan Repayment		190
93.197	Childhood Lead Poisoning Prevention Projects		1,536
93.230	Consolidated Knowledge Development and Application (KD&A)		403
93.234	Traumatic Brain Injury - State Demonstration Grant Program		46
93.235	Abstinence Education		2,146
93.240	State Capacity Building		340
93.241	State Rural Hospital Flexibility Program		412
93.251	Universal Newborn Hearing Screening		1
93.259	Rural Access to Emergency Devices Grant		1
93.268	Immunization Grants		7,320
93.283	Centers for Disease Control & Prevention - Invest & Tech Asst		18,925
93.556	Promoting Safe and Stable Families		9,803
93.558	Temporary Assistance for Needy Families		711,508
93.563	Child Support Enforcement		115,951
93.566	Refugee and Entrant Assistance - State Administered Programs		8,973
93.568	Low-Income Home Energy Assistance		155,066
93.569	Community Services Block Grant		24,171
93.571	Community Services Block Grant - Discretionary Awards		155
93.576	Refugee and Entrant Assistance - Discretionary Grants		1,228
93.584	Refugee and Entrant Assistance - Targeted Assistance		831
93.585	Empowerment Zones Program		12,309
93.590	Community-Based Family Resource and Support Grants		816
93.597	Grants to States for Access and Visitation Programs		356
93.600	Head Start		290
93.602	New Assets for Independence Demonstration Program		1,031
93.603	Adoption Incentive Payments		322
93.630	Developmental Disabilities Basic Support and Advocacy Grants		3,333
93.631	Developmental Disabilities Projects of National Significance		86
93.645	Child Welfare Services - State Grants		8,379

Schedule of Expenditures of Federal Awards - June 30, 2003

CFDA #	CFDA Program Name	Federal Expenditures (000's)
93.658	Foster Care - Title IV-E	335,253
93.659	Adoption Assistance	62,012
93.667	Social Services Block Grant	108,231
93.671	Family Violence Prevention and Services	2,912
93.674	Chafee Foster Care Independent Living	4,692
93.767	State Children's Insurance Program	111,333
93.768	Medicaid Infrastructure Grants - Employ of People with Disabilities	89
93.779	CMS Research Demonstrations and Evaluations	531
93.917	HIV Care Formula Grants	25,162
93.919	Cooperative Agreements for State-Based Cancer Programs	2,649
93.940	HIV Prevention Activities - Health Department Based	4,903
93.944	HIV/AIDS Surveillance	542
93.945	Assistance Programs for Chronic Disease Prevention & Control	126
93.952	Improving EMS/Trauma Care in Rural Areas	15
93.958	Block Grants for Community Mental Health Services	17,273
93.959	Block Grants for Prevention and Treatment of Substance Abuse	57,375
93.965	Coal Miners Respiratory Impairment Treatment Clinics & Services	23
93.977	Prev Health Serv - Sexually Transmitted Diseases Control Grants	2,640
93.988	Cooperative Agreements for State-Based Diabetes Control	485
93.991	Preventive Health and Health Services Block Grant	6,083
93.994	Maternal and Child Health Services Block Grant to the States	23,755
93.999	Miscellaneous	1,611
	Total - Department of Health and Human Services	**$9,375,583**
94.003	State Commissions	301
94.004	Learn & Serve America - School & Community Based Programs	942
94.006	AmeriCorps	5,514
94.007	Planning and Program Development Grants	193
94.009	Training and Technical Assistance	(18)
	Total - Corporation for National and Community Service	**$6,932**
96.001	Social Security Disability Insurance	69,090
96.999	Miscellaneous	9,003
	Total - Social Security Administration	**$78,093**
99.999	Miscellaneous	1,256
	Total - Miscellaneous	**$1,256**
	GRAND TOTAL	**$17,866,663**

- See Notes to Schedule of Expenditures of Federal Awards -

Notes to the Schedule of Expenditures of Federal Awards - June 30, 2003

Note A: Single Audit Reporting Entity

The Commonwealth of Pennsylvania (the Commonwealth) includes expenditures in its schedule of expenditures of federal awards for all federal programs administered by the same funds, agencies, boards, commissions, and component units included in the Commonwealth's financial reporting entity used for its basic financial statements. However, the State System of Higher Education (SSHE), the Pennsylvania Higher Education Assistance Agency (PHEAA), the Pennsylvania Housing Finance Agency (PHFA), and the Philadelphia Shipyard Development Corporation (PSDC) elect to have their own single audits and are therefore excluded from the Commonwealth's schedule of expenditures of federal awards. These four component units are required to submit their own single audit reports to the federal Audit Clearinghouse.

Note B: Basis of Accounting

All expenditures for each program included in the schedule of expenditures of federal awards are net of applicable program income and refunds.

Expenditures for the following programs are presented on the accrual basis for payroll expenditures and the cash plus invoices payable basis for all non-payroll expenditures.

CFDA#	PROGRAM
10.561	State Administrative Matching Grants for Food Stamp Program (L&I only)
17.002	Labor Force Statistics
17.203	Labor Certification for Alien Workers
17.207	Employment Service
17.225	Unemployment Insurance
17.245	Trade Adjustment Assistance – Workers
17.255	Workforce Investment Act (L&I Only)
17.258	Workforce Investment Act – Adult Program (L&I Only)
17.259	Workforce Investment Act – Youth Activities (L&I Only)
17.260	Workforce Investment Act – Dislocated Workers (L&I Only)
17.801	Disabled Veterans Outreach Program
17.804	Local Veterans Employment Representative Program
84.346	Occupational and Employment Information State Grants (L&I Only)
93.558	Temporary Assistance For Needy Families (L&I Only)

Expenditures for CFDA #20.205, Highway Planning and Construction Program, are presented on the basis that expenditures are reported to the U.S. Department of Transportation. Accordingly, certain expenditures are recorded when paid and certain other expenditures are recorded when the federal obligation is determined.

Expenditures reported under CFDA #10.550, Food Donation, and CFDA #10.569, Emergency Food Assistance Program, represent the value of food commodity distributions calculated using the U.S. Department of Agriculture, Food and Nutrition Service commodity price list in effect as of November 15, 2001.

Expenditures reported under CFDA #10.551, Food Stamps, represent amounts the Electronic Benefits Transfer (EBT) contractor paid to retail outlets for participants' food stamp purchases during the fiscal year ended June 30, 2003.

Subrecipient expenditures reported under CFDA #14.228, Community Development Block Grants, CFDA #14.239, Home Investment Partnerships Program, and CFDA #14.231, Emergency Shelter Grants, represent funds drawn directly from the Housing and Urban Development (HUD) Integrated Disbursement and Information System (IDIS) by subrecipients of the Commonwealth.

Amounts reported as expenditures for CFDA #39.003, Donation of Federal Surplus Personal Property, represent the General Services Administration's average fair market value percentage of 23.3 percent of the federal government's original acquisition cost (OAC) of the federal property transferred to recipients by the Commonwealth.

Note B: Basis of Accounting (Continued)

The remaining expenditures included in the schedule of expenditures of federal awards are presented on the cash plus invoice payable basis. Invoice payable represent Commonwealth expenditures recorded on the general ledger for which the Commonwealth Treasury Department has not made cash disbursements.

Note C: Categorization of Expenditures

The schedule of expenditures of federal awards reflects federal expenditures for all individual grants that were active during the fiscal year ended June 30, 2003. The categorization of expenditures by program included in the schedule of expenditures of federal awards is based on the Catalog of Federal Domestic Assistance (CFDA). Changes in the categorization of expenditures occur based on revisions to the CFDA, which are issued in June and December of each year both in print and on the CFDA website. In accordance with the Commonwealth's policy, the schedule of expenditures of federal awards for the year ended June 30, 2003 reflects CFDA changes issued through December 2002.

Note D: Oil Overcharge Funds

The Commonwealth has received restitutionary funds from certain oil companies, either directly or through the federal government, as a result of settlement agreements for overcharging customers. All oil overcharge funds expended by the Commonwealth have been included within the scope of its single audit in accordance with the settlement agreements and federal guidance.

Expenditures of such funds reflected in the schedule of expenditures of federal awards include $199 thousand under CFDA #81.041, State Energy Conservation, and $113 thousand under CFDA #81.999, Miscellaneous.

Oil overcharge funds received by the Commonwealth that remain unexpended earn interest which is credited on a monthly basis to the oil overcharge fund for future expenditure as approved in the Commonwealth's energy plan. At June 30, 2003, the Commonwealth had unexpended oil overcharge funds including interest of approximately $2.9 million.

Note E: Pennsylvania Infrastructure Investment Authority

The Pennsylvania Infrastructure Investment Authority (the Authority) is an instrumentality of the Commonwealth created by Act 16 of the General Assembly in March 1988 (the PENNVEST Act). The purpose of the Authority is to provide long-term, low-interest loans for corporations, partnerships, sole proprietorships, nonprofit organizations, authorities, and municipalities for repair, construction, reconstruction, rehabilitation, extension, and improvement of drinking water (CFDA #66.468) and wastewater (CFDA #66.458) systems. The Authority is funded through revenue bonds, federal grants, and Commonwealth general obligation bonds. The Authority is a component unit of the Commonwealth. The Authority accounts for the drinking water and wastewater programs in separate funds.

At June 30, 2003, the Authority had gross outstanding federal loans of $531.4 million for CFDA #66.458 and $104.9 million for CFDA #66.468. No losses were incurred by the Authority on these loans during the fiscal year ended June 30, 2003.

Note F: Unemployment Insurance

In accordance with Department of Labor, Office of Inspector General instructions, the Commonwealth recorded State Regular Unemployment Compensation (UC) benefits under CFDA #17.225 on the schedule of expenditures of federal awards. The individual state and federal portions are as follows (amounts in thousands):

State Regular UC Benefits	$2,724,456
Federal UC Benefits	924,305
Federal Admin.	158,463
Total Expenditures	$3,807,224

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Compliance and Internal Control

Commonwealth of Pennsylvania

Department of the Auditor General
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120-0018

ERNST & YOUNG LLP

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19103-7096

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

The Honorable Edward G. Rendell, Governor
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania

We have jointly audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Pennsylvania, as of and for the year ended June 30, 2003, which collectively comprise the Commonwealth's basic financial statements, and have issued our report thereon dated April 9, 2004.

We did not jointly audit the financial statements of certain component units, which represent 99 percent of total assets and 98 percent of total revenues of the aggregate discretely presented component units. We did not jointly audit 100 percent of the total assets and 100 percent of the total revenues of the Pension Trust Funds. This comprises 90% of total assets and 42% of total revenues of the aggregate remaining fund information. We also did not jointly audit the financial statements of two Enterprise Funds, which represent 1 percent of total assets and 1 percent of total revenues of the aggregate remaining fund information and 4 percent of total assets and 1 percent of total revenues of the business-type activities. The financial statements of these component units, the Pension Trust Funds and the Enterprise Funds were audited by other auditors, including Ernst & Young LLP acting separately, whose reports thereon have been furnished to us, and our opinions, insofar as they relate to the amounts included for those component units, the Pension Trust Funds and Enterprise Funds, are based solely on the reports of the other auditors. Ernst & Young LLP has audited separately 21 percent of total assets and 21 percent of total operating revenues of the discretely presented component units.

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. The financial statements of the State Employees Retirement System, the Public School Employees Retirement System, the Deferred Compensation Fund, the PA Life and Health Insurance Guaranty Association, the PA Property and Casualty Insurance Guaranty Association, the Machinery and Equipment Loan Fund, the Small Business First Fund, the PA Industrial Development Authority, the PA Turnpike Commission, the State Public School Building Authority, the PA Higher Education Facilities Authority, the Insurance Fraud Prevention Authority, the Philadelphia Regional Port Authority, the Port of Pittsburgh Commission, the Ben Franklin Technology Development Fund, and the Patient Safety Trust Authority were not audited in accordance with *Government Auditing Standards*.

The Honorable Edward G. Rendell
Governor
Page 2

Compliance

As part of obtaining reasonable assurance about whether the Commonwealth of Pennsylvania'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 no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Commonwealth of Pennsylvania'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. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Commonwealth of Pennsylvania's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as Comments 03-1 through 03-18.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Comments 03-1 to 03-7, 03-9 to 03-12, and 03-14 to 03-18 to be material weaknesses.

We also noted other matters involving the internal control over financial reporting which we have reported to the management of the Commonwealth of Pennsylvania in a separate letter dated April 9, 2004.

This report is intended solely for the information and use of management, the Office of Inspector General - U.S. Department of Health and Human Services, and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

Robert P. Casey, Jr.

Ernst & Young LLP

April 9, 2004

Department of the Auditor General
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120-0018

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19103-7096

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133

The Honorable Edward G. Rendell, Governor
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania

Compliance

We have jointly audited the compliance of the Commonwealth of Pennsylvania with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2003. The Commonwealth's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Commonwealth's management. Our responsibility is to express an opinion on the Commonwealth's compliance based on our audit.

The Commonwealth's basic financial statements included the operations of the State System of Higher Education, the Pennsylvania Higher Education Assistance Agency, the Philadelphia Shipyard Development Corporation, and the Pennsylvania Housing Finance Agency, component units which received federal awards, and which are not included in the schedule of expenditures of federal awards for the year ended June 30, 2003. Our audit, described below, did not include the operations of these four component units because the Commonwealth engaged other auditors to perform an audit in accordance with OMB Circular A-133.

Except as discussed in the following paragraph, we conducted our audit of compliance 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 OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Commonwealth's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Commonwealth's compliance with those requirements.

As explained in Basic Financial Statements Comment 03-16 in the accompanying schedule of findings and questioned costs, we were unable to obtain sufficient audit evidence supporting compliance of the Commonwealth with requirements governing the procurement of goods and services for competitively-bid Commonwealth contracts. This is as a result of the Commonwealth's overall policy to not release certain procurement documentation that management considers to be proprietary and confidential, and which management will not allow us to review as part of our audit. As explained in Comment 03-16, we do not agree with the Commonwealth's policy in this regard. As a result of this overall Commonwealth policy, we are prevented from reviewing documentation that would enable us to determine whether procurements in the Medicaid Cluster (CFDA #93.778), the Temporary Assistance for Needy Families Program (CFDA #93.558), the Child Support Enforcement Program (CFDA #93.563), the State Administrative Matching Grants for the Food Stamps Program (CFDA #10.561), the Maternal and Child Health Services Block Grant (CFDA #93.994), the State Children's Insurance Program (CFDA #93.767), the Adoption Assistance Program (CFDA #93.659), and the Child Care Cluster (CFDAs #93.575 and #93.596) were made in compliance with the Commonwealth's requirements governing the procurement of goods and services, nor are we able to satisfy ourselves as to the Commonwealth's compliance with those requirements by other auditing procedures.

As described in the accompanying schedule of findings and questioned costs, the Commonwealth did not comply with requirements as noted below that are applicable to its major programs as follows:

- The Food Donation Program (CFDA #10.550), as reported in Finding 03-1, did not comply with eligibility requirements, allowable costs requirements, and a special test and provision related to processor recordkeeping.

- The Food Stamps Program (CFDA #10.551), as reported in Finding 03-2, did not comply with eligibility and allowable costs requirements.

- The Trade Adjustment Assistance Program (CFDA #17.245) did not comply with cash management regulations as reported in Finding 03-6, did not comply with federal reporting requirements as reported in Findings 03-7 and 03-9, and did not comply with eligibility and allowable costs requirements as reported in Finding 03-8.

- The Workforce Investment Act Cluster (CFDA #17.258, #17.259, and #17.260) did not comply with federal reporting requirements as reported in Finding 03-10 and did not comply with subrecipient monitoring requirements as reported in Finding 03-28.

- The Capitalization Grants for Drinking Water State Revolving Fund Program (CFDA #66.468), as reported in Finding 03-12, did not comply with a special test and provision related to the timeliness of loan repayment provisions.

- The Vocational Education – Basic Grants to States Program (CFDA #84.048), as reported in Finding 03-15, did not comply with federal reporting requirements.

- The Rehabilitation Services – Vocational Rehabilitation Grants to States Program (CFDA #84.126), as reported in Finding 03-18, did not comply with allowable costs/cost principles requirements.

- The Temporary Assistance for Needy Families Program (CFDA #93.558) did not comply with eligibility and allowable costs requirements as reported in Finding 03-2, did not comply with a special test and provision related to individual assessment requirements as reported in Finding 03-20, and did not comply with federal reporting requirements as reported in Finding 03-21.

- The Child Support Enforcement Program (CFDA #93.563), as reported in Finding 03-22, did not comply with a special test and provision related to the timeliness of processing on interstate registry cases.

- The Child Care Cluster (CFDA #93.575 and #93.596) did not comply with eligibility and allowable costs requirements as reported in Finding 03-2 and did not comply with subrecipient monitoring requirements as reported in Finding 03-24.

- The Social Services Block Grant Program (CFDA #93.667), as reported in Finding 03-24, did not comply with subrecipient monitoring requirements.

- The Medical Assistance Program (CFDA #93.778), as reported in Finding 03-2, did not comply with eligibility and allowable costs requirements.

- For all major federal programs covered by CMIA as reported in finding number 03-29, the Commonwealth did not comply with CMIA-90 cash management regulations.

Compliance with such requirements is necessary, in our opinion, for the Commonwealth to comply with the requirements applicable to those programs.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the Commonwealth's compliance with procurement requirements in the federal programs identified above, and except for the noncompliance described in the preceding paragraph, the Commonwealth complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2003. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements which are required to be reported in accordance with OMB Circular A-133, and which are described in the accompanying schedule of findings and questioned costs as finding numbers 03-3, 03-4, 03-13, 03-14, and 03-23.

Internal Control Over Compliance

The management of the Commonwealth is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Commonwealth's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Commonwealth's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as Findings 03-1 through 03-30.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider finding numbers 03-1, 03-2, 03-4, 03-6 to 03-10, 03-12, 03-15, 03-18 to 03-22, 03-24, 03-28, and 03-29, as identified in the accompanying schedule of findings and questioned costs, to be material weaknesses.

This report is intended solely for the information and use of management, the Office of Inspector General—U.S. Department of Health and Human Services, and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

Robert P. Casey, Jr.   Ernst + Young LLP

September 9, 2004

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Schedule of Findings and Questioned Costs

Commonwealth of Pennsylvania

Summary of Auditors' Results - June 30, 2003

Financial Statements

Type of auditors' report issued:	Unqualified	
Internal control over financial reporting:		
Material weakness(es) identified?	X yes	___ no
Reportable condition(s) identified not considered to be material weaknesses?	X yes	___ no
Noncompliance material to financial statements noted?	___ yes	X no

Federal Awards

Internal control over major programs:		
Material weakness(es) identified?	X yes	___ no
Reportable condition(s) identified not considered to be material weaknesses?	X yes	___ no

Type of auditors' report issued on compliance for major programs:

Qualified for noncompliance in the following major programs:

Food Donation (CFDA #10.550)
Food Stamps (CFDA #10.551)
Trade Adjustment Assistance – Workers (CFDA #17.245)
WIA Cluster (CFDA #17.258, #17.259, and #17.260)
Capitalization Grants for Drinking Water State Revolving Funds (CFDA #66.468)
Vocational Education – Basic Grants to States (CFDA #84.048)
Rehabilitation Services – Vocational Rehabilitation Grants to States (CFDA #84.126)
Temporary Assistance for Needy Families (CFDA #93.558)
Child Support Enforcement (CFDA #93.563)
Child Care Cluster (CFDA #93.575 and #93.596)
Social Services Block Grant (CFDA #93.667)
Medical Assistance (CFDA #93.778)
All Major Federal Programs Covered by CMIA

Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)?	X yes	___ no

Identification of Major Programs:

CFDA Number(s)	Name of Federal Program or Cluster	Federal Expenditures (000s)
10.550	Food Donation	$ 29,153
10.551 and 10.561	Food Stamp Cluster	878,487
10.557	Special Supplemental Nutrition Program for WIC	117,388
14.228	Community Development Block Grants/State's Program	54,017
14.239	HOME Investment Partnerships Program	13,137
17.207, 17.801, and 17.804	Employment Services Cluster	38,398
17.225	Unemployment Insurance	3,807,224
17.245	Trade Adjustment Assistance – Workers	39,790
17.258, 17.259, and 17.260	Workforce Investment Act Cluster	156,920
20.205 and 23.003	Highway Planning and Construction Cluster	1,322,578
66.458	Capitalization Grants for Clean Water State Revolving Funds	86,545
66.468	Capitalization Grants for Drinking Water State Revolving Funds	19,822
84.010	Title I Grants to Local Educational Agencies	382,625
84.027 and 84.173	Special Education Cluster	301,693
84.048	Vocational Education – Basic Grants to States	44,384
84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	102,636
84.367	Improving Teacher Quality State Grants	72,887
93.044 and 93.045	Aging Cluster	49,016
93.558	Temporary Assistance for Needy Families	711,508
93.563	Child Support Enforcement	115,951
93.568	Low-Income Home Energy Assistance	155,066
93.575 and 93.596	Child Care Cluster	266,300
93.658	Foster Care Title IV-E	335,253
93.659	Adoption Assistance	62,012
93.667	Social Services Block Grant	108,231
93.767	State Children's Insurance Program	111,333
93.775, 93.777 and 93.778	Medicaid Cluster	7,188,923
93.994	Maternal & Child Health Services Block Grant to the States	23,755
	Total Federal Expenditures – Major Programs	$ 16,595,032

Dollar threshold used to distinguish between Type A and Type B programs: $30,000,000

Auditee qualified as low-risk auditee? ____yes X no

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03-3**	Internal Control Weakness Over Financial Reporting in the Capital Facilities Fund	OB/CS	**140**	288
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03-17**	Internal Control Weakness in the Reporting of Investments and Cash	OB/BFM	**171**	289
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*	- Reportable Condition
**	- Material Weakness
CAP	- Corrective Action Plan

Comment 03 – 1:

Department of Public Welfare

Internal Control Weaknesses Result in Improper Payments in the Tobacco Settlement Fund

Condition: Our testing of uncompensated care (UC) payments to hospitals in the Tobacco Settlement Fund disclosed internal control weaknesses at DPW which caused improper payments from the Tobacco Settlement Fund as noted below.

Our testing of UC payments made under Section 1103 of the Tobacco Settlement Act disclosed that DPW made payments to only three hospitals totaling $3,801,018 as of June 30, 2003 from Budget Year 2002-03 UC funds. DPW had paid these three hospitals based on calculations as of 6/13/03; however, subsequent recalculations dated 6/18/03 disclosed these three hospitals were overpaid several hundred dollars per hospital. Further review of the calculations disclosed that when calculating the number of Medicare SSI days as a percentage of total inpatient days, one of three key percentages used to determine a qualified hospital, DPW inappropriately used different fiscal years in the numerator vs. the denominator. DPW used Medicare SSI days for the fiscal years 99, 00 and 01 in the numerator, but total inpatient days in the denominator were for fiscal years 98, 99 and 00. Since one hospital was right at the median score, the minimum to qualify for a UC payment, a small change in the scoring could have caused that hospital to score below the median and not be eligible for its calculated payment of $1,864,927. The three hospitals that were paid during the audit period had scores significantly above the median.

Our testing of the DPW calculation of the one-time UC federal share payment of approximately $16 million made to hospitals under Section 5101(a)(4) of the Act disclosed DPW used Medicare SSI days for the fiscal years 99, 00 and 01 in the numerator, but total inpatient days in the denominator were for fiscal years 94, 95 and 96. We disclosed a similar problem with the state share calculation of Section 5101(a)(4) UC payments which were made during the prior year.

The above inconsistencies may have caused improper eligibility determinations and payments to the hospitals in question.

Further, audits by the Department of Auditor General, Bureau of State-Aided Audits disclosed significant discrepancies in data provided by hospitals to support the calculation of UC payments. However, DPW has not yet resolved these issues, nor has DPW developed an audit plan to detect and resolve the submission of erroneous data by hospitals.

Criteria: The Tobacco Settlement Fund Act 77 of 2001 states:

Section 1102. Definitions

"Qualified hospital." An eligible hospital which has an uncompensated care score at or exceeding the median score of all eligible hospitals.

Section 1103. Hospital uncompensated care payments.

(b) Department responsibilities. The department has the following powers and duties:

> *(3) Calculate uncompensated care scores for eligible hospitals under Section 1104(c).*
> *(4) Calculate and make payments to qualified hospitals under Section 1104(d) on an annual basis.*

Comment 03 – 1: (continued)

Section 1104. Eligibility and payment.

(c) Uncompensated care scoring. The department shall annually calculate the uncompensated care score of each eligible hospital from collected data. If information necessary to determine the uncompensated care score of an eligible hospital is unavailable due to the refusal of the hospital to provide the information, the hospital shall not be eligible for payment from the Hospital Uncompensated Care Program. If the department determines that such data cannot be provided after due diligence, the department shall use the average of the collected data. An eligible hospital's uncompensated care score shall be the sum of the following, using three-year average data as determined by the department:

(2) The number of Medicare SSI days as a percentage of total inpatient days based on the most recent data available to the department.

Cause: Regarding the use of different fiscal years in the calculation of Medicare SSI percentages, DPW personnel stated they used the latest data available without regard to consistency between the numerator and the denominator of the equation.

Regarding the resolution of prior year audits, DPW had not received all the Tobacco Settlement audits as of the date of our Basic Financial Statement Report. Further, no audit plan was developed because DPW decided to rely on audits of hospitals performed by the Department of Auditor General.

Effect: The above data discrepancies caused improper UC payments to hospitals from the Tobacco Settlement Fund. If the noted internal control weaknesses are not corrected, these improper payments may continue into the future.

Recommendation: DPW should establish procedures to ensure that data submitted by hospitals is valid and properly supports payments from the Tobacco Settlement Act. In addition, DPW should resolve all issues related to the UC payments made to hospitals after ensuring that they are based on correct and accurate data, and make the necessary payment adjustments to each hospital. Further, DPW's calculations of its regular UC payments should be based on a methodology which is reasonable and avoids the inconsistencies in fiscal years identified above.

Also, DPW should establish an audit plan, which may include reliance on audits preformed by the Auditor General, which will ensure data submitted by hospitals is accurate, and includes appropriate audit resolution when inaccurate data is submitted.

Agency Response: The Uncompensated Care (UC) payments in question (NPHS – Girard, NPHS – St. Joseph, and Friends Hospital) were expedited payments made to these facilities experiencing financial hardships. After the expedited payments were made, the tobacco calculations were updated and the amounts for all hospitals were slightly lowered. There are funds remaining in the UC appropriation for FYE 03 due to some hospitals being unable to overcome their hospital specific disproportionate share upper payment limit (DSH-UPL). When these funds are redistributed to all of the eligible hospitals, to include the three noted above, the payments for these hospitals will be adjusted for the overpayments.

As stated in the Tobacco Settlement Act of 2001 (Act 77), Section 1104 (c) 2 the Department was to use the most recent data available in its calculations for UC. The decision was made to use differing years in an attempt to provide the most up-to-date data available as all data is not uniformly available. The Department believes that the statistical variance in using different base years would not be significant enough to cause a material change in eligibility outcomes. Furthermore, the Auditor General cites conditions for the very first UC payments processed in August 2001, which were made very quickly at the direction of the Ridge Administration and before the Department and the Pennsylvania Healthcare Cost Containment Council (PHC4) had developed and finalized data validation processes and protocols for Act 77 purposes.

Comment 03 – 1: (continued)

The Department continues to follow the requirements outlined in the Tobacco Settlement Act 77 of 2001. As referenced above, the Department and PHC4 have developed extensive data validation processes and protocols, in line with the auditor recommendation, since the first UC payments were processed.

Regarding the recommendation to develop an audit plan to ensure the accuracy of the data, the Department is confused with this recommendation for the UC payments. Discussions with the Auditor General Bureau of State-Aided Audits (BSAA) and individual audits of the UC payments have not resulted in any material discrepancies or questioned UC payments. In fact, the auditors with very few exceptions have been able to validate the data's accuracy when they are onsite at the hospitals. The Department is relying on BSAA audits to finalize payments for the Act 77, Extraordinary Expense payments.

Auditors' Conclusion: Our recommendation remains as stated above. BSAA audits of the data used to support both EE and regular UC payments disclosed significant errors at several hospitals. While it was disclosed that at least $3 million in prior year EE payments were made in error, DPW has not yet determined the impact of errors disclosed at hospitals receiving regular UC payments as recommended within Bureau of State-Aided Audits. DPW's statement that BSAA audits have not resulted in material discrepancies and have very few exceptions is incorrect and not supported by any follow up on DPW's part.

Since DPW is responsible for the accuracy of UC payments to hospitals, DPW should have an audit plan which includes appropriate corrective action when errors are disclosed.

As explained in the body of the finding, DPW's response that the impact of inconsistent years being used for Medicare SSI days would be minimal is incorrect since a small scoring change for one hospital could cause ineligibility for the entire amount.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 2:

Insurance Department
Central Services Comptroller Office

Cash and Investment Balances in the Statutory Liquidator Fund Were Misstated in the Preparation of the GAAP Template

Condition: The investment balances for cash with fiscal agents, temporary investments, and long-term investments were misstated by material amounts in the preparation of the GAAP template for the Statutory Liquidator Fund. Material auditor adjustments were necessary to correct these balances in the CAFR.

Criteria: Strong internal controls should ensure that balances are reported accurately and appropriately reviewed and approved by management.

Cause: In recording the investment balances for two of the insurance companies in liquidation, the fund simply reported the amounts per the companies' accounting departments. No additional review was performed by the fund to determine that the balances reported by the companies were correct. Furthermore, assumptions were made by the fund in order to classify the investments since the companies do not report according to the Commonwealth's disclosure requirements. These classification assumptions were incorrect.

Effect: The total effect was an understatement of cash with fiscal agents of $21 million and long-term investments of $491 million and an overstatement of temporary investments of $186 million. Auditor adjustments were required because the overstatements and understatements were material to the fund. Furthermore, errors in preparation of the BFS like those reported above caused significant delays in the issuance of the CAFR.

Recommendation: We recommend that procedures be put in place to ensure that cash and investments of insurance companies are reported correctly, both in dollars reported and classification. Those responsible for the fund's investments should be knowledgeable about the cash and investment balances for each company in liquidation and understand how to proceed to obtain further information when it is not provided.

Agency Response: When an Insurance Company is in liquidation, the standard procedure is for the Office of Insurance Liquidations, Rehabilitations and Special Funds (OILRSF) to review and confirm the assets and liabilities reported on the company financial statements. This information is then included in the Statutory Liquidator Asset Status Report for the fiscal year end. The size of both the PHICO and Reliance precluded this occurrence for fiscal year ended June 30, 2003.

The Office of Insurance Liquidations, Rehabilitations, and Special Funds has now concluded this effort for PHICO and will show PHICO data on the Statutory Liquidator Asset Status Report. PHICO will not be a problem for fiscal year ended June 30, 2004.

However, it does not appear that the review of Reliance will be done. Therefore, it is Central Services' intent to mail confirmations to confirm the financial data received from Reliance for the fiscal year ended June 30, 2004 to ensure the accuracy of the Cash and the Investment Balances reported.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 3:

Central Services Comptroller Office

Internal Control Weakness Over Financial Reporting in the Capital Facilities Fund

Condition: The Commonwealth's BFS contained material misstatements in the Capital Facilities Fund that required material adjusting entries by the auditors. Because of errors in GAAP template preparation, liabilities were understated by $60 million and receivables were overstated by $27 million, causing $87 million in total overstatements of both fund balance in governmental funds and governmental activities net assets in the government-wide statements.

Criteria: Strong internal controls should ensure that accounting transactions are reported accurately and are appropriately reviewed and approved by management.

Cause: The misstatements were caused by an inadequate review of the GAAP template. Neither the GAAP template preparer nor the reviewer performed a comparison of current year liabilities and receivables to the prior year to detect unusual changes. Liabilities were understated by $15 million because the GAAP template preparer did not consider fiscal activity subsequent to September for impact on liabilities. Also, liabilities were understated by an additional $45 million because the GAAP template preparer misinterpreted liability information provided by another Comptroller Office, and incorrectly reported liabilities in an asset account, due from other funds. Additionally, the GAAP template preparer made an accrual for receivables that was already accounted for in the functionality of SAP, resulting in double recording $27 million in receivables.

Effect: Liability and receivable accounts in the government-wide and fund financial statements were materially misstated and required auditor adjustment. In addition, the noted weaknesses in internal review procedures could result in additional misstatements in the future. Furthermore, errors in preparation of the BFS like those reported above caused significant delays in the issuance of the CAFR.

Recommendation: The Central Service Comptroller Office should review its methodologies and internal review procedures for the Capital Facilities Fund GAAP template and ensure accruals are correct.

Agency Response: The Central Services Comptroller Office is reviewing its methodologies and internal review procedures for the Capital Facilities Fund. A detailed analysis of each erroneous accrual is being performed to ensure that future accruals are properly analyzed and reviewed. Specific analytic techniques will be identified and implemented going forward to ensure that accruals are reflected correctly in the Capital Facilities Fund GAAP template.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 4

Central Services Comptroller Office

Internal Control Weakness over Financial Reporting for Lottery Fund's Property Tax Rent Rebate Accrual

Condition: The Central Services Comptroller Office prepared the Lottery Fund's GAAP template without including a liability accrual for the Property Tax/Rent Rebate (PTRR) Program. Because of this weakness, liabilities were understated by $135 million and an auditor adjustment was necessary to correct this balance in the CAFR.

Criteria: Strong internal controls should ensure that accounting transactions are reported accurately and are appropriately reviewed and approved by management.

Cause: The omitted accrual was caused by an inadequate review of the GAAP template. Neither the GAAP template preparer nor the reviewer performed a comparison of current year liabilities to the prior year to detect unusual changes.

Effect: Liability accounts in the government-wide and fund financial statements were materially misstated and required auditor adjustment. In addition, the noted weakness in internal review procedures could result in additional misstatements in the future. Furthermore, errors in preparation of the BFS like those reported above caused significant delays in the issuance of the CAFR.

Recommendation: The Central Service Comptroller Office should review its methodologies and internal review procedures in preparation of the Lottery GAAP template.

Agency Response: The Central Services Comptroller Office is reviewing its methodologies and internal review procedures relating to the preparation of the Lottery GAAP template. Going forward, the GAAP template preparer and reviewer will perform a comparison of current year liabilities to prior year to detect unusual changes. This change in methodology should ensure that accounting transactions are reported accurately.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 5:

Executive Offices
Office of the Budget – Bureau of Financial Management

Internal Control Weakness Over Reporting Inter– and Intrafund Activity in the Basic Financial Statements

Condition: Internal transactions between various funds and agencies within the Commonwealth reporting entity cause the simultaneous recording of revenues in receiving funds/agencies and expenditures/expenses in the paying funds/agencies on the Commonwealth's accounting system. Because these transactions are between Commonwealth funds/agencies only and do not involve the receipt of monies from or the payment of monies to outside parties, they are not revenues or expenditures/expenses for the Commonwealth as a whole, and GASB 34 mandates that these transactions not be reported in the BFS.

OB management is to be commended in its improvements from the prior year implementation of GASB 34 reporting standard since procedures were clearly in place this year to exclude or eliminate these transactions from the BFS. However, our detail testwork identified internal transactions which were incorrectly included in the BFS, whether through clerical errors or preparer oversight, and adjustments were necessary as a result of our testwork to ensure the BFS were presented in accordance with GASB 34. Several examples of internal activity adjustments to properly reduce revenues and expenditures in the BFS were as follows:

- $48.9 million in DCED in the General Fund (Auditor entry)
- $9.4 million in Corrections in the General Fund (Auditor entry)
- $13.7 million in the PACE Fund (BFM entry)
- $21.5 million in the Capital Facilities Fund (BFM entry)

We also noted that GAAP template preparers in the various Comptroller Offices did not make all the internal activity elimination entries that were necessary in the SAP system, and BFM had to book a complex statewide elimination entry which impacted numerous agencies and funds and which resulted in inaccuracies in the BFS described above.

Criteria: GAAP requires internal activity to be accurately and properly accounted for in the Commonwealth's BFS. Internal controls should ensure that these accounting transactions are presented in the financial statements in accordance with GAAP.

Cause: Our testwork disclosed that the review and consideration of internal transactions within OB-BFM and the various Comptrollers' Offices during the preparation of the BFS was not sufficient in scope to ensure all material internal transactions were accounted for in accordance with GASB 34. In addition, the new financial reporting process using SAP for the first time made it difficult to ensure all necessary internal activity eliminations were booked.

Effect: As a result of the internal control weakness, the BFS were not materially correct with regard to internal activity, and adjustments were necessary to correct the BFS. If the internal control weakness is not corrected, the BFS will continue to be misstated in the future. The accurate reporting of internal activity is especially critical in the Statement of Activities required by GASB 34. Furthermore, inaccurate BFS preparation by Commonwealth management caused significant delays in the issuance of the CAFR.

Recommendation: We recommend that internal controls be strengthened over the reporting of internal transactions in OB's preparation of the BFS. All internal transactions should be considered and reviewed during OB's BFS preparation process. We also recommend strengthened monitoring and oversight of internal transactions by BFM to ensure the Comptrollers' Offices report correct amounts.

Comment 03 – 5: (continued)

Agency Response: We will instruct June 30, 2004 CAFR template preparers to include the effects of SAP document type SP transaction postings as part of intra- and interfund elimination entries. We will also direct Central Services Comptroller's Office to review Capital Facilities Fund accounts receivable balance detail to detect potential duplicate elimination postings.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 6:

Executive Offices
Office of the Budget – Labor, Education and Community Services Comptroller Office

Internal Control Weakness Over Financial Reporting in the Unemployment Compensation Fund

Condition: The Commonwealth's BFS contained material misstatements in the Unemployment Compensation (UC) Fund that required material adjusting entries by the auditors. Our testing of the UC Fund GAAP template led to four adjusting entries totaling $150.5 million resulting in a net decrease in fund balance of $22 million. Furthermore, two of the four adjusting entries were similar to entries made in preparation of the prior year GAAP package, but were overlooked by the LECS Comptroller Office in preparation of the current year financial statement amounts.

Criteria: Strong internal controls would ensure that account balances and adjustments are reported accurately and are appropriately reviewed and approved by management.

Cause: During the current fiscal year, the Commonwealth implemented a new accounting system, SAP. The entire process of preparing the financial statements (i.e. GAAP templates) was completely changed for the current year. Furthermore, LECS personnel indicated that this new accounting system was much more complex making it harder to track adjustments and follow the flow of transactions. Therefore, certain adjustments that were made in preparation of prior year financial statements were inadvertently overlooked by LECS personnel in the current year due to difficulties encountered with the new accounting system. Furthermore, the LECS internal review procedures were not adequate to detect and correct these errors. Neither the GAAP template preparer nor the reviewer performed a comparison of current year amounts to prior year amounts to detect unusual variances.

Effect: UC Fund account balances in the government-wide and fund financial statements were materially misstated and required auditor adjustment. In addition, the noted weakness in internal review procedures could result in additional misstatements in the future. Furthermore, errors in preparation of the BFS like those reported above caused significant delays in the issuance of the CAFR.

Recommendation: LECS should evaluate its methodology and its internal review procedures for preparing the UC Fund GAAP template and ensure accruals are accurate.

Agency Response: We agree that the noted adjustments had to be made and that we should review our internal procedures to ensure the accuracy of future GAAP templates. However, we think it is also important to note that the SAP system was new. There was also limited information available at that time on the SAP transaction codes, the interaction between SAP modules, and the financial data already in the system for preparing templates. In addition, we understand that the error corrections would add some time to the audit process; however, we do not agree that they caused significant delays.

Some comparisons were done with prior year reporting but not on an account-to-account basis. Of the four adjustments mentioned, two were reclassifications, which did not affect any balance sheet changes. LECS personnel did detect the need to adjust the 64 Fund cash. However, we could not physically make the change in SAP. The Bureau of Financial Management was notified of this issue for their review.

With regard to the two adjustments where receivables were involved, LECS issues an accounts receivable letter each year to the agency. This letter identifies appropriate GAAP reporting criteria to be collected and reported to our office for the GAAP statements. Since the data is maintained in agency legacy systems, we have no access to the data and cannot determine the specific accuracy of the information. The agency has been informed to maintain the information for audit purposes.

Comment 03 – 6: (continued)

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 7:

Executive Offices
Office of the Budget – Labor, Education and Community Services Comptroller Office

Internal Control Weakness Over Financial Reporting in the Department of Education GAAP Template

Condition: The Commonwealth's BFS contained material misstatements in federal receivables, expenditures and encumbrances that required adjusting entries by the auditors. Because of errors and oversights in the Department of Education template preparation, federal receivables were overstated by $118 million, expenditures were understated by $25.8 million and encumbrances were understated by $28.2 million.

Criteria: Strong internal controls should ensure that accounting transactions are reported accurately and are appropriately reviewed and approved by management.

Cause: The misstatements were caused by an inadequate review of the GAAP template. Federal receivables were overstated because the beginning balances were incorrectly input into SAP resulting in the receivables being also included in the year-end receivable accrual. The misstatement of expenditures and encumbrances are the result of the GAAP template preparer being unfamiliar with SAP and not making sure all necessary accruals were made.

Effect: Federal receivables, expenditures and encumbrances in the government-wide and fund financial statements were materially misstated. In addition, the noted weaknesses in internal controls could result in additional misstatements in the future. Furthermore, errors in the preparation of the BFS like those reported above caused significant delays in the issuance of the CAFR.

Recommendation: The Labor, Education and Community Services Comptroller Office should review its methodologies and internal review procedures for the GAAP templates it prepares to ensure account balances and accruals are correct.

Agency Response: We agree that the noted adjustments had to be made and that we should review our internet procedures to ensure the accuracy of future GAAP templates. However, we think it is also important to note that the SAP system was new. There was also limited information available at that time on the SAP transaction codes, the interaction between SAP modules, and the financial data already in the system for preparing templates. In addition, we understand that the error corrections would add some time to the audit process; however, we do not agree that they caused significant delays.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 8:

Department of Health

DOH Did Not Comply with Annual Contractor Audit Requirement for the Tobacco Settlement Fund

Condition: Our testing of the receipt of contractor audits during the SFYE June 30, 2003 under the Tobacco Use Prevention and Cessation program disclosed that DOH did not have an annual audit conducted of Tobacco Settlement funding received by the Neiman Group for the SFYE June 30, 2002. The Neiman Group received $5.4 million of the $7.1 million in Tobacco Use Prevention and Cessation funding disbursed during the SFYE June 30, 2002.

Criteria: The Tobacco Settlement Act 77 of 2001applicable to Tobacco Use Prevention and Cessation states:

Section 709. Accountability.

(a) Audits. Contracts with Statewide contractors and primary contractors and grants to service providers shall be subject to audit as provided by law. Contracts with Statewide contractors and primary contractors and grants to service providers shall be subject to an annual audit by the department. Audits of these contracts and grants are to be conducted in accordance with generally accepted government auditing standards.

Cause: DOH personnel indicated that the lack of an audit for the Neiman Group for the SFYE June 30, 2002 was an oversight, and that an audit was received subsequent to our audit period for SFYE June 30, 2003 Tobacco Use Prevention and Cessation funding. However, this audit did not cover any funds received in SFYE June 30, 2002.

Effect: Since DOH personnel did not receive an audit of the Neiman Group for the SFYE June 30, 2002, DOH did not comply with Section 709 (a) of the Tobacco Settlement Act. Further, without an audit of the contractor DOH can not be assured the funds were spent in compliance with the Act.

Recommendation: DOH should ensure that an audit is conducted for the Nieman Group for SFYE June 30, 2002 and that all annual audits required by Section 709 (a) of the Tobacco Settlement Act are completed and received.

Agency Response: DOH agrees with the Auditor General's recommendation that an audit be conducted for the Neiman Group for SFYE June 30, 2002. The Neiman Group notified DOH on July 2, 2004 that the audit will be completed within 150 days.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 9:

Department of Health

Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance

Condition: Our testing of DOH Tobacco Settlement Fund expenditures revealed that all monies granted to eligible institutions under the Commonwealth Universal Research Enhancement (CURE) program were paid in full to the grant recipients at the start of the grant. However, the majority of the 40 CURE contracts extend beyond the end of the fiscal year and up to four years in length. In addition, as reported in the 2002-2003 Annual CURE Report maintained on the DOH website, since the inception of the CURE grants in 2001, only $43.6 million of $147.1 million, or 29.6% of all CURE funds distributed in the aggregate have been expended by grant recipients as of 6/30/03. Since the Commonwealth no longer has jurisdiction over this cash, internal controls are weak over the $103.5 million in unexpended grant funds being held by outside grant recipients, which are at risk of loss to the Commonwealth.

Criteria: Prudent use of Commonwealth funds dictates that payments to grantees normally be made as reimbursements or as close to a grantee's cash needs as possible. Further, forwarding the entire contract amount in one advance payment for multi-year contracts is not a prudent business practice.

Cause: DOH personnel indicated that CURE grant recipients had to be paid the full amount of the contract by October 31 of the subsequent fiscal year or any remaining funds would lapse without special approval of the Office of the Budget (OB). Further, DOH personnel indicated that they initially requested OB to make the CURE appropriations continuing appropriations so the funds would not lapse in the subsequent fiscal year; however, OB did not approve the DOH request. Based on this, DOH personnel felt their best option was to pay all grantees in one advance payment and require that the funds be kept in interest bearing accounts.

Effect: Since over $100 million in Tobacco Settlement funds remain unexpended in the possession of grantees as of June 30, 2003, the Commonwealth is exposing significant amounts of Tobacco Settlement funds to the risk of loss by the grantee through possible financial failure, or other risk of nonperformance. Further, since the DOH is not restricting the amount of advances to grantees to their immediate needs, the Commonwealth is not able to maximize the amount of investment income for the State's Health Endowment Account.

Recommendation: DOH, in conjunction with OB, should consider establishing procedures to reimburse grant recipients for the actual cost of research services performed or, at a minimum, establish procedures that would allow for forwarding of grant funds in a manner that more closely resembles the grant recipient's actual cash needs in performing these services. By doing this, the Commonwealth would be better safeguarding its own assets and also have a stronger hand in monitoring the actual expenditures by the grant recipients. Also, the State's Health Endowment Account would achieve additional investment income which is necessary to continue funding Tobacco Settlement Fund health programs after tobacco settlement payments from cigarette manufacturers cease in the future.

Agency Response: DOH believes it took the appropriate steps necessary to ensure grant recipients were reimbursed in the best manner possible, and at the same time took into consideration steps to safeguard Commonwealth funding.

When the Tobacco Settlement Act was passed with specific requirements related to the Research Grants, DOH consulted with its Legal Office, Comptroller's Office, and the Office of the Budget on the best course of action to take to effectively utilize, monitor and manage these funds. Full concurrence was received from all parties that language should be inserted in the grant agreements to provide for advance payments. These grant agreements were developed and fully executed, with approvals from DOH's Agency Head, Comptroller's Office, Legal Office, Office of General Counsel and the Attorney General's Office.

Comment 03 – 9: (continued)

All health research grant recipients are required to invest the funds in an insured interest bearing account and all interest earned must be invested in the health research. Grantees are required to report how the funds generated by interest earned are used for health research. Any unspent funds on original grant funds and interest earned must be returned to the Commonwealth at the end of the grant.

Health research grant recipients are research institutions that have received at least three consecutive years of funding from the National Institutes of Health. As such, all grantees have proven records of performance.

The Tobacco Settlement Act funds for health research were intended to be administered as grants, not contracts. The act states that recipients must adhere to federal ethical and procedural standards related to research grants and that the state should select the competitive health research grants using federal criteria for the award of research grants. Upfront payments allow the institutions to competitively hire world-class researchers and to purchase needed equipment without delays. As a result, they are able to complete research faster, improving the likelihood of attracting additional research funding into the state and bringing research results to commercial development in a timelier manner.

Health research grantees are held accountable for the dollars invested in health research by a performance review process. In accordance with the Tobacco Settlement Act, all research projects upon completion are subject to a performance review. If a recipient receives an unfavorable review, the grantee may be ineligible for future funding. This system ensures that health research funds are invested productively and that unproductive grantees will not receive future health research funding.

Upfront payments have eliminated the need for DOH to create an extensive bureaucracy to manage the program. Currently, the health research program is in its third year of operations and oversees 126 grants, which fund a total of 514 research projects. By the end of the fourth year when the program will be fully operational, the program will be managing 180 grants and over 650 research projects. Current staff consists of three professionals and a half-time administrative officer. If the payment system is changed to require cost reimbursement or reimbursement based on expenditures, DOH would need to add at least one professional and two full time administrative staff to process the invoices/expenditure reports, budget revisions, and grant amendments. (A program in PADOT that administers 200 grants amounting to $10 million a year requires 10 staff, including two full-time administrative staff to review requests for rebudgets and process invoices.) If the system is changed to a cost reimbursement system, the Commonwealth ultimately may lose more money than it gains. The Tobacco Settlement Act does not permit expenditures on staff to manage the program, so these additional positions would be state funded.

In addition to the burden imposed on the state, the cost reimbursement system would create more paperwork for grantees, both for the researchers managing the projects and their administrative staff. This would translate into less money being used for research by the grant recipients, thus defeating the intent of the Act.

Auditors' Conclusion: As an example, if DOH monitored the cash needs of only 12 grantees that received one million or more in funding in any one year on a quarterly basis, that would be adequate to control over 90 percent of the CURE funding and would require minimal paperwork and staff effort. Without implementing any procedures at all to control the cash on hand at grantees, Commonwealth funds are subjected to unnecessary risk of loss; therefore, our finding and recommendation remain as stated above.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 10:

Department of Community and Economic Development

Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed

Condition: Our testing disclosed that DCED personnel did not perform their annual performance reviews of the three Regional Biotechnology Research Centers required by the Tobacco Settlement Act.

Criteria: The Tobacco Settlement Act 77 of 2001 states:

Section 1703. Regional Biotechnology Research Centers.

(j) Review and Report.

(1) Each Regional Biotechnology Research Center shall be subject to an annual performance review by the Department.

(2) Each Regional Biotechnology Research Center shall, by November 30, 2002, and annually thereafter, prepare and submit a report to the Department…

Cause: DCED personnel indicated that they reviewed and accepted each annual report required by Section 1703(j)(2) of the Tobacco Settlement Act which were submitted by all three Regional Biotechnology Research Centers and this constituted their annual performance review. However, DCED did not review or conclude about the performance of any of the Centers, including among other things, whether or not the Centers were meeting any of the timelines to achieve their goals and functions required by the Tobacco Settlement Act and their contracts with the Department. Although certain performance information was presented in these Center reports for DCED review, no review/verification procedures were documented or performed by DCED on the information presented, and no results/conclusions were drawn at the state-level.

Effect: Since DCED personnel did not perform annual performance reviews of the Regional Biotechnology Research Centers, compliance with Section 1703(j)(1) could not be established. Further, without the annual performance reviews, DCED did not verify whether each Center was meeting and achieving their goals and functions on a timely basis.

Recommendation: DCED should establish procedures to ensure that annual performance reviews required by Section 1703(j)(1) of the Tobacco Settlement Act are performed and clearly documented. Such procedures should clarify key areas and items to be reviewed, and establish appropriate performance factors.

Agency Response: The regional Greenhouses were established by legislation in 2001, however, were not operational until February 2002. DCED staff has attended each of the Board meetings held by the respective Greenhouses. Board books of each are received prior to Board meetings and reviewed in advance. DCED staff has participated in discussions before and during the Board meetings. Through these exchanges and participation in meetings the staff of DCED has been involved with the activities of each of the Greenhouses. This participation is contemporaneous with the actions of the Greenhouse management and is in addition to the Annual Report.

DCED staff is in the process of developing more comprehensive procedures with PriceWaterhouseCoopers for the annual review of the Regional Biotechnology Centers Annual Reports. DCED staff has reviewed the annual reports submitted by the Regional Biotechnology Centers and in the future will submit written recommendations and review findings.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 11:

Executive Offices
Office of the Budget – Bureau of Financial Management
Public Health and Human Services Comptroller Office

Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund

Condition: Our audit of the Commonwealth's Tobacco Settlement Fund (TSF) for the fiscal year ended June 30, 2003, disclosed that financial activity was not properly reported in the TSF GAAP Template in accordance with GAAP. Our audit identified material misstatements in the TSF, which also caused misstatements in the government-wide statements. Material auditor adjustments were necessary to ensure TSF amounts were presented in accordance with GAAP as detailed below.

BFM did not reverse the prior year federal accounts receivable and accrued intergovernmental revenue; thus, overstating both accounts receivable and intergovernmental revenue in the current year by $73.9 million.

BFM misclassified $416.9 million of revenues from the Tobacco Master Settlement Agreement (MSA) as charges for sales and services instead of other revenue in the governmental fund statements.

PHHS Comptroller Office did not recognize $10 million in Tobacco MSA revenue on the current year BFS that was received on June 30, 2003 but recorded on the Commonwealth's revenue accounting system on July 1, 2003.

PHHS Comptroller Office understated the year end federal receivable by a net $22.3 million due to various errors in calculating federal receivables and intergovernmental revenue. The state share Medical Assistance (MA) payments were included in the federal receivable balance causing a $39 million overstatement in receivables and intergovernmental revenue. Uncollected federal revenue of $58.7 million for the federal share MA payments disbursed at DPW during SFYE June 30, 2003 and prior, but not collected as of June 30, 2003 was not reported as a receivable. Also, $2.6 million in federal receivables at the Department of Aging were not included in the receivables balance.

PHHS Comptroller Office did not accrue an interfund transfer of $19.5 million from the TSF to the General Fund that occurred after the balance sheet date. This caused an understatement of expenditures and due to other funds in the TSF of $19.5 million. Also, because the expenditures were made under the MA program, the following additional reporting errors in the TSF occurred: TSF intergovernmental revenues were understated by the related federal share of $10.7 million, $6.2 million of which was collected and recorded in the General Fund as of June 30, 2003 and was due to the TSF but not properly reported, and an additional $4.5 million that was a federal receivable in the TSF at June 30, 2003, but not reported. The Comptroller also failed to make related entries to the General Fund for these accruals.

PHHS Comptroller Office personnel reduced the reserve for encumbrances by approximately $38 million in Health Venture Investment restricted revenue account; however, this reduction was erroneously posted to unreserved/undesignated fund balance instead of the reserved for other account.

Criteria: GAAP requires financial activity to be accurately and properly accounted for in the Commonwealth's BFS. Internal controls should ensure that these accounting transactions are presented in the financial statements in accordance with GAAP.

Cause: The review and consideration of financial transactions within OB-BFM and the PHHS Comptroller Office during the preparation of the BFS was not sufficient in scope to ensure all material financial transactions in the TSF were accounted for in accordance with GAAP.

Effect: As a result of the internal control weakness, the BFS were not materially correct, and numerous auditor adjustments were necessary to correct the BFS. Furthermore, if the internal control weakness is not corrected, the BFS will continue to be misstated in the future.

Comment 03 – 11: (continued)

Recommendation: We recommend that OB-BFM and PHHS Comptroller Office internal controls be strengthened over the reporting of financial transactions in the TSF GAAP template. We also recommend strengthened monitoring and oversight of the GAAP template by BFM to ensure the Comptrollers' Offices report correct amounts.

Agency Response: OB-BFM and PHHS Comptroller Office agree with the Auditor General's recommendation that internal controls can be strengthened over the reporting of financial transactions in the TSF GAAP template. The PHHS Comptroller Office has implemented several procedures to strengthen internal controls as follows: PHHS instituted a requirement for staff to review TSF revenue postings at the inception of a new fiscal year and ensure revenues are properly recorded based on fiscal year activity; PHHS incorporated a requirement that an adjustment to accrue intergovernmental revenue be recorded at the same time an adjustment is recorded to transfer expenses from the General Fund to the TSF; and PHHS instituted a requirement to contact DPW during completion of the GAAP package to determine if any fund transfers remain outstanding. If transfers remain outstanding but cannot be finalized, PHHS Comptroller staff will record an estimate. Finally, as a measure of maintaining and improving the transition to a new financial accounting system, as well as accommodating the training of many new staff, the PHHS Comptroller Office has re-emphasized its policy to ensure staff thoroughly review all financial activity in the TSF in accordance to GAAP and Commonwealth policy.

For June 30, 2004 TSF financial reporting purposes, PHHS will reclassify amounts reported by SAP from Charges for Sales and Services to Other Revenues. Subsequent to June 30, 2004, BFM will direct PHHS to establish a new general ledger account that will cause MSA receipts to be reported as Other Revenues.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 12:

Executive Offices
Office of the Budget – Bureau of Financial Management

Statewide Errors and Internal Control Weaknesses Over Financial Reporting in the BFS

Condition: Our audit of the BFS for the fiscal year ended June 30, 2003 disclosed numerous statewide errors and internal control weaknesses in the preparation of GAAP templates on the state's new SAP accounting system, many of which necessitated major auditor and client adjustments to BFS amounts. Examples of the overall errors we found in preparation of GAAP templates were as follows:

- We noted a $124 million misclass of general tax revenues in the Statement of Activities by tax type, overstating Personal Income Tax revenue and understating Corporation Taxes by this amount. In addition, further research showed additional tax revenue misclasses in the GAAP template in which $845 million in Corporation Tax and $902 million in Personal Income Tax were both understated and various other tax types were overstated by these amounts.

- In the Lottery Fund, we noted a $68 million misclass in Department of Aging operating revenues and a related $65 million misclass in operating expenses in the fund statements. The GAAP template preparer misreported these amounts as Charges for Sales and Services and Cost of Sales and Services and auditor adjustments were needed to report these as Other Operating Revenue and Expenses. Program revenues in the government-wide Statement of Activities were also adjusted from Charges for Sales and Services to Operating Grants.

- In the Motor License Fund, $114 million in PADOT expenditures were erroneously misclassed as Direction and Supportive Services ($80 million) and Protection of Persons and Property ($34 million) and had to be reclassed to the Transportation function in the BFS.

- $1.094 billion in governmental activities expenses was erroneously posted in the GAAP templates to Direction and Supportive Services in the Statement of Activities and an overall entry was needed by BFM to report these costs in the correct functional areas.

- A $100 million loan (or advance) from the Underground Storage Tank Indemnification Fund to the General Fund during the current year was not properly reported in the GAAP templates until we noted the missing item in our testwork and an auditor-recommended adjustment was made.

- In the General Obligation Bonds and Debt Service accounts, several auditor-recommended adjustments were made by BFM to correct GAAP template amounts: $458 million in bonds payable was reclassed from the long term to a short term obligation in the Statement of Net Assets, $27 million was posted to record a deferred loss on refunded bonds and the related amortization amount in the government-wide statements, and $11 million was posted to the Capital Facilities Fund to reclassify bond principal payments for refunded bonds to conform with GAAP.

- In the General Fund, $41 million was erroneously posted to the GR/IR account for Nonvaluated Purchase Orders on the SAP system and reported as Accrued Liabilities in the government-wide and fund statements. Our inquiry into this account disclosed that virtually none of the transactions posted to this GR/IR account represented liabilities at June 30th.

- We noted over $40 million in misclasses whereby Due To accounts were misreported as Accounts Payable in both the government-wide and fund statements. In addition, we noted that there is no system in place to break out the vouchers payable balance at June 30th into the Accounts Payable and Accrued Liabilities account and the Due To accounts.

Comment 03 – 12: (continued)

- Reserves for Encumbrances were understated by $49 million in the Keystone Recreation, Park, and Conservation Fund, $14 million in the Environmental Stewardship Fund, and $11 million in the General Fund due to GAAP template errors on the SAP system requiring auditor adjustment.

- We noted numerous examples of mispostings in the GAAP templates related to Operating Transfers between funds and component units: $53.4 million for DCED in the general fund was misclassed as a Transfer-Out, and had to be adjusted to Transfers to Component Units; $13.3 million in expenditures and interfund revenues in the Agricultural Conservation Easement Fund was erroneously eliminated and an auditor adjustment was necessary to correctly report the revenue as an Operating Transfer-in; $13.8 million in the PACE Fund represented internal activity that was eliminated, but an incorrect debit to the Operating Transfer-in account had to be reversed; a $256 million reversing entry related to a prior year transfer to the General Fund from PIDA was misposted to the wrong account on SAP and a BFM adjustment was necessary; and Treasury misreported $608 million in operating transfers as expenditures in its general fund GAAP template and a subsequent BFM adjustment was needed to correct this.

In addition to the above errors in SAP GAAP template preparation, we also noted several major problems in BFM's preparation and roll-up of SAP balances into the current-year CAFR, which necessitated auditor-recommended changes and adjustments to the CAFR as follows:

- All investment income in the government-wide statements was misclassed as Charges for Sales and Services and needed to be reclassed as Operating Grants and Contributions in accordance with GAAP. This included investment income of $250 million in governmental activities, $252 million in business-type activities, and $597 million for discretely presented component units.

- Primary government payments to discretely presented component units of approximately $1 billion were not presented as external transactions and broken out by functional area in the government-wide and fund statements as required by GAAP.

- Restricted and Unrestricted Net Assets in the Statement of Net Assets were not presented accurately and necessitated significant auditor adjustments. These adjustments resulted in a total increase of $553 million to Unrestricted Net Assets and significantly changed the breakout of Restricted Net Asset amounts for various purposes.

Criteria: Good internal control dictates that amounts in the BFS are accurate and properly presented in accordance with GAAP.

Cause: The errors in GAAP template preparation mentioned above, most of which have not occurred in prior years, were primarily due to the Commonwealth's first-year implementation of its new statewide SAP accounting system. There were major difficulties and significant delays in producing accurate CAFR amounts for June 30, 2003. Comptroller and BFM staff were not experienced with the new SAP system and review/approval procedures in GAAP template preparation were not thorough enough to detect errors like the examples reported above. In addition, these template errors and major delays made it difficult during CAFR preparation and roll-up for BFM to review and ensure that the presentation of investment income, component unit subsidies and net assets components were in accordance with GAAP.

Effect: The BFS were materially misstated and required numerous client and auditor adjustments to ensure presentation in accordance with GAAP. Also, issuance of the CAFR was significantly delayed. The BFS will continue to be misstated in the future if internal controls over GAAP template preparation and CAFR roll-up are not strengthened.

Recommendation: We recommend that more thorough review and approval procedures be implemented within OB to ensure GAAP templates are accurately prepared and accounts are properly rolled up into the CAFR. These enhanced review procedures should be timely implemented in all the Comptroller Offices and overall at BFM to minimize subsequent adjustments to BFS amounts.

Comment 03 – 12: (continued)

Agency Response: Regarding the $124 million error, BFM posted the reversing entry for all of the prior year tax revenue accrual to one general ledger account; it should have been split among appropriate general ledger accounts for the different taxes (PIT, Corp., etc). This error was identified and corrected by BFM.

Regarding the $68 million error, the SAP general ledger hierarchy pointed specific revenues and expenditures to Charges for Sales and Services and Cost of Sales and Services. The report hierarchy will be changed so those general ledger accounts are pointed to Other Operating Revenue and Expenses.

Regarding the $114 million error, at the time the reclassification was made, BFM was not aware of the auditors' rationale in proposing the change. At this time BFM does not agree with the reclassification because the auditor stated that this adjustment was only necessary to avoid year-over-year variation.

Regarding the $1.094 billion error, this was a reversing entry for the BFM GAAP template. BFM followed prior year protocol and posted the entry to one functional area. This error was corrected by BFM.

Regarding the $100 million error, initially, the GAAP template for USTIF did not report either the advance or the corresponding liability; however, the receiving General Fund template initially reported the advance proceeds as a Transfer In. This item was not missing but rather was misclassified.

Regarding the $458 million error, this was a change BFM made after the first CAFR draft, but a change we knew would be necessary prior to issuance.

Regarding the $27 million error, auditors advised us that, unlike the prior year when the related items were much smaller, we would have to establish and amortize a deferred refunded loss.

Regarding the $41 million error, much of the reported balance was caused by the way some of the Goods Receipts posted in SAP through June 30. For some purchase orders, items received quantities were not properly extended by per-unit prices, but were extended by PO line item totals.

Regarding the $40 million error, since 1986, vouchers payable has always been classified as Accounts Payable. In conversations with BFM, Auditor General and IES, it was made clear to the auditors that IES cannot presently categorize detail postings in the Invoices Payable account. Any change in the present reporting treatment would not be cost effective.

The $49 million adjustment to the Keystone Recreation, Park and Conservation Fund was only made because of the lateness of the 2003 CAFR audit testing. In normal reporting and auditing time frames, the information revealing the understatement would not be available to propose this adjustment.

The $14 million adjustment to the Environmental Stewardship Fund was only made because of the lateness of the 2003 CAFR audit testing. In normal reporting and auditing time frames, the information would not be available to propose this adjustment.

Regarding the $11 million error, for General Fund this is a normal routine auditor adjustment.

Regarding the $256 million error, the reversing entry was posted correctly according to general rules, however, because there was not a current fiscal year transfer this reversing entry created a negative transfer which looked inappropriate on the statement of activities. It was decided for presentation purposes that this would be reclassified.;

Regarding the $608 million error, Treasury made a mistake and BFM corrected it.

Comment 03 – 12: (continued)

Regarding the misclassification of investment income, this was an interpretation change this year and was not voiced by the auditors until after the statements were presented to them. Had we been made aware of this change in thinking during the course of the audit we would have discussed this matter and made any resultant adjustments.

Regarding payments of $1 billion to discretely presented component units, in the current and prior years the transfers were not reclassified in the accounting system, but were pointed as transfers to expenditures in the Excel CAFR statements. We believe that governmental fund statements ought to report transfers and that only the government-wide statements should report expenses for component unit subsidies.

Regarding the errors in Restricted and Unrestricted Net Assets, this occurred mostly as a result of posting entity-wide adjustments to the BFM template. This protocol was agreed to by the auditors, both E&Y and Auditor General, prior to the adjustments being posted in SAP. It wasn’t until after the entity-wide adjustments were made that the auditors changed their mind as to how the entity-wide adjustments should be posted.

Auditors’ Conclusion: The details provided by management in its response regarding the timing and circumstances of each of the errors reported above do not address the internal control weaknesses which caused these errors. In addition, the timing of our audit procedures, our detection of errors, and our communications with management during the course of our audit are not relevant to management’s BFS preparation process and related controls that need to be in place. Further, BFM’s detection and correction of errors in GAAP template preparation is not by itself an indication that internal controls in the BFS preparation process are adequate. The point of our finding is that Commonwealth management is responsible for the preparation of accurate BFS in accordance with GAAP. In the future, management needs to correct these types of errors throughout its BFS preparation process and internal controls clearly need to be strengthened at various points in both BFM and in the Comptroller’s Offices in order to do this. For any issues where there is disagreement between management and the auditors, these items will be addressed in our subsequent audit. Our finding and recommendation, therefore, remain as stated above.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 13:

Executive Offices
Office of the Budget – Bureau of Financial Management

Statewide Weaknesses in Segregation of Duties Within the SAP Accounting System

Condition: In our review and testing of Commonwealth internal controls over transactions posted to the SAP accounting system, we noted overall internal control weaknesses regarding segregation of duties in the SAP environment. Many individuals were assigned the "SAP_APP_ALL_NO_HR" role. These users were primarily IES (formerly ImaginePA) staff, who posted a high volume of significant transactions to SAP during our audit period. This role allows users to enter purchase orders, goods receipts, invoices, and change vendor master data. Further, several IPA users have multiple user accounts. We also noted that several outside consultants were granted the "SAP_APP_ALL_NO_HR" role, with at least one outside consultant given permission to create a SAP user account and another consultant permitted to post transactions to the system.

We also found in our detail test of transactions that numerous individuals within Commonwealth agencies had the ability to approve a payment processed on SAP at more than one key control point in the process. The SAP software contains a built-in "three-way match" feature whereby a payment is approved at three separate key control points: purchase order approval, goods/services receipt posting, and an invoice receipt posting. The intent of this attribute is to provide for a proper segregation of duties in processing and approving SAP payments. Many individuals in agencies had roles in both purchase order approval and goods/services receipt posting which circumvented this segregation of duties function inherent in SAP. Although this may be an acceptable practice if limited in scope on an exception basis, we found this practice to be prevalent within Commonwealth agencies with little or no monitoring procedures in place, or subsequent evaluation by management to ensure these segregation of duties conflicts remained justified.

We also noted that a very high proportion of Commonwealth payments were processed through SAP during our audit period without the use of the three-way match control inherent in SAP software. SAP has another feature, known as an FB-60 transaction type, which allows management to bypass the three-way match control. This may be an acceptable practice if the number of FB-60 transactions is limited in scope or if these transaction types are manually reviewed by management and a segregation of duties exists outside of the SAP system. However, we found that the manual review of FB-60 transactions was not always occurring in the Comptroller's Offices and the high number of FB-60 transactions on a statewide basis combined with management's limited monitoring could significantly increase the risk of unauthorized or improper payments on SAP using the FB-60 transaction type.

Achieving a proper segregation of duties is especially critical in Commonwealth agencies with numerous separate institutions such as DOC, DMVA, and DPW, or multiple district offices such as L&I, DPW, and PADOT, where individual SAP users in those institutions and district offices have been granted roles that permit them to complete mapped roles and process transactions for the entire agency, not just in the institutions/offices where they work. While there are internal controls outside of SAP to monitor purchases in various agencies using SAP, these controls do not appear to be effective in all cases in detecting unauthorized purchasing activity. The prevalence of incompatible roles noted in our audit increases the likelihood that unauthorized purchases can occur and not be detected by supervisors.

Furthermore, it is not apparent whether the Bureau of Audits (BOA) has performed all the responsibilities outlined in SAP Security Procedures Document Section 2.2.4 "Audit Services." This procedure indicates that BOA is responsible for role mapping, role development, review of user requests, review of user access, review of User IDs, review of IES roles, review of documentation/activity logs/audit logs, etc. While there is evidence that data transport processes are documented and that several role mapping and role analysis activities were performed, it is not clear whether BOA (or IES) has reviewed audit logs, IES user activity, role mapping of HR/Payroll, tolerance settings, and other functions. This

Comment 03 – 13: (continued)

seems to be due to an overall lack of resources within BOA assigned to these tasks, accompanied by the diversion of BOA personnel for activities such as GAAP audit support, SAP account reconciliations, and other duties. We also noted that, after reviewing initial role mapping requests and notifying agencies about incompatible roles, BOA did not conduct follow-up reviews of any revised role assignments to verify an appropriate segregation of duties was achieved.

Regarding advancement accounts, a review of SAP role assignments was conducted to determine if any users have the ability to process advancement account checks and also approve reimbursements from Treasury (Roles FB-60/KR, F-58, and ZFCHN). We noted 17 comptroller employees with these roles indicating a segregation of duties conflict.

Criteria: Proper segregation of duties is critical in minimizing and mitigating the risks of inappropriate transactions occurring. Verifying that third parties, such as consultants, do not have unmonitored and excessive access to production environments is also important to be consistent with best practices.

Cause: It appears that these roles and conflicts were created in order to provide consultants, IES staff, and others within the agencies with the ability to assist in multiple situations during an expedited implementation timeframe, and to overcome problems noted during the transition from the old ICS accounting system to SAP. However, it does not appear that the requisite revocation and refinement of roles has occurred since the bulk of the implementations occurred during our audit period.

Effect: Segregation of duties conflicts significantly increase the risk of misappropriation of assets, inappropriate changes to data or files, and unauthorized activity (whether intentional or unintentional). Further, such situations significantly increase the need for increased monitoring, review, and verification of SAP activities and transactions.

Recommendation: We recommend that the segregation of duties issues noted above be investigated and, if necessary, excessive access within SAP be revoked. If specific business justification exists (i.e. administrators, short term needs, etc.), a minimal number of users should have the SAP_APP_ALL_NO_HR role. Further, consultant access should not include the ability to create additional user accounts or post transactions to the system. SAP roles in the "three-way match" and FB-60 transaction type functions and in the advancement account process should be closely monitored, and segregation of duties conflicts should be appropriately justified in writing on an as needed basis.

Agency Response: Integrated Enterprise Systems (IES) has removed the "SAP_APP_ALL_NO_HR" from outside consultants. IES is also working to remove this role from all IES employees by creating support roles that provide sufficient update and display capability for team members to perform their daily tasks while limiting their access to the extent possible.

The Commonwealth is in the process of reviewing role assignments, particularly those assignments that may result in segregation of duties issues.

The three-way match in SAP can only be used when a Purchase Order is established in SAP. Shortly after SAP was implemented in July 2002 for the Wave 1 agencies, most documents and contracts were converted from the legacy system to SAP as Funds Commitments since converting them to SAP Purchase Orders from the legacy documents did not work. All subsequent wave documents were then converted automatically to SAP as Funds Commitments. As such, the invoices processed against these converted documents were and are manually approved by the agencies and submitted to the Comptroller's Offices to be audited manually against the contracts or purchasing documents and then processed as an FB60 transaction, liquidating the Funds Commitment. As these converted documents are terminated, SAP Purchase Orders are processed.

Currently, however, exceptions remain to the SAP Purchase Order process which include grant agreements, direct grant invoices such as in lieu of taxes, direct invoices such as utilities and complex contracts, i.e., a contract where a simple description, quantity and price ordered cannot be entered as a SAP Purchase Order line item. The complexity of grant agreements as well as the fact that invoices for utilities, rent, direct grant payments and some service contracts are best

Comment 03 – 13: (continued)

processed without an electronic three-way match, mandate that an FB60-type transaction be used. Using the FB60 transaction in the latter instances enables us to process such invoices in the most cost–effective manner, given the limitations of SAP.

The use of the FB60 transaction, as stated previously, includes agency approval of the invoice, Comptroller audit against a contractual document (grant agreement, complex contract) and posting the expenditure as an FB60 transaction with a concurrent liquidation of the Funds Commitment document, if applicable. Thus, using an FB60 transaction is not an attempt to bypass the three-way match nor does it significantly increase the risk of unauthorized or improper payments. The effort that precedes the entry of an FB60 transaction into SAP provides sufficient checks and balances to minimize the risk of unauthorized or improper payments, in accordance with good internal controls.

The Commonwealth is currently establishing shared services centers for purchasing, whereby, Department of General Services (DGS) staff will procure items for various business areas and have the vendor ship the items to various locations. For other than DGS staff, procurement activities are limited by business area. This provides for an available, trained staff, which can provide services on a business area-wide basis. Temporary staff shortages in an area can be overcome by assigning responsibilities to staff at another location. SAP functionality enables the procurement services to be provided for a location without requiring the physical presence of the staff at that location. All procurement and related finance activities are readily available real time in SAP for supervisory review to assist in the timely detection of errors or irregularities.

BOA is responsible for reviewing role mapping, role development, and related activities. As indicated, BOA has completed several such activities as a part of this GAAP audit. As additional resources become available, reviews will be completed in other areas.

Auditors' Conclusion: Regarding FB60 transaction types, we recognize management's need to process these transactions in the most cost-effective manner, as long as strong internal controls exist outside the SAP system. We found instances, however, where the use of FB60 transactions resulted in the Comptroller approval and forwarding of duplicate or incorrect payments to Treasury (which Treasury detected before actual payment), payments to incorrect vendors which went undetected until vendor follow up, and mispostings of payments to wrong SAP accounts. Although these types of errors did not appear to be widespread throughout the Comptroller and agencies during our audit period, nevertheless they point to the need for close management monitoring of these transaction types because of increased risk, especially during the implementation period for the new SAP system. As SAP becomes fully operational throughout the Commonwealth in subsequent fiscal years, strong manual prevention controls are needed for those areas that continue to use the FB60 transaction type in the majority of their payments through SAP.

For the other issues noted in the above condition, management indicates that corrective action is planned for the subsequent audit period. Therefore, our current-year finding and recommendation, with the above clarifications, remain as stated above. Any corrective action will be reviewed by us in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 14:

Executive Offices
Office of the Budget – Bureau of Financial Management

Internal Control Weaknesses Over Agency Accounting for Capital Assets

Condition: Management Directive 310.14, *General Capital Asset and Other Fixed Asset Accounting and Reporting in SAP*, established policies and responsibilities for the proper recording of the Commonwealth's General and Proprietary Fund Capital Assets in the SAP Fixed Assets sub-module. It further recognized that the transition to SAP required two significant operational changes, identifying capital assets and appointing Agency Fixed Assets Coordinators. General and Proprietary Fund Capital Assets must be identified prior to initiating any type of procurement using the SAP system because an Asset Master Record Number needs to be established. This number is obtained through the Agency Fixed Asset Coordinator who should possess substantial knowledge of the SAP Fixed Asset, Procurement and Finance modules, and who has considerable experience and expertise regarding proper acquisition, use, and control of agency fixed assets.

We noted during the performance of fieldwork and through discussion with Bureau of Financial Management staff that several Agencies were not adhering to the policies and responsibilities of the Directive. This caused BFM to post numerous adjustments because Capital Assets were not identified prior to the initiation of transactions and therefore were not being properly captured in the SAP Fixed Assets sub-module.

In addition, we found that no procedures exist for transferring assets under construction (or AUC) to depreciable capital asset classification on a timely basis. If the transfer is not recorded with an accurate transaction date, depreciation amounts may be misstated, (and timely processes for estimated journal entries are necessary to post depreciation). Further, there do not seem to currently exist effective reporting mechanisms within SAP to evaluate and track capital asset balances, transfers, and AUC costs.

Criteria: Good internal control and Agency Fixed Assets Coordinators that possess the appropriate knowledge and expertise dictate that the amounts in the Fixed Assets sub-module are accurate and properly presented in accordance with GAAP.

Cause: The errors in the Fixed Assets sub-module were primarily due to the Commonwealth's first-year implementation of its new statewide SAP accounting system. Fixed Assets Coordinators did not possess substantial knowledge of the SAP modules required for accurate Capital Assets reporting nor did they have the experience and expertise regarding proper acquisition, use, and control of agency fixed assets.

Effect: The Fixed Assets sub-module will continue to be misstated in the future if internal controls are not strengthened and proper training of Agency Fixed Asset Coordinators does not occur.

Recommendation: We recommend that the Directive be adhered to fully to ensure the proper reporting of the Commonwealth's Capital Assets within the SAP Fixed Assets sub-module. We further recommend that Agency Fixed Assets Coordinators participate in extensive training so that they do possess the necessary knowledge of the required SAP sub-modules and gain experience and expertise regarding proper acquisition, use, and control of agency capital assets.

Agency Response: Paragraph 3 states that "no procedures exist for transferring assets under construction to depreciable capital assets." The monthly closing process in SAP does provide a mechanism for reclassifying costs accrued to Work Breakdown Structure (WBS) elements during each month. During the monthly closing managed by BFM personnel, the SAP program RA_CREATE_ASSET_FM reads the monthly transactions and creates an AUC sub-asset for any project expense posted to a fund for which there is no sub-asset. After the RA_CREATE_ASSET_FM program runs, the program CJ8G, running in the "by period" mode, settles the monthly costs to the sub-assets created by the

Comment 03 – 14: (continued)

RA_CREATE_ASSET_FM program. Next, the CJ8G program, running in the "partial capitalization" mode, settles finished AUC sub-assets to final, fully completed asset numbers. Finally, the RAPOST2000 program calculates, as a part of the monthly closing process, depreciation for all applicable assets residing in the fixed assets sub-module.

If the procedures to trigger project settlement are properly followed, the process described above will maintain accurate balances within the SAP fixed assets sub-module for assets, depreciation expense, and accumulated depreciation. However, agency personnel did not follow through in creating settlement rules thus necessiting the creation of GAAP journal entries to properly reflect final capital assets balances. Actions have been taken to remedy this situation through additional training and oversight.

Although it is possible that slight variances may exist at times between the amount of depreciation that the sub-module reports and the true, acquisition date-driven depreciation amount, any misstatement of depreciation would certainly fall within the parameters of audit materiality.

Reports do exist in SAP to track all pertinent fixed assets transactions. Some of the most frequently used reports are:

S_ALR_87012052 - Asset Retirements
S_ALR_87012050 - Asset Acquisitions
S_ALR_87012056 - Directory of Unposted Assets
S_ALR_87012026 – Depreciation

During the performance of GAAP analytics, some differences (primarily related to enterprise funds) between load amounts to SAP and prior-year GAAP-reported amounts became apparent. These differences, along with GAAP-related fixed asset entries, did slow the accumulation of fixed asset data for CAFR production. BFM has, over the course of the past several months, and in conjunction with efforts to confirm the accuracy and inclusiveness of agency transaction activity within the SAP fixed assets sub-module, provided much assistance to agency and comptroller fixed assets coordinators. On numerous occasions, BFM personnel have provided assistance directly, on an employee and transaction-specific basis. In addition to providing continuing assistance and training, BFM has initiated a quarterly fixed assets transaction confirmation process with all agencies that use the fixed assets sub-module. We are confident that the additional training and transaction monitoring has and will continue to significantly improve the quality and timeliness of the data in the fixed assets sub-module.

Auditors' Conclusion: Based on the agency response, our finding and recommendation remain as stated above. We will review any corrective action in our subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 15:

Executive Offices
Office of the Budget – Bureau of Financial Management

Internal Control Weaknesses in the Implementation of the New Statewide SAP Accounting System

Condition: The Commonwealth began implementing SAP as its primary accounting system on July 1, 2002. Implementation was done in multiple stages, or "waves," resulting in some agencies being cut-over to SAP at the beginning of the fiscal year and others implementing SAP during the fiscal year. Four agencies, or business areas, did not implement SAP at all until the subsequent fiscal year. Business areas that did not begin to use SAP on July 1, 2002, continued to process data through the old ICS system until their conversion to SAP. All ICS expenditure data was interfaced into SAP in summary form so that SAP contained all Commonwealth expenditure data from throughout the year.

The Commonwealth's overall Revenue Accounting System, or RAS, was out of scope in the SAP conversion project and continues to function separately from SAP in the recording of all Commonwealth revenues. Also, the independent Treasury Department did not convert and maintains its separate accounting systems outside the scope of SAP. Numerous other legacy accounting systems within individual agencies are also maintained separately outside the SAP system. All these separate systems interface with SAP.

As the result of our audit, we noted weaknesses in internal controls over many SAP financial reporting processes that need to be corrected or improved upon. Noted weaknesses include the following:

The Commonwealth did not establish effective written policies to guide SAP users on how to perform many of the necessary reconciliations and other procedures to ensure accuracy in financial reporting. In many cases the written SAP "To Be" process documentation did not agree to the processes actually put into place after implementation. Further, it was not apparent in many cases who had ownership/responsibility for a given process or group of transactions, including appropriate levels of monitoring, review, and approval. This situation created inconsistencies in the various comptroller offices in attempting to implement SAP and ensure it was functioning as prescribed. Examples were in the following areas:

- GR/IR Analysis (Goods Receipts/Invoice Receipt);
- Month End and Year End Closing;
- Reopening of Closed-Out Accounting Periods (0-16);
- Various Reconciliations (COPA Fund, SAP Fund, RAS to SAP, and others);
- Encumbrances;
- Invoice Processing;
- Master Data maintenance;
- Three-way matching tolerances, thresholds, and deviations (i.e., direct pay items – FB60); and
- User maintenance (role changes, transfers).

The Commonwealth did not ensure timely reconciliations of SAP cash and short term investment balances with Treasury's independent records by COPA Fund. No COPA Fund reconciliations were performed until May 2003, or eleven months into the fiscal year. This created significant delays in the financial reporting process.

The Commonwealth did not ensure timely reconciliations of SAP revenues to its separate RAS system. No RAS-to-SAP reconciliations were performed until after the fiscal year-end. In addition, the reconciliations were not well documented and they contained numerous errors. Inaccurate SAP data files were used and inconsistent revenue codes were reconciled among the various COPA Funds.

Comment 03 – 15: (continued)

We noted instances of inadequate controls over the accuracy of the Commonwealth's Status of Appropriations, a key monthly report of RSI budgetary revenues and expenditures from the SAP FM Module, which reports on the system of budgetary control. We noted high-dollar truncation errors for certain component unit expenditures during our current year which were not detected in OB management's review prior to issuance of the Status. We also found smaller errors in the reporting of encumbrance balances and augmenting revenues within the Status that went undetected by management.

Encumbrance balances were not well documented and lacked a clear audit trail from the FI to the FM Module. Data files were discarded that would have helped reconcile encumbrance balances on the financial statements (FI) to encumbrances in the FM module. An audit trail was identified only after auditor inquiry, which indicates that inadequate review of financial statement encumbrance balances was performed by GAAP template preparers or reviewers.

The Goods Receipt/Invoice Receipt (GR/IR) account reconciliations were not begun until late in the fiscal year. The GR/IR account reconciliations were inadequately documented and the auditors could not test the reconciliation process. There was no tracking of adjustments made to clear the outstanding goods or invoice receipts. Also, there was no aging analysis performed on the account to identify long standing items that required comptroller or agency attention to clear. No documented history was maintained of tolerances in SAP for invoice clearing. Only the current settings could be reviewed.

There appeared to be a general lack of understanding of SAP functionality by GAAP template preparers and reviewers. Auditor inquiries with template preparers, template reviewers, and program personnel on routine questions such as unusual increases or decreases in program revenues or expenditures, could not be readily addressed and had to be referred to BFM for answers. Also, there was an overall lack of ownership of the financial statements and data by agency and comptroller personnel. BFM controlled a disproportionate share of the reporting process; ownership by the agency and comptroller offices where the stewardship/accountability resided was not adequate. As a result, a greater risk of error was present and occurred.

Due to the complexity and lack of understanding of SAP, an exorbitant number of GAAP template preparer and BFM errors were made in preparing the BFS, and a large volume of adjustments were required to ensure the BFS were fairly presented in accordance with GAAP. Many templates had an excessive number of significant entries that were entered, reversed, and re-entered multiple times so that it was difficult to follow the intent of the entry. Also, there were numerous instances in which a template preparer made an entry, but was unable to explain why it was made and the explanation was not sufficiently documented in the template.

The GAAP template preparation and review process used by OB was not effective in the first year of SAP. Many individual templates were prepared, reviewed and signed off as accurate and complete, but period 14 client adjustments continued to be posted to these templates long after they were signed off as finalized. The untimely close-out of period 14 for client (i.e., BFM) adjustments contributed significantly to errors and delays in the BFS preparation process.

In addition, the reporting process audit trail was not well documented. The basic set of financial statements did not reconcile with SAP GAAP templates. In the absence of a GAAP reporting package with T-accounts and journal entries (as was available in prior audit years), the auditors had to develop and compile reports from the SAP data in order to reconcile source documents/schedules with the account balances in the SAP GAAP templates.

We also noted that periods 00 to 13 (including July 1, 2002 beginning balances), which originally closed out in early July 2003 right after the June 30th year-end, were re-opened several times by IES staff at later dates during our audit, creating further confusion and problems in preparing accurate and timely BFS.

Criteria: Good internal controls are necessary to ensure accounting transactions are properly presented in the BFS in accordance with GAAP. Internal controls should be designed to provide a clear audit trail to all accounting transactions. Well developed audit trails facilitate and help ensure management review of fiscal activity and provide auditors adequate documentation to review to support the financial transactions.

Comment 03 – 15: (continued)

<u>Cause</u>: The size and complexity of the Commonwealth's reporting entity contributed to the difficulty of implementing SAP, so that GAAP template preparation procedures and month and year-end closing procedures were not effective to ensure accurate BFS were prepared. SAP required the Commonwealth to significantly revise many of its business practices and procedures. Also, customization of SAP configuration was necessary to fully implement its functionality. Additionally, there appeared to be some user resistance to change during the implementation. Many key Commonwealth accounting personnel were reassigned to work for the statewide ImaginePA implementation team, and their positions were filled with less experienced staff, compounding difficulties in the preparation of the BFS from SAP.

<u>Effect</u>: As a result of the above internal control weaknesses, there were many GAAP template adjustments initiated by BFM and the auditors to ensure the BFS were fairly presented in accordance with GAAP. Because the various reconciliations were not in place and functioning as prescribed on a timely basis, the number and complexity of accounting adjustment entries increased as a result of multiple accounting periods being done simultaneously. Also, the weaknesses noted above caused significant delays in the issuance of the current-year BFS.

<u>Recommendation</u>: Overall, OB needs to strengthen controls to correct the various weaknesses noted above to improve the financial reporting process using the new SAP system. Policies and procedures need to be as clear as possible, in writing, and communicated effectively amongst all SAP user staff to ensure consistency throughout various SAP reporting processes. Also, effective review, reconciliation, and close-out procedures need to be performed routinely and in a timely manner to ensure the BFS are issued more timely in the future.

<u>Agency Response</u>: IES staff developed and used a methodology to reconcile COPA Fund cash and short-term investments following the initial July 1, 2002 SAP implementation and performed all of these reconciliations during Wave 1 implementation with the understanding that this process would eventually transition to the process owner. With the advent of Wave 2, the magnitude of the reconciliation effort grew significantly and it became necessary to quickly transition to the process owner. This transition began in February with the development of strategies, reports and procedures to enable the reconciliation processes to occur. BFM and comptroller office staff began performing the COPA Fund reconciliations during May 2003. BFM has been using a monthly convention to complete COPA Fund reconciliations through June 30, 2004. Our goal is to largely complete the FYE June 30, 2004 COPA Fund reconciliations during July and August 2004.

BFM staff became involved in RAS to SAP reconciliations in July 2003. Several conventions were developed whereby IES provided data to BFM and BFM, in turn, provided different reports to comptroller offices for further research. We have continued to use this convention through June 30, 2004.

The truncation errors noted did not affect our RSI presentation, as component unit organizations are not included in that presentation. Further, we largely rely on audited financial statements from the component unit organizations for financial reporting purposes.

IES had a clearly documented month-end process that posted the reserve for encumbrances in FI. IES and BFM met with the auditors in December 2003 to review this process. After this meeting, the auditors continued to ask many additional questions and request additional documentation. The documentation requested was to match up the FI expenditure document to the FM liquidation document. There is not a link between the FI and FM documents, rather the link between FI and FM is based on general ledger account balances.

For the GR/IR account, BFM staff began using SAP transaction zff19 in May 2003 but this effort was a monitoring effort, not a reconciliation effort – no reconciliation effort was required. Rather, large detail items that had been posted by key dates, such as February 28 or March 31, 2003, which had not cleared by June 30, 2003, were provided to comptroller offices several times for further research. In many cases, it was determined that the "uncleared" detail items included in the reported June 30, 2003 balance in general ledger account 2100100 were caused by the sequence of when specific goods receipt information was posted, in relation to when invoice information was posted for specific purchase orders. In many cases, "uncleared" GR/IR detail was present because the goods receipt had posted and the invoice had not yet posted in SAP or vice-versa.

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This was the first year for preparing GAAP templates from SAP. Comptroller Office personnel are gaining a greater understanding of SAP as they learn more and have more experience using SAP.

In prior years, a GAAP package preparer could type in a journal entry and, if needed, change or delete it. In SAP, once an entry is posted it is permanent. If the GAAP template entry was posted wrong, the only option is to reverse the original and repost a new entry. The instance of posting errors will diminish as time passes and GAAP template preparers gain a better understanding of SAP.

The template approach to preparing the Commonwealth's CAFR was very appropriate under the Commonwealth's legacy system which was on a cash basis and whereby information was loaded into templates and then adjusted to reflect modified and full accrual balances. While still in use under SAP, the templates take on a somewhat different concept in that no "load" actually occurs. Instead, the information continues to reside in SAP and any adjusting entries are made directly in SAP rather than outside SAP in a template. This concept requires recognition by the auditors.

The condition of adjusting entries being made after templates are provided will exist until BFM can review all templates, make all period 14 adjustments, and analyze the BFS prior to releasing the GAAP templates to the auditors. However, given the capabilities of SAP and the auditor's online visibility of this activity, the condition should not be viewed as an internal control weakness. As BFM's knowledge and experience with preparing the BFS using SAP improves, and as the auditors gain a better understanding of SAP, instances of this condition will lessen.

Regarding the reporting process audit trail, we urge the auditors to rely more on the SAP logic and functionality instead of recomputing reported SAP amounts.

Regarding the re-opening of closed periods, BFM is working to ensure that these instances are lessened. However, as with any implementation of this magnitude, instances arose where the only solution to ensure that balances were properly established in SAP without extensive amounts of off-system bookkeeping, was to reopen prior periods and post corrected information.

Auditors' Conclusion: As indicated in the agency response, management believes that the CAFR preparation and issuance process will become easier as employees gain more experience using the new SAP system, and we concur with management in this regard. In those cases where the agency response explains that improvement or corrective action should occur for the June 30, 2004 CAFR, we will review this corrective action in our subsequent audit.

For several of the internal control weaknesses disclosed in the comment, the agency response provides further explanation or information on the weakness, but there is no indication that internal controls will be strengthened in the future. Based on the examples reported in the above comment, we believe stronger oversight and review procedures need to be in place over the monthly Status of Appropriations, FI and FM Encumbrance balances, the GR/IR account, and GAAP template preparation. While we recognize the overall appropriateness of the GAAP template approach in preparing the BFS, we believe that this approach needs to be more effective to ensure timely issuance of accurate CAFRs in the future. The exorbitant number of errors and adjustments in the current-year templates need to be avoided, and internal controls need to be strengthened, to make this happen. In the meantime, because of the major errors we noted in the financial reporting process, we do not believe we can rely on SAP logic and functionality without recomputing reported SAP amounts as part of our audit. Therefore, our finding and recommendation with the above clarifications remain as previously stated.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 16:

Office of the Budget
Office of Administration

Lack of Documentation and Internal Control Weaknesses Over Contracting and Procurement (A Similar Condition Was Noted in Prior Year Comment #02–8)

Condition: During prior audit periods, the Commonwealth awarded numerous statewide technology contracts to modernize and upgrade the Commonwealth's information systems technology, to outsource agency data center computer operations, and to consolidate the acquisition of telecommunications services. The contracts awarded for these types of technology services total to over $1.5 billion and involve all major agencies in the Commonwealth. In our prior-year audit for the fiscal year ended June 30, 2002, we reported that management refused to provide us with key procurement documentation to enable us to audit the awarding of these contracts and to verify compliance with Commonwealth procurement regulations (see prior year Comment #02-8). We also disclosed numerous weaknesses in the Commonwealth's internal controls over documentation supporting procurement of these contracts in the prior year. It should be noted that these prior-year disclosures also involved contract awards, other than for technology, which were limited to specific agencies and funds.

Our current year follow up for the fiscal year ended June 30, 2003, disclosed that, as in the prior year, management continues its policy of refusing to provide us with key procurement documentation to enable us to audit the awarding of contracts to verify compliance with Commonwealth procurement regulations. Documentation again not provided to us for the above contract awards consisted of the following:

- List of proposal evaluation committee members.
- Copies of losing vendor proposals.
- Detailed scoring sheets used by evaluation committee members for each proposal submitted for review.
- Summary documentation to audit the overall scoring and selection process including maximum point values assigned to each major evaluation criterion and the evaluation committee members recommendations for vendor selection.
- Documentation to support that the evaluation committee verified that prospective vendor's cost proposals were reasonable.
- Documentation required for evaluating the participation of Socially and Economically Restricted Businesses (SERB) for each of the submitted proposals.

Furthermore, in our current follow up on the internal control weaknesses noted in prior-year Comment #02-8, management provided no information or documentation to demonstrate that these weaknesses were corrected in the current year. The noted internal control weaknesses are as follows:

- The STD-21, "Compliance Review Form" is not being completed for each contract award and maintained on file as required.
- There are multiple systemic control weaknesses in the Commonwealth Contractor Responsibility Program (CRP) which fail to prevent the Commonwealth from contracting with nonresponsible contractors. These control weaknesses include: the failure to adequately track and recoup tax and other liabilities owed by contractors to the Commonwealth; an inadequate statewide database (or Contractor Responsibility File) for tracking and rendering information on nonresponsible contractors; inadequate oversight of the statewide CRP by management; and systemic control weaknesses in agencies' procedures for checking the CRF and verifying that their contractors are responsible in accordance with established CRP mandates.

Comment 03 – 16: (continued)

- We found significant inconsistencies between amounts and terms in RFPs vs. actual terms of executed contracts which call into question the sufficiency of original RFPs used in competitively bidding contracts.

- There is inadequate documentation maintained to demonstrate that management is sufficiently monitoring contract amendments to ensure increasing contract costs are reasonable and properly controlled. In particular, there is no documented support for contractor-estimated costs, contractor billing rates used, or impact studies by management to verify the necessity for increasing contract costs. In addition, management does not track cumulative total costs for a telecommunications contract, does not document or analyze billing rates for reasonableness, does not track contract change requests for increasing costs and maintain a contract log when required, and did not implement a segregation of duties to ensure contract amendments were accurate, justified, and properly reviewed before approval.

Criteria: The Commonwealth established procurement policy and procedures in the "Field Procurement Handbook" (M215.3 as Amended). Commonwealth agencies are required to adhere to this handbook when awarding contracts. Part III, Chapter 7 of the handbook details a step-by-step process that must be followed when a contract is to be awarded via a "Request for Proposal." Good internal controls require management to maintain sufficient documentation to demonstrate that proper purchasing procedures were reasonably followed and contract awards and costs were properly accounted for. Regarding procurement duties, specific sections of Chapter 7 state:

Evaluation Committee	*21.*	*Determines that the offeror and the proposed subcontractors are responsible in accordance with Management Directive 215.9, Contractor Responsibility Program. The date of determination should be recorded for future reference.*
Evaluation Committee	*25.*	*Performs final technical and cost evaluations after discussions have been completed* (i.e. score sheets).
Agency	*43.*	*Forward Form STD-21 Compliance Review Form, to selected contractor, if the contract exceeds $50,000.*
Agency Comptroller	*38.*	*Reviews for fiscal responsibility, budgetary appropriateness and availability of funds….*

Governor's Executive Order (EO) 1990-03, dated June 29, 1990, established the statewide Contractor Responsibility Program (CRP) to "identify, evaluate, and sanction appropriately, contractors that do not meet the standards of responsibility, that render deficient performance, or that engage in wrongdoing or other activity adversely affecting their fitness to contract with Commonwealth agencies." Commonwealth Management Directive (MD) 215.9 was issued by the Governor's Office on July 17, 1990 in order to implement the CRP within the Commonwealth as directed by EO 1990-03.

The stated purpose of MD 215.9 was *"To ensure that the Commonwealth's contractors are competent and responsible and that the contracting process is free of fraud, waste, and abuse. To identify, declare ineligible, and sanction contractors that have rendered deficient performance or engaged in other activities that adversely affect their fitness to contract with Commonwealth agencies."* This MD applied to all departments, boards, and commissions under the Governor's jurisdiction.

A strong system of internal control should ensure that contract amendments and related costs are properly justified and supported and adequately reviewed prior to amending original contracts. Strong internal controls should also ensure that the CRP is functioning as intended by Governor's EO 1990–03 and Commonwealth MD 215.9 to ensure that Commonwealth agencies only contract with responsible vendors.

Cause: Management maintains that the identity of evaluation committee members, committee scoring sheets, SERB participation, losing proposals and other documents listed above are considered confidential information that we are not entitled to review. Management also maintains that these documents are not within the scope of a financial statement audit.

Comment 03 – 16: (continued)

For the internal control issues above, management indicated that the Commonwealth's sign-off on the change documents applicable to the technology contracts is the key evidence of management's detailed review that is necessary and appropriate. The documentation supporting the contract amendments is considered by management to be adequate. Also, management considered the change orders affecting certain contracts to be too limited in number to warrant an official log record. Concerning the STD–21, management believed that this weakness was corrected. Regarding the CRP, management stated that it did not agree with our conclusions and claimed that the CRP collected approximately $61.7 million in liabilities owed the Commonwealth since its inception. Management further stated that the CRP should be strengthened in the future with the statewide implementation of its new ERP system involving automated key controls and maintaining better suspension and debarment records.

Effect: By refusing to provide the requested documentation, management has prevented the Department of the Auditor General from performing duties required of it by Pennsylvania's Constitution and by Pennsylvania law. The Constitution provides that "all departments, boards, commissions, agencies, instrumentalities, authorities and institutions of the Commonwealth shall be subject to audits made in accordance with generally accepted auditing standards." (Article VIII, Section 10) The Fiscal Code directs the Department of the Auditor General "to make all audits of transactions after their occurrence, which may be necessary, in connection with the administration of the financial affairs of the government of this Commonwealth,…" (72 P.S. § 402) Management has taken the position that the invocation of confidentiality supersedes these constitutional and statutory directives.

Without the necessary documentation, we could not verify that management adhered to Commonwealth procurement standards and laws, or exercised due diligence in awarding the contracts disclosed above. More specifically, we could not verify that management awarded contracts to the most qualified vendors or that the appropriate Commonwealth officials conducted proper fiscal reviews of amendments that substantially increased contract costs. In short, management imposed scope limitations on our audit procedures.

Furthermore, management's refusal to provide procurement documentation to our department is a violation of the Commonwealth Procurement Code, which states: *Retention of procurement records. All procurement records, including any written determinations issued in accordance with section 561 (relating to finality of determinations), shall be retained for a minimum of three years from the date of final payment under the contract and disposed of in accordance with records retention guidelines and schedules as provided by law. In accordance with applicable law, all retained documents shall be made available to the . . . Auditor General . . . upon request. (62 Pa.C.S.A. § 563)*

We again noted that the system of internal controls over the review and approval of changes to contract terms and increasing total costs is weak. Documentation supporting a proper review of contract changes and increasing costs by management is lacking. Change order documents contain errors which should have been detected and corrected during a proper review prior to management approval. STD-21 forms are not being prepared as required. If these weaknesses are not corrected, we can have only limited assurance that the overall procurement system is functioning as intended and that services are being properly contracted out. Close scrutiny over contract change requests is critical to effective contract cost management. Otherwise, management may not realize the desired savings and other benefits intended by the guidelines set forth in the Field Procurement Handbook.

Also, the Commonwealth is contracting with nonresponsible contractors and is not recouping tax and other liabilities owed the Commonwealth as required by the CRP in MD 215.9.

Recommendation: We recommend that management more closely monitor its statewide and agency contracts to ensure Commonwealth funds are being properly committed at the most reasonable cost. The fiscal impact of amendments and their amounts should be better justified and documented, and proper support should be adequately reviewed and approved by management prior to amending the contracts; all required contract forms should be filed timely; and vendor

Comment 03 – 16: (continued)

activities should be adequately monitored and better documented in the future to ensure that services are appropriate and at the most reasonable cost. In addition, internal controls need to be strengthened within the CRP to ensure that Commonwealth agencies are adequately following the provisions of MD 215.9 in procuring and awarding contracts to outside parties.

We also recommend that management evaluate the disclosures above for their impact on the overall procurement and accounting functions, and take similar corrective action where considered necessary on an overall basis.

Finally, we recommend that management abandon its practice of withholding documentation in order to allow the Department of the Auditor General to perform its constitutional and statutory duties, and to provide the public and other interested stakeholders with assurance that laws and policies are being properly followed in the procuring of goods and services.

Agency Response: Our response to the above condition on procurement documentation is the same as our prior year's response. Management does not agree that the documents are necessary for the completion of the auditor's work. Management reached an agreement with the Auditor General's office in October 2003 in which management provided certain summary and other information. Management believed and continues to believe that the agreement resolved these issues.

Regarding the STD-21 Form, our response to the above condition is the same as our prior year's response. Action was taken to remedy the specific instance noted in the prior year's condition.

Regarding the CRP issues, our response to the above condition is the same as our prior year's response. We do not agree with the auditor's conclusion to findings contained in a separate special audit of our program by the Department of the Auditor General. Our response to the specific findings contained in that special audit report are contained in our November 13, 2002 letter to the Department of the Auditor General, a copy of which is again being provided as part of this response. Furthermore, we wish to reiterate that the CRP has benefited the Commonwealth by collecting roughly $61.7 million since its inception.

Regarding RFPs, our response to the above condition is the same as our prior year's response.

Regarding contract amendments, our response to the above condition is the same as our prior year's response. Management provided a response in the prior year which management believes more than adequately addressed the conditions.

Auditors' Conclusion: Management refers to an October 2003 "agreement" with the Department of the Auditor General, which was part of a separate audit engagement, not our audit of the Commonwealth's BFS, and claims that this so-called "agreement" resolves the issues to enable us to verify compliance with procurement regulations. We noted, however, in our current-year audit of the BFS that management continues in its refusal to provide any documentation, summary or otherwise, related to the specific procurement items noted in the condition above. Our finding, therefore, does not change in this regard.

For the CRP weaknesses, management refers to a separate CRP audit performed by the Department of the Auditor General in the prior year and reiterates its prior-year response with no new information provided, so these same statewide, systemic weaknesses in the CRP in the prior year still existed in our current year and need to be corrected. It should be further noted that management's comment about the $61.7 million in cumulative collections from the CRP has not been audited by us and does not address the potential CRP savings and/or collections that could have occurred if the control weaknesses pointed out by us in the finding were corrected.

Comment 03 – 16: (continued)

For the other procurement weaknesses noted in the condition, management has provided no new information to demonstrate improved controls, so our conclusion is that proper corrective action has not been implemented in our current audit period. We disagree with management's assertion that its internal controls are adequate.

Therefore, our finding and recommendation, with the above clarifications, remain as stated above.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 17:

Bureau of Financial Management

Internal Control Weakness in the Reporting of Investments and Cash

Condition: The Pennsylvania Treasury is the designated custodian for cash and investments for almost all Commonwealth funds. Cash not required for immediate disbursement by various funds is invested by Treasury in one of two short-term investment pools: Pool 098 and Pool 099. Treasury also manages and accounts for several long-term investment accounts, including the long-term investment portfolios for the General and Motor License funds. Each year, the Bureau of Financial Management requests information from Treasury for use in preparing the Commonwealth's financial statements. The information requested includes the fair value of investments, accrued investment income and the fair value of investments in the short-term investment pools, both of which are reported on the basis of the Net Asset Value, or NAV. The Bureau uses the information provided by Treasury to prepare and record any adjustments needed to correctly report the Temporary and Long-term Investment balances, as well as related account balances in the various funds.

As a result of our audit we found that the Net Asset Value for one of the short-term investment pools, Pool 098, was understated by $60.9 million. The effect of the understatement was material for three funds. Auditor adjustments were necessary to correct the temporary investment balances in these funds.

Criteria: Strong internal controls should ensure that cash and investment balances are accurately and correctly reported by funds that participate in Treasury investment pools.

Cause: Because the Bureau of Financial Management's request for information on Pool 098 was unclear, Treasury did not provide the Bureau with the NAV for Pool 098 at June 30, and BFM recorded the NAV incorrectly.

Effect: The effect was an understatement of $60.9 million in the temporary investment accounts of participating funds. Auditor adjustments were necessary because the understatement was material to three of the funds.

Recommendation: We recommend that procedures be strengthened to ensure that the Bureau of Financial Management's request to Treasury clearly and accurately describes the information needed for financial reporting purposes. In addition, when values provided by Treasury are changed, procedures should be in place to ensure that a reconciliation is performed between the amounts provided by Treasury and the amounts being reported.

Agency Response: We have changed the content of our annual request letter to the Treasury Department. We met with Treasury staff on two occasions and sent our letter to them on July 28, 2004. The request letter makes it clear that we need the Net Asset Value (NAV), in total, for both Fund 98 and Fund 99 at June 30, 2004. Further, we have asked the Treasury Department for significant amounts of other data and we have asked that the Fund 98 and Fund 99 NAVs be allocated among the different participating COPA Funds.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Comment 03 – 18:

Insurance Department
Central Services Comptroller Office

Internal Control Weaknesses in Accounting for and Reporting Investments in Insurance Funds

Condition: In our review and testing of the investment accounts for two Insurance Funds, Underground Storage Tank Indemnification Fund (USTIF) and Workers Compensation Security Trust Fund (WCSTF), we noted overall internal control weaknesses in the process of accounting for long-term investments managed by the Insurance Department in the SAP accounting system.

In a meeting with the Central Services Comptroller Office to discuss the accounting treatment for long-term investments using the SAP accounting software, we determined that investment sales, purchases, and income are recorded on a cash basis during the year based on advises from Mellon Bank (the custodian bank). However, regular reconciliations are not performed between the accounting records and the Mellon Bank statements. The long-term investment balances were not reviewed periodically to determine if they were reasonable and unusual transactions were not investigated on a regular basis. We noted that there were three credits to the USTIF investment income fund, totaling $88 million, in the fall of 2002 that had not been investigated or adjusted by the accountant until the GAAP template was being prepared. In addition, a number of transactions posted by ImaginePA staff to the investment accounts were not investigated to determine the purpose or effect of the adjustments on the investment balances. We also noted that a number of duplicate transactions were posted to the WCSTF investment account. These transactions were not adjusted until September 2003.

Criteria: Strong internal controls should ensure that the investment income accounts and balances are reconciled monthly to the custodian bank's records and that unusual investment balances and transactions are investigated and resolved promptly. Such procedures are an essential component in a system of internal control designed to safeguard the funds' assets, as well as to provide useful and timely information about the investment accounts.

Cause: Central Services Comptroller staff do not perform regular reconciliations of investment accounts and investigate unusual balances or transactions for propriety.

Effect: The effect was that the fund's accounting records did not accurately report the correct investment balances during the year and that numerous adjustments were required in order to correctly report year-end balances. In the case of USTIF, an agency fund, many of the adjustments were posted to the investment income account. Although this account is not reported because USTIF is an agency fund, the effect of the adjustments on the investment income account was a material understatement of investment income in the accounting records (as compared to the custodian bank records). These errors will continue in the future if internal controls are not strengthened.

Recommendation: We recommend that written procedures be developed and put in place to ensure that investment balances are reconciled periodically and that unusual transactions are investigated and adjusted on a timely basis throughout the year.

Agency Response: The Central Services Comptroller Office is reviewing its methodologies for the processing of long-term investments for the USTIF and WCSTF funds managed by Mellon Bank. A detailed analysis of the reports received from Mellon Bank is being performed to ensure that an accurate reconciliation of the investments is completed each month. Detailed procedures will be developed and implemented going forward to assure that the long-term investments are correctly reflected in the SAP accounting system.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this comment, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Index to Federal Award Findings and Questioned Costs
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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-1**	10.550	Food Donation Program	Internal Control Weaknesses and Noncompliance With Processor Recordkeeping and Reporting Requirements Result in Questioned Costs of $8,278,102 (A Similar Condition Was Noted in Prior Year Finding #02-1)	$8,278,102	AGRI	**177**	290
03-2**	10.551 93.558 93.575 93.596 93.778	Food Stamps Temporary Assistance for Needy Families Child Care and Development Block Grant Child Care Mandatory and Matching Funds Medical Assistance	Internal Control Weaknesses at DPW Result in Noncompliance With Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #02-02)		DPW	**182**	298
03-3*	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance and Internal Control Weaknesses in DOH Systems Result in at Least $36,015 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-3)	$36,015	DOH	**186**	294
03-4**	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance in DOH Preparation of the WIC Financial Management and Participation FNS-798 Report Results in $4,490,772 in Questioned Costs	$4,490,772	DOH	**189**	294
03-5*	14.239	HOME Investment Partnerships Program	DCED Did Not Perform Adequate Monitoring of Community Housing Development Organization Operating Grants (A Similar Condition Was Noted in Prior Year Finding #02-7)		DCED	**192**	291
03-6**	17.207 17.225 17.245 17.801 17.804	Employment Service Unemployment Insurance Trade Adjustment Assistance – Workers Disabled Veterans Outreach Program Local Veterans Employment Rep Program	Noncompliance and Internal Control Weaknesses in the LECS Comptroller Office System of Cash Management		OB/ LECS	**194**	289
03-7**	17.245	Trade Adjustment Assistance – Workers	Inaccurate Data and Weaknesses in L&I's Controls Over Preparation and Submission of the Trade Act Participant Report to USDOL (A Similar Condition Was Noted in Prior Finding #02-10)		L&I	**197**	294

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-8**	17.245	Trade Adjustment Assistance – Workers	Overpayment of TRA Benefits Resulted in Questioned Costs of $8,392 (A Similar Condition Was Noted in Prior Year Finding #02-11)	$8,392	L&I	**201**	295
03-9**	17.245	Trade Adjustment Assistance – Workers	Lack of Supporting Documentation for Statistical Information on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #02-09)		L&I	**205**	296
03-10**	17.258 17.259 17.260	WIA Adult Program WIA Youth Activities WIA Dislocated Workers	Errors and Inadequate Controls in the WIA Annual Performance Report (A Similar Condition Was Noted in Prior Year Finding #02-13)		L&I	**207**	297
03-11*	66.458 66.468	Clean Water State Revolving Funds Drinking Water State Revolving Funds	Internal Control Weakness Over the Preparation of DEP Quarterly Billings to PENNVEST (A Similar Condition Was Noted in Prior Year Finding #02-15)		DEP	**210**	292
03-12**	66.468	Capitalization Grants for Drinking Water State Revolving Funds	PENNVEST Did Not Comply With Federal Loan Repayment Provision		PENN-VEST	**211**	294
03-13*	66.468	Capitalization Grants for Drinking Water State Revolving Funds	DEP Failed to Provide Documentation to Support Administrative Expenditures Resulting in Questioned Costs of $159,622	$159,622	DEP	**212**	293
03-14*	84.027	Special Education – Grants to States	Noncompliance and Internal Control Weaknesses at DOH Result in $100,606 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-16)	$100,606	DOH	**214**	294
03-15**	84.048	Vocational Education – Basic Grants to States	Inadequate Controls Over PDE's VOC ED Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE (A Similar Condition Was Noted in Prior Year Finding #02-17)		PDE	**217**	291

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-16*	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	$886,728 in Excess Funds Were Drawn Down from USDE in Violation of Federal Cash Management Regulations (A Similar Condition Was Noted in Prior Year Finding #02-19)		OB/ LECS	**221**	290
03-17*	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	A Weakness Exists in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #02-18)		L&I	**223**	297
03-18**	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	Noncompliance and Weaknesses in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding #02-20)		L&I	**225**	297
03-19**	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	Internal Control Weakness Over Preparation and Submission of Vocational Rehabilitation Provider Claim Forms to SSA (A Similar Condition Was Noted in Prior Year Finding #02-21)		L&I	**227**	297
03-20**	93.558	Temporary Assistance for Needy Families	Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #02-23)		DPW	**229**	299
03-21**	93.558	Temporary Assistance for Needy Families	Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #02-24)		DPW	**231**	299
03-22**	93.563	Child Support Enforcement	Noncompliance and Internal Control Weakness Over the Processing of Interstate Registry Cases (A Similar Condition Was Noted in Prior Year Finding #02-25)		DPW	**238**	299
03-23*	93.575 93.596	Child Care and Development Block Grant Child Care Mandatory and Matching Funds	Internal Control Weaknesses and Noncompliance With Federal Earmarking Requirements Result in Questioned Costs of $3,224,570 (A Similar Condition Was Noted in Prior Year Finding #02-27)	$3,224,570	DPW	**243**	299

CAP - Corrective Action Plan
*   - Reportable Condition
** - Material Weakness

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-24**	93.575 93.596 93.667	Child Care and Development Block Grant Child Care Mandatory and Matching Funds Social Services Block Grant	Weaknesses in DPW Monitoring of Subgrantees Results in Over $7 Million in Excess Subgrantee Federal Cash at June 30, 2003 (A Similar Condition Was Noted in Prior Year Finding #02-26)		DPW	**245**	300
03-25*	93.767	State Children's Insurance Program	Internal Control Weaknesses in Federal Reporting and State Matching Procedures (A Similar Condition Was Noted in Prior Year Finding #02-29)		OB/CS	**248**	290
03-26*	14.228 14.239	Community Development Block Grant HOME Investment Partnerships Program	An Internal Control Weakness Exists in DCED's Subrecipient Audit Resolution Process		DCED	**251**	291
03-27*	20.205 23.003	Highway Planning and Construction Appalachian Development Highway Syste	An Internal Control Weakness Exists in PADOT's Subrecipient Audit Resolution Process		PADOT	**253**	300
03-28**	10.561 17.258 17.259 17.260 93.558	State Administrative Matching Grants – Food Stamp Program WIA Adult Program WIA Youth Activities WIA Dislocated Workers Temporary Assistance for Needy Families	Noncompliance With OMB Circular A-133 Subrecipient Audit Requirements (A Similar Condition Was Noted in Prior Year Finding #02-34)		L&I	**255**	297
03-29**	Various	All Major Programs Covered by CMIA	The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #02-36)		OB/BFM	**258**	290
03-30*	93.558 93.767 93.778 Various	Temporary Assistance for Needy Families State Children's Insurance Program Medical Assistance All Major Programs Covered by CMIA	The CMIA Interest Liability Was Understated by at Least $1,218,014 (A Similar Condition Was Noted in Prior Year Finding #02-37)		OB/BFM	**262**	290
			Total Questioned Costs	$16,298,079			

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

Finding 03 – 1:

CFDA #10.550 – Food Donation Program

Internal Control Weaknesses and Noncompliance With Processor Recordkeeping and Reporting Requirements Result in Questioned Costs of $8,278,102 (A Similar Condition Was Noted in Prior Year Finding #02-1)

Condition: As part of the FD Program, the Bureau of Food Distribution (BFD) enters into contracts with processors to convert certain donated commodities into end products. These end products are then distributed by the processors to eligible recipient agencies. BFD uses monthly reports from the processors to record distributions of donated commodities used in end products by individual recipient agency for the year. The total processor distributions to all recipient agencies recorded on BFD's system and reported by BFD on the June 30, 2003 SEFA was $8,278,102.

In our prior year audit, our testwork revealed questioned costs and a major weakness in BFD's system used to accumulate and report inventory information from the processors monthly performance reports. Our follow up and testwork for the current year disclosed that this same weakness remained throughout our audit period. In particular, our testing of BFD's system used to account and report for the processing of donated commodities revealed the following:

- In order to test the accuracy of the processor distributions reported by BFD for the current year, we selected a sample of 15 recipient agencies receiving end products from processors. We then selected one donated commodity for each recipient agency and attempted to support BFD's recording of the total pounds of donated commodity for FY 2003 that were used in the production of the end product distributed to the recipient agency. However, BFD did not provide documentation to support the allowability of any of the distributions reported by BFD for our sample of recipient agencies. Additionally, we were unable to perform any alternate procedures, as was done in the prior year, to verify the distributions were allowable. As a result of this 100 percent error rate, the entire amount of processor distributions reported by BFD on the current year SEFA of $8,278,102 is unsupported due to the lack of an audit trail and is questioned.

- We also selected a sample of 40 recipient agencies in order to determine if the agencies were eligible to participate in the FD Program. For one of the agencies in our sample (Harrisburg Academy), we noted that BFD reported $605 in processor distributions to the agency even though the agency was ineligible to receive donated commodities. This agency had been terminated from the National School Lunch Program in August 2002, making the agency ineligible to participate in the FD Program, but BFD reported a distribution of end products to the agency in October 2002 and a distribution in March 2003. While all processor distributions of $8,278,102 for the current year are already questioned as noted above, $605 included in this questioned processor total is further questioned for this ineligible recipient.

- During our testing and reconciliation of BFD's detail list of distributions by recipient agency to the SEFA, we noted an anomaly in that BFD reported $23,198 in processor distributions for the year under audit to a charitable institution, two summer camps and a day care institution. In response to our inquiries, BFD informed us that these types of agencies did not actually receive distributions from processors and therefore these distributions were not accurately reported. While all processor distributions for the current year are questioned as noted above, $23,198 included in the questioned processor total is further questioned in connection with this improper supporting documentation.

- We requested a roll-forward of the inventory of donated foods balance for each processor under contract with BFD from July 1, 2002 through June 30, 2003. However, consistent with prior year, BFD was unable to provide us with this rollforward. As a result, FD distributions on the SEFA could not be corroborated with beginning and ending inventory records.

We also noted, as in the prior year, that BFD did not have a system in place for the performance of on-site monitoring of its in-state processors and did not perform any monitoring of these processors for the year under audit. Federal regulations require that BFD perform on-site monitoring of at least 50 percent of its in-state processors each year.

Finding 03 – 1: (continued)

<u>Criteria</u>: 7 CFR, Part 250.16 (a) regarding maintenance of records, states, in part:

(a) General requirements. (1) Accurate and complete records shall be maintained with respect to the receipt, distribution/use and inventory of donated foods including:

(i) End products processed from donated foods. . .

7 CFR, Part 250.13 regarding processor reporting states:

m. Performance reports. (1) Processors shall be required to submit to distributing agencies monthly reports of performance under each processing contract with year to date totals. . . . The report shall include:

(i) A list of all recipient agencies purchasing end products under the contract;
(ii) Donated-food inventory at the beginning of the reporting period;
(iii) Amount of donated foods received during the reporting period;
(iv) Amount of donated foods transferred to and /or from existing inventories;
(v) Number of units approved end products delivered to each eligible recipient agency during the reporting period and the number of pounds of each donated food represented by these delivered products;
(vi) Donated food inventory at the end of the reporting period.

o. Processing inventory reports. (1) Distributing agencies shall forward to the FNS Regional Office the inventory summary portion of the monthly performance report submitted by the processor in accordance with paragraph (m) (1) of this section for the last month of each fiscal quarter.

OMB Circular A-87, Attachment A, Section C.1., regarding the factors affecting allowability of costs states in part:

j. Be adequately documented.

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in Section ___.510 states in part:

(a) <u>Audit findings reported</u>. The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

(3) Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. . . . In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than $10,000 for a type of compliance requirement for a major program. . .

7 CFR, Part 250.48 regarding eligibility states in part:

(a) Distribution. (1) School food authorities which participate in the National School Lunch Program or as commodity schools under part 210 of this chapter or the School Breakfast Program under part 220 of this chapter are eligible to receive donated foods. The distributing agency shall distribute donated foods only to those school food authorities whose eligibility for participation in the program has been confirmed in writing by the State agency or FNSRO administering the applicable program.

Finding 03 – 1: (continued)

7 CFR, Part 250.19 pertains to review systems required to be established by distributing agencies and states, in part:

(b) Responsibilities of distributing agencies. (1) Each distributing agency shall establish review procedures encompassing eligibility, food ordering procedures, storage practices, inventory controls, reporting and recordkeeping requirements and compliance with nondiscrimination provisions. The procedures shall include:

iii. An on-site review at least once every 2 years of all processors except those that are multi-State processors as defined in 250.3, with no fewer than 50 percent being reviewed each year.

Cause: In response to our prior year finding, BFD had planned to implement a new software system during the year under audit whereby activity would have been electronically transmitted to BFD by the processors in a standard reporting format and downloaded to BFD's system. However, BFD had major changes in staffing and major problems with the software implementation. As a result, there was no standard reporting format for the processor data submitted for the year under audit and the data was entered manually, with inadequate supervisory review. BFD indicated that the new software system was fully implemented and operational for fiscal year 2004 but, in the meantime, failed to provide the documentation from its old system for fiscal year 2003 for us to audit.

With respect to the distributions to the Harrisburg Academy, BFD indicated that the distribution in October 2002 was made to the school since the processor apparently had not been notified of the agency's termination from the program. The distribution in March 2003 was actually shipped to another school but the agency code on the processor's report was inaccurate. It should be noted that BFD reports the distributions based on the agency codes on the processors' monthly reports. However, BFD did not detect the ineligible agency code for either of these distributions during the data entry process. BFD also stated that the inaccurate reporting of processor distributions to the charitable institution, summer camps and day care cited in the condition was a result of data entry errors that were not detected by BFD.

Regarding the on-site monitoring of in-state processors, BFD informed us that the lack of monitoring was due to a shortage of staff and that BFD started to perform on-site monitoring during fiscal year 2004.

Effect: BFD did not provide adequate documentation to support the allowability of processor distributions for our sample of recipient agencies. Based on the lack of supporting documentation for our sample testwork and since we were unable to perform any alternate procedures to support the allowability of the distributions reported by BFD, including the inability of BFD to provide a rollforward of the inventory balances at the processors, the total processor distributions reported by BFD on the SEFA of $8,278,102 are questioned. Additionally, there is no assurance that the subrecipient information provided to OB-BOA to track subrecipient audit submission is accurate.

Further, BFD did not have an adequate system in place during the year under audit for the accumulation and reporting of inventory information from the processors monthly reports, including the preparation and submission of accurate Quarterly Processor Reports to FNS. Further, BFD did not perform any on-site monitoring of its in-state processors. As a result, BFD has little assurance that processors are complying with program requirements. Additionally, there is a lack of segregation of duties with respect to the processor recordkeeping and reporting by BFD.

Recommendation: We recommend that BFD pursue appropriate settlement of the $8,278,102 in questioned costs with FNS.

As mentioned above, BFD informed us that they implemented a new system for fiscal year 2004 that eliminates the manual entry of processors' monthly activity. Accordingly, we recommend that BFD ensure that adequate supervisory review procedures are in place under this new system to verify the accuracy of the processor information reported on BFD's system and in the quarterly reports provided to FNS. Additionally, BFD also indicated that they are performing monitoring of in-state processors in fiscal year 2004. As a result, we recommend that BFD ensure that their procedures are adequate and supporting documentation is maintained to comply with federal requirements.

Finding 03 – 1: (continued)

Agency Response: BFD agrees with the Audit Finding that indicates its data collection procedures for its USDA commodity-processing program for the year of the Audit (FYE June 30, 2003) were flawed. It therefore stipulates that the data collection procedures diminished the level of confidence in the final processing figures submitted to subrecipients. The manual entry of data from 65+ processors under agreement, which the existing data collection system required, inevitably resulted in data entry errors when measured against the thousands of transactions entered each month.

However, BFD does not believe the volume of data entry errors was sufficient to warrant the conclusion that the full value of processed commodity be viewed as "Questioned Costs," and for several reasons.

First, processors with the highest number of transactions, where data entry errors were most likely to have occurred, involved the USDA commodity of the lowest value: flour; where a data entry error affecting pounds of flour received has nominal cash value.

Second, BFD's primary data collection function has been fully privatized with contract commercial distributors and commercial processors for the last seventeen years. Commercial distributors track USDA commodity received and delivered to each RA, and processors track the receipt, processing, and delivery of USDA commodity to each RA.

In previous program years, the value of processed commodity reported by BFD was relatively constant. In each of those years, most of the active processors made up the same group of processors under contract for the year of the audit in question; and most of those processors are identified as "multi-state" processors. As multi-state processors, each was subject by regulation to an annual audit by Certified Public Accountants (CPAs). For no less than the five previous years, not one CPA audit revealed any significant discrepancy with its USDA commodity processing activity.

Furthermore, most RAs receiving processed USDA commodity under BFD's commodity processing program are also subject by regulation to annual audit, and none of those audits have identified any significant discrepancies with regard to USDA commodity received, either through commodity processing or through BFD's contract distributors. Therefore, BFD believes it is unfair to conclude, as the audit finding does, that the full value of processing reported by BFD represents "Questioned Costs."

Nevertheless, BFD accepts the basic thrust of the Finding and acknowledged prior to the conclusion of the program year in question (FYE June 30, 2003) that improvements in its data collection procedures were needed. To that end, BFD has fully automated its data collection procedures for processors. Monthly activity reports are received electronically, eliminating the manual entry of data on monthly processing activity; a system that is virtually paperless.

When questions arise about specific transactions, documentation can be requested from the keeper of the "primary" source - each processor. However, BFD is developing procedures to involve its field staff in the periodic "testing" of processor monthly activity. Transactions will be randomly selected, documentation secured from the identified processor, and receipts verified by on-sight reviews by BFD field staff. Those procedures, when fully implemented and when coupled with the required CPA audits of processors and the subsequent audits of affected RAs, should dramatically improve the reliability of BFD's data collection and reporting procedures.

Auditors' Conclusion: With respect to our decision to question the full value of processing distributions reported on the SEFA, BFD did not provide documentation to support the allowability of processor distributions for our sample of recipient agencies. Since there was no audit trail, we were unable to determine the extent of data entry errors in our sample testwork, and what commodities were affected by such errors. As a result, a projection of such errors over the population of processor distributions could not be performed. Such a projection could have resulted in a proportion of the processor distributions being questioned as opposed to the entire amount reported by BFD.

Finding 03 – 1: (continued)

We acknowledge that the multi-state processors and majority of recipient agencies are subject to annual independent audits. However, these audits do not absolve the Commonwealth from complying with the allowable cost provisions contained in OMB Circular A-87, including the requirement that costs be adequately documented.

Regarding the remaining disclosures in the finding, any corrective action will be reviewed in our subsequent audit. Accordingly, the finding and recommendation remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 2:

CFDA #10.551 – Food Stamps
CFDA #93.558 – Temporary Assistance for Needy Families
CFDA #93.575 – Child Care and Development Block Grant
CFDA #93.596 – Child Care Mandatory and Matching Funds of the Child Care and Development Fund
CFDA #93.778 – Medical Assistance

Internal Control Weaknesses at DPW Result in Noncompliance With Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #02-02)

Condition: In connection with our audit of the TANF and FS Programs, we reviewed reports issued by other auditors during our audit period in order to determine if the reports had any impact on the programs. Based on our review, we noted that another bureau within the Department of the Auditor General performed separate audits of certain DPW County Assistance Offices (CAOs) in order to determine if public assistance payments for the TANF and FS programs were made only to eligible recipients. Based on our review of these individual CAO audit reports issued during our audit period (which covered various prior audit periods up through June 30, 2003), we noted that the other auditors identified internal control weaknesses which are systemic in nature when evaluated on a statewide basis.

Our review of these other auditor reports and discussions with the other auditors indicated the following:

- The CAO caseworkers are not properly completing or including certain forms required by DPW's Cash Assistance Handbook to support eligibility determinations in the case records. The other auditors did not report the specific eligibility forms that were incomplete or missing; they indicated that completed forms were not on file, so weaknesses exist over CAO support for eligibility determinations.

- The CAO caseworkers do not adequately monitor recipient compliance with court-ordered payment plans for fines, costs and/or restitution. Per state law (Act 1996-35) and DPW's Cash Assistance Handbook, recipients that are not in compliance with the payment plans are not eligible to receive public assistance benefits.

- The CAO caseworkers are not entering or are incorrectly entering the recipients' and legally responsible relatives' social security numbers in case records. Additionally, the caseworkers also are not entering the recipients' or legally responsible relatives' social security numbers in the State's Client Information System and/or the Income Eligibility and Verification System.

- The CAO caseworkers are entering the incorrect codes into DPW's Automated Restitution Referral and Computation (ARRC) System, which is used to track and recover overpayments. In most cases, the improper coding stops the system's processing of an overpayment and refunding these overpayments to HHS. Additionally, the CAO caseworkers are not following the procedures relative to investigating suspected overpayments, controlling and documenting investigations, and referring verified overpayments timely.

- The CAO caseworkers are not following DPW childcare regulations regarding unregulated providers. Specifically, CAO personnel did not properly review childcare provider verification forms, did not verify the amounts actually paid by the recipients to the providers, did not verify the hours of childcare actually needed, and did not verify that childcare was provided by the person listed as the provider.

- The State has established and implemented an Income Eligibility and Verification System (IEVS), which is used for coordinating data exchanges with other federally assisted benefit programs. The CAO caseworkers are required to access this information and compare the information against the case file when making eligibility determinations. However, the CAO caseworkers are not reconciling the information in IEVS to the income information in the case file and are not verifying or failing to document verification of the information in IEVS with third parties. Additionally, the caseworkers are not using IEVS on eligibility re-determinations.

Finding 03 – 2: (continued)

- System deficiencies in DPW's ARRC system resulted in unprocessed or incorrectly processed overpayments which were not detected or properly followed up on at the CAOs. This system performs calculations to compute cash overpayments and food stamp over-issuances and is designed to track potential overpayments from the point of discovery through the verification/claim calculation process to automated transfer of the claim to the Commonwealth's OIG. The deficiency cited most frequently in the reports related to the ARRC's 24-month calculation limit that causes overpayments and/or over-issuances occurring more than two years prior to the current date to be computed as zero, and therefore ignored with no follow up.

In analyzing the above results, we noted that the internal control weaknesses which led to these errors would also impact eligibility determinations in the Medical Assistance Program. Additionally, the weakness relative to the caseworkers not following DPW childcare regulations would impact the allowability and eligibility of payments in the Child Care Cluster.

Criteria: Cash Assistance Handbook Section 104.3, "Screening Interview," provides instructions to the caseworkers on assisting the applicant in completing the application (PA 600) for public assistance and states in part:

1. *Explain that every question on the PA 600 must be answered.*

4. *Determine what information needs to be verified and explain what is needed to verify the information.*

Cash Assistance Handbook, Section 104.42, "Responsibilities of the County Assistance Office," provides instructions to the caseworkers on the application process and eligibility determination process and states in part:

6. *Ensure that each applicant has a social security number (SSN).*

Cash Assistance Handbook Section 178.1, "General Policy," states in part:

The CAO will verify conditions of eligibility, need, income, and resource items at application. The CAO will verify income, resources, and any other eligibility factors which are subject to change at redetermination.

Sources of verification include:

Written evidence;
Public records;
Collateral contracts;
Automated sources; and
Other means which will establish the truth of the client's statement.

DPW regulations and Act 1996-35 state:

Assistance may not be granted to any person who has been sentenced for a felony or misdemeanor offense and who has not otherwise satisfied the penalty imposed on that person by law….

Additionally, Cash Assistance Handbook, Section 104, "Application," Appendix B-1, "Procedure for Criminal History Inquiry," states in part:

An answer to any question which indicates he is on probation or parole and has either not paid all fines, costs and restitution or is not in compliance with an approved payment plan, will result in ineligibility.

Cash Assistance Handbook, Section 183.6, "Authorizing the Childcare Payment" states:

When authorizing a childcare allowance the CAO will:

Finding 03 – 2: (continued)

- *Determine the actual cost of childcare for each eligible child in the budget group. Do a separate calculation for each child.*

- *Verify the childcare costs by using PA 1591 or PA 1583 which has been signed by the childcare provider.*

The DPW Supplemental Handbook (SH), Chapter 910, "Restitution and Disqualification," Section 910.1 "General Policy," states:

An overpayment exists when a client receives assistance for which he is ineligible.
The DPW is responsible by law to identify overpayments and recover overpayments from clients.

In addition, OMB Circular A-133 - Subpart C.300 (b) provides that the auditee shall:

Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.

Cause: The CAO caseworkers are not following established DPW policies and procedures for maintaining case records and processing information obtained from recipients and collateral sources. Based on our discussions with the other auditors, the errors are the result of caseworkers not being adequately trained and supervised in the performance of their duties.

With regard to the monitoring of compliance with court-ordered payment plans, state law and the Cash Assistance Handbook require the caseworkers to verify compliance with court-ordered payment plans. This occurs at the initial application and at eligibility re-determinations. Since the re-determinations are typically at either a six or twelve-month interval, some recipients make a court-ordered payment at the initial application and at eligibility re-determinations but not during the intervening months. The CAO interprets this as being in compliance and authorizes benefits for months in which no court-ordered payments are made. We further noted that, in the Philadelphia metropolitan area, where by far the largest federal program payments are made, there is little or no enforcement of Act 1996-35 or DPW's Cash Assistance Handbook requiring adherence to court-ordered payment plans to ensure continuing client eligibility.

Regarding DPW's AARC system, DPW has not addressed the system deficiencies and does not have any manual compensating controls at the CAOs in place to ensure that the overpayments and over-issuances are processed accurately and completely.

Effect: Due to the control weakness identified above, there is limited assurance that DPW's eligibility determinations and related benefit payments are being made in accordance with federal regulations and that overpayments and over-issuances are being processed by DPW accurately and completely.

Recommendation: We recommend that, in order to correct the internal control weaknesses identified in the condition above, DPW ensure the CAO caseworkers receive additional training and are more thoroughly supervised to follow established DPW policies and procedures regarding eligibility determinations and re-determinations. We also recommend that DPW and its CAOs strengthen procedures to ensure DPW's compliance with Act 1996-35 and ensure recipient compliance with court-ordered payment plans. Further, we recommend that DPW enhance or develop procedures to ensure that overpayments and over-issuances are processed completely and accurately.

Agency Response: The Office of Income Maintenance (OIM) concurs with these three audit findings that identify the need for: the DPW to ensure the CAO caseworkers receive additional training and are more thoroughly supervised; DPW and its CAOs strengthen procedures to ensure DPW's compliance with Act 1996-35 and recipient compliance with court-ordered payment plans; and DPW to enhance or develop procedures to ensure that overpayments and over-issuances are processed completely and accurately.

Finding 03 – 2: (continued)

In reference to the first recommendation for CAO caseworker training and supervision, OIM ensures that the CAO caseworkers receive additional training by utilizing the availability of e-learning modules that are offered through Staff Development. Staff now has easy access to current information. Supervisors conduct periodic Comprehensive Supervisory Reviews and Targeted Supervisory Reviews to make sure the staff are following established DPW policies and procedures regarding determining eligibility and re-determinations. These periodic reviews are done on an ongoing basis.

Secondly, in order to strengthen procedures to ensure compliance with Act 1996-35 and ensure recipient compliance with court-ordered payment plans, OIM uses the IEVS "Exchange 10" for communication with local courts and other authorities and the exchange of information. IEVS Exchange 10 screens have recently been revised to make it easier for the user to interpret the information on the screens.

OIM also agrees with the third recommendation to enhance or develop procedures to ensure that overpayments and over-issuances are processed completely and accurately. OIM has recently changed the process to verify information from employers who participate in the Work Number Verification Service. In addition to the CAOs having access to the Work Number web site, we are currently reviewing the process statewide to enhance other procedures relating to overpayments. The Automated Restitution Referral and Computation Procedures releases and all other applicable regulations pertaining to overpayments are reviewed with IM caseworkers on a regular basis. The IM caseworkers have been advised of the necessity to comply with the requirements to ensure that overpayments and overissuances are processed completely and accurately.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 3:

CFDA #10.557 – Special Supplemental Nutrition Program For Women, Infants, and Children

Noncompliance and Internal Control Weaknesses in DOH Systems Result in at Least $36,015 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding # 02-3)

Condition: Our review and testing of DOH's systems for food instrument (FI) redemption and FI disposition revealed that WIC personnel rely primarily on the Commonwealth's Health Data Center computerized system for internal controls over these areas. However, our reviews of controls over the administration of the WIC Program have found that manual controls over the computerized outputs from this system are inadequate. In addition, on March 11, 2002, DOH implemented a new WIC database system, which converted their old legacy mainframe system to a network based system, thereby increasing the significance of the control weaknesses in the system.

In particular, our testing of Redeemed Food Instruments (RFIs) and FI disposition revealed unresolved discrepancies with the FI data in WIC's database system as follows.

- **Food Instrument Redemption.** As part of our review of FI redemptions, we selected a sample of ten days to test during SFYE June 30, 2003. For each sampled day, we compared the total amount from the SAP reimbursement to the bank for the day to the total FIs recorded in DOH's WIC database system as redeemed for that day. Our testing disclosed that for the ten days tested, $17,395 in total payments were made without supporting RFIs recorded on the database, or an average of $1,740 in unsupported overpayments per day.

  WIC management stated that the above differences are accounted for on RFI Monthly Error Reports which include FI numbers that do not match records on the system, voided FIs, redeemed FIs, and FIs with invalid check digits. However, WIC stated that during SFYE June 30, 2003 these error reports were not reviewed to ensure that the RFIs are validly redeemed.

  In addition, FIs that are redeemed and paid but listed as "voided" on WIC's database are reported on the Redeemed/Voided FI Monthly Report, and need further investigation to ensure the payments were allowable. However, WIC personnel stated that this report is not reviewed to ensure that these FIs are valid. Furthermore, DOH could not provide the Redeemed/Voided FI Monthly Report for November 2002. For the 11 other monthly reports for SFYE June 30, 2003, we found $18,620 in redeemed but voided FIs. Since no investigation of these voided RFIs was performed, the entire $18,620 is considered unallowable, and an undetermined amount is unallowable for November 2002.

- **Food Instrument Disposition.** A state agency must account for the disposition of all FIs within 150 days of the FIs' first valid date for participant use. The state agency must identify all FIs as either issued or voided and identify issued FIs as either redeemed or unredeemed. Redeemed FIs must be identified as either validly issued, lost or stolen, expired, duplicate, or not matching valid enrollment and issuance records. In order to comply with this requirement, WIC relies on computer generated reports mentioned above – RFI Error Monthly Reports, Redeemed/Voided or Lost or Stolen FI Monthly Reports. However, as stated above, WIC is not reviewing these reports or respective FIs for accuracy and propriety. Also, since implementation of the QuickWIC computer system in March 2002, DOH could not provide documentation showing that the disposition of all FIs was accounted for within 150 days of the FIs' first valid date for participant use since the reports mentioned above contained no summary data and include only checks with errors, voids, lost, or stolen.

Criteria: Regarding Food delivery systems, 7 CFR 246.12(a) states:

(1) *Management. The State agency is responsible for the fiscal management of, and accountability for, food delivery systems under its jurisdiction.*

Finding 03 – 3: (continued)

Regarding Food Instrument redemptions and disposition, 7 CFR 246.12(q) states:

(q) Food instrument disposition. The State agency must account for the disposition of all food instruments as either issued or voided, and as either redeemed or unredeemed. Redeemed food instruments must be identified as validly issued, lost, stolen, expired, duplicate, or not matching valid enrollment and issuance records. In an EBT system, evidence of matching redeemed food instruments to valid enrollment and issuance records may be satisfied through the linking of the Primary Account Number (PAN) associated with the electronic transaction to valid enrollment and issuance records. This process must be performed within 150 days of the first valid date for participant use of the food instruments and must be conducted in accordance with the financial management requirements of Sec. 246.13. The State agency will be subject to claims as outlined in Sec. 246.23(a)(4) for redeemed food instruments that do not meet the conditions established in paragraph (q) of this section.

Further, 7 CFR 246.13 states the following pertaining to financial management systems:

(a) Disclosure of expenditures. The State agency shall maintain a financial management system which provides accurate, current and complete disclosure of the financial status of the Program. This shall include an accounting for all . . . Program funds received and expended each fiscal year.

(b) Internal control. The State agency shall maintain effective control over and accountability for all Program grants and funds. The State agency must have effective internal controls to ensure that expenditures financed with Program funds are authorized and properly chargeable to the Program.

(c) Record of expenditures. The State agency shall maintain records which adequately identify the source and use of funds expended for Program activities. These records shall contain, but are not limited to, information pertaining to authorization, receipt of funds, obligations, unobligated balances, assets, liabilities, outlays, and income.

Recordkeeping requirements are specified in 7 CFR 246.25:

(a) Recordkeeping requirements. Each State and local agency shall maintain full and complete records concerning Program operations. Such records shall comply with 7 CFR part 3016 and the following requirements:

(1) Records shall include, but not be limited to, information pertaining to financial operations . . . food instrument issuance and redemption . . .

(2) All records shall be retained for a minimum of three years following the date of submission of the final expenditure report for the period to which the report pertains. If any litigation, claim, negotiation, audit or other action involving the records has been started before the end of the three-year period, the records shall be kept until all issues are resolved, or until the end of the regular three-year period, whichever is later.

OMB Circular A-87, *Cost Principles for State and Local Governments*, Attachment A, Section C.1 states that to be allowable, a cost must meet the following general criteria:

(a) Be necessary and reasonable for proper and efficient performance and administration of Federal awards. . . .
(d) Conform to any limitations or exclusions set forth in these principles, Federal laws, terms and conditions of the Federal award, or other governing regulations as to types or amounts of cost items. . . .
(i) Be the net of all applicable credits.
(j) Be adequately documented.

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in Section ___.510 states in part:

Finding 03 – 3: (continued)

(a) <u>Audit findings reported</u>. The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

(4) Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. . . .

<u>Cause</u>: In regard to FI redemption, WIC personnel stated that for SFYE June 30, 2003 the RFI Monthly Error Reports and Redeemed/Voided FI Monthly Reports were not reviewed to ensure that the RFIs were validly redeemed. In response to prior year Finding Number 02-3, DOH notified USDA that they will implement procedures to review these reports beginning April 2004. We will review these procedures and evaluate for adequacy during our subsequent year audit.

In regard to FI disposition, DOH relies on the WIC computer system to report FIs as issued or voided, issued FIs as redeemed or unredeemed, and redeemed FIs as validly issued, lost or stolen, expired, duplicate, or not matching issuance records. However, WIC has no manual controls to review these computer generated reports or to reconcile all FIs within 150 days of the first valid date for participant use.

<u>Effect</u>: We question $17,395 in unallowable WIC payments which are not supported by the WIC database redemption files, and we question $18,620 in paid but voided RFIs on WIC's system which have not been properly investigated and are, therefore, unallowable. We also question an unknown amount for the month of November 2002 for which the Redeemed/Voided FI Monthly Report was not provided. Total questioned costs are at least $36,015. In addition, without adequate controls, food instruments can be inappropriately redeemed without DOH's knowledge which could lead to unallowable costs being charged to the federal WIC grants.

<u>Recommendation</u>: DOH should pursue appropriate settlement of the $36,015 in questioned costs with FNS, and review its WIC system for additional questioned costs due to the discrepancies identified above. We also recommend that WIC implement sufficient controls over the FI redemption and disposition process. DOH should ensure that problems encountered with the QuickWIC computer database system are identified, timely followed up on, and properly corrected.

<u>Agency Response</u>: It is important to note there were no FIs that were posted to the accounting system that were not appropriately produced and processed through DOH's banking contractor. The questioned discrepancy was identified on the daily FI error reports (with the exception of possible errors for November of 2002). USDA agreed with DOH's resolution to the prior year finding which was identical in nature. In that resolution DOH agreed to start reviewing these reports by April of 2004. This was done and DOH is now in compliance.

<u>Auditors' Conclusion</u>: Since DOH personnel did not review FI error reports during SFYE June 30, 2003, DOH cannot support and we cannot determine that no FIs were inappropriately produced or processed. As a result, based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 4:

CFDA #10.557 – Special Supplemental Nutrition Program For Women, Infants, and Children

Noncompliance in DOH Preparation of the WIC Financial Management and Participation FNS-798 Report Results in $4,490,772 in Questioned Costs

Condition: Our review and testing of the WIC Financial Management and Participation FNS-798 Closeout Report for Federal fiscal year ended September 30, 2002, submitted to FNS in March of 2003, revealed that amounts reported for the Net Federal Food Outlays Line 12 and the Year-to-Date NSA Net Federal Outlays Line 26 do not agree to DOH's SAP grant accounting records for the FFY 2002 Grant as follows:

Net Federal Food Outlays Line 12:

As reported on the FFY 2002 FNS-798 Closeout Report	$89,899,794
SAP Grant Accounting for the FFY 2002 WIC Grant	85,526,436
Difference	$ 4,373,358

Year-to-Date NSA Net Federal Outlays Line 26:

As reported on the FFY 2002 FNS-798 Closeout Report	$34,389,107
SAP Grant Accounting for the FFY 2002 WIC Grant	34,271,693
Difference	$ 117,414

The amounts we utilized from the SAP Grant Accounting System in the above comparisons were as of the end of our current audit period at June 30, 2003.

Criteria: Regarding financial management systems, 7 CFR 246.13 states:

(a) *Disclosure of expenditures. The State agency shall maintain a financial management system which provides accurate, current and complete disclosure of the financial status of the Program. This shall include an accounting for all . . . Program funds received and expended each fiscal year.*

(b) *Internal control. The State agency shall maintain effective control over and accountability for all Program grants and funds. The State agency must have effective internal controls to ensure that expenditures financed with Program funds are authorized and properly chargeable to the Program.*

(c) *Record of expenditures. The State agency shall maintain records which adequately identify the source and use of funds expended for Program activities. These records shall contain, but are not limited to, information pertaining to authorization, receipt of funds, obligations, unobligated balances, assets, liabilities, outlays, and income.*

Closeout procedures requirements are specified in 7 CFR 246.17:

(a) *General. State agencies shall submit preliminary and final closeout reports for each fiscal year. All obligations shall be liquated before closure of a fiscal year grant. Obligations shall be reported for the fiscal year in which they occur.*

(b) *Fiscal year closeout reports. State agencies -*

  (2) *Shall submit to FNS, within 150 days after the end of the of the fiscal year, final fiscal year closeout reports;*

Finding 03 – 4: (continued)

Recordkeeping and Reporting requirements are specified in 7 CFR 246.25:

(a) *Recordkeeping requirements. Each State and local agency shall maintain full and complete records concerning Program operations. Such records shall comply with 7 CFR part 3016 and the following requirements. . .*

(d) *Source documentation. To be acceptable for audit purposes, all financial and Program performance reports shall be tracable to source documentation.*

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in Section ___.510 states in part:

(a) *Audit findings reported. The auditor shall report the following as audit findings in a schedule of findings and questioned costs:*

> (3) *Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. . . .*

Cause: DOH is using sources other than the Commonwealth's SAP accounting system as the basis for their federal reporting and is supposed to make subsequent adjustments to SAP to agree accounting records to the FNS-798 federal report. However, DOH is not subsequently reviewing SAP to ensure that amounts being recorded in SAP Grant Accounting agree to what is reported to FNS.

In regard to the difference in Net Federal Food Outlays, WIC management stated that the majority of this difference is accounted for in the fact that a closeout adjustment was prepared on March 10, 2003 in the amount of $4,370,993 to transfer food expenditures from the FFY 2003 to the FFY 2002 food grant; however, this adjustment was never posted to the Commonwealth's SAP accounting system. The reason that this adjustment was not posted is unknown. In addition, WIC personnel stated per their review of SAP Grant Accounting compared to reported amounts for the FFY 2003 grant, SAP was not greater than amounts reported on the FNS-798, as would be expected if the $4,370,993 was never recorded on SAP to transfer food expenditures from FFY 2003 to FFY 2002. Since the above federal reporting difference could not be adequately explained, and we could not verify that WIC expenditure amounts were accurately reported to FNS, we question costs in the amount of the difference of $4,373,358 between the SAP accounting records and the FNS-798 closeout report.

In regard to the difference in Year-to-Date NSA Net Federal Outlays, WIC management stated that postings continued to be made to the SAP grant accounting records for the FFY 2002 grant after the grant was closed on March 18, 2003. The reason for the net negative amount in postings could not be adequately explained. Therefore, we question costs in the amount of the difference of $117,414 between the SAP accounting records and the FNS-798 closeout report.

Effect: Federal expenditures recorded in the Commonwealth's SAP Grant Accounting system do not agree to, and are less than, amounts reported on DOH's WIC FNS-798 closeout report for FFY 2002. We question the difference of $4,373,358 between the amount reported on the FNS-798 and SAP for Net Federal Food Outlays, and we question the difference of $117,414 for Year-to-Date NSA Net Federal Outlays. Total questioned costs are $4,490,772.

Recommendation: DOH should pursue appropriate settlement of the $4,490,772 in questioned costs with FNS. We also recommend that WIC implement sufficient controls over the preparation of the FNS-798 Report and grant closeout process to ensure that accurate expenditures are reported to FNS which are properly supported by SAP grant accounting records.

Agency Response: DOH will pursue resolution of the questioned costs in this finding with USDA. Also, DOH's Division of WIC will review the SAP grant accounting records and ensure that adjustments are made to them, or prepare a revised FNS-798 to make them equal. DOH's Division of WIC will also implement procedures to ensure the proper posting of adjustments in the future.

Finding 03 – 4: (continued)

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 5:

CFDA #14.239 – HOME Investment Partnerships Program

DCED Did Not Perform Adequate Monitoring of Community Housing Development Organization Operating Grants (A Similar Condition Was Noted in Prior Year Finding #02-7)

Condition: Our review of DCED's subrecipient project close out procedures for the Home Investment Partnerships (HOME) program disclosed that DCED does not perform on-site monitoring for Community Housing Development Organization (CHDO) operating grants. During SFYE June 30, 2003, CHDO operating grants were $492,706, or 3.8 percent of total DCED HOME program expenditures of $13,137,185.

DCED stated that their procedures for reviewing CHDO operating grants include: 1) Review of initial application to ensure all costs are allowable; 2) Review of Fiscal Status Report submitted at contract closeout by the subgrantee to ensure that all costs are recorded as CHDO operating expenditures; and 3) Obtain and review a single audit if required to be submitted by the subgrantee. Effective January 29, 2002, DCED implemented additional procedures which require CHDO's to provide additional documentation which was to be reviewed by DCED for compliance with HOME regulations and eligibility of operating costs. Additional documentation was to include CHDO's total operating costs for the fiscal year, two expenditure invoices each from categories of travel, training, and equipment purchases, and evidence that a housing project is completed or underway. In May 2003, HUD reviewed DCED's CHDO operating grant monitoring procedures and approved the procedures that DCED implemented on January 29, 2002, with the exception that DCED should require CHDOs to submit a complete list of expenditure invoices and DCED should select which invoices are to be reviewed.

We selected one CHDO operating grant, Carlisle Borough Contract #20-190-0004, closed by DCED on May 30, 2003, and confirmed that DCED followed their procedures implemented on January 29, 2002; however, DCED did not require the CHDO to submit a complete list of expenditure invoices for the grant and DCED did not select the invoices reviewed in accordance with HUD's approved procedures.

Criteria: Regarding subrecipient monitoring, 24 CFR Section 92.201(b)(3)

(i) *A State that uses State recipients to perform program functions shall ensure that the State recipient uses HOME funds in accordance with the requirements of this part and other applicable laws. The State may require the State recipient to comply with requirements established by the State or may permit the State recipient to establish its own requirements to comply with this part.*

(ii) *The State shall conduct such reviews and audits of its State recipients as may be necessary or appropriate to determine whether the State recipient has committed and expended the HOME funds in the United States Treasury account as required by §92.500 and has met the requirements of this part, particularly eligible activities, income targeting, affordability, and matching contribution requirements.*

In addition, HUD stated that the CHDO should provide a listing by category, by vendor, by invoice with cost and purpose, and DCED should choose the invoices with supporting documentation to be provided.

Cause: DCED stated since procedures were not approved by HUD until May 2003, DCED followed their procedures implemented on January 29, 2002, which do not require subrecipients to submit entire listing of expenditure invoices and allows CHDOs to submit invoices chosen by the CHDO.

Effect: Since DCED did not require CHDOs to submit a complete list of expenditure invoices and allowed the CHDOs to select the invoices to submit to DCED, HOME funds could be used in violation of regulations or for unallowable activities which would not be detected by DCED.

Recommendation: We recommend that DCED strengthen its monitoring of CHDO operating grants by implementing the procedures approved by HUD in May 2003.

Finding 03 – 5: (continued)

Agency Response: DCED implemented new close-out procedures for CHDO Operating Grants as of January 29, 2002 and did not receive HUD's approval comments and instructions for minor modifications on selection of invoices until May 2003 (16 months after the revised procedures were implemented). During that same period of time, the Carlisle CHDO Operating Grant followed the procedures implemented on January 29, 2002, as was concluded by the audit. The Carlisle CHDO Operating Grant information submitted to DCED was received earlier than HUD's May 2003 modification and approval of DCED's close-out procedures so it was closed without the HUD modified procedures on selection of invoices. Close-outs of CHDO Operating Grants from that point forward have and will continue to implement the revised invoice selection process per HUD's instructions of May 2003.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 6:

CFDA #17.207 – Employment Service
CFDA #17.225 – Unemployment Insurance
CFDA #17.245 – Trade Adjustment Assistance – Workers
CFDA #17.801 – Disabled Veterans Outreach Program
CFDA #17.804 – Local Veterans Employment Rep Program

Noncompliance and Internal Control Weaknesses in the LECS Comptroller Office System of Cash Management

Condition: As part of our testing of federal cash management for the ES Cluster, TAA, and the UI programs, we noted a drawdown control system in the LECS Comptroller Office that was common to these programs. Revenue and expenditure activity was recorded in several different funds on the accounting system, including the 026 Fund for administrative costs and the 064 Fund for benefit payments. In our testing of administrative expenditures under Pennsylvania's 026 Fund, we selected a sample of 5 drawdowns out of a population of 41 draws for the year ended June 30, 2003 under the TAA Program. LECS informed us that TAA draws are based on actual expenditures incurred to date. However, for 2 of the 5 draws in our sample, or 40 percent, LECS violated cash management rules as follows:

- On January 17, 2003, LECS made a draw of $3,450,000 for TAA grant #1703. However, LECS was unable to provide any detail to support the calculation of the amount drawn in violation of cash management regulations. We noted that LECS subsequently returned the entire drawdown to USDOL on February 1, 2003, or 15 days after the funds were improperly drawn.

- On December 6, 2002, LECS made a draw of $1,194,000 for TAA grant #1742, which represented the remaining amount of the $3,059,000 awarded under this grant. However, LECS was unable to provide any detail in support of the amount drawn in violation of cash management regulations. We also noted that, after incurring TAA expenditures subsequent to the drawdown, LECS returned a total of $540,000 of the amount drawn to USDOL on March 28, 2003, or 112 days after the funds were improperly received.

In addition, for federal benefit expenditures under Pennsylvania's 064 Fund, we selected a sample of 10 drawdowns out of a population of 256 draws for the year ended June 30, 2003 under the UI and TAA programs combined. LECS performs drawdowns for the 064 Fund based on an Excel spreadsheet which contains a formula to calculate the draw amount based on various factors including the bank clearance amounts, the previous day's bank balance, etc. However, for 2 of the 10 drawdowns or 20 percent, LECS did not input the appropriate bank balance into the spreadsheet which caused incorrect amounts to be calculated and drawn as follows:

- On January 23, 2003, LECS made a draw of $6,400,000 under the UI program. At the time of the draw, a $0 bank balance was entered in the spreadsheet when the actual bank balance should have been entered as a negative ($3,615,940). Had the correct balance been entered, the draw amount would have been calculated as $12,400,000. As a result, the draw was incorrect by $6,000,000.

- On February 18, 2003, LECS made a draw of $14,500,000 under the UI and TAA programs. At the time of the draw, a $0 bank balance was entered in the spreadsheet when the actual bank balance should have been entered as $17,263,758. Had the correct balance been entered, the draw amount would have been calculated as $14,600,000. As a result, the draw was incorrect by $100,000.

Once LECS obtained the correct bank balances a few days after the draws, they entered the balances into the spreadsheet which then retroactively changed the projected draw/bank deposit amounts for the two dates noted above. Therefore, the projected draw/bank deposit amount on the Excel spreadsheet no longer agreed to the actual amounts drawn and deposited which, in turn, impacted subsequent drawdowns recorded on the spreadsheet and the LECS year-end analysis of interest liability for the 064 Fund. After performing additional analytical review procedures, however, we noted that these 064 Fund errors had no significant impact on the LECS analysis of interest liability for the current year and, since funds were actually underdrawn, did not cause noncompliance with cash management regulations.

Finding 03 – 6: (continued)

However, LECS did not detect any of the above errors at the time the drawdowns were requested since no procedures were in place for review and approval of drawdowns for the 026 or the 064 Funds during the year under audit. It should also be noted that this same internal control weakness impacts the ES Cluster.

Criteria: US Treasury Regulations in 31 CFR 205.33, Subpart B provides the rules applicable to federal assistance programs not included in a Treasury-State Agreement as follows:

(a) A State must minimize the time between the drawdown of Federal funds from the federal government and their disbursement for Federal program purposes. A Federal Program Agency must limit a funds transfer to a State to the minimum amounts needed by the State and must time the disbursement to be in accord with the actual, immediate cash requirements of the State in carrying out a Federal assistance program or project. The timing and amount of funds transfers must be as close as is administratively feasible to a State's actual cash outlay for direct program costs…

(b) Neither a State nor the Federal government will incur an interest liability under this part on the transfer of funds for a Federal assistance program subject to this subpart B.

In addition, US Treasury Regulations in 31 CFR 205.11, Subpart A provides the rules applicable to federal assistance programs included in a Treasury-State Agreement as follows:

(b) A State and a Federal Program Agency must limit the amount of funds transferred to the minimum required to meet a State's actual and immediate cash needs.

The US Treasury-State Agreement, Section 6.2.12, provides the following regarding the funding techniques under CFDA# 17.225:

The Commonwealth shall draw down funds daily. The amount of each day's drawdown will be based on the estimated amount of checks clearing for the day, adjusted to reflect any residual balances in the Commonwealth's benefit payment account. The daily estimate of clearance activity will be based on a clearing model derived from the historical average daily clearance activity of the benefit payment account. The draw amount for Federal accounts (FEAC, UCX, etc.) will be based on the daily check activity reported since the estimated clearing amount from the model also incorporates these check clearances.

In addition, 29 CRF 97.20 provides the following standard for financial management:

(b) (3) Internal control. Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets.

Cause: Regarding the draws under the 026 Fund, LECS stated that they could not provide an explanation as to why the amounts drawn were not supported by actual program expenditures.

With respect to the draws under the 064 Fund, LECS personnel stated that, occasionally, they are unable to determine the previous day's bank balance, so they process the draw without inputting a bank balance (i.e. $0 balance). Furthermore, in the two cases noted above, LECS personnel eventually input the correct bank balances, but did not consider the impact of this change on the amounts already drawn (i.e. actual draw amounts/deposits no longer agreed to projected draw amounts).

Additionally, LECS noted that due to staffing changes, the same person that prepared the draws also performed the draws. LECS had no procedures in place during the year under audit for a supervisory review and approval of 026 and 064 Fund drawdown information prior to drawing the funds.

Finding 03 – 6: (continued)

Effect: LECS violated cash management standards since material overdraws for TAA were not based on the program's actual immediate needs. Furthermore, inadequate internal controls over drawdown processing could lead to inaccuracies in future draws for all the major programs listed above and not be detected in a timely manner. However, since TAA is not included in the Treasury-State Agreement, there is no interest liability with respect to the TAA drawdowns. Regarding the UI drawdowns, since these errors resulted in funds being underdrawn with no significant impact on the LECS analysis of interest impact for the current year, there is no interest liability associated with these incorrect drawdowns.

Recommendation: We recommend that LECS implement supervisory review procedures over the 026 and 064 Fund drawdown processes to prevent similar undetected errors from occurring in the future. In addition, with respect to the 064 Fund drawdowns, LECS should use the actual bank balance or a reasonable estimate of the balance when calculating the drawdown rather than leaving the bank balance as $0 so that drawdown amounts are not significantly misstated.

Agency Response: LECS has implemented a review procedure for the drawdown process. It is not our intention to estimate bank balances due to the negative impacts mentioned in the audit response.

TAA Draws – We agree that the detailed back up was not attached to the drawdowns. In the case of the January 17, 2003 and December 6, 2002 draws, funds were requested in one case to cover payrolls and in another case to cover estimated invoices to be released for payment that were not paid during December 2002. The funds were returned when it was determined they were not needed.

UI Benefit Payment Draws – We were aware that the benefit payment draws for January 23, 2003 and February 18, 2003 contained a $0 bank balance. It is not possible for us to obtain the bank balance at the correct time needed each day. When this occurs, it has been our policy to enter a $0 bank balance rather than an estimate. The reason is that the fund operates on a cash balance at the State Treasury. We must have the money on hand when the checks are released. The draw program estimates the amount of checks that will clear tomorrow based on today's bank balances. If we estimate a bank balance in the absence of the real amount, the results can have a negative impact. That is, if we estimate a high balance, this will cause us to draw less and we can create a negative bank balance on the following day. If we estimate too low, this will cause us to have more on hand, resulting in an increased CMIA interest payment. If we assume the draw program is working correctly, we should minimize the negative impacts just mentioned. We do agree that once the true bank balance amount was known, it should have been updated in the program.

Auditors' Conclusion: As noted in the condition above, the use of a $0 bank balance did significantly impact the amount of funds drawn down under the UI program and did not appear to minimize the "negative impacts" as indicated in the agency response. Therefore, we still recommend that LECS use a reasonable estimate of the bank balance when the actual balance is not known. The finding and recommendation remain as previously stated.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 7:

CFDA #17.245 – Trade Adjustment Assistance – Workers

Inaccurate Data and Weaknesses in L&I's Controls Over Preparation and Submission of the Trade Act Participant Report to USDOL (A Similar Condition Was Noted in Prior Finding #02-10)

Condition: L&I is required to submit a Trade Act Participant Report (TAPR) to USDOL on a quarterly basis. The TAPR tracks program performance and participant outcomes for the TAA and NAFTA-TAA programs. Each report is to consist of 49 fields of information for each TAA participant who exited the program during a particular quarter. L&I electronically submits a file to USDOL that contains the aforementioned data.

We tested the accuracy of the data submitted to USDOL for the quarter ended March 31, 2003, which reported on TAA participants who had exited TAA during the quarter October 1, 2001 through December 31, 2001. We selected 25 participants from the TAPR out of a total of 482 participants and compared the key data (nine separate data fields) for each participant to supporting documentation. Our testing revealed the following:

- Ten of the twenty-five participants in our sample were improperly included on the report. Three of the individuals were still in training after the reported quarter of exit, three of the individuals exited the program in a period prior to the reported quarter of exit, and four participants received TRA benefit payments after the reported quarter of exit.

- The most recent qualifying separation date was incorrect for two of the participants in our sample. For one participant, the incorrect date was in the same quarter as the correct date, so the quarters for the reporting of wage information in the required two fields (44 & 45) were not affected by the error. For the other participant, the incorrect date was not in the same quarter as the correct separation date. This error did not affect the reporting of wage information in fields 44 & 45 since L&I did not enter any wage information for this participant as discussed in the next bullet.

- Wage information in fields 44 & 45 for four participants in our sample was reported as zero. However, based on our review of wage record transcripts, these fields should have contained wage information for all four participants. A total of 48 other participants on the report that were not part of our sample also had zeros in these same two data fields. TAA personnel informed us that the zeros were entered for these participants only because they did not obtain wage records for these individuals.

In addition to the above discrepancies, we also noted that participants who receive a waiver from training are not being included on the TAPR when they exit the program. We were unable to determine how many such participants should have been included on the report for the quarter we tested.

Although L&I implemented a new system during the year for accumulating and reporting information for the TAPR, we noted the following weaknesses in L&I's controls over preparation and submission of the TAPR. The new system was used to generate the reports for last two quarters of the current year.

- The preparation of the TAPR is primarily a manual process. The majority of the data is accumulated from three separate databases and manually entered onto a data sheet for each participant who has been identified as exiting the program for the quarter. The information from the data sheet is then manually input into a database used to create the transmission file to USDOL. There was no supervisory review of the information that was manually accumulated and input into this database for the reports submitted for the first two quarters of the current year. Starting with the report for the third quarter, L&I performed a limited supervisory review of the data input which, based on the inaccuracies described above, is not adequate.

Finding 03 – 7: (continued)

- The exit date in the database used to generate the TAPR is based on the training completion date provided on the participant's application for training. However, based on our review of the report instructions and discussions with USDOL personnel, the exit date should be based on the last date on which the participant receives any type of TAA or partner funded service or benefit. The training completion date and program exit date can be different since there are cases in which the participant is still receiving services and benefits after training has been completed.

- L&I stated that they had internal edit checks in place for the reports submitted during the year under audit. However, L&I did not maintain records on the tools used to generate the reports. Additionally, L&I did not maintain copies of error reports for review of invalid data rejected as a result of such edit checks. Accordingly, we were unable to determine the adequacy of these internal edit checks. However, based on our discussions with L&I personnel, it was disclosed that the initial report submitted for our test quarter was rejected by USDOL due to a large number of errors. L&I subsequently corrected these errors and resubmitted the report. Based on this resubmission and the number of errors noted in the report for our test quarter, it would appear that the edit checks that L&I established were inadequate and did not fully consider the overall accuracy of Pennsylvania's data.

Criteria: The instructions for the TAPR are contained in USDOL's Training and Employment Guidance Letter No. 11-00, and state in part:

General Instructions:

1. *TAPR reports must be submitted each quarter. Each report is to consist of records for Trade Act participants who have exited during a particular quarter…. The quarter of exit is the quarter in which the participants, whose records are in the report, exited the Trade Act program. The reporting quarter is the quarter during which the records for the exiters should be completed and the report assembled…. The reporting quarter is five quarters after the quarter of exit.*

Revised Participant Record Layout, Section III: Outcomes:

Field Number 22, Date of participation-Record the date on which the individual BEGAN to receive Trade Act-funded program benefits and/or services. An applicant becomes a participant upon first receipt of training, TRA, job search allowance, or relocation allowance.

Field Number 39, Date of exit-Record the last date on which Trade Act-funded services or WIA Title I partner services were received by the participant.

Field Number 44, Three quarters prior to most recent qualifying separation-Earnings in the third full quarter prior to the participant's most recent qualifying separation.

Field Number 45, Two quarters prior to most recent qualifying separation-Earnings in the second full quarter prior to the participant's most recent qualifying separation.

In addition, good internal controls would ensure that the data included on the TAPR is accurate and complete.

Cause: The exit date in the TAPR system is based on the completion date provided on the participant's application for training. However, L&I does not have adequate procedures in place to ensure that this date is the actual exit date, as defined in the reporting instructions, when identifying exiters to include on the TAPR. With respect to participants who receive waivers from the training requirement, L&I's current database used to generate the TAPR does not include these participants since L&I was unaware that these individuals were to be included on the TAPR. Additionally, most of the data for the TAPR is compiled from a variety of databases and manually input into the TAPR system. However, L&I had

Finding 03 – 7: (continued)

no or limited review procedures in place during the year to verify the accuracy of the information accumulated and transmitted to USDOL. Although L&I represented that they had internal edit checks in place during the year under audit, it appears these internal edit checks were not adequate based on the large number of errors noted on the report for our test quarter.

Effect: Based on the errors noted in the condition, TAPR data is not accurate and TAA did not comply with federal reporting requirements. Also, the control weaknesses cited in the condition provide little assurance that the information reported for the TAA participants on the TAPR is accurate and that all participants who exited the program are identified and reported in the proper quarter.

Recommendation: We understand that L&I is still in the process of developing a formal system to collect and accurately report the TAPR data to USDOL and that the system developed during the year was designed as an interim system. Accordingly, we recommend that L&I continue its efforts in developing a formal system. In the interim, we recommend that L&I consult with USDOL to clarify the reporting instructions relative to definition of exiters, to ascertain corrective action on past data errors, and to and ensure that the current system is adequate to report all program exiters. Additionally, L&I should strengthen existing procedures to verify the completeness and accuracy of the TAPR information that is accumulated and transmitted to USDOL, including a review of existing internal edit checks to ensure they fully consider every field of entry. Further, we recommend that L&I maintain documentation to support the internal edit check process.

Agency Response: The TAPR that was tested for the quarter ended March 31, 2003 reported on the participants that exited the program during the fourth quarter of 2001, October 1 through December 31, 2001. That period reflected information that was collected for the participants from the old manually produced database system that utilized three separate databases in order to attain all the required data. As such, numerous cases of human error occurred during the information collection process.

Over the course of this program, L&I recognized the need to totally reengineer the data collection process for the TAPR. On July 1, 2003, L&I implemented an interim system that cross-walked the information from the old system with new data such as an electronic feed from the Unemployment Compensation (UC) System. This provides more complete, accurate information. It also improves the process of retrieving data directly from the UC system to collect wages instead of having staff research and enter information manually on each case as was done for this audited TAPR report. Wage Record Interchange System (WRIS) data is also included in the report to capture the most accurate representation of wages that are available for each exiter. Further enhancement was accomplished with the electronic extraction of the data directly from the Career Link System.

These improvements serve to address the related deficiencies cited within the finding. However, due to the nature and timing of the TAPR reporting system for time periods in which the participants exited, some manual checks and input will continue to be necessary until the full transition is complete.

It should be noted that WRIS, for Interstate wages, was not available to any state, which created zeroes in wage information. USDOL was aware of this and was also cognizant that in some cases, such as participants being employed in other states, wage information could not always be retrieved thus creating zero fills.

The USDOL was consulted to confirm that individuals who received only Waiver and TRA should be included in the TAPR when they exit. Beginning with the last TAPR submitted in May 2004, these participants have been included and will continue to be in all future reports.

As noted, the preparation of the TAPR is no longer primarily a manual process due to the improvements of electronically fed data. Only transitional or adjusted information will be required to be entered manually.

Finding 03 – 7: (continued)

We believe there was a miscommunication on the scope of supervisory review. The interim system, as it is designed, actually requires the supervisor to collect, review and process the information as it is entered. This has been the case since March 2003. Additionally, if edit checks occur as the information is processed, they are reviewed and corrected as necessary. The document cannot be completed until these edit checks are addressed; they cannot be overridden.

L&I has a complete breakdown of IT document controls and processes including edit checks. It should be noted that our internal edit checks are in the program where the data is collected from the two modules to prepare the TAPR and differ from USDOL's. Under the current process, edit checks exist for every field of entry and must be addressed before the report can be completed. Critical information acts as a cross-link system; blanks or incorrect information are not accepted nor can they be overridden. USDOL edit checks can still track errors such as typographical errors, incorrect dates or zero-filled fields that may not have been evident during the test review period. Each progressive report has seen improvement as the system recognized similar errors that were subsequently addressed or validated. The error, or edit, checks produced from the Excel spreadsheets were not maintained because the simple errors they reported were generally corrected immediately prior to the submission of the report to USDOL.

Lastly, regarding the exit dates that are used, it is anticipated that with the new electronic data feeds, this will no longer be an issue, as the dates will be entered correctly. Within the interim system, every effort is made to ensure the completion date is accurate. Edit checks also assist in this area.

Auditors' Conclusion: We acknowledge that L&I did not have access to WRIS for the report quarter tested. However, the condition states that wage information from the UC system was available for four participants in our sample but the two fields (44&45) in the TAPR contained zeros for these participants. Accordingly, these errors were unrelated to the unavailability of WRIS.

With respect to the scope of supervisory review, we agree that supervisory review procedures were implemented in March 2003. However, based on our discussions with L&I personnel and based on our testing, the supervisor was performing a random review of the datasheets used to input information into the TAPR system. Additionally, based on the number of errors noted for our test quarter, the review procedures were not adequate.

Regarding the edit checks, L&I did not maintain documentation of the edit check process used for the reports submitted during the year. Accordingly, we were unable to determine the adequacy of the internal edit checks.

Based on the above, the finding and recommendation remain as stated. We will evaluate the agency's corrective action during our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 8:

CFDA #17.245 – Trade Adjustment Assistance – Workers

Overpayment of TRA Benefits Resulted in Questioned Costs of $8,392 (A Similar Condition Was Noted in Prior Year Finding #02-11)

Condition: As part of our testing of program expenditures, we randomly selected 35 Trade Readjustment Assistance (TRA) weekly benefit payments made to claimants during SFYE June 30, 2003 and determined whether claimants were eligible for TRA and whether they received the correct benefit amount. Our testing disclosed the following:

- Two of the 35 claimants in our sample (Claimants A and B for $408 and $142, respectively) received additional TRA benefit payments even though the claimants did not make a bona fide application for training within the 210 day time frame as required by federal regulations. Claimant A's most recent total or partial separation date was July 20, 2001 and the date of the certification under which the claimant was covered was October 1, 2001. However, a bona fide application was not made until June 11, 2002, or 253 days after the certification date. Claimant B's most recent total or partial separation date was May 3, 2001 and the date of the certification under which the claimant was covered was May 14, 2001. However a bona fide application was not made until May 17, 2002, or 368 days after the certification date. As a result, we question the entire amount of additional TRA benefit payments made during our audit period to Claimants A and B in the amounts of $5,304 and $2,414, respectively.

- One of the 35 claimants in our sample (Claimant C) was eligible to receive 13 weeks of basic TRA and 26 weeks of additional TRA, for a total of 39 weeks of benefit payments. However, we noted that Claimant C received a total of 40 weeks of benefit payments during our audit period and therefore was overpaid a total of 1 week of additional TRA benefits resulting in questioned costs of $257.

- One of the 35 claimants in our sample (Claimant D) received a waiver from training but did not provide tangible evidence to satisfy the extended benefit work test for the benefit week selected. This test is a basic condition of entitlement to basic TRA unless the individual is enrolled in or participating in an approved training program. Accordingly, the weekly benefit paid to this claimant of $417 for the benefit week selected is questioned.

A summary of the questioned costs for Claimants A, B, C and D is as follows:

Claimant	Weekly Benefit Amount	Weeks in Question	Amount of Overpayment	Total Questioned Costs
A	408	13	$5,304	$5,304
B	142	17	2,414	2,414
C	257	1	257	257
D	417	1	417	417
Total			$8,392	$8,392

The total amount of the 35 benefit payments tested was $11,069, which consisted of payments for basic TRA totaling $6,814 and payments for additional TRA benefits totaling $4,255. The amounts questioned from our original four sample items were $417 for basic TRA and $807 for additional TRA benefits. During the period under audit, there were TRA benefit payments made totaling $26,654,573, which consisted of $19,511,597 for basic TRA and $7,142,976 for additional TRA benefits.

Finding 03 – 8: (continued)

<u>Criteria</u>: 20 CFR 617.15(b)(2) states in part:

To be eligible for TRA for additional weeks, an individual must make a bona fide application for training- (i) within 210 days after the date of the first certification under which the individual is covered, or(ii) if later, within 210 days after the date of the individual's most recent partial or total separation under such certification.

20 CFR 617.3(i) defines a bona fide application as follows:

Bona fide application for training means an individual's signed and dated application for training filed with the State agency administering the TAA training program, on a form necessarily containing the individual's name, petition number, local office number, and specific occupational training. This form shall be signed and date by a State agency representative upon receipt.

20 CFR 617.11 (a) (2) (vi) states, in part, that:

(vi) Extended Benefit work test. (A) The individual must-
- *(1) Accept any offer of suitable work, as defined in 617.3 (kk), and actually apply for any suitable work the individual is referred to by the State agency, and*
- *(2) Actively engage in seeking work and furnish the State agency tangible evidence of such efforts each week, and*
- (3) *Register for work and be referred by the State agency to suitable work, in accordance with those provisions of the applicable State law which apply to claimants for Extended Benefits and which are consistent with part 615 of this chapter.*

20 CFR 617.17(a) and (b) describe the extended benefit work test as follows:

(a) Extended Benefit work test applicable. Except as provided in paragraph (b) of this section, an individual shall, as a basic condition of entitlement to basic TRA for a week of unemployment-
- *(3) be unemployed, as defined in the applicable State law for UI claimants, and*
- *(4) be able to work and available for work, as defined in the applicable State law for UI claimants, and*
- *(5) satisfy the Extended Benefit work test in each week for which TRA is claimed, . . .*

20 CFR 617.14 regarding maximum amount of TRA states in part:

(a) General rule. Except as provided under paragraph (b) of this section, the maximum amount of TRA payable to an individual under a certification shall be the amount determined by:
- *(1) Multiplying by 52 the weekly amount of TRA payable to such individual for a week of total unemployment, as determined under 617.13(a); and*
- *(2) Subtracting from the product derived under paragraph (a)(1) of this section, the total sum of UI to which the individual was entitled in the individual's first benefit period described in*

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in Section ___.510 states in part:

(a) <u>Audit findings reported</u>. The auditor shall report the following as audit findings in a schedule of findings and questioned costs:
- *(3) Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. . . . The auditor shall also report known questioned costs when likely questioned costs are greater than $10,000 for a type of compliance requirement for a major program. . . .*

Finding 03 – 8: (continued)

<u>Cause</u>: With respect to Claimants A and B, L&I indicated that the date on the front of the ES-1927 "Application for Training" form was used in determining the time frame for the bona fide application requirement. However, this was the wrong date since the applicant's signature with a different date appears on the back of this form. For Claimant C, a basic TRA weekly benefit was not processed by L&I in error. L&I subsequently paid the claimant for this benefit week but did not consider this basic payment when calculating the number of weeks of additional TRA to which the claimant was entitled. For Claimant D, L&I stated that the claimant originally submitted the proper documentation to satisfy the extended benefit work test but failed to sign the form. As a result, L&I mailed the form back to the claimant for signature but the form was never returned to L&I. Therefore, no form was on file to support the payment.

<u>Effect</u>: Since TRA benefits were overpaid to the claimants listed above, there are questioned costs of $8,392. Also, L&I's existing procedures are not adequate to ensure that TRA eligibility determinations and related benefit payments are being made in accordance with federal regulations.

<u>Recommendation</u>: We recommend that L&I repay the questioned costs or pursue appropriate settlement with the U.S. Department of Labor. Additionally, we recommend that L&I strengthen existing procedures at the career link sites and at the agency level to ensure that TRA benefit payments are made only to eligible claimants and for the proper amount.

<u>Agency Response</u>: The findings regarding Claimants A & B are correct, and we do not dispute that there was an error in payment because the information provided to the Unemployment Compensation (UC) Service Center was incorrect. The UC Service Center relies solely on the information provided by the Pennsylvania CareerLink in regards to training application dates. In both cases, the PA CareerLink provided information to the UC Service Center to indicate that the original application was within the 210-day period as required by 20 CFR 617.15(b)(2) and 617.3(i). The CareerLink inadvertently transposed the incorrect date on Form ETA 8-58, Request by Worker for Training Approval and Allowances while in Training, which was sent to the UC Service Center. The CareerLink should have used the date the application was signed as the valid application date instead of the date the application was handed out. Both of these cases had a time lapse between the issuance of the application and the actual valid signed application, which is not a common occurrence, and not the State's normal policy or procedure. Further corrective actions are not warranted, as the application process is now totally computerized. The bona fide application date is automatically populated from the application to the ETA 8-58. This date cannot be altered by the CareerLink staff and will represent the date the application was actually signed. A determination will be issued establishing non-fraud overpayments of $5,304 and $2,414, respectively, which are subject to the repayment, recovery and waiver provisions of Section 243(a) of the Trade Act.

The finding regarding Claimant C is correct, and we do not dispute that there was an error because a benefit payment was issued out of sequence. On October 30, 2002, the UC Service Center issued payment for the week ending October 26, 2002, which paid as the final week of basic TRA. Subsequently, the week ending November 2, 2002, and November 9, 2002, were issued on the claimant's additional TRA on November 15, 2002. On December 4, 2002, the UC Service Center issued payment for October 19, 2002, which would have exhausted the claimant's basic TRA had it been paid at the correct time. On December 5, 2002, the UC Service Center requested additional TRA monies be placed back in the claimant's account, which was processed by Unemployment Insurance Payment Services, which resulted in the overpayment. A determination will be issued establishing a non-fraud overpayment of $257, which is subject to the repayment, recovery and waiver provisions of Section 243(a) of the Trade Act. Further corrective action is not warranted because this was a manual processing error.

The finding regarding Claimant D is incorrect; the claimant did conduct a work search while covered by a waiver. On March 26, 2004, the Federal Programs Unit was able to secure a copy of UC-169, which shows that the claimant completed work searches during the week ended June 7, 2003. By Pennsylvania Law, the Claim Record is a business record and as such, the notation of the receipt of Form B-4 on June 12, 2003, and of the verbal certification, is documentation that the payment was appropriate. Therefore, an overpayment would not be appropriate in this case. Further corrective actions are not warranted.

Finding 03 – 8: (continued)

Auditors' Conclusion: Regarding L&I's statement for Claimant D, the UC-169 is a record of an oral interview that the UC representative signed stating that Claimant D completed the work search for the week in question. However, this document does not satisfy the extended benefit work test, which requires that the individual furnish the State agency with tangible evidence that a work search was performed.

Regarding the remaining disclosures in L&I's response, no additional information was provided to mitigate the condition in the finding. Therefore, the finding and recommendation remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 9:

CFDA #17.245 – Trade Adjustment Assistance – Workers

Lack of Supporting Documentation for Statistical Information on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #02-09)

Condition: L&I is required to submit an ETA 563 Report titled "Quarterly Determinations, Allowance and Reemployment Services Under the Trade Act," to USDOL on a quarterly basis. The ETA 563 report provides information on eligibility determinations, income support payments, reemployment services and training. The data supplied on the ETA 563 is used by USDOL to measure the effectiveness of the TAA and NAFTA-TAA programs in helping adversely affected workers adjust and find new employment. A separate report is required to be filed for each certified petition under which services are provided.

Each quarter, L&I submits the ETA 563 in electronic format to USDOL. The submission includes a separate report for each certified petition under regular TAA and NAFTA-TAA, along with summary pages. Each separate report contains 37 data fields used to report both financial and statistical information by petition number, 5 data fields for financial and 32 data fields for statistical information.

In order to test the accuracy of the information submitted to USDOL, we obtained the ETA 563 submitted for the quarter ended 6/30/03 for the NAFTA-TAA petitions. We then selected a sample of five petitions and requested documentation to support the financial and statistical information reported by L&I in the 37 data fields. Our audit found that L&I was unable to provide any documentation to support the statistical information reported for the five petitions, representing 32 of the 37 fields of required data.

In the prior year audit, we also noted that, due to the incompatability of separate databases, L&I did not have an adequate system in place to accurately report the statistical information on the ETA 563 that is provided by the career link sites. Based on our follow up and current year testing, we noted that this same weakness existed during the year under audit. Specifically, 15 of the 32 data fields that L&I could not support on the ETA 563 for the quarter ended 6/30/03 related to statistical information provided by the career link sites. As a result, these data fields could not be audited by us.

Criteria: 20 CFR 617.57 states:

(a) Recordkeeping. Each state agency will make and maintain records pertaining to the administration of the Act as the Secretary requires and will make all such records available for inspection, examination and audit by such Federal officials as the Secretary may designate or as may be required by law. Such recordkeeping will be adequate to support the reporting of TAA activity on reporting form ETA 563 approved under OMB control number 1205-0016.

Part D, Chapter III of the Handbook on the Trade Adjustment Assistance Program provides the reporting instructions for ETA 563 and states in part:

2. General Instructions. Each report is for reporting activity under a specified certified petition. A separate report is required for each certified petition under which services are provided.

Cause: The ETA 563 report includes 15 data fields of information that are provided by the career link sites. However, L&I could not explain how the career link information was reported on the ETA 563 since they were unfamiliar with the source for this information and since they did not have an adequate system in place during the year under audit to report this information. With respect to the remaining statistical information that L&I could not support, L&I stated that the system used to create the 563 report is not a static system and therefore, the data is constantly changing. L&I stated that the data used to generate the report was stored but due to subsequent changes in the data they were unable to retrieve the information.

Finding 03 – 9: (continued)

Effect: L&I was unable to provide support for the statistical information reported on the ETA 563 for the quarter ended June 30, 2003 and, therefore, did not comply with federal reporting requirements. Additionally, L&I does not have an adequate system in place to accurately report the information being provided from the career link sites.

Recommendation: We recommend that L&I store their data used to generate the quarterly 563 reports and ensure that the data can be retrieved in order to support the information being reported to the federal government. Additionally, L&I should modify their existing system to ensure that information being provided by the career link sites is accurately captured and reported to USDOL. Additionally, once this system is in place, L&I should consult with USDOL and evaluate the feasibility of submitting revised ETA 563 reports for the year ended June 30, 2003 since these reports are used by USDOL to measure the effectiveness of the TAA program.

Agency Response: In regard to the ETA 563 Report and the support of the information provided, it came to our attention at the close of the review, that not all of the key people who could attest to the documentation had been involved. The program that generated the ETA 563 was developed when employment service and training information was generated from a mainframe system. With the development of the web based PA CareerLink System and the online Trade Adjustment Assistance application system, a multi-bureau workgroup comprised of UI, ES and IT staff was formed in February 2004. Definitions and explanations for each data item in the USDOL guidance were reviewed to determine where the information could be provided from and to identify new sources that were needed for the generation of the ETA 563. The March and June 2004 reports reflect this comprehensive compilation of data.

The USDOL has expressed satisfaction with the information submitted in Sections A and B of the report and has permitted Pennsylvania to resubmit the data in Sections C and D for Federal Fiscal Years 03 and 04. Copies of this information, as well as the March and June 2004 reports, are available for review.

In regard to future testing and support from the UI source which constantly updates and is not a static system, backup tapes of files will be created and maintained in order that information can be verified.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 10:

CFDA #17.258 – WIA Adult Program
CFDA #17.259 – WIA Youth Activities
CFDA #17.260 – WIA Dislocated Workers

Errors and Inadequate Controls in the WIA Annual Performance Report (A Similar Condition Was Noted in Prior Year Finding #02-13)

Condition: L&I is required to submit an Annual Performance Report to USDOL for each program year. The report provides participant and performance outcome data for the WIA programs. The report includes a Narrative Section and Tables containing summaries of participant and performance level information. The data (exclusive of wage information), in support of the Tables in the Annual Report is based on a collection of individual records for each participant and is entered directly into L&I's system by the users at the Career Link local offices. These individual records or WIA Standard Record Data Files (WIASRDs) are also sent to USDOL as part of the Annual Report process. However, the WIASRDs are submitted separate from the Tables.

L&I submitted its Annual Performance Report during our audit period that covered the Program Year 2001 (July 1, 2001 to June 30, 2002). The performance measures in the Annual Report Tables are based on information for all individuals who exited the WIA program or terminated from JTPA during a certain period of time. For the key tables tested, the exit periods are from October 1, 2000 through September 30, 2001 (Tables B, E & H) and for the period from October 1, 2000 through September 30, 2001 and July 1, 2001 through June 30, 2002 (Table J). Our testing disclosed the following errors and control weaknesses over the accumulation and submission of data for the WIASRDs and the Annual Report Tables:

- We noted that, for 15 out of a sample of 25 individuals tested, the wages reported in field 614 (Wages for Second Quarter Prior to Registration), did not agree to the PA UC wage record transcripts. We also noted that these WIASRDs did not support the levels that were reported for the earnings replacement/change measures in the Annual Report Tables. L&I subsequently corrected these errors in the Data Analysis and Reporting Tool (DART), which creates the WIASRDs and the Annual Report Tables, and was permitted to resubmit the Tables to USDOL with the revised performance levels. (Note: USDOL did not permit resubmission of the revised WIASRDS supporting the tables.) Although our testwork showed these revised tables to be correct, we noted internal control weaknesses which need to be corrected in future reports. L&I generates an extract file from DART that is forwarded to its Office of Information Technology (OIT) for the input of PA UC Wage Data. A separate application within OIT matches the wages to the individual and adds the wages to the extract file, which is then returned to WIA personnel. However, there were no procedures in place during our audit period to ensure that the file that was forwarded to OIT was reconciled to the file that was returned to validate that the information was complete. Additionally, per the original reporting errors disclosed above, L&I did not have adequate controls in place to ensure that the PA UC Wage Data was accurate, including matching of wages to the proper quarter.

- The data in the CL is extracted for the appropriate timeframe by L&I and imported into DART, which as mentioned above, is used to create the WIASRDS and the Annual Report Tables. During our audit period, L&I had no procedures in place to validate the size of the files or the number of records during the data migration process to ensure that all information was properly transferred from the CL to DART.

Criteria: The instructions for the WIA Annual Performance Report are contained in USDOL's Training and Employment Guidance Letter (TEGAL) No. 14-00, and state in part:

4. *Reporting and Record Keeping Information. States are required to submit three different participant reports. They are:*

Finding 03 – 10: (continued)

1) *The Workforce Investment Act Standardized Record Data (WIASRD). States are required to maintain this collection of individual records containing activity and outcome information for each participant. The WIASRD is the foundation for the quarterly and annual reports. These records are due by December 1 following the end of each program year.*

3) *The WIA Annual Performance Report. Annual performance reports will contain information on the progress of the State in exceeding negotiated levels of performance, including information on the levels of performance achieved by the State with respect to the core indicators of performance and the customer satisfaction indicators. This report is due by December 1st following the end of each program year.*

USDOL's Training and Employment Guidance Letter (TEGAL) No. 7-01 provides guidance on the performance reporting submission procedures for the WIASRD and the Annual Report and states in part

5. *WIA Standardized Record Data (WIASRD). These individual records are to be submitted as follows:*

   D) *…The WIASRD individual records must be consistent with the numerical data submitted in the tabular sections of the annual report. . . .*

In addition, an adequate internal control system would ensure that information accumulated and submitted on the WIASRDs and the Annual Report Tables is accurate and complete.

Cause: L&I did not have adequate procedures in place during the year under audit to verify the accuracy of the PA UC wage information reported for the participants in the WIASRDs. Based on our testing of the wage data, the errors reported in field 614 appeared to be a result of wages being reported for two quarters. With respect to the transfer of data from the CL to DART, we understand that L&I is currently performing a validation of the file sizes prior to loading the data into DART. However, this reconciliation was not being performed during the year under audit.

Effect: The WIA Annual Performance Report contained errors in violation of USDOL reporting requirements. Also, the control weaknesses cited in the condition provide limited assurance that the PA UC Wage data being reported for the participants is accurate and that data exchanged during the various migration processes is complete.

Recommendation: We recommend that L&I strengthen its procedures to verify the accuracy of the PA UC wage information reported in DART and the WIASRDs in order to avoid any potential sanctions for not achieving negotiated performance levels. We also recommend that L&I implement procedures to validate the completeness of information during all migrations of data files. These procedures could include validation of the size of data files or record counts, depending on the purpose of the migration.

Agency Response:

1) **"L&I did not have adequate controls in place to ensure that the PA UC Wage Data was accurate, including matching of wages to the proper quarter."** The Bureau of Workforce Investment (BWI) staff discovered the wage error during an internal review, prior to it being cited by the auditors, and had already undertaken the actions necessary to correct the WIASRD and DART files. This was substantiated by the fact that USDOL did not permit resubmission of the revised WIASRDs supporting the tables, as stated within the finding, though they did accept a corrected Annual Report. However, without the updated WIASRDs, the data was guaranteed to not match the corrected Annual Report. It should also be noted that there were no wage record errors cited by the auditors when the revised WIASRD file was utilized.

2) **"L&I had no procedures in place to validate the size of the files or the number of records during the data migration process to ensure that all information was properly transferred from the CL to DART."** The importance of this has been recognized; a procedural change has already been implemented to validate the file sizes prior to loading the data into DART, as noted in the "**Cause**" section of the finding.

Finding 03 – 10: (continued)

With regard to the recommendation "*that L&I strengthen its procedures to verify the accuracy of the PA UC wage information reported in DART and the WIASRDs in order to avoid any potential sanctions for not achieving negotiated performance levels*," given that CWIA currently spot-checks wage records from WRIS, MD exchanges UC wage data with on-line PA wages prior to entry, and BWI is denied access to wage record data on an as-needed basis due to confidentiality concerns, it is unclear as to what procedures can be enacted to further verify wage match data as recommended. It should also be noted that Pennsylvania is developing an RFP for redesign of the UC system, the first project of which is earmarked to be the UC wage records. Sixteen quarters of wage data would be requested to be kept on-line, expanding the access to spot-check/verification of pre-wages. It is unknown at this time when this will occur.

Auditors' Conclusion: We agree that BWI discovered the wage errors during an internal review. However, this review was performed subsequent to the submission of the WIASRD and subsequent to the initial submission of the Annual Report Tables and, therefore, was not an adequate manual detect control since the errors were not identified and corrected in a timely manner. With respect to L&I's comment on our recommendation, the significant number of errors in reported wages as cited in the condition suggests that the procedures in place during the year under audit for verification of PA UC wage information reported by L&I were not adequate. Any corrective action cited by L&I will be reviewed in our subsequent audit. Our finding and recommendation, therefore, remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. **See Corrective Action Plans located elsewhere in this Report.**

Finding 03 – 11:

CFDA #66.458 – Capitalization Grants For Clean Water State Revolving Funds
CFDA #66.468 – Capitalization Grants For Drinking Water State Revolving Funds

Internal Control Weakness Over the Preparation of DEP Quarterly Billings to PENNVEST (A Similar Condition Was Noted in Prior Year Finding #02-15)

Condition: PENNVEST is responsible for drawing CWSRF and DWSRF funds for set aside expenditures incurred by DEP on behalf of PENNVEST. DEP prepares quarterly billings to PENNVEST for reimbursement of these expenditures. Our prior year testing disclosed that no supervisory review was performed of these billings by DEP prior to submission to PENNVEST for reimbursement. Our current audit follow up disclosed that, although no errors were noted in our actual testwork, this weakness was not corrected by DEP. DEP's total billings to PENNVEST during the current year were $928,349 for CWSRF (CFDA #66.458) and $539,519 for DWSRF (CFDA #66.468).

Criteria: Strong internal controls should ensure that billings are appropriately reviewed and approved by management to ensure they are accurate.

Cause: According to DEP management, corrective action on our prior-year finding was not implemented until after the end of our current audit period.

Effect: The lack of supervisory review provides limited assurance that future DEP quarterly billings to PENNVEST under CWSRF and DWSRF will be accurate.

Recommendation: We recommend that DEP ensure adequate supervisory reviews of the quarterly billings to PENNVEST are in place to verify that CWSRF and DWSRF billings are accurate.

Agency Response: On May 1, 2003, the Department was formally notified of this finding and DEP has complied with the recommendation made by the Auditor General's report. The April 25, 2003 quarterly bill was reviewed by the Federal Unit supervisor and the Acting Bureau Director. By signing the General Invoice, the Acting Director authorized the charges submitted to PENNVEST. However, quarterly billings prior to that time were not reviewed by the Bureau Director or the agency supervisor, but were left to the discretion of the budget analyst preparing the invoice.

It is our intention to provide further proof of review by having the Federal Unit supervisor initial and date each page of the back up documentation. It will then be assembled and a General Invoice will be submitted to the Bureau Director for a second review and approval.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 12:

CFDA #66.468 – Capitalization Grants For Drinking Water State Revolving Funds

PENNVEST Did Not Comply With Federal Loan Repayment Provision

Condition: We tested DWSRF close-out loans in the current year to determine whether loan repayments began within one year of the date of project completion. In determining our population of 18 prior year DWSRF loans which stopped receiving loan payments in the current year, we identified one federal loan to Pennsylvania American Water Company (Loan #80079) totaling $1.7 million that closed out but was not properly tracked for repayment by PENNVEST on its accounting system. As a result, repayments did not begin for this loan within one year of project completion. The project was completed and final DEP inspection occurred on July 5, 2001. Loan repayments began in February 2004, or over 2½ years later, after the issue was detected by the auditors.

Criteria: Compliance Supplement, Part 4, Section N. 3. Deposits to DWSRF states:

Repayment of loans shall begin within one year after project completion.

Public Law 104-182, Section 1452(f)(1)(B), states:

Principal and interest payments on each loan will commence not later than 1 year after completion of the project for which the loan was made.

Cause: The loan was scheduled to begin amortizing in April, 2001. An extension was requested and granted to change the amortization date to October, 2001. On July 20, 2001, PENNVEST notified the loan recipient that repayment was scheduled to begin on October 1, 2001 unless an additional extension was requested. The loan file was set aside waiting for a response from the loan recipient. However, the loan recipient never responded, and the loan was overlooked and repayment did not begin as required.

Effect: Since PENNVEST did not ensure this loan began repayment within one year of project completion, they did not comply with federal regulations. The weakness in PENNVEST's tracking system provides limited assurance of compliance in the future.

Recommendation: PENNVEST should strengthen their internal controls to ensure repayments for DWSRF loans begin within one year of completion to be in compliance with federal regulations.

Agency Response: PENNVEST is in agreement with the finding that PENNVEST failed to amortize one federally funded loan within one year of completion of construction. While notification to the borrower was timely, there was no follow-up when the borrower failed to respond. PENNVEST is undertaking a system information redesign for financial management. It is contemplated that the computer based tracking of project status will monitor all required actions including project amortization.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 13:

CFDA #66.468 – Capitalization Grants For Drinking Water State Revolving Funds

DEP Failed to Provide Documentation to Support Administrative Expenditures Resulting in Questioned Costs of $159,622

Condition: In our testing of $1,820,322 in personnel and operational expenditures charged by DEP to the DWSRF program for the fiscal year, DEP failed to provide documentation to support $159,622 in charges to DWSRF for the month of May 2003. Therefore, unallowable DEP costs of $159,622 were claimed under the DWSRF program during SFYE June 30, 2003 and are questioned.

Criteria: OMB Circular A-87 regarding allowability of costs, Attachment A, Section C.1, states that to be allowable, a cost must:

j. Be adequately documented

Cause: In following up on one of our sampled charges, DEP personnel learned that they inadvertently used the wrong data from its ACDS cost distribution system in charging the $159,622 in costs to DWSRF for May 2003. DEP personnel could not retrieve the correct data from ACDS to make an adjustment and charge the correct amount for May. Therefore, the correct amount is unavailable. We noted that the other months in our sample were properly charged to DWSRF by DEP.

We also noted there is inadequate in-house review of DEP's monthly billings to DWSRF, as evidenced by the above incorrect charge for May of 2003 and other instances where we also noted potential undercharges to DWSRF in our sample. DEP officials also indicated that key employees have retired from the Department and they have had difficulties locating the necessary documentation to support the DWSRF expenditures.

Effect: Without the documentation, we were unable to confirm that $159,622 in expenditures are allowable uses of DWSRF funds and, therefore, we question costs. In addition, if controls over DEP billings are not strengthened, future charges to DWSRF may also be unallowable.

Recommendation: We recommend that DEP pursue appropriate settlement of the $159,622, in questioned costs with the federal government. In addition, we recommend strengthened controls be implemented to ensure proper review and adequate documentation to support that expenditures made under the DWSRF are allowable.

Agency Response: Within the past year, key individuals that were responsible for the agency's automated cost distribution system have retired, leaving both current staff and new staff unfamiliar with the system at a disadvantage as to the inter-workings of this complex data collection accounting. The staff available to assist the auditors has tried to compile as much data as possible to prove the individual test transactions and re-create the backup documentation to support the agency charges.

In reviewing past audits that have affected this fund, it is noted there have been no major finding in the past relating to the ACDS cost distribution system. DEP has provided to PENNVEST similar, documented service efforts over the last few years at the following levels: FY2000-01 -$1,642,945; and FY2001-02 - $1,565,877. The level of service for the fiscal year ended June 30, 2003 was $1,820,322.

Regarding the May 2003 charges, based on prior years' audits, the only explanation for this finding is a result of staffing shortages to properly interpret the ACDS information and staff inexperience in collecting and interpreting the backup documentation to warrant the expenditure posted. Steps have been taken to ensure that current staff keeps all backup data pertinent to any invoice requesting reimbursement. Multiple staff will be responsible for ensuring information is provided to the Office of the Auditor General staff in a timely manner and on a priority basis. This finding was an unfortunate, extraordinary circumstance and DEP does not expect this instance to reoccur in future audits.

Finding 03 – 13: (continued)

Auditors' Conclusion: Based on the above agency response, our finding and recommendation remain as stated above. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 14:

CFDA #84.027 – Special Education – Grants to States

Noncompliance and Internal Control Weaknesses at DOH Result in $100,606 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-16)

Condition: During the prior SFYE June 30, 2002, the Governor's Office launched a new initiative called the "I Am Your Child" Campaign, which was primarily designed to encourage parents to take more responsibility for their children's lives. A portion of this initiative was administered through DOH working with the Pennsylvania Department of Corrections' Bureau of Correctional Industries (an Internal Service Fund in the Basic Financial Statements), with costs incurred primarily for the development, printing, and distribution of promotional materials throughout the Commonwealth. We noted that costs related to this initiative were allocated and charged by DOH to three different federal programs during the prior state fiscal year: the MCH Block Grant, the Special Education – Grants to States Programs, and the Even Start – State Education Agencies Program.

Our prior audit reported unallowable costs since DOH could not provide adequate documentation to support the reasonableness of the methodology for determining and allocating these amounts to all three federal programs. In addition, although some of the general descriptions of activities in this initiative appeared appropriate for the federal programs involved, DOH documentation failed to properly explain how these costs actually benefited the health and education objectives specific to these three federal programs.

During our current audit period, SFYE June 30, 2003, we determined that the final invoice for the campaign at DOH charged $100,606 on FI document number 1900015644 to only one program CFDA #84.027 Special Education – Grants to States, and that the same documentation was lacking so these costs are unallowable for the current year. Further, based on our review of DOH's budget of over $1.9 million for its portion of the campaign over several state fiscal years, two cost categories in the budget, one totaling $80,241 for "Administration" and the other $160,482 for "Retained Earnings," or $240,723 in total, provided no tangible benefit to federal programs and are not allowable. The "Administration" category is not program-related, but a general government cost, and "Retained Earnings" in an Internal Service Fund are contingency costs, both of which are specifically deemed unallowable by federal regulations (OMB Circular A-87). Only state funds should be used for these two categories, but without a documented cost allocation method for the $100,606 charged to the Special Education – Grants to States program during SFYE June 30, 2003, DOH cannot support how much of the $240,723 has been, or will be, federally funded in violation of OMB A-87. However, since the current-year federal billing amount of $100,606 is less than this unallowable portion of $240,723 in the budget, the entire $100,606 is considered to be charged to the Special Education – Grants to States program in violation of OMB Circular A-87 during our audit period.

Criteria: 34 CFR 80.20(a)(5) allowable Cost applicable to USDE programs states:

Applicable OMB cost principles, agency program regulations, and the terms of grant and subgrant agreements will be followed in determining the reasonableness, allowability, and allocability of costs.

OMB Circular A-87, Cost Principles for State and Local Governments, Attachment A, Section A, states:

1. *Objectives. This attachment establishes principles for determining the allowable costs incurred by State, local and federally-recognized Indian tribal governments under grants . . . with the Federal Government. The principles are designed to provide that federal awards bear their fair share of cost recognized under these principles except where restricted or prohibited by law. Provision for profit or other increment above cost is outside the scope of this Circular.*

Attachment A, Section C, outlines basic guidelines governing allowable costs:

1. *Factors affecting the allowability of costs: To be allowable under Federal awards, costs must meet the following general criteria:*

Finding 03 – 14: (continued)

> a. *Be necessary and reasonable for proper and efficient performance and administration of Federal awards.*
>
> b. *Be allocable to Federal awards under the provisions of this Circular . . .*
>
> d. *Conform to any limitations or exclusions set forth in these principles . . .*
>
> j. *Be adequately documented.*

OMB Circular A-87, Attachment A – Section F – Indirect Costs states:

1. *General. Indirect costs are those (a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved. . . . To facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect costs within a governmental unit department or in other agencies providing services to a governmental unit department. Indirect cost pools should be distributed to benefited cost objectives on bases which will produce an equitable result in consideration of relative benefits derived.*

Attachment B, Section Items of Cost, states:

12. *Contingencies. Contributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, or intensity, or with an assurance of their happening, are unallowable.*

23. *General government expenses.*

    a. *The general costs of government are unallowable.*

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in Section ___.510 states in part:

(a) *<u>Audit findings reported</u>. The auditor shall report the following as audit findings in a schedule of findings and questioned costs:*

> (3) *Known questioned costs which are greater than $10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. . .*
>
> (4) *Known questioned costs which are greater than $10,000 for a Federal program which is not audited as a major program. . . . if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than $10,000, then the auditor shall report this as an audit finding.*

<u>Cause</u>: DOH personnel stated that the cost allocations were based upon the appropriations signed into law by the Governor. The Administration and Retained Earnings categories were included in the budget by Department of Corrections, and DOH personnel stated they exercised no control over Correctional Industries inclusion of these categories in its budget.

<u>Effect</u>: Since DOH could not provide documentation to adequately support the allocation and reasonableness of the $100,606 charged to the Special Education – Grants to States program noted above, we question the $100,606 in current-year charges as unallowable. Also, we found additional violations of federal allowability regulations in OMB Circular A-87 because of federal participation in costs budgeted in this campaign for general administration and retained earnings in an Internal Service Fund.

Finding 03 – 14: (continued)

Internal control weaknesses at DOH may cause similar unallowable costs from this or other initiatives to be allocated and charged to federal programs in the future.

Recommendation: DOH should pursue appropriate settlement of the $100,606 in questioned costs with USDE. DOH should also implement procedures to ensure that projects funded by federal grants are equitably allocated to programs based on a documented cost allocation methodology which demonstrates the benefits derived and shows that the types of costs are allowable under the program charged.

We also recommend that appropriate procedures be established by DOH to ensure that cost categories not allowed by OMB Circular A-87 (such as general administration and retained earnings) are appropriately excluded from federal participation.

Agency Response: DOH maintains that the process followed in procuring the questioned costs was appropriate per the Agency Response to this same finding in the prior audit.

DOH has been working with USDE in resolving the questioned costs in the prior audit finding, and will pursue resolution of the questioned costs in this finding with USDE.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 15:

CFDA #84.048 – Vocational Education – Basic Grants to States

Inadequate Controls Over PDE's VOC ED Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE (A Similar Condition was Noted in Prior Year Finding #02-17)

Condition: PDE is required to submit a Consolidated Annual Performance, Accountability, and Financial Status Report, otherwise known as the Comprehensive Annual Report (CAR), to provide VOC ED performance data to USDE. There are 24 total subindicators reported on Form IV of the CAR. Fifteen are reported under the four Core indicators of performance and the remaining nine are reported as additional measures. Three different bureaus within PDE are responsible for gathering data for preparation of the CAR. Supporting data is received on hard-copy reports, on diskette, or via the Internet from LEAs and outside contractors who administer standardized testing. In our prior year audit of the CAR, we found inadequate controls at PDE over the compilation and review of CAR data to ensure the data is accurate and complete prior to submission to USDE. In our current audit follow up, we sampled and tested 8 of the 24 subindicators in the current report, and we found that these weaknesses had not been corrected.

For two of the eight subindicators (Code 1S2 – Skill Attainment, Secondary Level; and Code 2S2 – Diploma, Secondary Level), our prior year finding reported that a standardized testing contractor submits test completion data to both PDE and another third party contractor for review. PDE places major reliance on the third party contractor reviews of the test completion data for these two subindicators. Although PDE performs its own limited assessment of the data, our current year follow up showed that, as in the prior year, PDE does not document its review.

For another subindicator (Code 1S1 – Academic Achievement, Secondary Level), our prior year finding reported that PDE summarizes test score data from another testing contractor for reporting on the CAR. In addition to providing the data to LEAs for their review and correction, PDE has developed internal procedures to analyze the reasonableness of the data at the state level. However, as in the prior year, these procedures were not properly documented by PDE staff to support conclusions reached or to support that the data analyses were reviewed and approved in-house prior to submission of the CAR. Additionally, PDE did not perform or document procedures to confirm that the data control totals used for this subindicator on the CAR agreed to the control totals submitted by the test contractor to ensure data on the CAR was complete.

For an additional subindicator 3P2 – Postsecondary Retention – sampled in the current year, PDE completed the CAR using estimated data based on a projection of prior years' activity. Our inquiry of USDE indicated that submission of estimated data does not comply with federal reporting requirements.

Once the three bureaus gather their CAR data, it is submitted to one individual in the Bureau of Career and Technical Education who completes the actual CAR. Although there is a supervisory signature on the report, we found that the supporting compilations are not reviewed by the supervisor to ensure CAR data is accurately supported and complete, and the data has been properly analyzed for reasonableness. Therefore, this overall weakness reported in the prior year was not corrected in the current year.

Criteria: Federal Regulation 34 CFR 80.40 regarding a state's performance reporting, provides, in part:

(1) Grantees shall submit annual performance reports . . .

(2) Performance reports will contain, for each grant, brief information on the following:

(i) A comparison of actual accomplishments to the objectives established for the period . . .

Finding 03 – 15: (continued)

Federal Law 20 USC 2323(c) states:

(c) Report

(1) In general

Each eligible agency that receives an allotment under Section 2321 of this title shall annually prepare and submit to the Secretary a report regarding –

(A) The progress of the State in achieving the State adjusted levels of performance on the core indicators of performance; and

(B) Information on the levels of performance achieved by the State with respect to the additional indicators of performance, including the levels of performance for special populations.

20 USC 2323(b)(2) related to VOC ED State Performance Measures, states:

(2) Indicators of performance

(A) Core indicators of performance

Each eligible agency shall identify in the State plan core indicators of performance that include, at a minimum, measures of each of the following:

(i) Student attainment of challenging State established academic, and vocational and technical, skill proficiencies.

(ii) Student attainment of a secondary school diploma or its recognized equivalent, a proficiency credential in conjunction with a secondary school diploma, or a postsecondary degree or credential.

(iii) Placement in, retention in, and completion of, postsecondary education or advanced training, placement in military service, or placement or retention in employment.

(iv) Student participation in and completion of vocational and technical education programs that lead to nontraditional training and employment.

(B) Additional indicators of performance

An eligible agency, with input from eligible recipients, may identify in the State plan additional indicators of performance for vocational and technical education activities authorized under the subchapter.

20 USC 2342 related to the VOC ED State Plan states:

(c) Plan Contents. The State Plan shall include information that:

(20) describes how the eligible agency will ensure that the data reported to the eligible agency from local educational agencies and eligible institutions under this title and the data the eligible agency reports to the Secretary are complete, accurate, and reliable.

In order for PDE to ensure that the CAR is accurate and in accordance with program requirements, strong internal controls should be developed, functioning, and documented for each year's CAR submitted to USDE.

Finding 03 – 15: (continued)

Cause: PDE officials believed at the time of submission of the CAR that the data was accurate and complete and that their compilation and reporting procedures were appropriate. Also, PDE's corrective action plan for prior year Finding #02-17 was not implemented for the 2001-2002 CAR, which was tested during the current audit.

Effect: As a result of continued internal control weaknesses and the lack of documentation noted above, we were unable to verify the reasonableness, accuracy, or completeness of CAR data reporting VOC ED program results to USDE. The CAR may contain erroneous data that is not being detected and corrected by PDE.

Recommendation: We recommend that PDE review and improve its internal control procedures over the CAR and establish a system to ensure that all CAR data is accurate, complete, adequately supported, and is analyzed and properly reviewed prior to submission. PDE should also ensure that the performance of these control procedures is adequately documented.

Agency Response: The finding was based on the review of the 2001-2002 CAR for Career and Technical Education Programs, Services and Activities funded through the Carl D. Perkins Vocational and Applied Technology Education Act. The finding includes several references to the prior year audit, Finding #02-17, as well as a statement that the 2001/2002 Audit's Corrective Action Plan was not implemented for the 2001-2002 CAR.

Because of delays in the completion of the Commonwealth's 2001/2002 Single Audit, the auditors' ending dates for actions related to the audit resolution were extended and revised deadlines were developed. The completion date for the last finding and recommendation to be issued by the auditors was March 28, 2003. Although March 2003 was a revised extended date, Finding #02-17 was not received by the PDE until May 2003. Due to the lateness of the receipt of the Single Audit Finding for 2001-02, the implementation of the Corrective Action Plan was delayed. However, the Single Audit Year Ended June 30, 2002, Finding #02-17 has been and continues to be addressed and portions of the Corrective Action Plan have been implemented. The actual timeline for resolution of the 2001-02 Single Audit Finding #02-17 is as follows:

Audit finding provided to BCTE		
Response of BCTE to Bureau of Budget and Fiscal Management	–	May 16, 2003
U.S. Department of Education Office of Vocational and Adult Education requests information on Single Audit Finding	–	July 25, 2003
Corrective Action Plan submitted to U.S. Department of Education Office of Vocational and Adult Education	–	August 21, 2003
Specific steps to be taken are projected to be completed by	–	December 31, 2003
U.S. Department of Education Office of Vocational and Adult Education indicates that the Corrective Action Plan is accepted.	–	January 30, 2004

Finding 03 – 15: (continued)

Sequences submitted in the "Timeline for Processing National Occupational Competency Testing Institute, Alternate Tests, and Accountability Data for the Federal Consolidated Annual Report, e-Grant Matrix and Standard and Poor's" have been partially met, which means as indicated in the current Single Audit finding, the audit Finding #02-17 for 2001-2002 has not been fully met.

Documentation available that supports progress in meeting the Single Audit finding of 2001-2002 includes the following:

- In terms of supervisory signatory process, per the October 7, 2003 memo from the Director of State Administration and Accountability Group, Office of Vocational and Adult Education, the Consolidated Annual Report Network Site provides "Director Approval and Data Attestation: All data attestation and signatures are electronic by use of Personal Identification Number for each state."

- File evidences data review and changes by the Bureau Director to data prior to submission to the USDE. Signature is on the data changes document.

- Files evidence supervisory signatures to verify accuracy of data. The file evidences the role of each supervisory in the process. Internal Controls Document is dated December 29, 2003.

- In terms of verification of data between L&I and PDE, a Computer Data Sharing Agreement was developed and put into place November 19, 2003 as evidenced by the signatures and date on the Computer Data Sharing Agreement.

- Related to signatures, a copy of the electronic submission cover sheet for the Consolidated Annual Performance, Accountability and Financial Status Report Database is presented. This evidences the electronic signature.

In addition, the finding states that estimated data is submitted to USDE. At the State Director's meeting held in Arizona in September 2003, the USDE, Office of Vocational and Adult Education representatives stated that if final data is not available, states can submit estimated data.

Auditors' Conclusion: Regarding the use of actual versus estimated data, the auditors contacted USDE and were informed that estimated data is unacceptable. We recommend PDE obtain formal written approval from USDE to substitute estimated data in place of actual data on the CAR. In addition, as indicated in the agency response, any corrective action by PDE was not implemented in the current fiscal year, but will apply to the CAR submitted in the subsequent fiscal year. Therefore, the finding and recommendation for our current audit remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 16:

CFDA #84.126 – Rehabilitation Services – Vocational Rehabilitation Grants to States

$886,728 in Excess Funds Were Drawn Down From USDE in Violation of Federal Cash Management Regulations (A Similar Condition Was Noted in Prior Year Finding #02-19)

Condition: Our testing of ten draws out of a population of 178 disclosed that for one draw on February 21, 2003, the LECS Comptroller's Office received $2,102,039 of RSBS funds under Federal Grants #H126A020056 and #H126A030056. However, upon further investigation, we determined that only $1,215,311 should have been drawn down under these federal grants resulting in an excess federal drawdown of $886,728. In addition, this overdraw was not detected by LECS personnel and was not adjusted until we inquired about the excess federal revenue as part of our current audit. We noted that LECS personnel posted an adjustment and returned the excess cash to USDE on March 29, 2004. Therefore, the Commonwealth maintained $886,728 in excess federal cash for over 13 months. Furthermore, LECS supervisory personnel reviewed and approved the documents supporting the initial drawdown, but did not detect the error, indicating a weakness in internal controls. Additional analytical review procedures of RSBS drawdowns during our audit period disclosed no other errors in LECS drawdown activity.

Criteria: 34 CFR 80.20 provides the following standard for financial management:

(3) Internal control. Effective control and accountability must be maintained for all grant and subgrant cash. . . .

In addition, US Treasury Regulations in 31 CFR 205.11 provide the following regarding requesting and transferring funds:

(b) A State and a Federal Program Agency must limit the amount of funds transferred to the minimum required to meet a State's actual and immediate cash needs.

Cause: An Access database was developed by OB–BMIS and is used for RSBS draw processing. Each day prior to the actual drawdown (i.e., the projected draw date), LECS personnel perform an Access query using a manually input projected draw date. This query is then used to prepare the Transmittal of Revenue and the support for the drawdown the next day. However, when LECS personnel performed the query for the February 21, 2003 draw date, they inadvertently extracted the ICS expenditure transactions twice for certain voucher transmittals, causing the drawdown amount to be overstated. LECS personnel stated that since there was no difference between the Daily Expenditure Report expenditure total and the Access query expenditure total, the overstated draw amount was not detected during LECS personnel's review and approval of the draw or during the 13 month period subsequent to the draw.

Effect: Due to the error and weakness noted above, L&I violated federal cash management regulations and owes an interest liability to the federal government in accordance with CMIA Treasury-State Agreement. Furthermore, inadequate internal controls over drawdown processing and excess cash could lead to inaccuracies in future draws and not be detected in a timely manner.

Recommendation: LECS should ensure that the appropriate amount of interest payable for the excess cash identified above is reported and remitted to the US Treasury in accordance with CMIA. In addition, LECS should strengthen its internal controls over both the RSBS drawdown process and excess cash recorded on the accounting system to prevent similar undetected errors in the future.

LECS personnel should also perform an overall review of its RSBS drawdowns during our audit period and thereafter to ensure any additional interest owed to the federal government as a result of the above weakness is properly reported and remitted in accordance with CMIA.

Agency Response: LECS is no longer using the drawdown database methodology that led to the drawdown of excess Federal cash. Effective July 1, 2003, with the separation of the OVR Federal and State monies, the RSBS program began

Finding 03 – 16: (continued)

utilizing the Commonwealth's CMIA Drawdown System (CDS) that is used for the majority of Federal Grants in the Commonwealth. The use of this system, with all of its controls in place, will eliminate the problem identified under Cause and Effect of this finding.

A manually prepared interest report for the excess cash on hand for the 13 months will be included with the June 30, 2004 CDS generated CMIA Interest Reports.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 17:

CFDA #84.126 – Rehabilitation Services – Vocational Rehabilitation Grants to States

A Weakness Exists in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #02-18)

Condition: In response to a prior audit finding, OVR personnel indicated that procedures were established to manually check the List of Parties Excluded from Federal Procurement and Nonprocurement Programs and to document the date when new vendors were checked for debarment/suspension in a field named "Debar Review" on the "Supplier Master Display" screen in OVR's computerized vendor system. During the current audit period on June 19, 2003, OVR added a field named "Date Record Added" to indicate the date each new vendor is initially added to the vendor file.

We tested a sample of 23 vendors to verify whether OVR was documenting its review of the Federal List and noted that for 9 of these 23 vendors, the respective vendor file indicated a "Date Record Added" between August 1, 2000 and June 19, 2003. However, for all nine vendors, there was no indication in the "Debar Review" field that the vendor was reviewed for debarment or suspension.

Criteria: USDE Regulation 34 CFR 85.510, regarding participants' responsibilities for debarment and suspension, states in part:

(b) Certification by participants in lower tier covered transactions.

(1) Each participant shall require participants in lower tier covered transactions to include the certification in Appendix B to this part for it and its principals in any proposal submitted in connection with such lower tier covered transactions.

(2) A participant may rely upon the certification of a prospective participant in a lower tier covered transaction that it and its principals are not debarred, suspended, ineligible, or voluntarily excluded from the covered transaction by any Federal agency, unless it knows that the certification is erroneous . . . In addition, a participant may, but is not required to, check the Nonprocurement List for its principals and for participants . . .

34 CFR 80.36(a) states:

When procuring property and services under a grant, a State will follow the same policies and procedures it uses for procurements from its non-Federal funds. The State will ensure that every purchase order or other contract includes any clauses required by Federal statutes and executive orders and their implementing regulations.

Commonwealth Management Directive 215.9, Section 7.a.(2)(B), dated 4-16-99, states:

If the agency makes a written determination of responsibility, the determination shall contain a statement that the contractor was determined to be responsible pursuant to this directive. This statement shall be included in the agency's contract file.

Cause: A letter written by USDE personnel in August 2000 regarding resolution of a similar prior year finding stated that USDE accepted OVR's corrective action, which was to manually verify that all new vendors added on or after August 1, 2000 were not on the List of Parties Excluded from Federal Procurement and Nonprocurement Programs before these vendors were entered into OVR's computerized vendor file.

Finding 03 – 17: (continued)

With respect to the nine vendors in question, OVR represented that these were not new vendors (i.e. added on or after August 1, 2000) and, therefore, they were not checked for debarment/suspension. In response to the prior year finding, effective June 19, 2003 OVR added an unchanging field called "Date Record Added" to the "Supplier Master Display" screen to indicate the date each new vendor is initially added to the vendor file. The date used as the "Date Record Added" for vendors existing prior to June 19, 2003 was the date from "Add/Change Date" field. However, as noted in the prior year audit finding, the "Add/Change Date" field is automatically updated any time a change is made to the vendor file (i.e., address, phone number, contact person, etc.), so this date does not necessarily represent the date the vendor was initially added to the system. Therefore, for vendors existing prior to June 19, 2003 with "Date Record Added" dates between August 1, 2000 and June 19, 2003, and no date in the "Debar Review" field, there is no way to determine if the vendor was an existing vendor as of August 1, 2000 and not required by USDE to be checked for debarment/suspension, or if the vendor was new between August 1, 2000 and June 19, 2003, and required to be checked for debarment/suspension.

Furthermore, OVR could not provide any additional documentation to support that these nine vendors existed prior to August 2000 since their system only maintains historical data for three years. Therefore, OVR could not support their representation that these were not new vendors and should not have been reviewed for debarment or suspension.

Effect: Since L&I personnel did not adequately document their verification that new service providers were not on the List of Parties Excluded from Federal Procurement and Nonprocurement Programs, a control weakness exists and there is limited assurance that RSBS funds were not paid to service providers who have been debarred or suspended from participating in federal programs.

Recommendation: We recommend that OVR maintain adequate documentation to support when service providers were added to OVR's computerized vendor file and/or documentation to support that new service providers were checked for debarment or suspension prior to allowing these providers to participate in the RSBS program.

Agency Response: In the prior year Single Audit finding, it was determined that OVR could not verify the date a vendor was added to their computerized vendor file. The problem stemmed from the fact that the Add/Change Date field OVR was relying on to determine when a vendor was added to the file was not static and would update as other changes were made to the vendor's records. In response to this, OVR implemented a corrective measure on June 19, 2003 in its computerized vendor system. The new information was in the form of a field entitled "Date Record Added" and was implemented to establish a benchmark date on when a new vendor was added and verified for suspension and debarment. Unfortunately, we were unable to get the corrective action plan in place soon enough to effect the current audit period, but the matter should be resolved for future audit periods.

We can now verify, as of July 1, 2003, that through the use of both the "Date Record Added" field and "Debar Review" field, that new vendors have been checked for suspension and debarment and have an accurate certification date in accordance with regulations. This information will also serve to support when service providers have been added to OVR's computerized vendor file. With the correction of this technical problem, we believe that this finding is resolved.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 18:

CFDA #84.126 – Rehabilitation Services – Vocational Rehabilitation Grants to States

Noncompliance and Weaknesses in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding # 02-20)

Condition: During our prior year audit, we noted a weakness in internal controls related to personnel costs charged 100 percent to RSBS. Approximately 98 percent of the employees charging personnel costs to RSBS work only on Vocational Rehabilitation-related activities, and their salaries and benefits are charged 100 percent to RSBS. Based on our sampling and review of job descriptions supporting these costs charged 100 percent, we found the documented grant activities of OVR personnel to be allowable under RSBS. However, although OVR's activities were judged allowable, we noted that OVR was not maintaining properly updated documentation required by OMB Circular A-87 for personnel costs. Specifically, OVR was not obtaining signed semi-annual updates to its job descriptions (or any other semi-annual certification documents) on file to certify that the respective employees worked solely on the RSBS program during the audit period. Our current year audit disclosed that this condition still exists for SFYE June 30, 2003. During the state fiscal year ended June 30, 2003, OVR incurred personnel expenditures of $ 28,853,328 in salaries and $ 8,479,724 in fringe benefits, or $ 37,333,052 in total (federal portion) for the RSBS program.

Criteria: *OMB Circular A-87, Attachment B, Section 11(h), pertaining to the support for salaries and wages states, in part:*

(3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

Cause: OVR indicated that they maintain job descriptions, updated once every four years, detailing the respective employees' job duties for the employees charging 100 percent of their personnel costs to the RSBS program. OVR personnel stated that in response to the prior year finding, they were trying to determine other methods through which the semi-annual certification requirement could be met. However, no changes were made during the fiscal year ended June 30, 2003.

Effect: Since OVR's signed job descriptions or other certification documents are not timely updated on a semi-annual basis as required by OMB A-87 for 100 percent-charged employees, there may be unallowable activities being charged to RSBS which are not being timely detected and corrected by OVR management.

Recommendation: OVR management should strengthen internal controls to ensure that all personnel costs charged to RSBS for employees doing RSBS-related work (including employees working within L&I's Hiram G. Andrews Center) are allowable and properly supported in accordance with OMB Circular A-87.

Agency Response: Over the past year, OVR has been exploring an alternative to completing semi-annual certifications for employees working solely on a single Federal award or cost objective. Information on this exception, contained in ASMB C-10 Implementation Guide for Circular A-87 Part 3-19, provides three examples to show how this certification process can be met through certain payroll codings and time and attendance certifications pursuant to payroll authorizations. This alternate process was discussed with audit staff, however, based on the limited and unclear information available to us we were unable to clearly determine if OVR's payroll codings and other information meet the criteria in the Implementation Guide. Individuals in our Federal Office and the USDOL were also

Finding 03 – 18: (continued)

unable to provide us with an answer on whether our program qualified under these criteria. We have, therefore, decided that it is in our best interest to no longer pursue this option. We have decided instead to set in place a semi-annual certification process. The first certifications will take place in September or December 2004 and the second in March or June 2005. This solution as stated will correct this finding for the audit period ending June 2005.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 19:

CFDA #84.126 – Rehabilitation Services – Vocational Rehabilitation Grants to States

Internal Control Weakness Over Preparation and Submission of Vocational Rehabilitation Provider Claim Forms to SSA (A Similar Condition Was Noted in Prior Year Finding #02-21)

Condition: As part of rehabilitating Social Security beneficiaries, OVR is permitted to request reimbursement from SSA for the costs incurred while serving eligible vocational rehabilitation clients. These SSA reimbursements are considered program income to the RSBS program. To request reimbursement, OVR prepares and submits a Vocational Rehabilitation (VR) Provider Claim form to SSA for each eligible client. During our prior audit, we noted an internal control weakness since the same individual was responsible for preparing, approving, and submitting the claim forms to SSA. There were no procedures in place for a separate OVR supervisory review and approval of the SSA-VR Provider Claim forms. Our current year audit disclosed that this condition still existed for the state fiscal year ended June 30, 2003.

In addition, our testwork disclosed that OVR did not retain the VR Provider Claim form in the amount of $89,458 for one eligible client tested which is further evidence of the internal control weakness noted above.

OVR received approximately $8.6 million in reimbursements from SSA during state fiscal year ended June 30, 2003, based on the claims submitted.

Criteria: 34 CFR 80.20 provides the following standard for financial management:

(b)(3) Internal control. Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets.

In addition, adequate internal controls over the preparation of SSA claims should include a segregation of duties between the preparation and the review and approval of the claims.

34 CFR 80.42 regarding record retention states:

(b) Length of retention period. (1) ...records must be retained for three years...

(c)(3) Records for income transactions after grant or subgrant support. In some cases grantees must report income after the period of grant support. Where there is such a requirement, the retention period for the records pertaining to the earning of the income starts from the end of the grantee's fiscal year in which the income is earned.

Cause: OVR personnel stated that an individual was hired and trained to prepare the SSA claim forms, and the employee who was previously responsible for preparing, approving, and submitting the claim forms to SSA became responsible for reviewing and approving SSA claim forms prior to submission to SSA. However, the separate duties were implemented effective February 2004, which was subsequent to the end of our audit period.

Regarding the missing VR Provider Claim form, OVR personnel could not explain why the form was not retained.

Effect: Since the internal control weakness identified above was not corrected during our audit period, SSA-VR Provider Claims could have been submitted in error and not been timely detected or corrected by management.

Regarding the missing VR Provider Claim Form, OVR was able to provide outside documentation which substantiated the allowability and SSA's subsequent approval of the claim for reimbursement.

Finding 03 – 19: (continued)

Recommendation: OVR personnel should continue performing the separate supervisory review and approval of the SSA-VR Provider Claims which was implemented in February 2004 to ensure that claims are appropriate and accurate. OVR should also implement procedures to ensure that all VR Provider Claim forms and supporting documents are retained for the time period required by the Federal government.

Agency Response: In response to the segregation of duties finding, effective February 11, 2004, OVR began training a newly hired support person to assume the responsibility of preparing and submitting the claim forms to Social Security. The person formerly responsible for preparation, review and approval of Social Security claim forms is now only responsible for review and approval of the forms. The duties of preparation and approval are now separated and since we have complied with the recommendations of the audit finding, we are now no longer out of compliance with this finding.

Regarding the claim form OVR was unable to locate, we plan to issue a memo to all OVR offices re-emphasizing the fact that all claims forms must be filed in client case files to better adhere to 34 CFR 80.20 and in keeping with OVR case file retention policies. We will also emphasize the fact that more care should be taken when filing to avoid the misfiling of items. These items will be further addressed in our corrective action plan.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 20:

CFDA #93.558 – Temporary Assistance for Needy Families

Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #02-23)

Condition: Our review of 37 active TANF cases for those individuals subject to federal work requirements disclosed that only one case file record provided by DPW contained documentation supporting DPW's initial assessment of the skills, prior work experience, and employability of the TANF recipient. Therefore, DPW could not support compliance with federal welfare reform regulations.

Criteria: Federal regulation 45 CFR 261.11(a) states:

(a) The State must make an initial assessment of the skills, prior work experience, and employability of each recipient who is at least age 18 or who has not completed high school (or equivalent) and is not attending secondary school.

In addition, 45 CFR 74.53(b) states:

(b) Financial records, supporting documents, statistical records, and all other records pertinent to an award shall be retained for a period of three years from the date of submission of the final expenditure report or, for awards that are renewed quarterly or annually, from the date of submission of the quarterly or annual financial report.

Cause: DPW personnel stated that the Department's assessments consist of the RESET Participant Guide to Success (Guide - PA 1680) and the job search process. RESET, which stands for Road to Economic Self-Sufficiency through Employment and Training, is the process by which the recipient and the caseworker together prepare a plan of action using the RESET Guide. The DPW, Office of Income Maintenance, issued Operations Memorandum – OPS020202, dated February 13, 2002, to remind caseworkers of the requirement to file and retain the Participant Guide to Success, PA 1680, as part of the client's case record for a period of three years. However, DPW officials could not explain why the CAOs failed to maintain a copy of the RESET Guide within the TANF recipients' case files.

Effect: Since DPW could only provide a copy of the completed RESET Guide (PA 1680) for one of the case files we tested, it cannot support compliance with federal regulation 45 CFR 261.11. Further, since the documented assessments were not maintained, we could not determine whether TANF recipients received the appropriate training and/or employment placement guidance required by TANF regulations and the federal Welfare Reform Act of 1996.

Recommendation: DPW should strengthen its existing procedures to ensure that the assessment of skills, prior work experience, and employability of each recipient is properly documented within a RESET Guide (PA 1680) and retained in each case file as required.

Agency Response: The Office of Income Maintenance (OIM) concurs with the audit finding. The Department's assessment is to be documented in each file as the "RESET Participant Guide to Success and the Job Search Process" (Guide – PA 1680). An Operations Memorandum dated February 13, 2002, giving direction to carry this out and use the Guide was distributed to Area Managers and yet this audit could only find one PA 1680 in 37 case files reviewed.

In response to this audit, which is recognized as a repeat finding from a previous audit, three points of action are being implemented to ensure proper use and filing of the Guide. First, additional direction has been issued to Area Managers to make the PA 1680 a part of the targeted supervisory review. Second, the Bureau of Employment and Training will have their program advisors review case files for PA 1680s during their monitoring visits. Third, the Bureau of Employment and Training will issue another Operations Memorandum on this issue.

Finding 03 – 20: (continued)

DPW agrees that documentation of the TANF recipients' skills, prior work experience and employability assessment is critical in confirming they received the appropriate training and employment placement guidance required by TANF regulations and the Federal Welfare Reform Act of 1996. This is a functional responsibility of the County Assistance Office to file this form in the record.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 21:

CFDA #93.558 – Temporary Assistance for Needy Families

Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #02-24)

Condition: Within the TANF program, DPW is required to submit the TANF Data Report, or Form ACF-199, on a quarterly basis. The ACF-199 Report provides HHS with various types of data on Pennsylvania's TANF participants including family type, work participation status, subsidized and unsubsidized employment activity, job search and job readiness activities, etc. Each quarter, DPW electronically submits a file to HHS that contains the aforementioned data. This file consists of three individual monthly files (one for each month of the quarter) of all TANF participants contained on DPW's Client Information System (CIS). In order to test the data on the file submitted to HHS, we obtained the data for the sampled month of March 2003. Our analytical review of aggregated data revealed significant inconsistencies in totals reported under three different categories with little or no DPW review and follow up to ensure the accuracy of totals reported.

In particular, under person-level data-marital status (item #37), the March 2003 CIS file reported 12,832 adults as married, living together. Under person-level data-relationship to head of household status (item #38), CIS reported only 4,699 spouses. CIS also reported only 3,110 two-parent families in the aggregate. Because of the wide disparities in these totals, we inquired at DPW about the reasons for these inconsistencies. While DPW responded with some general explanations about how differences *could* occur in these categories, we found that DPW could provide no evidence to support the actual difference since officials had not properly reviewed the CIS file to determine its completeness and accuracy before submitting it to HHS as the ACF-199 Report. Based on HHS's report format, all or some of these category totals appear to be in error.

In addition, we randomly selected 42 cases from the March 2003 CIS data file, performed analytical review procedures, and attempted to trace certain data, as required by the Federal A–133 Compliance Supplement, to documentation in the participant's case file. This testing disclosed errors for 15 of the 42 cases, or 36 percent, as follows:

- Out of the 42 cases reviewed on the data report, 34 cases had no work activity for the period and 8 cases included work activity. However, for 4 of the 8 cases with work activity, or 50.0 percent, the number of unsubsidized weekly employment hours (item #49) reported did not agree with, or could not be supported by, the case file as follows:

Case Number	Number of Hours Reported on the ACF-199 Report	Number of Hours Worked Per the Case File	Difference
020873836	0	28	28
021009019	9	17	8
480143470	13	*	*
511436062	19	*	*

* The hours worked could not be determined since the check stubs supporting the number of hours the participant worked were not included within the case file.

- Two of 42 cases sampled included job search and job readiness (item #54) activity on the ACF-199 Report; however, case file documentation provided did not agree with, or did not support any hours for job search activities as follows:

Finding 03 – 21: (continued)

Case Number	Number of Hours Reported on the ACF-199 Report	Number of Job Search and Job Readiness Hours Per the Case File	Difference
220140065	17	*	17
390179667	11	10	1

* The number of job search and job readiness activities could not be determined since there was no documentation to support these activities within the case file.

- One of the 42 case files included education related to employment with no high school diploma (item #58) activity on the ACF-199 Report. However, case file documentation provided did not support any hours for education related to employment with no high school diploma activities as follows:

Case Number	Number of Hours Reported on the ACF-199 Report
480141739	8

- One of the 42 case files included job skills training – employment related (item #57) activity on the ACF-199 Report. However, case file documentation provided did not support any hours for job skills training – employment related activities as follows:

Case Number	Number of Hours Reported on the ACF-199 Report
511436062	11

- The work participation status for 1 of 42 case files was reported as Code 7 – Exempt, disabled (not using an extended definition under a state waiver). However, there was no documentation such as a letter from a physician to support the disability.

- For 2 of the 42 cases tested, there was no personal level data (i.e., date of birth, social security number, work participation status, etc.), reported on the ACF-199 Report as follows.

Case Number
110164967
511324262

- For 3 of the 42 cases tested, the number of family members identified within the case file (item #11) did not agree with the ACF-199 Report as follows:

Finding 03 – 21: (continued)

Case Number	Number of Family Members Per the Case File	Number of Family Members Reported on The ACF-199 Report
511333487	3	2
511777934	3	2
512355973	4	5

- One of the 42 case files included the vocational education training hours (item #58) activity on the ACF-199 Report. However, case file documentation provided did not support any hours for vocational education training as follows:

Case Number	Number of Hours Reported on the ACF-199 Report
021009019	19

In addition, since DPW's CIS data files are also used for other TANF data reports submitted to HHS (i.e., the ACF-202 Report), our testwork calls into question the accuracy of the CIS data reported to HHS in these other federal reports.

Criteria: Section 411(a)(1) of the Social Security Act states, in part:

(A) CONTENTS OF REPORT.—Each eligible State shall collect on a monthly basis, and report to the Secretary on a quarterly basis, the following disaggregated case record information on the families receiving assistance under the State program funded under this part:

(iv) The number of individuals in the family, and the relation of each family member to the head of the family….

(ix) Whether the family received subsidized housing, medical assistance under the State plan approved under title XIX, food stamps, or subsidized child care, and if the latter 2, the amount received.

(x) The number of months that the family has received each type of assistance under the program.

(xi) If the adults participated in, and the number of hours per week of participation in, the following activities:

(I) Education.
(II) Subsidized private sector employment.
(III) Unsubsidized employment.
(IV) Public sector employment, work experience, or community service.
(V) Job search.
(VI) Job skills training or on-the-job training.
(VII) Vocational education

(xii) Information necessary to calculate participation rates under section 407.

In addition, 45 CFR Part 265.3 states:

(b) TANF Data Report. The TANF Data Report consists of three sections. Two sections contain disaggregated data elements and one section contains aggregated data elements.

Finding 03 – 21: (continued)

(1) Disaggregated Data on Families Receiving TANF Assistance – Section one. Each State must file disaggregated information on families receiving TANF assistance.[2] This section specifies identifying and demographic data such as the individual's Social Security Number; and information such as the type and amount of assistance received, educational level, employment status, work participation activities, citizenship status, and earned and unearned income. The data apply to adults and children.

(2) Disaggregated Data on Families No Longer Receiving TANF Assistance – Section two. Each State must file disaggregated information on families no longer receiving TANF assistance.[3] This section specifies the reasons for case closure and data similar to the data in section one.

(3) Aggregated Data – Section three. Each State must file aggregated information on families receiving, applying for, and no longer receiving TANF assistance.[4] This section of the Report requires aggregate figures in such areas as: The number of applications and their disposition; the number of recipient families, adult recipients, and child recipients; the number of births and out-of-wedlock births for families receiving TANF assistance; the number of noncustodial parents participating in work activities; and the number of closed cases.

[2] See Appendix A for the specific data elements and instructions.
[3] See Appendix B for the specific data elements and instructions.
[4] See Appendix C for the specific data elements and instructions.

Also, 45 CFR, Part 265.2(b) states:

(b) For data collection and reporting purposes only, family means:

(1) All individuals receiving assistance as part of a family under the State's TANF or separate State program (including noncustodial parents, where required under § 265.3(f)); and

(2) The following additional persons living in the household, if not included under paragraph (b)(1) of this section:

(i) Parent(s) or caretaker relative(s) of any minor child receiving assistance;

(ii) Minor siblings of any child receiving assistance.

Cause: DPW officials cannot explain the major inconsistencies between the number of two-parent families versus the number of spouses classified as heads of households, or the number of married adults living together. While DPW disagrees with our conclusion regarding the aggregate data on two-parent families and spouses (Item #38), DPW cannot explain the 51 percent variance between the reported totals disclosed above, which appears unreasonable without further explanation and follow-up.

Since the TANF case files are prepared and maintained at the CAOs, DPW central office personnel could not explain the variances between the case files and ACF-199 Report regarding the classifications of certain individuals, the number of family members, or the variances in work activity hours. For hours that were not documented at all, pay stubs were not available because there is no policy requiring the retention of pay stubs or other documents that could support work hours after the hours are entered on to CIS.

With regard to the documentation supporting work experience, job search, and job readiness activities, DPW personnel indicated that these hours are entered into the Automated Interface Management System (AIMS) by outside contractors who are subject to program monitoring. AIMS is then supposed to interface with CIS, from which the applicable participant's hours for work experience, job search, and job readiness activities are calculated. However, DPW cannot demonstrate that these contractors are being monitored or that the hours they are reporting are correct.

Finding 03 – 21: (continued)

Effect: Based on the error rates and the nature of the errors noted in the condition, DPW did not comply with federal reporting requirements. DPW also provides little assurance that the information submitted to HHS on the ACF-199 Report is accurate. In addition, the accuracy of CIS data for other TANF reports submitted to HHS is also questionable. As a result, HHS may not be accurately calculating and evaluating Pennsylvania's work participation rates within the TANF program. Furthermore, as in the prior year, Pennsylvania's work participation rate for FFY 2002 may be materially incorrect.

Recommendation: DPW should evaluate the feasibility of submitting revised ACF-199 reports for the FFY 2002. Also, DPW should review and evaluate its procedures and controls to accumulate, review, and report its TANF information on the ACF-199 Report and make the necessary revisions to ensure that future information reported is complete, accurate, and properly supported by the participants' case files. Further, DPW should ensure any other TANF reports prepared using CIS data are accurate.

Agency Response: DPW's Office of Income Maintenance (OIM) agrees with most of the conditions as stated, and concurs with the recommendation. Currently, DPW/OIM is researching the feasibility of resubmitting the data for FFY 2002 and is willing to resubmit the data if HHS will accept the resubmission. Secondly, DPW/OIM acknowledges deficiencies with the ACF-199 Data Report. To address these issues, corrective actions have been implemented which will ensure the ACF-199 Data Report is complete and accurate. Lastly, we would like to provide clarification in reference to certain findings detailed below.

Marital Status, Relationship to Head of Household, and Two Parent Families Are Inconsistent

DPW has implemented corrective actions described below which will determine if this issue has merit.

Personal Level Data Missing

Case Number: 11/0164967

We disagree with this finding. The child born February 21, 2003 was added to the TANF grant on February 25, 2003 (effective February 21, 2003). We have verified the child was enumerated at birth and the Social Security Number was not issued by the Social Security Administration until March 10, 2003. The grace period for enumeration extended until April 1, 2003, subsequent to the March 2003 review month.

Number of Family Members

We disagree with the finding because we believe in each case, the number of family members reported on the ACF-199 Report was correct.

Case Number	Number of Family Members Per The Case File	Number of Family Members Reported On The ACF-199 Report
51/1333487 Son, Age 19 Receiving FS and MA, but not TANF eligible	3	2
51/1777934 Grandaughter, born 6/5/03, subsequent to 03/03 review month	3	2
51/2355973 Grandmother active in case as NS through 03/18	4	5

Finding 03 – 21: (continued)

DPW/OIM requests consideration be given to withdrawing the findings related to Personal Level Data and Number of Family Members.

By acknowledging deficiencies in the ACF-199 Data Report, DPW/OIM has implemented and is developing corrective actions. Corrective Actions implemented since January 2002 include:

- Submitting the ACF-199 Report from a stratified random sample of TANF households, instead of information extracted from the entire TANF universe. Sampling provides the opportunity to audit data prior to submission. The monthly sample is 250-300 cases and is comprised of cases from the following categories to TANF cases:

  New Applicant Families: Approximately 50 cases per month
  Two Parent Families: Approximately 50 cases per month
  Ongoing Cases: Approximately 150 cases per month

- Software modification implemented to ensure reporting of subsidized child care payments
- Software modification implemented to verify individuals reported as adults are 18 years of age or older
- On-line notification to County Offices of sampled ACF-199 cases
- Designation of a contact person within each County Office to coordinate collection of monthly employment and activity hours, and online submission of the ACF-199 Report for cases sampled from their office.
- Redesign of forms to collect and verify monthly activity hours from clients and/or training facilities. The completed forms and supporting documentation will be retained in the case file.
- Implementation of a review of contracted employment and training programs to ensure they operate in accordance with performance standards established for each program to include entry of information into the Automated Integrated Management System (AIMS)

Effective October 2003, DPW/OIM began a review of the adult individuals sampled in the ACF-199. The review encompassed:

- Verifying the employment/activity hours were correct
- Ensuring verification of employment/activity hours is retained in the case record
- Verifying marital status/relationship
- Ensuring that deficiencies were corrected

Beginning October 2004, DPW/OIM will initiate an ongoing structured review of selected cases within the ACF-199 sample to include:

- Verify all contracted and non-contracted activities and work hours
- Ensure that documentation to support the activity hours is in the case file
- Review the marital status and relationship of each adult
- Ensure child care payments are reported
- Verify individuals under 18 are coded as children and not a minor parent
- Ensure appropriate follow up and corrections to the ACF-199 and/or County data

In closing, DPW/OIM believes that a more accurate ACF-199 Report will result from these corrective actions, which have been implemented. As a result of sampling, we now have the ability to audit the ACF-199 and make corrections prior to submission. This audit will institute a pro-active approach in identifying problems and implementing the necessary corrective actions.

Auditors' Conclusion: Regarding Personal Level Data for case number 11/0164967, regulations state that any person that is receiving assistance for the month under TANF should be included in the TANF Data Report.

Finding 03 – 21: (continued)

Regarding the Number of Family Members data we offer the following:

For case number 51/1333487, the application provided to support case file data reported was signed and dated January 2, 2003 showing a 20 year old son as part of the case for TANF benefits.

For case number 51/1777934, the application provided to support case file data reported was signed and dated December 2, 2002 and the birth date listed in the case file appeared to be June 5, 2002. However, given that the birth date is not fully legible a DPW employee may have written this in the application subsequent to the application date of December 2, 2002 to support the addition of the child to the case with a birth date of June 5, 2003 instead of requiring an updated application from the parent. Without a birth certificate to support the actual birth date this case remains as stated in the condition above.

For case number 51/2355973, the application provided to support case file data reported was signed and dated February 28, 2003 showing that the grandmother was not living in the household. As a result, the grandmother should have been removed from the case for the month of March 2003. However, documentation provided by DPW disclosed the grandmother was not removed from the case until March 19, 2003.

For all other issues in the finding, we will evaluate any corrective action in our subsequent audit. Based on the agency response, our finding and recommendation, with the above clarifications, remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 22:

CFDA #93.563 – Child Support Enforcement

Noncompliance and Internal Control Weakness Over the Processing of Interstate Registry Cases (A Similar Condition Was Noted in Prior Year Finding #02-25)

Condition: Federal regulations require that DPW establish an interstate central registry for CSE which is responsible for receiving, distributing, and responding to inquiries on all interstate IV-D cases within established timeframes. Our test of 20 responding interstate cases during our test month of March 2003 disclosed that DPW did not meet the 10-day established timeframe for processing the case for 2 of the 20 items tested (or 10 percent) as follows:

Case ID	Date Case Received	Date Case Processed	Working Days Between Receipt And Processing
698105373	3/10/03	4/02/03	17
957105373	3/17/03	4/01/03	11

In addition, our test of 20 initiating interstate cases during our test month of March 2003 disclosed that DPW did not meet the 20-day established timeframe for processing the case for 2 of the 20 cases tested (or 10 percent) as follows:

Case ID	Date Case Initiated	Date Case Processed	Calendar Days Between Receipt And Processing
268105532	3/04/03	6/05/03	93
772105417	3/10/03	4/16/03	37

Furthermore, we noted an internal control weakness in that interstate processing dates were not being recorded accurately on DPW's PACSES system. We found that out of 10 cases examined for accuracy of dates recorded on PACSES (5 responding and 5 initiating cases), 6 of the 10 cases (or 60 percent) had inaccurate dates on PACSES, and the system does not appear reliable. Although all 6 errors caused PACSES to record timeframes which turned out to be longer than the actual timeframe in the supporting case files, the 60 percent error rate is indicative of a weakness in DPW's controls over the accuracy of PACSES data. The 6 case ID numbers are 844105334, 833105342, 899106260, 957105302, 457105313, and 728105337.

Criteria: 45 CFR, Part 303.7(a) and (b), state in part:

(a) Interstate central registry. (1) The State IV-D agency must establish an interstate central registry responsible for receiving, distributing and responding to inquiries on all incoming interstate IV-D cases.

(2) Within 10 working days of receipt of an interstate IV-D case from an initiating State, the central registry must:

(i) Ensure that the documentation submitted with the case has been reviewed to determine completeness;

(ii) Forward the case for necessary action either to the State PLS for location services or to the appropriate agency for processing;

(iii) Acknowledge receipt of the case and ensure that any missing documentation has been requested from the initiating State; and

(iv) Inform the IV-D agency in the initiating State where the case was sent for action.

Finding 03 – 22: (continued)

(b) Initiating State IV-D agency responsibilities. The IV-D agency must:

(1) If the State has a long-arm statute which allows paternity establishment, use the authority to establish paternity whenever appropriate.

(2) Except as provided in paragraph (b)(1) of this section, within 20 calendar days of determining that the noncustodial parent is in another State, and, if appropriate, receipt of any necessary information needed to process the case, refer any interstate IV-D case to the responding State's interstate central registry for action, including requests for location, document verification, administrative reviews in Federal income tax refund offset cases, wage withholding, and State income tax refund offset in IV-D cases.

Cause: DPW personnel stated that the delays were due to DPW awaiting additional required documentation from the initiating state or DRS to process the case, or in many instances, the cases were processed within the timeframes but were not documented as processed on PACSES since the case was not closed. Regarding PACSES recording, we noted that there is ineffective review and oversight by DPW to ensure PACSES dates are accurate.

In addition, DPW did not implement changes to its procedures or internal controls in response to our prior year finding because CSE officials believe the overall error rates in processing initiating and responding cases are within limits that are acceptable to HHS.

Effect: Since DPW did not process the responding and initiating interstate cases within the required timeframes, DPW was not in compliance with federal regulations, and internal controls need to be strengthened. In addition, DPW cannot enforce support obligations on behalf of requesting states on a timely basis, or ensure that support obligations are forwarded to other states on a timely basis. Furthermore, if controls over PACSES recording are not strengthened, dates on the system will continue to be inaccurate in the future, thus causing inaccurate reporting to HHS.

Recommendation: DPW should strengthen its existing controls to ensure that responding and initiating interstate registry cases are processed within the established timeframes and that processing dates recorded on PACSES are accurate.

Agency Response: The Bureau of Child Support Enforcement (BCSE), Division of Program Development and Evaluation, reviewed the Department of the Auditor General (AG) Single Audit Finding for Child Support Enforcement – for fiscal year ended June 30, 2003, which reported material non-compliance and internal control weakness over the process of Interstate Registry Cases. BCSE independently reviewed each of the reported sample cases and found material errors within the Single Audit conclusions. The results of BCSE's individual case reviews, along with supporting case documentation, were provided to the AG Single Auditors. Subsequently, the AG Single Auditors disclosed that the audit sample is not representative of either the interstate responding case universe or the interstate initiating case universe for State Fiscal Year Ended June 30, 2003. BCSE was advised that the audit sample selection was not random, but specifically selected cases with initial date points that would support an audit finding of noncompliance with interstate time frames.

Responding Interstate Cases

BCSE acknowledges that case IDs 698105373 and 957105373 were not processed within the required 10 working day timeframe.

Finding 03 – 22: (continued)

General Interstate Responding Case Comments:

The BCSE notes that 45 CFR 305.63, Standards for determining substantial compliance with IV-D requirements, Section C, specifies that BCSE must provide interstate services, required under 45 CFR 307, in at least 75 percent of the cases reviewed. The BCSE review disclosed that BCSE responded timely in 18 out of 20 cases for a sample compliance rate of 90 percent, which indicates material compliance with federal regulations. Furthermore, the BCSE, Division of Central Operations, has had an independent interstate central registry case tracking system in place since 1999. This tracking system is used to monitor all cases processed by the BCSE interstate case registry, including incomplete cases that cannot be recorded on PACSES, and must subsequently be returned to the initiating state. The global tracking system records for the audit period of July 1, 2002 to June 30, 2003 disclosed that BCSE received 5,154 responding interstate petitions. The average interstate central registry processing time for all of those petitions was 7.94 calendar days. Similar records exist for the prior audit period of July 1, 2001 to June 30, 2002. Summary reporting records were provided to the AG Single Auditors. In addition, BCSE tracking system records are available for inspection upon AG Single Auditors' request.

Initiating Interstate Cases

In accordance with 45 CFR §303.7, the Title IV-D agency must, within 20 calendar days of determining that the non-custodial parent is in another state, refer any interstate IV-D case to the responding state's interstate central registry for action. BCSE, through Title IV-D Cooperative Agreements with all 67 Counties, has agreed to have the individual DRSs provide initiating services to Title IV-D recipients. In accordance with Title 23 of the Pennsylvania Consolidated Statutes Annotated (23 Pa.C.S.A.), Section 4342(c), DRSs are expected to process interstate cases under local long-arm procedures before referring the case to the other state. 23 Pa.C.S.A. Section 4342(c) is provided below:

§ 4342. Expedited procedure.

(c) Long arm procedures--The Supreme Court shall by general rule establish procedures for the exercise of long-arm jurisdiction to establish paternity and to establish and enforce support. Long arm jurisdiction shall be used in preference to proceedings under Part VIII (relating to uniform interstate family support) or VIII-A (relating to intrastate family support) unless it would be more effective to proceed otherwise. Long-arm proceedings may be commenced or continued in any county where the plaintiff resides regardless of whether the parties maintained a family domicile in that county.

The results of BCSE's sample case review are provided as follows:

	BCSE	Auditors
Case ID: 268105532		
Date Case Initiated	3/4/03	3/4/03
Date Case Processed:	3/20/03	6/5/03
Number of Calendar Days:	16	93

Two cases exist for the child. The DRS actively worked this case under Case ID 045101697, which was initiated November 11, 1999, with an order subsequently established by the State of Delaware. On March 20, 2003, the DRS forwarded an interstate controlling order determination request to the State of Delaware. The response to that request is reflected in Case ID 268105532 when the existing support order beneficiary was officially changed from the plaintiff in Case ID 045101697 to the Somerset County Children & Youth (C&Y) in Case ID 268105532. PACSES case documentation supporting the BCSE review was presented to the AG Single Auditors.

Finding 03 – 22: (continued)

	BCSE	Auditors
Case ID: 772105417		
Date Case Initiated as local case:	3/10/03	
Case Determined Interstate	4/16/03	3/10/03
Date Case Processed:	4/16/03	4/16/03
Number of Calendar Days:	0	37

The BCSE review of PACSES records disclosed that the case was processed on the date the case was determined to be an interstate case. PACSES case documentation supporting the BCSE review was presented to the AG Single Auditors.

General Interstate Initiating Case Comments:

Interstate initiating cases are not processed by DPW's interstate central registry: they are sent directly to other state central registries by local DRSs. However, even though BCSE does not process interstate initiating cases, BCSE has individual county-level monitoring and tracking reports in place to verify compliance with Federal time frames. Those county-level tracking reports are also used within BCSE's annual county risk assessment to determine BCSE's annual performance audit schedule. Counties found not to be in compliance with Federal criteria are required to complete a corrective action plan. The results of our audits are available for Single Audit inspection.

The BCSE further notes that 45 CFR §305.63, Standards for determining substantial compliance with IV-D requirements, Section C, specifies that BCSE must provide interstate services, required under 45 CFR §303.7, in at least 75 percent of the cases reviewed. The BCSE review disclosed that BCSE responded timely in 20 out of 20 cases for a sample compliance rate of 100 percent, which indicates material compliance with federal regulations. Furthermore, the last BCSE self-assessment report for Federal Fiscal Year ended September 30, 2003, disclosed a global interstate processing compliance rate of 75 percent. Further, the compliance rate criteria used in the self-assessment report is significantly more restrictive than the criteria found at 45 CFR §303.7. BCSE self-assessment records are available for inspection upon AG Single Auditors request.

Auditors' Conclusion: Regarding the sample selection method, we did not (nor are we required to) select a random or statistical/representative based sample because DPW had already provided us the CSE Self-Assessment Report for the federal fiscal year ended September 30, 2003 which disclosed a 25 percent noncompliance rate within the universe of all interstate cases. This rate exceeds our definition of material noncompliance as documented within auditing standards, so our conclusion that material noncompliance occurred does not change. Since the error rate within the universe was already represented to us as 25 percent, one of the objectives in our sampling was to determine if the PACSES dates establishing the time frames in the universe were accurate. As a result, we selected a judgmental sample of 75 percent of cases meeting the time frame requirements and 25 percent that exceeded the time frame (i.e., the same rate of noncompliance that DPW acknowledged is present in the universe of interstate cases). Based on our condition above, six date errors were disclosed in the ten items noted above in the PACSES data extractions.

For case ID 268105532 and 772105417, case file data provided did not contain adequate information to support the BCSE claim that they were processed or determined to be interstate on the dates indicated in the agency response.

Further, regarding the substantial compliance requirements of 45 CFR 305.63, this regulation applies to audits conducted by HHS, not our Single Audit. The Single Audit A-133 Compliance Supplement for the CSE program states the audit objective to be: "Determine whether the State IV-D agency provided required child support services to interstate case

Finding 03 – 22: (continued)

within the required time frame." The time frame regulations quoted in the A-133 Compliance Supplement are 45 CFR 303.7. The Compliance Supplement does not establish any substantial compliance requirements for the Single Audit; therefore, our materiality for the Single Audit is actually lower than the 25 percent rate noted in 45 CFR 305.63. In addition, we are awaiting federal resolution on our prior year findings and conclusions on these issues.

Based on the agency response, our finding and recommendation, with the above clarifications, remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 23:

CFDA #93.575 – Child Care and Development Block Grant
CFDA #93.596 – Child Care Mandatory and Matching Funds of the Child Care and Development Fund

Internal Control Weaknesses and Noncompliance With Federal Earmarking Requirements Result in Questioned Costs of $3,224,570 (A Similar Condition Was Noted in Prior Year Finding #02-27)

Condition: Federal regulations applicable to the Discretionary Fund portion of the CCDF program established an earmark within the FFY 2001 federal award requiring a minimum funding level of $3,224,570 to increase the supply of quality child care for infants and toddlers. Our test of expenditures charged and obligated to the FFY 2001 grant as of September 30, 2002, disclosed that DPW could not provide documentation to support the amount of expenditures claimed for the infant and toddler earmark.

DPW claimed $1,685,920 for infant and toddler quality activities for FFY 2001 on document number CV00072346 dated August 13, 2002, which consisted of funds paid to three subrecipients. Total payments to these three subrecipients for the FFY 2001 CCDF grant were actually over $10 million, but DPW retained no documentation to support the infant and toddler portion of this payment total. Also, no additional funds were obligated under the infant and toddler quality activities as of September 30, 2002, the last day of the period of availability for FFY 2001 CCDF Discretionary Funds. Since DPW could provide no documentation to support whether any of these $1,685,920 in subrecipient payments qualified for inclusion in the infant and toddler earmark, and DPW did not obligate any additional funds towards the infant and toddler earmark by September 30, 2002, DPW cannot support that any of the $3,224,570 minimum earmark was met for the FFY 2001 grant.

Criteria: The terms and conditions issued with the FFY 2001 Child Care and Development Fund grant award state:

Discretionary Fund

Discretionary Funds must be obligated by September 30, 2002. States must liquidate obligations by September 30, 2003.

Earmarks associated with the Discretionary Fund

The FY 2001 Consolidated Appropriations Act earmarked specific amounts for these activities:

- *Child Care Quality Improvement Activities*
- *Infant and Toddler Quality Improvement*
- *Child Care Resource and Referral and School Aged Child Care Activities*

The amount of these earmarks is included as part of the Discretionary Fund in calculating the "not less than 4% quality expenditure requirement" of Section 658G of the CCDBG Act. However, the expenditures of these earmarked amounts are not counted toward meeting the 4% quality expenditure requirement.

In addition, HHS Information Memorandum No. ACYF-IM-CC-01-01 regarding the FFY 2001 Final Allotments and Earmarked Funds established Pennsylvania's infant and toddler earmark as $3,224,570.

Also, 45 CFR 98.60(d)(1) states:

(1) Discretionary Fund allotments shall be obligated in the fiscal year in which funds are awarded or in the succeeding fiscal year.

Finding 03 – 23: (continued)

Furthermore, 45 CFR Part 98.60(d)(7) states:

(7) Any funds not obligated during the obligation period specified in paragraph (d) of this section will revert to the Federal government.

Cause: Compliance with the infant and toddler earmark was not properly documented, tracked, and monitored by DPW. According to personnel, the earmark was taken into consideration during the budgetary phase of the three subrecipient contracts mentioned above, but actual costs were apparently never tracked by DPW to measure compliance. In addition, DPW personnel could not explain why the full earmark was not obligated by September 30, 2002.

Effect: DPW did not retain documentation to support its compliance with federal earmarking regulations. Since the necessary documentation to support compliance with the earmark is not available, DPW cannot demonstrate that any FFY 2001 CCDF funds were spent on federally-mandated infant and toddler child care vs. other CCDF activities. Since costs spent or obligated on other CCDF activities are not allowable because of the earmarking requirement, the entire amount of the $3,224,570 earmark is questioned.

Recommendation: We recommend that DPW pursue appropriate settlement with HHS regarding the $3,224,570 of questioned costs. In addition, DPW should establish procedures to adequately document, track, and ensure that infant and toddler earmarks are met within future CCDF grants.

Agency Response: Although we acknowledge that documentation of expenditures by subrecipients for the infant toddler earmark were insufficient during this period to clearly document the earmark expenditures, we disagree with the conclusion that "DPW cannot support that any of the $3,224,570 minimum earmark was met for the FFY 2001 grant." We have subsequently conducted a retrospective review of infant-toddler expenditures for this period and have documentation to show that funds in excess of the above minimum amount required for the earmark were spent on quality initiatives for the infant toddler population. We are prepared to review with auditors the methodology we have used to conduct this retrospective review of expenditures and believe that it will clearly document that the required funds were spent in accordance with the Child Care Development Fund requirements. We conducted this review of infant-toddler expenditures in conjunction with our subrecipient agencies (the four Child Care Resource Developers agencies and Keystone University Research Corporation) using receipts of actual expenditures or attendance sheets for training sessions attended by child care providers.

In addition, we have made changes in our internal control procedures for documenting these expenditures through our subrecipients that we believe will ensure that we meet the federal documentation requirements moving forward from the current FFY.

Auditors' Conclusion: We met with DPW personnel to review their documentation to support the $3,224,570 in questioned costs. The documentation provided was represented by DPW to be training costs incurred by one of their subrecipients; however, these costs were not supported by adequate documentation from the subrecipient since there were no signed/certified subrecipient expenditure reports. In addition, these costs were not part of the expenditures posted to the accounting records and claimed by DPW to support the infant and toddler earmark. In addition, no documentation was provided to support that the infant and toddler earmark was obligated by September 30, 2002 as required. As a result, the costs remain questioned.

We will review DPW's changes to their procedures regarding this issue during our subsequent audit. Therefore, the finding and recommendation remain as previously stated.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 24:

CFDA #93.575 – Child Care and Development Block Grant
CFDA #93.596 – Child Care Mandatory and Matching Funds of the Child Care and Development Fund
CFDA #93.667 – Social Services Block Grant

Weaknesses in DPW Monitoring of Subgrantees Results in Over $7 Million in Excess Subgrantee Federal Cash at June 30, 2003 (A Similar Condition Was Noted in Prior Year Finding #02-26)

Condition: Our examination of DPW's procedures for monitoring SSBG and CCDBG/CCDF (Child Care Cluster) Mandatory and Matching subgrantees for compliance with federal regulations revealed that DPW advanced funds to CCDBG and CCDF subgrantees and to SSBG subgrantees in 6 of 11 SSBG program areas, representing approximately 85 percent and 74 percent of total CCDBG/CCDF Cluster and SSBG program expenditures, respectively. However, we noted that program monitoring of these subgrantees during the awards was not adequate to ensure subgrantee compliance with federal regulations, including cash management standards.

In particular, for the Emergency Shelter, Legal Services, and Child Care components of the SSBG program, DPW advanced funds to subgrantees on a monthly basis. For SSBG Mental Health, Mental Retardation, and Child Welfare, DPW advanced funds to subgrantees on a quarterly basis. Our inquiries with applicable DPW program administrators disclosed that DPW did not adequately monitor any of its SSBG subrecipients for compliance either at the time of payment or at any other time during the current state fiscal year.

Also, for the CCDBG/CCDF Cluster, between July 1 and November 21, 2003, subgrantees returned $7.6 million in year-end excess cash to DPW from advance payments made monthly but not monitored by DPW during SFYE June 30, 2003. DPW did not perform adequate monitoring procedures of CCDBG/CCDF subgrantees during the current fiscal year.

Criteria: Advances by a state to secondary recipients shall conform substantially to the same standards of timing and amount which apply to the state.

45 CFR 92.37, Subgrants, states:

(a) States. States shall follow state law and procedures when awarding and administering subgrants (whether on a cost reimbursement or fixed amount basis) of financial assistance to local and Indian tribal governments. States shall:

(4) Conform any advances of grant funds to subgrantees substantially to the same standards of timing and amount that apply to cash advances by Federal agencies.

In addition:

In discussions with our office, federal agencies have stated that cash advance balances on hand at subrecipients are reasonable if they approximate the grantee's (state's) payment cycle to the subgrantee. In light of the (state agencies) administrative system of making (daily, weekly or monthly) payments by check to subrecipients, a (daily, weekly or up to one month) cash advance on hand monitored at least quarterly is reasonable.

The OMB Circular A-133 Compliance Supplement Part 3.,M. Subrecipient Monitoring, states:

A pass-through entity is responsible for:

During-the-Award Monitoring – Monitoring the subrecipient's use of Federal awards through site visits or other means to provide reasonable assurance that the subrecipient administers Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.

Finding 03 – 24: (continued)

Cause: DPW personnel indicated that for child care payments under CCDBG/CCDF and SSBG, utilization reports from subgrantees were being reviewed for cash management purposes and payments to subgrantees were adjusted if necessary. However, given the fact that excessive refunds are returned to DPW every year and refunds for the current year were in excess of $7 million, DPW's subgrantee monitoring procedures for CCDBG/CCDF are not adequate.

Regarding the Emergency Shelter, Legal Services, Mental Health, Mental Retardation and Child Welfare components of SSBG, DPW personnel indicated that they provide subgrantees with advances in part to comply with Commonwealth law and also to ensure that adequate funds are available to provide services to participants on a timely basis. They believe that their payment procedures for the six components of the SSBG program mentioned above are as efficient as is administratively feasible and that controls exist in each of the program areas cited. We found, however, that although there are monitoring procedures within the SSBG subrecipient payment process, such as the periodic submission of subgrantee activity reports, these procedures are not effective enough to detect subrecipient noncompliance, including excess cash violations, nor does DPW adjust payments to the subgrantees.

As stated in the prior year findings, DPW is waiting for HHS resolution of the cash management issues. DPW again contacted HHS in writing in March 2000, but still has not received a response from HHS. Also, as stated in the prior year finding, our last contact with HHS officials in the Division of Payment Management was during SFYE June 30, 1998. At that time, HHS officials stated that, in order to resolve the cash management issues in this finding, DPW must either change their payments from advances to reimbursements or set up a system to at least quarterly monitor cash balances throughout the fiscal year.

Effect: DPW is not adequately performing during the award monitoring of subgrantees including the monitoring of subgrantee cash on hand, to ensure subgrantee compliance with federal regulations. Furthermore, day care subgrantees refunded $7.6 million in excess funds to DPW at year-end. As a result, DPW provides little assurance of subrecipient compliance with federal requirements, including cash management standards. Also, the large amount of refunds year after year may indicate that subgrantees are not serving as many eligible families as possible.

Recommendation: As recommended in previous Single Audits and supported by HHS, DPW should either consider changing their current subrecipient payment procedures from advancement basis to reimbursement basis or establish procedures to adequately monitor subrecipient cash on hand to ensure it is limited to immediate needs, but no longer than one month. The implementation and strengthening of these controls should provide DPW with reasonable assurance as to compliance with cash management requirements at the subgrantee level.

Further, DPW should strengthen its during the award monitoring procedures for all CCDF/CCDBG and SSBG subgrantees to ensure compliance with federal regulations.

Agency Response: The finding reports perceived weaknesses in DPW monitoring of subgrantees resulting in over $7 million in excess Federal cash on June 30, 2003. The report specifically addresses the CCDBG/CCDF returns during the period of July 1 to November 21, 2003.

Regarding "Reportable Condition":

- Paragraphs one and two are the same as Single Audit Finding for the year ending June 30, 2002. We have no additional comments on these paragraphs.
- Paragraph three indicates that the subgrantees returned $7.6 million in year-end excess cash from advance monthly payments during SFY 2002-03. We are in agreement with that general figure. (See additional comments regarding this amount in this section and in "Criteria.")

Finding 03 – 24: (continued)

- Regarding the finding that DPW did not perform adequate monitoring of the subgrantees during FY 2002-03: We submit that we actually monitored subgrantees more frequently and more closely during that time period. We were careful to review monthly service and expenditures from each subgrantee and actually moved funds from nonspending subgrantees to subgrantees with waiting lists during the second half of FY 2002-03. During FY 2003-04, we implemented the Child Care Management Information System (CCMIS) in 19 CCIS agencies statewide.

- In CCMIS, DPW no longer provides advanced 1/12 payments each month to CCIS agencies for service delivery. Instead, CCMIS will project a payment for the upcoming month that is based on current service levels along with reconciliation of the prior month's payments to balance over- or under-payments to the CCIS agencies. We will implement CCMIS statewide in the remaining CCIS agencies during FY 2004-05. This system will greatly reduce the amount of returned funds, although we can never eliminate some returned funds.

- CCIS agencies will always have unspent administrative funds because of staff turnover and actual service delivery occurring in June. This is because of staff vacancies that cannot immediately be filled. Also, the unspent funds reflect the influx of summer school-age children into the subsidized program in June and the inability of CCIS agencies to accurately assess the demand for summer school-age child care service at the end of the subgrant period.

- We are continuing our efforts to reduce the amount of the returned funds, as we stated in our response to last year's report covering the 2001-02 FY.

<u>Regarding "Criteria":</u>

The report refers to 45 CFR 92.37(a)(4), related to states responsibilities to subrantees and suggests that states must conform any advances of grant funds using substantially the same standards of timing and amount applicable to cash advances by federal agencies. Our response is that of DPW's $300,000,000 total funds to subgrantees in this time period, divided by 12 months, establishes $25,000,000 as the allowable range for monthly cash advances. With an annual total return of 7.6 million, we submit that we are within the allowable limits of 45 CFR, in that we returned only one-third of any one monthly cash advance amount.

<u>Auditors' Conclusion</u>: Regarding SSBG, the agency response did not address the weaknesses noted, so our conclusions for SSBG remain as stated in the finding.

For CCDF/CCDBG, no new information was provided in the agency response to resolve our current year finding for June 30, 2003. While we acknowledge that monitoring of subgrantee service and expenditure levels was performed by DPW as indicated in the response, this monitoring was limited in scope as explained by DPW above, and it was not adequate to ensure subgrantee payments were made in accordance with federal regulations. Our understanding is that the new CCMIS system referred to in the agency response is intended to help remedy this weakness in the subsequent fiscal year and beyond, but this monitoring system was not in place in our current year under audit.

We also acknowledge that subgrantees will typically have unspent funds every year and refunds to DPW will continue to occur. However, given the continuing weaknesses noted in DPW's cash management monitoring procedures in prior years through the end of our current year, we continue to believe that these refund levels after year-end are unreasonable and are not being minimized through the implementation of adequate controls by DPW.

Our finding and recommendation, therefore, remain as stated above. Any corrective action noted by DPW in the agency response will be reviewed in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 25:

CFDA #93.767 – State Children's Insurance Program

Internal Control Weaknesses in Federal Reporting and State Matching Procedures (A Similar Condition Was Noted in Prior Year Finding #02-29)

Condition: During our prior year audit of CHIP for SFYE June 30, 2002, we noted federal reporting errors, questioned costs, and an internal control weakness in that the CMS-21 and PSC-272 Reports were prepared by the same person in the Central Service (CS) Comptroller's Office who also certifies the report as accurate and submits it electronically to HHS, with no supervisory review or oversight to ensure the report is accurate and complete. Our follow-up for the current year SFYE June 30, 2003 revealed that effective for the quarter ended March 31, 2003, the CS Comptroller's Office implemented a segregation of duties between the preparation, entry, and review/approval of the CMS-21 and PSC-272 Reports. However, the following weakness described below from the prior year still existed through the end of our current year:

The CS Comptroller's Office does not review overall CHIP expenditures on a timely basis to ensure that the proper state and federal share is being recorded and reported, and that the proper amount of federal funds are being drawn. During our reconciliation of insurance premium payments to insurance contractors, we noted that an invoice for the month of February 2003 in the amount of $1,221,063 was posted 100 percent to SAP federal fund number 7036402000 on February 27, 2003 using SAP FI document #1900143266. However, the invoice should have posted $818,261 as federal share, $380,130 as state share, and $22,672 as state only. This posting error was not detected and corrected by CS until adjustments were made at the end of June 2003, so our current-year test of state match revealed no questioned costs since match requirements were met for SFYE June 30, 2003.

Further, as a result of the posting error federal funds were drawn and received on March 17, 2003 for the entire invoice amount including the state costs of $402,802 and were not returned until adjustments were made transferring these costs to state funds at the end of June 2003. Therefore, INS owes interest per federal CMIA cash management regulations.

Also, as a result of the posting error made in February 2003 actual federal expenditures posted to the SAP accounting system were greater than the computed federal share reported on the CMS-21 Report for the Quarter Ended March 31, 2003. The CS Comptroller Office's federal reporting procedures were not adequate to detect the error and ensure that the computed federal share agrees to actual federal expenditures posted to the SAP accounting system, and likewise were not adequate to ensure that the state match is being met at the time of payment.

Criteria: 42 CFR 457.606 Conditions for State allotments and Federal payments for a fiscal year.

(b) Federal payments for States' Children's Health Insurance Program (SCHIP) expenditures under an approved State child health plan are –

(2) Available based on a percentage of State SCHIP expenditures, at a rate equal to the enhanced Federal medical assistance percentage (FMAP) for each fiscal year, calculated in accordance with Sec. 457.622.

42 CFR 457.622 Rate of FFP for State expenditures.

(a) Basis. Sections 1905(b), 2105(a) and 2105(b) of the Act provides for payments to States from the States' allotments for a fiscal year, as determined under Sec. 457.608, for part of the cost of expenditures for services and administration made under an approved State child health assistance plan. The rate of payment is generally the enhanced Federal medical assistance percentage described below.

The enhanced Federal medical assistance percentage is published in the Federal Register Notices as follows:

Federal Register Vol. 66, No. 231 dated November 30, 2001 states enhanced Federal medical assistance percentage effective October 1, 2002 to September 30, 2003 for Pennsylvania is 68.28%.

Finding 03 – 25: (continued)

42 CFR 457.630 Grant procedures.

(c) Expenditure reports. (1) The State must submit . . . Form CMS-21 (Quarterly State Children's Health Insurance Program Statement of Expenditures for title XXI), to central office (with a copy to the regional office) not later than 30 days after the end of the quarter.

(2) This report is the State's accounting of actual recorded expenditures. This disposition of Federal funds may not be reported on the basis of estimates.

31 CFR 205.15 When does State interest liability accrue?

(d) Mandatory matching of Federal funds

A State incurs interest liabilities if it draws Federal funds in advance and/or in excess of the required proportionate of agreed upon levels of State contributions in programs utilizing mandatory matching of Federal funds with State funds.

In addition, strong internal controls should ensure that segregation of duties exist between preparation of reports and certification as to completeness and accuracy of reports and that timely reviews of expenditure posting occur to ensure state matching requirements are met.

Cause: For the first two quarters of SFYE June 30, 2003, the same person prepared, certified as accurate, and submitted to HHS the CMS-21 and PSC-272 Reports with no supervisory review and approval. Segregation of duties were not implemented until the quarter ended March 31, 2003 due to the timing of our prior year finding disclosing the internal control weakness.

In addition, the posting error for the February 2003 invoice appears to have been a clerical error; however, the CS Comptroller's Office review procedures were not adequate to ensure that the proper split between state and federal share was recorded timely, that computed federal share reported on the CMS-21 Report agreed to actual federal expenditures posted, and that the correct amount of funds was drawn from HHS.

Effect: Without proper supervisory review procedures, the CMS-21 and PSC-272 Reports submitted to HHS could contain incorrect data without the knowledge of CS Comptroller's Office management.

In addition, CS personnel are not ensuring that the federal computed share of expenditures reported in the quarterly CMS-21 Reports agrees to actual federal expenditures recorded in the SAP accounting system.

Furthermore, the Commonwealth has incurred a CMIA interest liability for the time period that the state share of the February 2003 invoice was drawn until federal funds were returned to HHS at the end of June 2003.

Recommendation: We recommend that the CS Comptroller's Office ensure that proper segregation of duties exists including supervisory review before submission of the CMS-21 and PSC-272 Reports to HHS.

In addition, we recommend that the CS Comptroller's Office improve procedures to post invoices to SAP and to improve review and reporting procedures to ensure that the actual federal expenditures per the SAP accounting system agrees to computed federal share of expenditures being reported on the CMS-21 Reports, including making timely adjustments as necessary.

Furthermore, the CS Comptroller's Office should ensure that they properly include the federal drawdown of state funds on its CMIA Interest Liability Report for SFYE June 30, 2003 in compliance with federal cash management regulations.

Finding 03 – 25: (continued)

Agency Response: CS Comptroller's Office has implemented a "separation of duties and proper oversight with supervisory review and approval." All financial reports including those that are electronically transmitted are reviewed to ensure compliance with matching requirements in accordance with appropriate Enhanced Federal Medical Assistance Percentages (EFMAP) rates.

CS Comptroller's Office and the Pennsylvania Insurance Department will continue to work more closely together to verify that the posting, monitoring and processing of SCHIP funds is correct.

In addition, we will manually calculate interest on the $402,802 erroneously posted as Federal Funds and drawn. The interest calculated will be included in the June 30, 2003 interest report.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 26:

CFDA #14.228 – Community Development Block Grant
CFDA #14.239 – HOME Investment Partnerships Program

An Internal Control Weakness Exists in DCED's Subrecipient Audit Resolution Process

Condition: Under the Commonwealth's implementation of the Single Audit Act, review and resolution of OMB Circular A-133 subrecipient audit reports is split into two stages. The Commonwealth receives all A-133 subrecipient audit reports through OB-BOA which ensures the reports meet technical standards through a desk review process. Once they are deemed acceptable by BOA, the reports are transmitted to the various funding agencies in the Commonwealth and each agency in the Commonwealth's resolution system must make a management decision on each finding within six months after the report is transmitted to them to ensure corrective action is taken by the subrecipient. The agency is also responsible for reviewing financial information in each audit report (e.g., SEFA) to determine whether the audit included all pass-through funding provided by the agency and to adjust Commonwealth records, if necessary.

Our testing disclosed that DCED is not issuing management decisions on findings within six months of receipt of audits from BOA. We obtained DCED's subrecipient audit report tracking list for audits received by DCED during SFYE June 30, 2003, which indicated that fourteen audit reports contained findings. Of these fourteen audits with findings, nine audit reports were not resolved within six months. Five of the nine audit reports were resolved within 9.5 months to 15 months. The remaining four audit reports were received from BOA between 12 to 14 months prior to our testwork but still remained open at the time of our audit.

Criteria: The Single Audit Act of 1984 and the Single Audit Act Amendments of 1996 require state and local governments to adhere to provisions of OMB Circular A -133.

OMB Circular A-133, Section 400, states the following:

(d) Pass-through entity responsibilities. A pass-through entity shall perform the following for the Federal awards it makes:

(4) Ensure that subrecipients expending $300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.

(5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.

(6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

Cause: DCED personnel stated that the untimely audit resolution was due to a change in the employees responsible for audit resolution during SFYE June 30, 2003. In addition, the new employee was not aware of the federal requirement that a management decision on audit findings must be issued within six months after receipt of the subrecipient's audit report.

Effect: Since DCED did not make the required management decisions within six months of receipt to ensure appropriate corrective action was taken on audits received from BOA, DCED subrecipients were not made aware of acceptance or rejection of corrective action plans in a timely manner; and subrecipient noncompliance may recur in future periods. Although we do not consider the errors noted above to be material violations of federal regulations in the Commonwealth's overall subrecipient audit monitoring process, we believe the errors represent significant deficiencies within DCED and, therefore, a reportable condition.

Finding 03 – 26: (continued)

Recommendation: We recommend that the weaknesses that cause untimely OMB A-133 audit resolution for DCED be corrected to ensure compliance with federal audit resolution requirements and to better ensure subrecipient compliance with program requirements.

Agency Response: We concur with your reportable condition and have set forth procedures to remediate the agency finding.

In March 2004, the Financial Management and Audits unit revised its internal procedures for review of audit reports to assure that those received with findings are reviewed within the six-month time frame. As audits are received by the Department, they are logged in two groups: 1) those having findings and questioned costs; and 2) those with no findings or questioned costs. Audits with findings and questioned costs are immediately distributed to staff for resolution.

Because the agency depends on program staff to assist in the resolution of audits with findings and/or questioned costs, we are also in the process of developing a tracking system that assures timely review and response by the program office as well as financial management and audit staff.

Please note that since the change of procedures in March 2004, all audits with findings are in the process of being reviewed and reconciled.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 27:

CFDA #20.205 – Highway Planning and Construction
CFDA #23.003 – Appalachian Development Highway System

An Internal Control Weakness Exists in PADOT's Subrecipient Audit Resolution Process

Condition: Under the Commonwealth's implementation of the Single Audit Act, review and resolution of OMB Circular A-133 subrecipient audit reports is split into two stages. The Commonwealth receives all A-133 subrecipient audit reports through OB-BOA which ensures the reports meet technical standards through a desk review process. Once they are deemed acceptable by BOA, the reports are transmitted to the various funding agencies in the Commonwealth and each agency in the Commonwealth's resolution system must make a management decision on each finding within six months after the report is transmitted to them to ensure corrective action is taken by the subrecipient. The agency is also responsible for reviewing financial information in each audit report (e.g., SEFA) to determine whether the audit included all pass-through funding provided by the agency and to adjust Commonwealth records, if necessary.

Our testing disclosed that PADOT is not issuing management decisions on findings within six months of receipt of audits from BOA. We obtained PADOT's subrecipient audit report tracking list for audits received by PADOT during SFYE June 30, 2003, which indicated that five audit reports contained findings. Of these five audits with findings, four audit reports were not resolved within six months. Two of the four audit reports were resolved in 10 months and 17 months, respectively. The remaining two audit reports were received from BOA over 14 and 19 months prior to our testwork but still remained open at the time of our testwork in May 2004.

Criteria: The Single Audit Act of 1984 and the Single Audit Act Amendments of 1996 require state and local governments to adhere to provisions of OMB Circular A -133.

OMB Circular A-133, Section 400, states the following:

(d) Pass-through entity responsibilities. A pass-through entity shall perform the following for the Federal awards it makes:

(4) Ensure that subrecipients expending $300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.

(5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.

(6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

Cause: PADOT personnel stated that the untimely audit resolution was due to the reassignment of the employee responsible for audit resolution effective October 2003, and PADOT's inability to fill that position as of our testwork date.

Effect: Since PADOT did not make the required management decisions within six months of receipt to ensure appropriate corrective action was taken on audits received from BOA, PADOT subrecipients were not made aware of acceptance or rejection of corrective action plans in a timely manner; and subrecipient noncompliance may recur in future periods. Although we do not consider the errors noted above to be material violations of federal regulations in the Commonwealth's overall subrecipient audit monitoring process, we believe the errors represent significant deficiencies within PADOT and, therefore, a reportable condition.

Recommendation: We recommend that the weaknesses that cause untimely OMB A-133 audit resolution for PADOT be corrected to ensure compliance with federal audit resolution requirements and to better ensure subrecipient compliance with program requirements.

Finding 03 – 27: (continued)

Agency Response: PADOT agrees with the finding. PADOT does have a formalized program to review both the financial information and findings within all subrecipient single audit reports that are received by the Department. We also have a very detailed database that provides various subrecipient information, such as the data requested by the auditors. This program has been in place for several years. Preceding and during the fiscal year 02-03 audit period, PADOT simply fell behind in reviewing and closing out subrecipient audit reports. This was due to lack of staff in the Audit Resolution Section that is assigned to work on the reports and other higher placed priorities within PADOT.

Beginning in May 2003, PADOT made a decision to decrease the large backlog of open files that had been accumulating over a period of several years. Personnel changes were made and the direct responsibility to manage the subrecipient program was transferred to another individual in October 2003. Two positions were assigned to work on the backlog. In that time we have reduced our backlog from approximately two years to two months and we hope to be completely caught up by September 2004.

It should be noted that the two audit reports with findings that were still open at the time of the audit were both resolved in May 2004. Closure letters were sent to both entities on May 28, 2004. Therefore, all five audit reports that included findings mentioned in the audit have been resolved.

Currently in fiscal year 03-04, PADOT has received 198 reports. As of June 30, 2004, approximately 90 percent of those audit reports have been resolved and management closure letters have been mailed to the entities. There were a total of four reports that included findings requiring action by PADOT. Three of the reports have been resolved and letters have been mailed. The length of time to resolve those three audits was 195, 125 and 114 days, respectively. The fourth report will be resolved in July 2004 within the required six-month period.

PADOT takes its responsibility to ensure compliance with federal audit resolution requirements very seriously. Due to the effort made over the past year, we feel PADOT is back on track in this area and is in compliance with OMB Circular A-133.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 28:

CFDA #10.561 – State Administrative Matching Grants – Food Stamp Program
CFDA #17.258 – WIA Adult Program
CFDA #17.259 – WIA Youth Activities
CFDA #17.260 – WIA Dislocated Workers
CFDA #93.558 – Temporary Assistance for Needy Families

Noncompliance With OMB Circular A-133 Subrecipient Audit Requirements (A Similar Condition Was Noted in Prior Year Finding #02-34)

Condition: During our prior year audit, we noted noncompliance and internal controls weaknesses in the L&I, Bureau of Workforce Development Partnership's (BWDP) oversight of its Local Workforce Investment Area (LWIA) subrecipients as follows:

1) Our prior year audit disclosed that BWDP did not adhere to its remedial action plan to ensure that subrecipients received annual Single Audits and submitted the reports to the Commonwealth in a timely manner as required by OMB Circular A-133. Southcentral Employment Corporation or SEC (formerly Susquehanna Employment and Training Consortium or SETCO) had not submitted an A-133 audit report since fiscal year ended June 30, 1996, or for four years. However, from January of 2001 to January of 2002, four delinquent Single Audit reports were submitted by SEC to the Commonwealth, ranging from 10 months to nearly 3 years delinquent. The SFYE June 30, 2001 audit report was not yet submitted and was over 11 months delinquent as of our March 2003 test date.

   Our current year audit procedures disclosed that SEC did submit an audit report covering the two fiscal years ending June 30, 2001 and June 30, 2002. However, this audit report was received by OB on January 9, 2004 which was 21 months after the fiscal year June 30, 2001 report due date of March 31, 2002 and 9 months after the fiscal year June 30, 2002 due date of March 31, 2003. SEC received approximately $6.1 million and $7.2 million in federal funds (includes WIA, Food Stamps Admin and TANF funding as well as funding from other programs not being audited by us as major) during fiscal years ended June 30, 2001 and June 30, 2002, respectively. In addition, the audit report for fiscal year ended June 30, 2003, which was due March 31, 2004, was over 3 months late as of our July 2004 test date. SEC received similar funding levels in fiscal year ended June 30, 2003. Furthermore, the audit report for the two year period ended June 30, 2002 disclosed significant internal control weaknesses and a scope limitation due to incomplete and inaccurate accounting records and a lack of adequate evidential matter to support accounting records at SEC which resulted in the disclaimer of an audit opinion by the independent auditors.

2) Our prior year audit also disclosed that BWDP's subrecipient monitoring procedures were not adequate to ensure that high-risk subrecipients not submitting audit reports were administering federal programs in compliance with regulations. Although regularly-scheduled program monitoring of SEC was conducted by BWDP in the prior year, there were no enhancements to the scope or frequency of BWDP's routine monitoring procedures, and no audits of SEC were scheduled or performed by Commonwealth officials (i.e., by L&I, OB, the LECS Comptroller's Office, or an outside auditor) for the years not being audited. No enhanced monitoring, audits, or other oversight procedures in prior years were included in BWDP's remedial action plan for nonsubmission of subrecipient Single Audit reports and incomplete/inaccurate recordkeeping by SEC (as evidenced by findings in the prior audits received).

Our current year audit disclosed that BWDP did not make any changes to their program monitoring procedures for SEC, but BWDP did arrange for a fiscal review to be performed by LECS auditors in order to determine whether SEC had adequate internal controls and whether SEC's financial system was adequate to capture and report accurate and supportable revenue and expenses of federal contracts. LECS's review disclosed numerous major internal control weaknesses and accounting problems at SEC which, like the problems noted in the A-133 audit reports, remain unresolved as of our July 2004 test date. No federal funds have been withheld or collected back from this subrecipient to date and no resolution has been performed by Commonwealth officials to ascertain amounts to be repaid, if any. It should be further noted that SEC has been a non-cooperative subrecipient in submitting A-133 audits to the Commonwealth for over 10 years.

Finding 03 – 28: (continued)

Criteria: The Single Audit Act Amendments of 1996 require state and local governments to adhere to the audit provisions of OMB Circular A-133.

OMB Circular A-133, Section ___.320, states the following:

(a) *General. The audit shall be completed and . . . submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and . . . submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period) . . .*

OMB Circular A-133, Section ___.400, states the following related to L&I's responsibilities as the pass-through agency:

(d) *Pass-through entity responsibilities. A pass-through entity shall perform the following for the federal awards it makes:*

  (4) *Ensure that subrecipients expending $300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.*

To ensure Commonwealth enforcement of OMB A-133 for subrecipient noncompliance with the above audit requirements, Commonwealth Management Directive 325.8, Remedies for Recipient Noncompliance With Audit Requirements, Section 5 related to policy states, in part:

(a) *Agencies must develop and implement a progressive series of remedial actions to be taken when recipients exhibit a continued inability or unwillingness to comply with performance, reporting and resolution requirements for audits of Commonwealth-funded programs . . .*

(d) *The progressive series of remedial actions should be tailored to the unique aspects of each program. . . . Such actions should be implemented in a timely and judicious manner to ensure that those entities who exhibit an inability or unwillingness to comply with the requirements of Circulars A-128 or A-133, and/or Commonwealth policy, rules and regulations relating to audit performance, reporting and resolution are promptly brought into compliance or are properly sanctioned.*

Overall timeframes for the implementation of the series of remedial actions should not exceed six months from the date the first remedial action is initiated. At the end of the six-month time period, either the appropriate corrective action should be taken by the subrecipient or the final stage of progressive remedial action should be imposed on the subrecipient.

Cause: Correspondence provided by BWDP personnel indicated that SEC had contracted with two different accounting firms in an attempt to reconstruct SEC's accounting records for fiscal years ended 1997 through 2000, but both firms were unsuccessful in establishing auditable beginning balances for the contracts that SEC had with BWDP. SEC contracted with another accounting firm in September 2002 to perform audits of both the June 30, 2001 and 2002 fiscal years together as part of one audit. Per discussion with BWDP personnel, the primary reason for the delay in the completion of the two year audit was the lack of complete and accurate accounting records at SEC. Also, OB personnel granted two extensions for the submission of the two year audit for the period ended June 30, 2002 until December 31, 2003.

Regarding increased monitoring of SEC, BWDP sent a copy of the LECS fiscal review to SEC in July 2004 and requested SEC to formulate a plan of corrective action for the internal control weaknesses and accounting problems disclosed by LECS. BWDP personnel stated that they have been meeting with SEC personnel, the SEC board, and SEC's solicitor regarding SEC's financial situation, changes in staffing, and improving the cost effectiveness of SEC's

Finding 03 – 28: (continued)

operations, and BWDP believes that SEC's performance has been improving. Furthermore, BWDP personnel indicated they are reluctant to withhold funds since this would deny services to the needy participants in a eight-county area served by SEC.

Effect: Since L&I did not obtain and review the audit report from SEC on a timely basis, federal funds were not being audited in compliance with OMB Circular A-133. In addition, since L&I is not following its written remedial action plan and is not withholding funds from SEC or ascertaining funds to be paid back, there is little incentive for SEC to make improvements to its accounting policies and procedures. Federal funds may be misspent by SEC without appropriate oversight and resolution by L&I.

Recommendation: If SEC is unable to reconcile its financial records and provide supporting documentation for general ledger transactions, BWDP should ensure that SEC reaches a financial settlement with BWDP and USDOL for the differences noted. Increased oversight should be placed on SEC due to the habitual noncompliance with audit submission requirements. BWDP should adhere to the progressive series of steps and timeframes in its written remedial action plan and withhold funds from its subrecipients, including SEC, as necessary in order to ensure the timely submission of audit reports in the future. In addition, BDWP should work with SEC to resolve the issues disclosed in the independent auditor's report and the LECS fiscal review.

Agency Response: L&I has developed and implemented a Technical Assistance and Sanction Policy for addressing performance problems under the Workforce Investment Act. While the concerns at SEC have not been solely performance-related, many aspects of this policy are applicable and have been implemented as L&I continues to work with SEC to resolve outstanding fiscal and programmatic concerns. The policy calls for submission of corrective action plans by the Local Workforce Investment Area, increased technical assistance, and participation in training sessions for LWIA's with performance or other problems. These action steps have been utilized in L&I's work with SEC in improving performance and fiscal accountability.

The BWDP has been working very closely with SEC in order to resolve the ongoing fiscal problems at the agency. There have been numerous meetings as well as informal discussions, e-mails and correspondence. Most recently, BWDP provided instructions in writing to SEC regarding the establishment of a beginning balance for PY 04 in order to eliminate the ongoing problem that has been addressed in previous audits. SEC's response is due in August 2004. Additionally, SEC just hired a new Workforce Investment Board (WIB) Director who assumed his position on July 26, 2004 and met with BWDP staff on July 27, 2004. The new director indicated that both he and the County Commissioners are eager to resolve the problems of the past and move forward in providing workforce development services. A number of options were discussed and will be pursued vigorously toward this resolution.

With regard to the audits of the period 1996-2000, BWDP issued the final determination on March 8, 2004. An appeal has been requested by SEC and is currently scheduled for September 2004. Therefore, further collection of the amount determined as unallowable is on hold pending resolution of the appeal.

The BWDP has chosen to not withdraw funding from SEC through this point because of the need for the provision of workforce development services to the population of the eight-county area. While the Workforce Investment Act allows for the possibility of the Governor assuming this responsibility for a local area, this is an extremely serious step that has never been undertaken before in Pennsylvania. The BWDP feels that SEC has been working with us to resolve outstanding issues, and therefore has elected to continue the process of resolving issues rather than moving to establish a new WIB, fiscal agent or program operator.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. While we recognize L&I's attempts to correct the situation, the noncompliance and internal control problems remain for our current audit period. We will review any corrective action in our subsequent audit.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 29:

CFDA #Various – All Major Programs Covered by CMIA

The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #02-36)

Condition: The Commonwealth of Pennsylvania has entered into an agreement with the U.S. Treasury Department in order to comply with the provisions of the Cash Management Improvement Act of 1990 (CMIA). In order to fulfill the requirements contained in the Treasury-State Agreement, the Commonwealth has developed policies and procedures contained in Comptroller Operations Directive #540.1 and has developed the CMIA Drawdown System (CDS) which calculates and provides recommended drawdown amounts using the Average Daily Clearance (ADC) method.

As provided by the Treasury-State Agreement, all checks associated with all voucher transmittals (VTs) for CMIA-covered programs were utilized for the period of February 1, 1999 through May 31, 1999 to determine the ADC check clearance pattern implemented on April 13, 2000. The clearance time of each check in the study was dollar-weighted to produce the dollar-weighted average day of clearance from the time the VT was posted to ICS (the Commonwealth's general ledger) until the checks associated with the VT cleared the state bank account. We tested the propriety of the Commonwealth's check clearance patterns during the prior Single Audit for SFYE June 30, 2000, and disclosed the following deficiencies with the Commonwealth's check clearance studies which remain unresolved for the SFYE June 30, 2003:

- The Commonwealth does not reconcile expenditure totals from the check clearance study (BFM Report 833) to the ICS general ledger to ensure the accuracy and completeness of data used in the ADC study.

  Further, as noted in previous Single Audits, each VT can only be captured in the study under one appropriation, regardless of how many appropriations are present on the VT. Since some appropriations are used for more than one program, but are assigned to only one program for the ADC study, some programs could have significantly less or significantly more expenditures in the study than were actually incurred.

- The ICS posting dates per the February 1, 1999 through May 31, 1999 clearance study did not always agree to the actual ICS general ledger posting dates.

  As a result, the prior-year material weakness regarding incorrect posting dates for the study caused material noncompliance with CMIA during SFYE June 30, 2002 since the Commonwealth is still using ADC patterns established from the February 1, 1999 through May 31, 1999 clearance study.

- A disproportionate amount of payroll cost was included in the clearance study for CFDA #20.205, Highway Planning and Construction (HPC). We believe this occurred due to the fact that appropriations other than HPC related appropriations were included on the payroll VTs included in the HPC study.

Further, starting on July 1, 2002, the Commonwealth began phased implementation of an Enterprise Resource Planning (ERP) software known as SAP that impacted all Commonwealth business functions, including the payment process. However, the Commonwealth has yet to perform a check clearance study to ensure the accuracy of the delay of draw for federal programs now using SAP. As of January 1, 2003, Federal grants comprising more than half the dollar value of programs covered under the Commonwealth's Treasury Agreement were processing payments on the SAP system including all grants funded by HHS. However, Commonwealth personnel indicated a check clearance study would not be performed for any program until all of the Commonwealth's payment process is converted to SAP, which will not occur until after January 2004.

Criteria: 31 CFR 205.20 provides the following regarding clearance patterns:

States use clearance patterns to project when funds are paid out, given a known dollar amount and a known date of disbursement. A State must ensure that clearance patterns meet the following standards:

Finding 03 – 29: (continued)

a. A clearance pattern must be auditable.

b. A clearance pattern must accurately represent the flow of Federal funds under the Federal assistance programs to which it is applied.

c. A clearance pattern must include seasonal or other periodic variations in clearance activity.

Also, 31 CFR 205.22 (a) on the accuracy of clearance patterns states:

If a State has knowledge, at any time, that a clearance pattern no longer reflects a Federal assistance program's actual clearance activity, or if a Federal assistance program undergoes operational changes that may affect clearance activity, the State must notify us, develop a new clearance pattern, and certify that the new pattern corresponds to the Federal assistance program's clearance activity.

Cause: Regarding the accuracy and completeness of the data used in the ADC study, BFM personnel stated that the current system in place to calculate the ADC can only sort expenditures by appropriation. Therefore, each voucher transmittal can only be included in the study under one appropriation, regardless of how many appropriations are included on the voucher. Since some appropriations are used for more than one program, in these instances, the appropriation must be assigned to one program for ADC purposes.

For the differences noted between the actual ICS post date and the post date per the ADC study, we found that the date used for the ADC study was the date on which magnetic tapes were forwarded to Treasury for payment, not the date the expenditures were actually posted to ICS. As in prior years, the Commonwealth has no controls in place to make sure the correct ICS post date is included on these magnetic tapes and incorporated into the check clearance study.

With respect to the payroll costs for the HPC program included in the clearance study, BFM stated no changes were made from prior years to change the study to ensure the appropriate amount of payroll was included in the study.

Effect: As a result of the weaknesses noted, the Commonwealth is not in compliance with the regulations and procedures for clearance pattern requirements in 31 CFR 205. We consider this noncompliance to be material to all major programs subject to CMIA.

In addition, the Commonwealth is receiving federal funds earlier than they should for the HPC program at PADOT. Because of the overall pervasiveness of the check clearance discrepancies involving incorrect posting dates, we cannot determine the overall impact of these weaknesses on major program check clearance patterns.

Recommendation: For future audit periods, we recommend BFM personnel implement a system to ensure the clearance patterns developed accurately represent the flow of federal funds as required by 31 CFR 205.20.

In addition, BFM personnel should determine the additional amount of interest due to the federal government as a result of all of the above noted discrepancies for all CMIA-covered programs and report and remit this additional interest liability to the U.S. Treasury.

Agency Response: The following is the Office of the Budget's agency response:

- Because CFDA numbers are not on VTs or checks, we must identify the VTs paid from appropriations that are linked to a CFDA number. Therefore, the Treasury Department can link only one appropriation to one VT because the checks cleared are not identified to an appropriation.

Finding 03 – 29: (continued)

Treasury must assign the entire VT to the first appropriation that matches to our appropriation/CFDA list. This process of assigning a VT to only one appropriation when other appropriations on the same VT are posted to the general ledger removes the link between BFM Report 833 and the general ledger, thus making the reconciliation between the two reports unrealistic.

CMIA regulations require that we do a check clearance study for only three consecutive months. Our February 1, 1999 to May 31, 1999 study involved four consecutive months, which exceeds CMIA requirements. Based on these facts and the system restrictions noted above, a detailed reconciliation to the general ledger does not appear to be justified.

- We have noted the differences between the clearance study posting dates and the actual ICS posting dates. Due to the implementation of SAP, ICS posting dates will not be used in future check clearance studies.

- For payroll in CFDA #20.205, the Commonwealth has historically selected appropriations that contain payments to CFDA #20.205. In the future, we will continue to ensure that only appropriations pertaining to CFDA #20.205 are used in our check clearance study for Highway Planning and Construction. For this reason, it is appropriate that we continue to include payroll costs in our ADC study.

Overall, we believe that our current check clearance study accurately represents the flow of federal funds and exceeds the standards set forth by 31 CFR 205.20.

The U.S. Treasury, Financial Management Services, granted the Commonwealth a waiver to delay its check clearance study due to the implementation of the Enterprise Resource Planning software. The Commonwealth has agreed to certify the check clearance pattern during the period July 1, 2003 through June 30, 2004.

Auditors' Conclusion: In order to ensure the accuracy of the population used for the check clearance study, BFM should perform an overall analysis or reconciliation to determine that the total check amounts cleared in the study reasonably agree to amounts recorded on the general ledger and reported to the federal government for each CFDA # in the ADC study. Although certain major programs (e.g., TANF and MA) may get close to 25 percent coverage in a four-month check clearance study, we noted in our current and prior audits that other major programs would get significantly less coverage (e.g., SSBG). Also, because of the weakness in the Treasury's inability to assign more than one appropriation to each VT, certain expenditures recorded under one CFDA # on the 833 Report were actually made under another CFDA # on ICS. Therefore, we have little assurance that the dollar value covered in the check clearance study as recorded on the 833 Report by major program is correct. We believe BFM should analyze this overall weakness, evaluate its impact on check clearance for the major programs covered by CMIA, and work with the federal government to implement a reasonable solution to this problem for future check clearance studies.

While the differences between the ADC study posting dates and the actual ICS posting dates disclosed in our testing could cause the Commonwealth to receive federal funds later than necessary, our prior audits have shown that ADC study dates could also be after ICS post dates, which would cause the Commonwealth to draw federal funds too early. Consequently, the Commonwealth has no controls in place to ensure the accuracy of post dates and there is a significant internal control weakness in the system used to calculate ADC patterns.

Regarding CFDA #20.205, BFM personnel need to ensure that the amount of payroll costs included in any future ADC studies is proportionate to the amount of payroll claimed for reimbursement under CFDA #20.205 in order to ensure the accuracy of the ADC study. Since direct deposit is now mandated for Commonwealth employees, payroll should clear the bank sooner than vendor checks, and the Commonwealth could be drawing down HPC funds in violation of CMIA.

Finding 03 – 29: (continued)

Any corrective action for the weaknesses in the finding will be reviewed in our subsequent audit. In addition, this is a long-standing finding where federal resolution has not been issued. Therefore, based on the agency response, our finding and recommendation remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Finding 03 – 30:

CFDA #93.558 – Temporary Assistance for Needy Families
CFDA #93.767 – State Children's Insurance Program
CFDA #93.778 – Medical Assistance
CFDA Various – All Major Programs Covered by CMIA

The CMIA Interest Liability Was Understated By At Least $1,218,014 (A Similar Condition Was Noted in Prior Year Finding #02-37)

Condition: The interest liability on the CMIA Annual Report for SFYE June 30, 2002 which was submitted to the U. S. Treasury during our audit period SFYE June 30, 2003, was misstated by a minimum of $1,218,014 as follows:

- Within the TANF program, we noted that the State Treasurer's Office rejected payment of $25,091,437 of expenditures from document VT12113522 dated March 5, 2002. As a result, DPW posted document CV12113522 on March 21, 2002 to reduce the TANF expenditures accordingly. However, our review of the TANF draws disclosed that DPW processed a drawdown on March 15, 2002, for the aforementioned $25,091,437, with the funds being received on March 18, 2002. These funds were not returned to the federal government until March 29, 2002. Our review of the CDS-301 Report disclosed that the Commonwealth did not pay any interest to the federal government for the 11 days that the cash was on hand. As a result, the state's interest liability was understated by $16,712.

- Within the CHIP program, we noted that INS posted an adjustment transaction (EA0010090030) on December 19, 2001 to increase the FFP rate which they thought was incorrectly applied to federal expenditures incurred. This adjustment resulted in a $277,578 increase in federal expenditures for which a drawdown was processed on December 21, 2001 and the funds were received on December 24, 2001. However, INS subsequently realized that the FFP rate had been properly applied and that EA0010090030 should not have been posted to draw the $277,578 of additional funding. As a result, INS posted EA001009046 on March 4, 2002 to reduce the CHIP expenditures and federal draws accordingly. The $277,578 was subsequently returned to HHS on March 8, 2002. Our review of the CDS-301 Report disclosed that the Commonwealth did not pay any interest to the federal government for the 74 days that the $277,578 was on hand. As a result, the state's interest liability was understated by $1,244.

- Within the Medical Assistance program, we noted that HHS deferred payment on $36,717,359 of expenditures incurred during SFYE June 30, 2002, that were subsequently determined to be disallowed. Our review of the CDS-303 Report disclosed that the Commonwealth claimed $360,083 of interest for these expenditure amounts, even though they were subsequently disallowed. BFM personnel provided us with a copy of a settlement letter from the U.S. Department of Treasury dated September 9, 2003, which denied the Commonwealth's claim for interest for the $36,717,359 of deferred/disallowed expenditures citing that neither the deferral period nor the disallowance caused a delay in the transfer of federal funds to the state. As a result, the state's interest receivable was overstated by the aforementioned $360,083.

- Within the Medical Assistance program, DPW's MAMIS system processes a file of medical claims on a weekly basis. Included within these claims are expenditures made by school districts for school based medical services. For all school based medical expenditures DPW submits a check to PDE, who administers the school based medical program. PDE then in turn reimburses the school districts for the medical services provided. Once DPW pays the money to PDE, the funds are subsequently drawn from the federal government. However, our review of the account used by PDE to reimburse the school districts disclosed that PDE is not reimbursing the school districts in a timely manner as this account had a balance of $40,620,331 at June 30, 2002, with a carry-forward balance from the prior fiscal year of $35,395,498. Our review of the CDS-301 Report disclosed that the Commonwealth did not pay any interest on the balance maintained within this account, even though it represents federal funds drawn down in excess

Finding 03 – 30: (continued)

of amounts paid to school districts. As a result, assuming the average balance in the account was $38,007,915 during the June 30, 2002 fiscal year, the state's interest liability was understated by an estimated $839,975. We also found that the excess cash in this account had grown to $53.9 million as of June 30, 2003, so additional CMIA interest is owed for SFYE June 30, 2003 to be remitted during SFYE June 30, 2004.

In addition, the following weaknesses, the interest effect of which we could not determine, were noted in prior years and remain unresolved pertaining to the CMIA interest calculation:

- CDS only identifies refund transactions with an R transaction code, such as an RE or RC transaction (Refund of Expenditure or Refund Correction), as interest generating and is not programmed to calculate interest on refund transactions processed with Expenditure Adjustments (EA), Correction Vouchers (CV), or similar documents. As a result, excess cash on hand can result due to the rejection of VTs by the PA Department of Treasury since CVs are posted to ICS to cancel rejected VTs. Therefore, as a result of the use of CVs or EAs to refund cash on hand, interest due to the federal government for such transactions is not recorded by CDS. While the Commonwealth has improved its system by modifying CDS to record CVs and EAs immediately and not subject them to a draw delay, Comptroller Office personnel are not consistent in posting CVs and EAs to the Commonwealth accounting system, so unrecognized interest liabilities still occur.

- Funds posted to Federal Revenue Collected in Advance accounts are not included in the CMIA interest calculation because CDS does not recognize these federal revenues in excess of federal expenditures as interest generating transactions. Therefore, an interest liability is not assessed by CDS, and the Commonwealth interest liability may be understated as a result. Although our review of major program revenues did not disclose any current year revenue collected in advance issues, our review of revenue collected in advance accounts at the Department of Agriculture, Department of Corrections, State Police, Department of Conservation and Natural Resources and the Executive Offices disclosed that federal cash was collected in advance for non-covered programs. While interest is not due for federal cash on hand in non-covered programs, this is a violation of federal cash management regulations.

Criteria: 31 CFR 205.14(a)(2), pertaining to federal interest liabilities, states:

(2) If a State pays out its own funds for Federal assistance program purposes without obligational authority, the Federal Program Agency will incur an interest liability if obligational authority subsequently is established. However, if the lack of obligational authority subsequently is established. However, if the lack of obligational authority is the result of the failure of the State to comply with a Federal Program Agency requirement established by statute, regulation, or agreement, interest liability may be denied. A Federal interest liability will accrue from the day a State pays out its own funds for Federal assistance program purposes to the day Federal funds are credited to a State bank account.

31 CFR 205.15 states the following pertaining to state interest liabilities:

(a) General rule. State interest liability may accrue if Federal funds are received by a State prior to the day the State pays out the funds for Federal assistance program purposes. State interest liability accrues from the day Federal funds are credited to a State account to the day the State pays out the Federal funds for Federal assistance program purposes.

(b) Refunds. (1) A State incurs interest liability on refunds of Federal funds from the day the refund is credited to a State account to the day the refund is either paid out for Federal assistance program purposes or credited to the Federal government.

Finding 03 – 30: (continued)

31 CFR 205.29(d) states the following regarding compliance and oversight:

(d) If a State repeatedly or deliberately fails to request funds in accordance with the procedures established for its funding techniques, as set forth in §205.11, §205.12, or a Treasury-State agreement, we may deny the State payment or credit for the resulting Federal interest liability, notwithstanding any other provision of this part.

Further, 31 CFR 205.26(a) related to the Annual Report states:

(a) A State must submit to us an Annual Report accounting for State and Federal interest liabilities of the State's most recently completed fiscal year. Adjustments to the Annual Report must be limited to the two State fiscal years prior to the State fiscal year covered by the report. The authorized State official must certify the accuracy of a State's Annual Report. A signed original of the Annual Report must be received by December 31 of the year in which the State's fiscal year ends. We will provide copies of Annual Reports to Federal agencies. We will prescribe the format of the Annual Report, and may prescribe the format of the Annual Report, and may prescribe that the Annual Report be submitted by electronic means.

The Commonwealth's CMIA Agreement with the U.S. Treasury Department Section 6.1.4 states:

With several programs subject to the Act, the primary Commonwealth agency administering a program will subgrant portions of the program to secondary Commonwealth agencies. As costs in support of the program are incurred, the secondary agency charges the primary agency, which in turn draws down Federal funds.

In all such cases, the secondary agency shall charge the primary agency no earlier than the day transactions post to the accounts of the secondary agency. The procedures governing the request for funds from the primary agency, and the payment of such requests, shall be in accordance with the agreement between the primary and secondary agencies.

Cause: Regarding the posting of refunds, CVs, EAs, and other adjustments causing unrecognized interest liabilities, BFM personnel have indicated that the implementation of a new accounting system using SAP software during SFYE June 30, 2003 will correct this issue. Also, the issue of Treasury rejecting payments of VTs is outside the control of BFM and is an inherent limitation within the CDS system because the draw delay is based on ICS general ledger postings and not check issuance. Therefore, when Treasury rejects paying a VT, excess cash will always result under the current system; however, management has indicated that this should be corrected with the implementation of the SAP software during SFYE June 30, 2003.

For other items addressed in the condition relating to weaknesses in the CMIA interest calculation, Commonwealth personnel indicated they either did not agree that the transactions created an interest liability or the transactions arose outside of CDS and were not considered when preparing the Annual Report of CMIA interest liabilities.

Effect: As a result of the weaknesses and errors noted above, the Commonwealth is not in compliance with regulations for the interest calculation in the Annual Report as stated in 31 CFR 205. Therefore, the state and federal interest liability amounts reported on the CMIA Annual Report for SFYE June 30, 2002, are not accurate. Further, our testing disclosed a minimum of $1,218,014 in understatements in the state interest liability to the federal government.

Also, various transactions that create interest liabilities, such as adjustment transactions (i.e., EA, CV, etc.), cancelled VTs, transactions incurred under interagency MOUs, and revenue collected in advance are not recognized by CDS as interest-generating transactions. Since manual adjustments are not made to compensate for this system weakness, the Commonwealth's CMIA interest calculation is inaccurate by an undetermined amount.

Recommendation: We recommend the Commonwealth pursue settlement on the interest liability to the federal government and follow CMIA policy and regulations when determining which transactions should incur federal interest liabilities.

Finding 03 – 30: (continued)

In addition, we recommend that BFM modify the CDS system or have Comptroller personnel review possible interest generating transactions occurring outside of CDS so that all transactions that generate interest are accurately included in the interest calculation.

Further, we recommend that BFM calculate any additional June 30, 2002 interest due to the U. S. Treasury as a result of the system weaknesses disclosed above and repay the amount calculated or pursue additional settlement with FMS.

Agency Response: The following is the Office of the Budget's agency response to the audit finding:

- The Commonwealth agrees that 11 days elapsed between the time funds were received on March 18, 2002 for VT12113522 and when funds were returned on March 29, 2002. When CV12113522 was posted and passed to CDS, it created a situation where the total letter-of-credit was negative. The Department of Health and Human Services (DHHS) manages its Payment Management System (PMS) to facilitate cash flow to states. The PMS Smartlink System prevents states from returning funds to the federal agency unless offset by at least the same amount in a drawdown for expenditures at the letter-of-credit level. The Commonwealth has previously discussed this shortcoming with PMS and U.S. Treasury representatives to assure that they are aware of this shortcoming. The total number of days the Commonwealth owes interest is three days, the time to process the refund. The Commonwealth will adjust the next Annual Report in the amount of $4,558.

- Central Services federal accounting staff will review adjustments to federal expenditures for the CHIP program to minimize the risk of drawing down federal funds erroneously, and incurring federal interest liability. Also, the FFP rate is subject to change on October 1 of each year. Therefore, federal accounting staff will verify that federal expenditures are calculated based on the proper FFP rate. In addition, the Commonwealth will repay the $1,244 of interest liability that is owed to the U.S. Treasury on the next Annual Report.

- The regulations governing disallowances were clarified with the issuance of the Final Rule, effective June 24, 2002. However, the Final Rule does not address deferrals. Therefore, the Commonwealth made a reasonable claim for interest resulting from deferrals based on past practice. The interpretation of the regulations was resolved with U.S. Treasury as part of the annual report process. The Commonwealth's claim was ultimately denied by U.S. Treasury, and the annual report was revised. Therefore, the Commonwealth disagrees that interest receivable was overstated.

- In 1988, Congress enacted the Medicare Catastrophic Coverage Act (PL 100-360). This law provides that federal Medicaid funds must be available to reimburse expenditures for health-related services included in each child's individualized education program (IEP), individualized service plan (ISP), or individualized family service plan (IFSP) for all children who are also Medicaid eligible.

  The Pennsylvania Department of Education (PDE) developed the ACCESS Program in response to this legislation. ACCESS is a means for gaining medical assistance (MA) reimbursements for the cost of the health-related services currently being provided to MA eligible students. Billable services include speech therapy, occupational therapy, physical therapy, psychological services, etc. Local education agencies (LEAs) must enroll as medical assistance providers in order to submit their invoices to MA for the billable services they are providing to the eligible students. The funds received from MA are reported as expenditures on the Single Audit and are maintained in LEA specific accounts managed by PDE and may accumulate over several state fiscal years. Each LEA controls its own draw down of reimbursements through the filing of ACCESS Requests with PDE. ACCESS funds must be used by LEAs to enhance or expand special education services and programs for students with disabilities.

  The total expenditures for the Medical Access program account for less than 1 percent of total expenditures for the Medical Assistance Program, therefore, the Medical Access program would be eligible for exemption under 31 CFR Part 205, Sec. 205.4. However, the Commonwealth maintains that the medical access funds were drawn for program purposes in accordance with the Treasury State Agreement. Therefore, the Commonwealth disagrees that CMIA interest is due.

Finding 03 – 30: (continued)

- The number of VTs rejected by the State Treasury is minimal and the effect is further reduced by the State Treasury only rejecting incorrect line item entries. In addition, CDS processes CVs and EAs immediately, thus alleviating this problem. BFM has gathered redline payment information and will perform a study to support this position.

- The final section of the finding is related to “Federal Revenue Collected in Advance” (RCIA). The Commonwealth does not transfer any “Federal drawdown” to RCIA. Any revenue that happens to reside in the revenue code entitled “Federal Revenue Collected in Advance” at any point in time, including on June 30, is the result of DPW budgetary considerations and/or fiscal year closing instructions and requirements. If for any reason we have “excess cash,” it would be the result of a minus expenditure adjustment or refund of expenditure posting to the Grant Accounting records. Excess funds in these situations would be returned as part of the regular daily drawdown process by offsetting the amount against a drawable amount. Any resulting Commonwealth interest liability is already appropriately included in the interest reports.

Overall, our cash drawdown system operates with a high degree of accuracy and complies with CMIA in all material respects.

Auditors’ Conclusion: Based on our review of the Office of the Budget’s response, we disagree that the Commonwealth only owes interest for the time to process a refund, or 3 days for CV12113522. As stated in the finding, VT12113522 was rejected by the State Treasurer’s Office on March 5, 2002, and CV12113522 was not posted until March 21, 2002. If the PHHS Comptroller Office had posted CV12113522 timely, the Commonwealth would not have drawn the $25,091,437 associated with VT12113522. Therefore, we believe that the $16,712 state interest liability is correct as stated.

Regarding the regulations governing disallowances, we do not understand OB’s agency response on this issue since U.S. Treasury practice has always been to only pay interest on deferrals that were not ultimately disallowed. Therefore, as stated in the condition the Commonwealth overstated its interest claim for deferred costs that were subsequently disallowed.

Regarding the excess Medicaid cash on hand at PDE, no new relevant information was provided in the agency response and we do not agree that no CMIA interest is due. The Commonwealth should resolve this issue and the issue of any exemption under the 31 CFR 205.4 with U.S. Treasury.

Regarding rejected VTs, since BFM did not track the number and dollar amount of the VTs rejected by the State Treasury Department relating to CMIA covered programs, the unreported interest liability related to this issue cannot be determined, but on a statewide basis may be significant.

We disagree with the response on Federal Revenue Collected in Advance (RCIA). OB’s statement that amounts in the RCIA account have no CMIA interest impact is not supported by detailed analysis at the major program level. Our program level testing in prior years disclosed that, in certain cases (e.g., Aging Parts B and C programs), refunds are being posted to RCIA throughout the year and are not being included in interest calculations. Also, for large refunds which are transferred to RCIA at year end until the next draw is made, no interest effect is being considered since RCIA accounts are not on CDS. Although the agency response may be correct in that federal drawdowns are not directly posted to RCIA, in many cases the amounts in these accounts represent federal revenues in excess of federal expenditures on the accounting system, which, according to the Treasury-State Agreement, should be the source of all CMIA interest calculations. We believe that BFM should develop and implement policies and procedures to properly address the CMIA interest impact of RCIA on the accounting system.

Based on the agency response, our finding and recommendation, with the above clarifications, remain as stated above.

The corrective action plan for this finding, if any, has not been reviewed by the auditors. See Corrective Action Plans located elsewhere in this Report.

Summary Schedule of Prior Audit Findings

Commonwealth of Pennsylvania

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS

FINDINGS FOR THE YEAR ENDED JUNE 30, 1994:

DEPARTMENT OF PUBLIC WELFARE (DPW)

Finding 103	DPW's Procedures Are Not Adequate to Ensure Subrecipient Cash is Limited to Immediate Needs (A Similar Condition Was Noted in Prior Year Finding #108)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.
Finding 112	DPW Procedures Were Not Adequate With Respect to Monitoring Subgrantees	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.

DEPARTMENT OF TRANSPORTATION (PADOT)

Finding 63	Costs Were Incorrectly Accumulated During Preparation of PADOT's Application for Reimbursement of Funds for the Blizzard of 1993 (FEMA 3105-EM-PA) and Severe Winter Weather of 1994 (FEMA 1015-DR-PA) Resulting in Questioned Costs of $2,927	FEMA	Unresolved – PADOT has responded to the discrepancies indicated in the finding. FEMA has closed out the disaster account and all parties have agreed to the amount of federally reimbursable funding. PADOT submitted a letter to PEMA on March 5, 2003 requesting closure. PEMA forwarded the request to FEMA on November 5, 2003. PADOT is awaiting final resolution from FEMA.

FINDINGS FOR THE YEAR ENDED JUNE 30, 1995:

DEPARTMENT OF PUBLIC WELFARE (DPW)

Finding 81	DPW's Procedures Are Not Adequate to Ensure Subrecipient Compliance With Cash Management Standards (A Similar Condition Was Noted in Prior Year Finding #103)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.
Finding 87	DPW Procedures Were Not Adequate With Respect to Monitoring Subgrantees For Excess Federal Cash (A Similar Condition Was Noted in Prior Year Finding #112)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
DEPARTMENT OF TRANSPORTATION (PADOT)			
Finding 40	Costs Were Incorrectly Accumulated During Preparation of PADOT's Application For Reimbursement of Funds for the Severe Winter Weather of 1994 (FEMA 1015-DR-PA) Resulting in Questioned Costs of $326 (A Similar Condition Was Noted in Prior Year Finding #63)	FEMA	Unresolved – PADOT has responded to the discrepancies indicated in the finding. FEMA has closed out the disaster account and all parties have agreed to the amount of federally reimbursable funding. PADOT submitted a letter to PEMA on March 5, 2003 requesting closure. PEMA forwarded the request to FEMA on November 5, 2003. PADOT is awaiting final resolution from FEMA.

FINDINGS FOR THE YEAR ENDED JUNE 30, 1996:

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 48	DPW Procedures Were Not Adequate With Respect to Monitoring Subgrantees for Excess Federal Cash (A Similar Condition Was Noted in Prior Year Finding #87)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.
DEPARTMENT OF TRANSPORTATION (PADOT)			
Finding 16	Inadequate Property Management Procedures (A Similar Condition Was Noted in Prior Year Finding #32)	DOT	Unresolved – Since this finding was issued, federal regulations were revised to reduce federal regulatory requirements. PADOT's right-of-way manual was approved by FHWA on August 8, 2002. PADOT believes it is in compliance with current federal regulations and will pursue closure with FHWA in 2004.
Finding 19	PADOT District Offices Need Improved Procedures to Ensure Subcontracted Work is Approved in Writing Prior to Commencement of Work	DOT	Unresolved – Corrective action has been implemented. The Bureau of Construction & Materials continues to hold labor compliance workshops to inform district personnel of proper procedures. PADOT believes it is in compliance with current regulations and will pursue closure with FHWA in 2004.
Finding 23	PADOT Did Not Properly Report Federal Expenditures on the SEFA for the Flood of 1996 (FEMA 1093-DR-PA)	FEMA	Unresolved – PADOT and FEMA have reached a settlement on the Flood of 1996, and the disaster has been formally closed out. In a letter dated November 7, 2001, FEMA requested verification of the corrective action taken. PADOT submitted a letter to PEMA on March 5, 2003 requesting closure to the finding. PEMA forwarded the request to FEMA on November 5, 2003. PADOT is awaiting final resolution from FEMA.

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
Finding 25	An Audit Completed by FEMA Discloses Material Weaknesses in PADOT's System Used to Accumulate and Report Expenditures Eligible for Reimbursement for the Blizzard of 1996 (A Similar Condition Was Noted in Prior Year Finding #40)	FEMA	Unresolved – PADOT has responded to the discrepancies indicated in the finding. FEMA has closed out the disaster account and all parties have agreed to the amount of federally reimbursable funding. PADOT submitted a letter to PEMA on March 5, 2003 requesting closure. PEMA forwarded the request to FEMA on November 5, 2003. PADOT is awaiting final resolution from FEMA.

FINDINGS FOR THE YEAR ENDED JUNE 30, 1997:

DEPARTMENT OF PUBLIC WELFARE (DPW)

Finding 26	DPW Procedures Were Not Adequate With Respect to Monitoring Subgrantees for Excess Federal Cash (A Similar Condition Was Noted in Prior Year Finding #48)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.

DEPARTMENT OF TRANSPORTATION (PADOT)

Finding 12	Weakness in PADOT Controls Over Davis-Bacon Monitoring	DOT	Unresolved – PADOT has made great strides over the past three years in increasing the number of wage rate spot-checks and is currently finalizing a report showing it is in compliance with the Davis-Bacon Act. PADOT will submit a letter to the FHWA in 2004 requesting that the finding be closed.
Finding 14	PADOT Did Not Properly Report Federal Expenditures on the SEFA for the Floods of 1996 (A Similar Condition Was Noted in Prior Year Finding #23)	FEMA	Unresolved – PADOT and FEMA have reached a settlement on the Flood of 1996, and the disaster has been formally closed out. In a letter dated November 7, 2001, FEMA requested verification of the corrective action taken. PADOT submitted a letter to PEMA on March 5, 2003 requesting closure to the finding. PEMA forwarded the request to FEMA on November 5, 2003. PADOT is awaiting final resolution from FEMA.
Finding 15	Weaknesses in PADOT’s System Used to Accumulate and Report Expenditures for the January Flood of 1996 Resulted in an Undetermined Amount of Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #25)	FEMA	Unresolved – PADOT has responded to the discrepancies indicated in the finding. FEMA has closed out the disaster account and all parties have agreed to the amount of federally reimbursable funding. PADOT submitted a letter to PEMA on March 5, 2003 requesting closure. PEMA forwarded the request to FEMA on November 5, 2003. PADOT is awaiting final resolution from FEMA.

Summary Schedule of Prior Audit Findings - June 30, 2003

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
FINDINGS FOR THE YEAR ENDED JUNE 30, 1998:			
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 12	DPW Procedures Were Not Adequate With Respect to Monitoring Subgrantees for Excess Federal Cash (A Similar Condition Was Noted in Prior Year Finding #26)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.
DEPARTMENT OF TRANSPORTATION (PADOT)			
Finding 5	Weakness in PADOT Controls Over Davis-Bacon Monitoring (A Similar Condition Was Noted in Prior Year Finding #12)	DOT	Unresolved – PADOT has made great strides over the past three years in increasing the number of wage rate spot-checks, and is currently finalizing a report showing it is in compliance with the Davis-Bacon Act. PADOT will submit a letter to the FHWA in 2004 requesting that the finding be closed.
FINDINGS FOR THE YEAR ENDED JUNE 30, 1999:			
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 10	DPW Procedures Were Not Adequate With Respect to Monitoring Subgrantees for Excess Federal Cash (A Similar Condition Was Noted in Prior Year Finding #12)	HHS	Closed – DPW considers this finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision was never issued.
FINDINGS FOR THE YEAR ENDED JUNE 30, 2000:			
OFFICE OF BUDGET (OB)			
Finding 00-6	PADOT Did Not Properly Report Federal Expenditures on the SEFA	FEMA	Unresolved – PADOT and OB have implemented a corrective action plan established in March 2001. OB will continue to monitor accounting for federal expenditures to ensure appropriate accounting for any future disasters. In a letter dated November 14, 2002, FEMA requested verification of the corrective action taken. PEMA submitted a response to FEMA on November 5, 2003. OB and PADOT are awaiting action from FEMA.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
Finding 00-17	The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #15)	USDA	Resolved – Corrective action has been taken. Additional information provided to USDA in a letter dated September 13, 2002. Closed per USDA/FNS letter of September 10, 2003.
Finding 00-18	The Federal Interest Liability Reported on the CMIA Annual Report is Overstated By $1,326,871 (A Similar Condition Was Noted in Prior Year Finding #16)	HHS	Closed – Corrective action taken. OB considers this finding closed per OMB Circular A-133, section 315(b)(4). No further action is warranted because two years have passed since the report was issued, HHS is not currently following up on the finding, and no management decision was issued.
DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT (DCED)			
Finding 00-1	Inaccurate Performance and Evaluation Report Submitted to HUD	HUD	Unresolved – DCED discussed this finding with HUD and has implemented new procedures to correct the problem. DCED is awaiting final action from HUD.
Finding 00-2	DCED Did Not Perform On-Site Monitoring of Community Housing Development Organization Operating Grants	HUD	Unresolved – DCED implemented new procedures to monitor subrecipients in January 2002. The new procedures were reviewed and approved by HUD in May 2003. DCED is awaiting final resolution from HUD.
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 00-10	Weakness in DPW's Controls Over Information Reported on ACF-202 TANF Caseload Reduction Report	HHS	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the report was issued, HHS is not currently following up on this finding, and a management decision has not been issued.
Finding 00-11	Inaccurate Reporting on the TANF ACF-198 Data Report (A Similar Condition Was Noted in Prior Year Finding #9)	HHS	Unresolved – Corrective compliance plan was submitted to HHS/ACF on October 28, 2003 in response to ACF letter of August 28, 2003 regarding a potential sanction action. Awaiting HHS/ACF approval of the plan.
Finding 00-12	Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations	HHS	Unresolved – DPW provided Operations Memo OPS 02-02-02 dated February 13, 2002, issued to implement corrective action to ACF on May 31, 2002. ACF will rely on auditor's review of corrective action as part of subsequent year audit.
Finding 00-13	Weakness in DPW Monitoring Procedures Results in Over $19 Million in Excess Subgrantee Federal Cash at June 30, 2000 (A Similar Condition Was Noted in Prior Year Finding #10)	HHS	Unresolved – DPW agrees with the condition but does not agree with the effect. The nature of the funding makes it improbable that any funding is left at year's end. DPW provided additional information to HHS on March 28, 2000, and again on June 14, 2002. To date, no federal resolution of this finding has been forthcoming.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS

FINDINGS FOR THE YEAR ENDED JUNE 30, 2001:

OFFICE OF BUDGET (OB)

Finding 01-8	Internal Control Weakness Over Expenditure Information Reported on the SEFA	DOT	Resolved – The necessary adjustments to correct the SEFA have been made. The Comptroller's Office began implementing procedures to review all spreadsheet calculations used in the preparation of the SEFA. An additional level of management review has been added to prevent future errors. A final resolution letter was signed by FHWA on December 23, 2003. OB considers this finding closed.
Finding 01-9	PEMA Did Not Properly Report Federal Expenditures on the SEFA	FEMA	Unresolved – The necessary adjustments to correct the SEFA have been made. OB/PPR has implemented procedures to review all grant CFDA numbers for accuracy. OB/PPR is awaiting final resolution from FEMA.
Finding 01-20	The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #00-17)	HHS	Unresolved – Additional information provided to HHS in a letter dated June 14, 2002. OB/BFM is awaiting action from HHS.
Finding 01-21	The CMIA Interest Liability Was Understated by a Minimum of $83,212 (A Similar Condition Was Noted in Prior Year Finding #00-18)	HHS	Unresolved – Additional information provided to HHS in a letter dated June 14, 2002. OB/BFM is awaiting action from HHS.

DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT (DCED)

Finding 01-2	Performance/Evaluation Report Submitted to HUD Was Not Supported by Adequate Documentation (A Similar Condition Was Noted in Prior Year Finding #00-1)	HUD	Unresolved – DCED discussed this finding with HUD and has begun to implement procedures to correct the problem. DCED is awaiting final action from HUD.
Finding 01-3	Internal Control Weakness Over Information Reported from the Integrated Disbursement and Information System	HUD	Unresolved – DECD implemented a new procedure with OB/LECS that provides for a review of HUD drawdowns to ensure accuracy. DCED is awaiting action from HUD on resolution of the finding.
Finding 01-4	DCED Did Not Perform On-Site Monitoring of Community Housing Development Organization Operating Grants (A Similar Condition Was Noted in Prior Year Finding #00-2)	HUD	Unresolved – DCED implemented new procedures to monitor subrecipients in January 2002. The new procedures were reviewed and approved by HUD in May 2003. DCED is awaiting final resolution from HUD.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
DEPARTMENT OF ENVIRONMENTAL PROTECTION (DEP)			
Finding 01-5	Unallowable Personnel Charges Result in Questioned Costs of $1,220	DOI	Unresolved – Questioned costs settled by refiling a Financial Status Report (FSR) for the grant and deducting the questioned amount. DEP is awaiting final resolution from DOI.
DEPARTMENT OF LABOR AND INDUSTRY (L&I)			
Finding 01-6	Overpayment of TRA Benefits Resulted in Questioned Costs of $264 (A Similar Condition Was Noted in Prior Year Finding #00-4)	DOL	Unresolved – Corrective action has been taken through establishment of a non-fraud overpayment. To date, additional funds have not been repaid or recovered. DOL has not yet contacted L&I concerning this finding.
Finding 01-7	Weakness in L&I's Controls Over Preparation and Submission of the Trade Act Participant Report	DOL	Unresolved – Corrective action has been implemented. DOL has not yet contacted L&I concerning this finding.
Finding 01-10	Weakness in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #00-8)	USDE	Unresolved – Corrective action has been implemented. USDE has not yet contacted L&I concerning this finding.
Finding 01-11	Inadequate Documentation to Support $33,276 in Unallowable Personnel Costs	USDE	Resolved – As indicated in the USDE program determination letter of December 18, 2003, OVR resolved the questioned costs by receiving full reimbursement from L&I.
Finding 01-12	Weaknesses in L&I's Monitoring of RSBS Subgrantees (A Similar Condition Was Noted in Prior Year Finding #00-9)	USDE	Unresolved – OVR has discussed this finding with USDE during resolution of a similar prior year finding. L&I has developed additional measures to improve its grant monitoring procedures. L&I is awaiting final resolution from USDE.
Finding 01-19	Weaknesses in L&I's Internal Controls Over Subrecipients	DOL	Unresolved – DOL has not yet contacted L&I concerning this finding.
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 01-13	Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #00-12)	HHS	Unresolved – DPW provided Operations Memo OPS 02-02-02 dated February 13, 2002, issued to implement corrective action to HHS/ACF on May 31, 2002. ACF will rely on auditor's review of corrective action as part of subsequent year audit.
Finding 01-14	Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #00-11)	HHS	Unresolved – Corrective compliance plan was submitted to HHS/ACF on October 28, 2003 in response to ACF letter of August 28, 2003 regarding a potential sanction action. Awaiting HHS/ACF approval of the plan.

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
Finding 01-15	Noncompliance and Internal Control Weakness Over the Process of Responding to Interstate Registry Cases	HHS	Unresolved – DPW provided additional documentation to HHS/ACF on May 31, 2002 in response to HHS letter of May 10, 2002. Awaiting federal audit resolution action.
Finding 01-16	Weakness in DPW Monitoring Procedures Results in Over $32 Million in Excess Subgrantee Federal Cash at June 30, 2001 (A Similar Condition Was Noted in Prior Year Finding #00-13)	HHS	Unresolved – DPW agrees with the condition but does not agree with the effect. The nature of the funding makes it improbable that any funding is left at year's end. DPW provided additional information to HHS on March 28, 2000, and again on June 14, 2002. To date, no federal resolution of this finding has been forthcoming.
Finding 01-17	Internal Control Weaknesses and Noncompliance With Federal Earmarking Requirements Result in Questioned Costs of $1,381,114	HHS	Unresolved – HHS/ACF's letter of January 30, 2004 recommended return of $58,121 in questioned costs. DPW refunded that amount on April 15, 2004 and is awaiting final resolution of the finding.
Finding 01-18	DPW Office of Children, Youth and Families Should Renew Licensing of Foster Care Agencies in a More Timely Manner	HHS	Resolved – Finding resolved per HHS/ACF letter of April 29, 2003.

FINDINGS FOR THE YEAR ENDED JUNE 30, 2002:

OFFICE OF BUDGET (OB)

Finding 02-6 (Issued to OB and DCED)	Internal Control Weakness Over Information Reported from the Integrated Disbursement and Information System (A Similar Condition Was Noted in Prior Year Finding #01-3)	HUD	Unresolved – No additional action has been taken. LECS is awaiting a management decision letter from HUD.
Finding 02-12	L&I Did Not Properly Report Federal Expenditures on the SEFA	DOL & HHS	Unresolved – As stated in the agency response, effective June 30, 2003, L&I implemented a policy that the second provider, the one providing the service, is responsible for removing the duplicate expenditure from the SEFA.
Finding 02-14	Internal Control Weakness Over Expenditure Information Reported on the SEFA (A Similar Condition Was Noted in Prior Year Finding #01-8)	DOT	Resolved – The necessary adjustments to correct the SEFA have been made. The Comptroller's Office began implementing procedures to review all spreadsheet calculations used in the preparation of the SEFA. An additional level of management review has been added to prevent future errors. A final resolution letter was signed by FHWA on December 23, 2003. OB considers this finding closed.

Summary Schedule of Prior Audit Findings - June 30, 2003

	STATE AGENCY / FINDING	*FEDERAL AGENCY*	*COMMENTS*
Finding 02-19	$3,890,912 in Excess Funds Were Drawn Down from USDE in Violation of Federal Cash Management Regulations	USDE	Unresolved – Corrective action has been taken. The access database cited in the findings is no longer being used for federal drawdowns. OVR expenditures have been separated into two ledgers - state and federal. The cash drawdown system is now used for federal drawdowns.
Finding 02-29 (Issued to OB and INS)	Noncompliance and Internal Control Weaknesses in Federal Reporting and State Matching Procedures Result in $31,576 in Questioned Costs	HHS	Unresolved – OB/CS has implemented a separation of duties and proper oversight with supervisory review and approval. All financial reports will be reviewed to ensure compliance with matching requirements. OB/CS staff will work with INS to ensure that CHIP financial transactions are appropriately matched. The $31,576 of questioned costs requires no settlement. The final CMS-21 report for the period ending December 31, 2002 submitted January 31, 2003, properly matched all costs at the end of the grant period. Awaiting action from HHS on resolution of the finding.
Finding 02-35	Lack of Statewide Monitoring of OMB Circular A-133 Subrecipient Audit Report Submission to the Federal Audit Clearinghouse	HHS	Resolved – Closed per HHS/OARCP letter of April 30, 2004.
Finding 02-36	The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #01-20)	HHS	Unresolved – Additional information provided to HHS/DPM in a letter dated December 26, 2003. OB/BFM is awaiting action from HHS/DPM.
Finding 02-37	The CMIA Interest Liability Was Understated by a Minimum of $86,290 (A Similar Condition Was Noted in Prior Year Finding #01-21)	HHS	Unresolved – Additional information provided to HHS/DPM in a letter dated December 26, 2003. OB/BFM is awaiting action from HHS/DPM.
DEPARTMENT OF AGING (PDA)			
Finding 02-33	A Material Weakness Exists in PDA's Subrecipient Audit Resolution Process	HHS	Resolved – In November 2003, PDA provided additional documentation to HHS on corrective action taken. Closed per HHS/AOA letter of February 17, 2004.
DEPARTMENT OF AGRICULTURE (AGRI)			
Finding 02-1	Internal Control Weaknesses and Noncompliance with Processor Record-keeping and Reporting Requirements Result in Questioned Costs of $2,088	USDA	Resolved – Closed per USDA letter of May 19, 2004.

Summary Schedule of Prior Audit Findings - June 30, 2003

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT (DCED)			
Finding 02-5	Performance/Evaluation Report Submitted to HUD Was Inaccurate (A Similar Condition Was Noted in Prior Year Finding #01-2)	HUD	Unresolved – DCED discussed this finding with HUD and has begun to implement procedures to correct the problem. DCED is awaiting final action from HUD.
Finding 02-6 (Issued to OB & DCED)	Internal Control Weakness Over Information Reported from the Integrated Disbursement and Information System (A Similar Condition Was Noted in Prior Year Finding #01-3)	HUD	Unresolved – DCED implemented a new procedure with OB/LECS that provides for a review of HUD drawdowns to ensure accuracy. DCED is awaiting action from HUD on resolution of the finding.
Finding 02-7	DCED Did Not Perform Adequate Monitoring of Community Housing Development Organization Operating Grants (A Similar Condition Was Noted in Prior Year Finding #01-4)	HUD	Unresolved – DCED implemented new procedures to monitor subrecipients in January 2002. The new procedures were reviewed and approved by HUD in May 2003. DCED is awaiting final resolution from HUD.
DEPARTMENT OF EDUCATION (PDE)			
Finding 02-17	Inadequate Controls Over PDE's Voc Ed Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE	USDE	Resolved – Corrective action has been taken. Resolved per USDE letter of January 30, 2004.
DEPARTMENT OF ENVIRONMENTAL PROTECTION (DEP)			
Finding 02-8	Unallowable Personnel Charges Result in Questioned Costs of $112 (A Similar Condition Was Noted in Prior Year Finding #01-5)	DOI	Unresolved – The questioned costs have been resolved. DEP is awaiting final resolution from DOI.
Finding 02-15	Internal Control Weakness Over the Preparation of DEP Quarterly Billings to PENNVEST	EPA	Resolved – DEP has implemented corrective action. Closed per EPA letter of May 24, 2004.
DEPARTMENT OF HEALTH (DOH)			
Finding 02-3	Noncompliance and Internal Control Weaknesses in DOH Systems Result in $144,126 in Questioned Costs	USDA	Resolved – The questioned costs were waived and the finding was resolved per USDA letter of May 4, 2004.
Finding 02-4	DOH Did Not Obtain Prior Approval from FNS for Project Costs Related to Acquisition and Implementation of a New Automated WIC Database System	USDA	Resolved – Closed per USDA letter of May 4, 2004.
Finding 02-16	Noncompliance and Internal Control Weaknesses at DOH Result in $551,764 in Questioned Costs	HHS & USDE	Unresolved –The portion of the finding relative to the MCH Block Grant was resolved by HHS and questioned costs of $302,370 were waived. DOH is working with USDE to resolve the portion of the finding pertaining to the Special Education and Even Start programs.

STATE AGENCY / FINDING		*FEDERAL AGENCY*	*COMMENTS*
Finding 02-31	DOH Could Not Support Information Submitted to HHS on its Annual Statistical Report	HHS	Resolved – DOH has substantially improved its recordkeeping procedures during the FYE June 30, 2003. The finding was resolved per HHS/HRSA letter of March 29, 2004.
PENNSYLVANIA INFRASTRUCTURE INVESTMENT AUTHORITY (PENNVEST)			
Finding 02-32	Noncompliance with OMB Circular A-133 Subrecipient Audit Requirements	EPA	Resolved – PENNVEST obtained the outstanding audit report and has refined its remedial action plan for subrecipient noncompliance. Closed per EPA letter of May 24, 2004.
DEPARTMENT OF INSURANCE (INS)			
Finding 02-29 (Issued to OB and INS)	Noncompliance and Internal Control Weaknesses in Federal Reporting and State Matching Procedures Result in $31,576 in Questioned Costs	HHS	Unresolved – OB/CS has implemented a separation of duties and proper oversight with supervisory review and approval. All financial reports will be reviewed to ensure compliance with matching requirements. OB/CS staff will also work with INS to ensure that CHIP financial transactions are appropriately matched. The $31,576 of questioned costs requires no settlement. The final CMS-21 Report for the period ending December 31, 2002 submitted January 31, 2003, properly matched all costs at the end of the grant period. Awaiting action from HHS on resolution of finding.
DEPARTMENT OF LABOR AND INDUSTRY (L&I)			
Finding 02-9	Incomplete Reporting on the ETA 563 Report	DOL	Unresolved – Updates and improvements have been made and a combined report for the third quarter 2003 was submitted to USDOL. A modified prior year report is in progress. DOL has not yet contacted L&I concerning this finding.
Finding 02-10	Weakness in L&I's Controls Over Preparation and Submission of the Trade Act Participant Report to USDOL (A Similar Condition Was Noted in Prior Year Finding #01-7)	DOL	Unresolved – Corrective action is in process with the first quarter 2003 report submitted timely to USDOL. DOL has not yet contacted L&I concerning this finding.
Finding 02-11	Overpayment of TRA Benefits Resulted in Questioned Costs of $3,989 (A Similar Condition Was Noted in Prior Year Finding #01-6)	DOL	Unresolved – DOL has not yet contacted L&I concerning this finding. However, on April 7, 2003, a determination was issued establishing a non-fraud overpayment in the amount of $3,989, which is subject to the provisions of Section 243(a) of the Trade Act. Further corrective actions are not warranted since the staff is aware of their unintentional error.
Finding 02-13	Incomplete Reporting on and Inadequate Controls Over the WIA Annual Performance Report	DOL	Unresolved – DOL has not yet contacted L&I concerning this finding.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
Finding 02-18	Weakness in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #01-10)	USDE	Unresolved – L&I provided additional information to USDE on February 19, 2004 in response to USDE's program determination letter of December 18, 2003. It is expected that upon receipt, USDE will make a final determination on resolution.
Finding 02-20	Noncompliance and Weaknesses in Internal Controls Over Charging of Personnel Costs Result in Questioned Costs of $11,969 (A Similar Condition Was Noted in Prior Year Finding #01-11)	USDE	Unresolved – L&I provided additional information to USDE on February 19, 2004 in response to USDE's program determination letter of December 18, 2003. It is expected that upon receipt, USDE will make a final determination on resolution. USDE's letter indicated that the questioned costs had been resolved by receiving full reimbursement from L&I.
Finding 02-21	Internal Control Weakness Over Preparation and Submission of Vocational Rehabilitation Provider Claim Forms to SSA	USDE	Unresolved – L&I provided additional information to USDE on February 19, 2004 in response to USDE's program determination letter of December 18, 2003. It is expected that upon receipt, USDE will make a final determination on resolution.
Finding 02-22	Weaknesses in L&I's Monitoring of RSBS Subgrantees (A Similar Condition Was Noted in Prior Year Finding #01-12)	USDE	Unresolved – L&I provided additional information to USDE on February 19, 2004 in response to USDE's program determination letter of December 18, 2003. It is expected that upon receipt, USDE will make a final determination on resolution.
Finding 02-34	Noncompliance With OMB Circular A-133 Subrecipient Audit Requirements (A Similar Condition Was Noted in Prior Year Finding #01-19)	DOL	Unresolved – DOL has not yet contacted L&I concerning this finding.
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 02-2	Internal Control Weaknesses at DPW Result in Noncompliance with Federal Regulations	HHS	Resolved – Resolved per HHS/OARCP letter of April 30, 2004.
Finding 02-23	Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #01-13)	HHS	Unresolved – DPW provided Operations Memo OPS 02-02-02 dated February 13, 2002, issued to implement corrective action to HHS/ACF on May 31, 2002. ACF will rely on auditor's review of corrective action as part of subsequent year audit.
Finding 02-24	Inaccurate Reporting on the TANF ACF-199 Report (A Similar Condition Was Noted in Prior Year Finding #01-14)	HHS	Unresolved – Corrective compliance plan was submitted to HHS/ACF on October 28, 2003 in response to ACF letter of August 28, 2003 regarding a potential sanction action. Awaiting HHS/ACF approval of the plan.

Summary Schedule of Prior Audit Findings - June 30, 2003

STATE AGENCY / FINDING		*FEDERAL AGENCY*	*COMMENTS*
Finding 02-25	Noncompliance and Internal Control Weakness Over the Process of Responding to Interstate Registry Cases (A Similar Condition Was Noted in Prior Year Finding #01-15)	HHS	Unresolved – DPW provided comments to HHS in correspondence dated November 18, 2003. Awaiting federal audit resolution action.
Finding 02-26	Weakness in DPW Monitoring Procedures Results in Over $15 Million in Excess Subgrantee Federal Cash at June 30, 2002 (A Similar Condition Was Noted in Prior Year Finding #01-16)	HHS	Unresolved – DPW agrees with the condition but does not agree with the effect. The nature of the funding makes it improbable that any funding is left at year's end. DPW provided additional information to HHS on March 28, 2000, and again on June 14, 2002 regarding prior similar findings. A letter dated November 17, 2003 from HHS/DPM requested agreement or disagreement with the current finding and copies of supporting documentation. DPW sent a letter dated November 18, 2003 to HHS encouraging resolution of this long-standing issue.
Finding 02-27	Internal Control Weaknesses and Noncompliance With Federal Earmarking Requirements Result in Questioned Costs of $1,624,404 (A Similar Condition Was Noted in Prior Year Finding #01-17)	HHS	Unresolved – DPW provided comments to HHS in correspondence dated November 18, 2003. Awaiting federal audit resolution action.
Finding 02-28	DPW Office of Children, Youth and Families Should Renew Licensing of Foster Care Agencies in a More Timely Manner (A Similar Condition Was Noted in Prior Year Finding #01-18)	HHS	Unresolved – DPW provided comments to HHS in correspondence dated November 18, 2003. Awaiting federal audit resolution action.
Finding 02-30	Ineligible Payments to MA Beneficiaries Result in Questioned Costs of $27,552	HHS	Unresolved – DPW provided comments to HHS in correspondence dated November 18, 2003. Awaiting federal audit resolution action.

Corrective Action Plans

Commonwealth of Pennsylvania

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Basic Financial Statement Comments - June 30, 2003

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03-3**	Internal Control Weakness Over Financial Reporting in the Capital Facilities Fund	OB/CS	140	**288**
03-4**	Internal Control Weakness over Financial Reporting for Lottery Fund’s Property Tax Rent Rebate Accrual	OB/CS	141	**288**
03-5**	Internal Control Weakness Over Reporting Inter- and Intrafund Activity in the Basic Financial Statements	OB/BFM	142	**288**
03-6**	Internal Control Weakness Over Financial Reporting in the Unemployment Compensation Fund	OB/LECS	144	**288**
03-7**	Internal Control Weakness Over Financial Reporting in the Department of Education GAAP Template	OB/LECS	146	**288**
03-8*	DOH Did Not Comply with Annual Contractor Audit Requirement for the Tobacco Settlement Fund	DOH	147	**294**
03-9**	Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance	DOH	148	**294**
03-10**	Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed	DCED	150	**291**
03-11**	Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund	OB/BFM OB/PHHS	151	**288**
03-12**	Statewide Errors and Internal Control Weaknesses Over Financial Reporting in the BFS	OB/BFM	153	**288**
03-13*	Statewide Weaknesses in Segregation of Duties Within the SAP Accounting System	OB/BFM	157	**289**
03-14**	Internal Control Weaknesses Over Agency Accounting for Capital Assets	OB/BFM	160	**289**
03-15**	Internal Control Weaknesses in the Implementation of the New Statewide SAP Accounting System	OB/BFM	162	**289**

Index to Corrective Action Plans
Basic Financial Statement Comments - June 30, 2003

Comment No.	Comment	Impacted State Agency	Comment Page	CAP Page
03-16**	Lack of Documentation and Internal Control Weaknesses Over Contracting and Procurement (A Similar Condition Was Noted in Prior Year Comment #02-8)	OB OA	166	**289**
03-17**	Internal Control Weakness in the Reporting of Investments and Cash	OB/BFM	171	**289**
03-18**	Internal Control Weakness in Accounting for and Reporting Investments in Insurance Funds	INS OB/CS	172	**289**

* - Reportable Condition
** - Material Weakness
CAP - Corrective Action Plan

COMMONWEALTH OF PENNSYLVANIA

Index to Corrective Action Plans
Federal Award Findings and Questioned Costs - June 30, 2003

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-1**	10.550	Food Donation Program	Internal Control Weaknesses and Noncompliance With Processor Recordkeeping and Reporting Requirements Result in Questioned Costs of $8,278,102 (A Similar Condition Was Noted in Prior Year Finding #02-1)	$8,278,102	AGRI	177	**290**
03-2**	10.551 93.558 93.575 93.596 93.778	Food Stamps Temporary Assistance for Needy Families Child Care and Development Block Grant Child Care Mandatory and Matching Funds Medical Assistance	Internal Control Weaknesses at DPW Result in Noncompliance With Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #02-02)		DPW	182	**298**
03-3*	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance and Internal Control Weaknesses in DOH Systems Result in at Least $36,015 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-3)	$36,015	DOH	186	**294**
03-4**	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance in DOH Preparation of the WIC Financial Management and Participation FNS-798 Report Results in $4,490,772 in Questioned Costs	$4,490,772	DOH	189	**294**
03-5*	14.239	HOME Investment Partnerships Program	DCED Did Not Perform Adequate Monitoring of Community Housing Development Organization Operating Grants (A Similar Condition Was Noted in Prior Year Finding #02-7)		DCED	192	**291**
03-6**	17.207 17.225 17.245 17.801 17.804	Employment Service Unemployment Insurance Trade Adjustment Assistance – Workers Disabled Veterans Outreach Program Local Veterans Employment Rep Program	Noncompliance and Internal Control Weaknesses in the LECS Comptroller Office System of Cash Management		OB/ LECS	194	**289**
03-7**	17.245	Trade Adjustment Assistance – Workers	Inaccurate Data and Weaknesses in L&I's Controls Over Preparation and Submission of the Trade Act Participant Report to USDOL (A Similar Condition Was Noted in Prior Finding #02-10)		L&I	197	**294**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

COMMONWEALTH OF PENNSYLVANIA

Index to Corrective Action Plans
Federal Award Findings and Questioned Costs - June 30, 2003

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-8**	17.245	Trade Adjustment Assistance – Workers	Overpayment of TRA Benefits Resulted in Questioned Costs of $8,392 (A Similar Condition Was Noted in Prior Year Finding #02-11)	$8,392	L&I	201	**295**
03-9**	17.245	Trade Adjustment Assistance – Workers	Lack of Supporting Documentation for Statistical Information on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #02-09)		L&I	205	**296**
03-10**	17.258 17.259 17.260	WIA Adult Program WIA Youth Activities WIA Dislocated Workers	Errors and Inadequate Controls in the WIA Annual Performance Report (A Similar Condition Was Noted in Prior Year Finding #02-13)		L&I	207	**297**
03-11*	66.458 66.468	Clean Water State Revolving Funds Drinking Water State Revolving Funds	Internal Control Weakness Over the Preparation of DEP Quarterly Billings to PENNVEST (A Similar Condition Was Noted in Prior Year Finding #02-15)		DEP	210	**292**
03-12**	66.468	Capitalization Grants for Drinking Water State Revolving Funds	PENNVEST Did Not Comply With Federal Loan Repayment Provision		PENN-VEST	211	**294**
03-13*	66.468	Capitalization Grants for Drinking Water State Revolving Funds	DEP Failed to Provide Documentation to Support Administrative Expenditures Resulting in Questioned Costs of $159,622	$159,622	DEP	212	**293**
03-14*	84.027	Special Education – Grants to States	Noncompliance and Internal Control Weaknesses at DOH Result in $100,606 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-16)	$100,606	DOH	214	**294**
03-15**	84.048	Vocational Education – Basic Grants to States	Inadequate Controls Over PDE's VOC ED Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE (A Similar Condition Was Noted in Prior Year Finding #02-17)		PDE	217	**291**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

COMMONWEALTH OF PENNSYLVANIA

Index to Corrective Action Plans
Federal Award Findings and Questioned Costs - June 30, 2003

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-16*	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	$886,728 in Excess Funds Were Drawn Down from USDE in Violation of Federal Cash Management Regulations (A Similar Condition Was Noted in Prior Year Finding #02-19)		OB/ LECS	221	**290**
03-17*	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	A Weakness Exists in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #02-18)		L&I	223	**297**
03-18**	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	Noncompliance and Weaknesses in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding #02-20)		L&I	225	**297**
03-19**	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	Internal Control Weakness Over Preparation and Submission of Vocational Rehabilitation Provider Claim Forms to SSA (A Similar Condition Was Noted in Prior Year Finding #02-21)		L&I	227	**297**
03-20**	93.558	Temporary Assistance for Needy Families	Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #02-23)		DPW	229	**299**
03-21**	93.558	Temporary Assistance for Needy Families	Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #02-24)		DPW	231	**299**
03-22**	93.563	Child Support Enforcement	Noncompliance and Internal Control Weakness Over the Processing of Interstate Registry Cases (A Similar Condition Was Noted in Prior Year Finding #02-25)		DPW	238	**299**
03-23*	93.575 93.596	Child Care and Development Block Grant Child Care Mandatory and Matching Funds	Internal Control Weaknesses and Noncompliance With Federal Earmarking Requirements Result in Questioned Costs of $3,224,570 (A Similar Condition Was Noted in Prior Year Finding #02-27)	$3,224,570	DPW	243	**299**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

COMMONWEALTH OF PENNSYLVANIA

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Federal Award Findings and Questioned Costs - June 30, 2003

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
03-24**	93.575 93.596 93.667	Child Care and Development Block Grant Child Care Mandatory and Matching Funds Social Services Block Grant	Weaknesses in DPW Monitoring of Subgrantees Results in Over $7 Million in Excess Subgrantee Federal Cash at June 30, 2003 (A Similar Condition Was Noted in Prior Year Finding #02-26)		DPW	245	**300**
03-25*	93.767	State Children's Insurance Program	Internal Control Weaknesses in Federal Reporting and State Matching Procedures (A Similar Condition Was Noted in Prior Year Finding #02-29)		OB/CS	248	**290**
03-26*	14.228 14.239	Community Development Block Grant HOME Investment Partnerships Program	An Internal Control Weakness Exists in DCED's Subrecipient Audit Resolution Process		DCED	251	**291**
03-27*	20.205 23.003	Highway Planning and Construction Appalachian Development Highway Syste	An Internal Control Weakness Exists in PADOT's Subrecipient Audit Resolution Process		PADOT	253	**300**
03-28**	10.561 17.258 17.259 17.260 93.558	State Administrative Matching Grants – Food Stamp Program WIA Adult Program WIA Youth Activities WIA Dislocated Workers Temporary Assistance for Needy Families	Noncompliance With OMB Circular A-133 Subrecipient Audit Requirements (A Similar Condition Was Noted in Prior Year Finding #02-34)		L&I	255	**297**
03-29**	Various	All Major Programs Covered by CMIA	The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #02-36)		OB/BFM	258	**290**
03-30*	93.558 93.767 93.778 Various	Temporary Assistance for Needy Families State Children's Insurance Program Medical Assistance All Major Programs Covered by CMIA	The CMIA Interest Liability Was Understated by at Least $1,218,014 (A Similar Condition Was Noted in Prior Year Finding #02-37)		OB/BFM	262	**290**
			Total Questioned Costs	$16,298,079			

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

OFFICE OF THE BUDGET (OB)

Comment 03-2: Cash and Investment Balances in the Statutory Liquidator Fund Were Misstated in the Preparation of the GAAP Template

No additional information provided. See Agency Response in the body of the finding.

Comment 03-3: Internal Control Weakness Over Financial Reporting in the Capital Facilities Fund

No additional information provided. See Agency Response in the body of the finding.

Comment 03-4: Internal Control Weakness over Financial Reporting for Lottery Fund's Property Tax Rent Rebate Accrual

No additional information provided. See Agency Response in the body of the finding.

Comment 03-5: Internal Control Weakness Over Reporting Inter- and Intra-fund Activity in the Basic Financial Statements

We have taken the actions noted in our Agency Response. We will continue to monitor internal activity transactions and adjustments to ensure that inter- and intra-fund activity is properly reported in our basic financial statements.

Comment 03-6: Internal Control Weakness Over Financial Reporting in the Unemployment Compensation Fund

No additional information provided. See Agency Response in the body of the finding.

Comment 03-7: Internal Control Weakness Over Financial Reporting in the Department of Education GAAP Template

No additional information provided. See Agency Response in the body of the finding.

Comment 03-11: Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund

The corrective actions noted in our Agency Response should adequately address this comment.

Comment 03-12: Statewide Errors and Internal Control Weaknesses Over Financial Reporting in the BFS

BFM has taken the following actions to enhance the CAFR template preparation process:

- Three ½-day training sessions have been provided to CAFR template preparers to provide additional guidance on the review and adjustment of transactions in SAP.
- CAFR template preparation checklists have been expanded to provide greater assurance that noted errors will not recur.
- CAFR template checklists have been modified to include a written acknowledgement by the preparing office that the information contained in the template meets the disclosure requirements for inclusion in the Commonwealth's Comprehensive Annual Financial Report.

OFFICE OF THE BUDGET (OB) - Continued

These additional actions plus added scrutiny during the CAFR template review process will avoid many of the errors noted in the auditor's comment.

Comment 03-13: Statewide Weaknesses in Segregation of Duties Within the SAP Accounting System

Corrective action has been or is being taken as noted in the Agency Response. No additional corrective actions are planned at this time.

Comment 03-14: Internal Control Weaknesses Over Agency Accounting for Capital Assets

The Bureau of Financial Management has taken corrective actions to enhance the capital asset reporting process. A confirmation process has been established to require quarterly verification of capital asset additions, transfers and retirements. Notices have been sent to key agencies to alert them to the need to enhance their capital assets accounting. The roles of Agency Fixed Asset Coordinators and Comptroller Office Fixed Asset Coordinators have been further refined and enforced. The Bureau of Financial Management has gained a greater understanding of the SAP Fixed Assets sub module and has focused on ensuring the accuracy and propriety of information in the system. These efforts have yielded dramatic improvements in the Commonwealth's ability to generate accurate and complete capital asset information for our Comprehensive Annual Financial Report.

Comment 03-15: Internal Control Weaknesses in the Implementation of the New Statewide SAP Accounting System

The Commonwealth has taken corrective actions to address the weaknesses noted in this comment, as noted in our Agency Response. Our progress is evidenced by the fact that reconciliations are much more timely, the June 30, 2004 GR/IR open items are declining at an acceptable rate, and month-end closings are progressing smoothly. Many of the weaknesses noted by the auditors are reflective of problems encountered with a new system implementation of the magnitude undertaken by the Commonwealth.

Comment 03-16: Lack of Documentation and Internal Control Weaknesses Over Contracting and Procurement (A Similar Condition Was Noted in Prior Year Comment #02-8)

No additional information provided. See Agency Response in the body of the finding.

Comment 03-17: Internal Control Weakness in the Reporting of Investments and Cash

We have taken the corrective actions noted in our Agency Response. As a result, we have received information from the Pennsylvania Treasury that is much more timely, accurate and complete than in the prior year.

Comment 03-18: Internal Control Weakness in Accounting for and Reporting Investments in Insurance Funds

No additional information provided. See Agency Response in the body of the finding.

Finding 03-6: Noncompliance and Internal Control Weaknesses in the LECS Comptroller Office System of Cash Management

No additional information provided. See Agency Response in the body of the finding.

OFFICE OF THE BUDGET (OB) - Continued

Finding 03-16: $886,728 in Excess Funds Were Drawn Down From USDE in Violation of Federal Cash Management Regulations (A Similar Condition Was Noted in Prior Year Finding #02-19)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-25: Internal Control Weaknesses in Federal Reporting and State Matching Procedures (A Similar Condition Was Noted in Prior Year Finding #02-29)

See Agency Response in the body of the finding.

In addition, please note the line in the Condition that states "However, the following weakness described below from the prior year still existed through the end of our current year," is not correct. Corrective action was implemented in March of 2003, therefore, the weakness described in this finding did not exist through the end of the current year (2003).

Finding 03-29: The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding #02-36)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-30: The CMIA Interest Liability Was Understated By At Least $1,218,014 (A Similar Condition Was Noted in Prior Year Finding #02-37)

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF AGRICULTURE (AGRI)

Finding 03-1: Internal Control Weaknesses and Noncompliance with Processor Recordkeeping and Reporting Requirements Result in Questioned Costs of $8,278,102 (A Similar Condition Was Noted in Prior Year Finding #02-1)

The Bureau of Food Distribution will expand its field review procedures to include the verification of sales and/or delivery of USDA commodity to eligible recipient agencies through its USDA commodity-processing program.

The Field Staff supervisor, working with the Commodity Processing Specialist, will no less than twice per program year:

1) Randomly select no less than 10% of processors under agreement with the Bureau for sales verification.
2) Select a period of time within the test period;
3) Randomly select no less than 10% of recipient agencies reflecting activity in the test period.

Using the data identified above, the Field Staff Supervisor will direct affected field staff to visit each recipient agency and verify the receipt of the items containing USDA commodity as reported by the respective processors. Where discrepancies are noted, the Commodity Processing Specialist will investigate and adjust the files as required, and direct a follow-up sales verification of the identified processor.

DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT (DCED)

Comment 03-10: Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed

DCED staff has already spoken with and has engaged PricewaterhouseCoopers, LLC (PwC) to develop more comprehensive procedures for the annual reviews of the Regional Biotechnology Centers including the Annual Reports (June 25, 2004 letter of engagement). DCED staff has reviewed the Annual Reports submitted by the Regional Biotechnology Centers. In the future, DCED staff will document and perform the procedures recommended by PwC to verify whether each Center is meeting and achieving its goals and functions on a timely basis. On July 29, 2004, DCED staff met with PwC to develop more comprehensive procedures. PwC would like to have these procedures completed by fall 2004 and DCED intends to implement them immediately after development and approval.

Finding 03-5: DCED Did Not Perform Adequate Monitoring of Community Housing Development Organization Operating Grants (A Similar Condition Was Noted in Prior Year Finding #02-7)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-26: An Internal Control Weakness Exists in DCED's Subrecipient Audit Resolution Process

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF EDUCATION (PDE)

Finding 03-15: Inadequate Controls Over PDE's VOC ED Consolidated Annual Performance, Accountability and Financial Status Report Submitted to USDE (A Similar Condition Was Noted in Prior Year Finding #02-17)

I. Period of Audit: July 1, 2002 through June 30, 2003

II. Audit Reference: CFDA 84.048 – Vocational Education – Basic Grants to States

III. Description of Noncompliance or Weakness:

The auditors review disclosed a weakness in PDE's internal controls over the Vocational Education Consolidated Annual Performance, Accountability and Financial Status Report submitted to USDE.

IV. Specific Steps to be Taken and Timetable:

Supervisory signatory reviews will be documented to assure reasonableness and accuracy of data prior to forwarding the CAR to the USDE.

The continued implementation of the "Timeline for Processing National Occupational Competency Testing Institute (NOCTI), Alternate Tests, and Accountability Data for the Federal Consolidated Annual Report (CAR), e-Grant Matrix and Standard and Poor's (S&P)" will be updated and implemented. The timetable will involve those months when data is received, compiled, analyzed and synthesized for the 2002 CAR.

DEPARTMENT OF EDUCATION (PDE) - Continued

A letter will be written and sent to USDE seeking written approval to substitute estimated data in place of actual data on the CAR. The letter will be prepared August 2004.

V. Description of Monitoring:

BCTE and BCAS will request and receive test data from the third party contractors for comparative data reviews of that collected internally. Individuals that are engaged in the processes will be identified, expected to document the analysis and submit such documentation for supervisory review and be available for audit upon request.

VI. Title of Official Responsible for Corrective Action:

Director, Bureau of Career and Technical Education

VII. Anticipated Completion Date for Corrective Action:

December 31, 2004

DEPARTMENT OF ENVIRONMENTAL PROTECTION (DEP)

Finding 03-11: Internal Control Weakness Over the Preparation of DEP Quarterly Billings to PENNVEST (A Similar Condition Was Noted in Prior Year Finding #02-15)

Procedures are in place to ensure that all quarterly billings to PENNVEST from the Drinking Water State Revolving Fund (DWSRF) and the Clean Water State Revolving Fund (CWSRF) are accurate and have been reviewed by the Federal/Audit Unit supervisor and the Fiscal Management Bureau Director. The procedures are as follows:

Budget Analyst –

1. Each Quarterly Report is run in Oracle and/or SAP to identify actual expenditures associated with the ICS Cost Function/SAP Internal Order Number for each ICS/SAP fund charged.

2. Expenditures are sorted and totaled by Personnel and Operating. The totals and appropriate code structure are entered into spreadsheets to calculate a grant total PENNVEST Quarterly Billing.

3. All back-up data associated with the total dollar amount derived is attached to the pertinent spreadsheet and submitted to the Senior Analyst for review.

Senior Analyst –

1. Reviews all back up that supports data provided on the spreadsheet. Initials and dates each page of documentation to indicate review and approval of the documentation.

2. Works out any discrepancies with Budget Analyst prior to submission of an invoice to PENNVEST.

3. Returns approved documentation to Budget Analyst who will generate General Invoices.

DEPARTMENT OF ENVIRONMENTAL PROTECTION (DEP) - Continued

Budget Analyst –

4. Upon receipt of approved/initialed documentation by Senior Analyst, creates general invoices to PENNVEST.

5. Creates invoices for the two parts of the PENNVEST billing (as listed above) using the spreadsheet totals and code structure.

6. Prepares and submits a memorandum for the Bureau Director's signature.

7. Attaches invoices to memorandum and forwards to Bureau Director.

Bureau Director –

1. Reviews back up data to ensure Senior Analyst has reviewed the data.

2. Upon favorable review, signs the general invoices and memorandum and returns to the Budget Analyst.

3. Upon unfavorable review, returns general invoices and memorandum to Budget Analyst with written comments of concern for Analyst.

Budget Analyst –

8. Submits all approved and signed documents and related back up spreadsheets to PENNVEST for reimbursement to DEP.

9. Keeps copies of all documents related to the billing amount in a file available for audit purposes.

10. Reviews and resubmits unapproved invoices to the Senior Analyst for review and continuation of process as above (Senior Analyst – Step 2).

Finding 03-13: DEP Failed to Provide Documentation to Support Administrative Expenditures Resulting in Questioned Costs of $159,622

Procedures are in place to ensure that all quarterly billings to PENNVEST from the Drinking Water State Revolving Fund (DWSRF) are accurate and have been reviewed by the Federal/Audit Unit supervisor and the Fiscal Management Bureau Director. (See Corrective Action Plan for Finding 03-11 for a description of the new procedures in place.)

Steps have been taken to ensure that staff keeps all backup data pertinent to any invoice requesting reimbursement. Multiple staff will be responsible for ensuring information is provided to the Office of the Auditor General staff in a timely manner and on a priority basis.

Prior to pursuing a settlement with the federal government on the $159,622 of questioned costs, DEP will re-run the May 2003 report with the correct data perimeters. DEP will then compare charges from the initial report run with the latest run and examine the variances on each charge. A new invoice will be generated if costs are higher than the initial billing. If charges are less than that billed, DEP will work with the federal government to ensure they are properly credited for the overpayment.

DEPARTMENT OF HEALTH (DOH)

Comment 03-8: DOH Did Not Comply with Annual Contractor Audit Requirement for the Tobacco Settlement Fund

No additional information provided. See Agency Response in the body of the finding.

Comment 03-9: Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance

No additional information provided. See Agency Response in the body of the finding.

Finding 03-3: Noncompliance and Internal Control Weaknesses in DOH Systems Result in at Least $36,015 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-3)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-4: Noncompliance in DOH Preparation of the WIC Financial Management and Participation FNS-798 Report Results in $4,490,772 in Questioned Costs

DOH will pursue resolution of this finding with USDA. No additional information provided. See Agency Response in the body of the finding.

Finding 03-14: Noncompliance and Internal Control Weaknesses at DOH Result in $100,606 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #02-16)

DOH will pursue resolution of this finding with USDE. No additional information provided. See Agency Response in the body of the finding.

PENNSYLVANIA INFRASTRUCTURE INVESTMENT AUTHORITY (PENNVEST)

Finding 03-12: PENNVEST Did Not Comply With Federal Loan Repayment Provision

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF LABOR AND INDUSTRY (L&I)

Finding 03-7: Inaccurate Data and Weaknesses in L&I's Controls Over Preparation and Submission of the Trade Act Participant Report to USDOL (A Similar Condition Was Noted in Prior Year Finding #02-10)

The Bureau has completed the process of developing a formal system to collect and accurately report the TAPR data to USDOL and has developed an interim system to populate information for the TAPR up to the point that all information can be collected through the automated system. Since the TAPR is compiled for those that exited the program almost six quarters ago, the automated system will not completely produce the TAPR until the first quarter of 2007. Accordingly, we will have to continue to rely on a manual system to secure some of the information required for completion of the report.

As per recommendation, we have already consulted with USDOL to clarify the reporting instructions relative to definition of exiters. USDOL confirmed that individuals who received only a Waiver and TRA should be included in the TAPR when they exit.

DEPARTMENT OF LABOR AND INDUSTRY (L&I) - Continued

Beginning with the last TAPR submitted in May 2004, these participants have been and will continue to be included in all future reports.

L&I has reviewed and complied with the corrective action on past data errors to the point possible. Additionally, L&I has strengthened existing procedures to verify the completeness and accuracy of the TAPR information that is accumulated and transmitted to USDOL, including a review of existing internal edit checks to ensure they fully consider every field of entry, and additional automated transfers of information from the CareerLinks operating site. As per the recommendation, L&I has also maintained documentation to support the internal edit check process.

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These improvements serve to address the related deficiencies cited within the finding. However, due to the nature and timing of the TAPR reporting system for time periods in which the participants exited, some manual checks and input will continue to be necessary until the full transition is complete. As noted, the preparation of the TAPR is no longer primarily a manual process due to the improvements of electronically fed data. Only transitional or adjusted information will be required to be entered manually.

Finding 03-8: **Overpayment of TRA Benefits Resulted in Questioned Costs of $8,392 (A Similar Condition Was Noted in Prior Year Finding #02-11)**

<u>Corrective Action Relating to Claimants A and B</u>

Paper applications were used at the time the training applications were taken for Claimants A and B. Since the paper application provided for more than one date, differing dates were recorded on the form due to the process in place at that time. Since July 1, 2003, Pennsylvania CareerLinks, under the oversight of the Bureau of Workforce Development Partnership (BWDP), has been accepting and processing applications for training under the TAA program electronically. The electronic system automatically records the date of application, which cannot be changed once submitted. The application date recorded by the electronic system is automatically transferred to an electronic application approval form. This is the date that UC Service Center staff will use to determine eligibility for additional Trade Readjustment Allowance (TRA) benefits, based on the 210-day application requirement.

In addition, the Trade Coordination Services division of BWDP is providing a three-day training session to Pennsylvania CareerLinks staff that includes instruction regarding correct and timely processing of TAA program applications. With two sessions completed since July 2004, six additional sessions of 32 staff each are scheduled through December. Additional sessions will be scheduled in 2005 for any remaining staff.

Section 501(e) of the Pennsylvania UC Law provides that determinations of the Department are final unless appealed within 15 calendar days after the determination was issued. Since the 15-day appeal period has expired, the Department cannot issue a subsequent determination finding Claimants A and B ineligible, or a related determination of overpayment of benefits.

The Department agrees to repay the questioned costs relating to Claimants A and B.

<u>Corrective Action Relating to Claimant C</u>

A determination will be issued establishing a non-fraud overpayment in the amount of $257, which is subject to the repayment, recovery and waiver provisions of Section 243(a) of the Trade Act. Since TRA is primarily a manual system and this was a manual

DEPARTMENT OF LABOR AND INDUSTRY (L&I) - Continued

adjustment error, no further corrective actions can be taken at this time. The Department has begun a multi-year systems modernization project that will include automatic calculation and adjustment of TRA benefits, and that will preclude manual errors of this type.

Since Claimant C has no current UI or TRA eligibility, the Department agrees to repay the questioned costs relating to Claimant C.

Corrective Action Relating to Claimant D

The Federal Programs Unit of the Bureau of UC Benefits and Allowances (BUCBA) is providing a three-day training session to UC Service Center staff that includes instruction regarding a detailed explanation of the weekly work search requirement and the correct processing of bi-weekly TRA mail claims for individuals who are required to complete an active work search for each week claimed. With two sessions completed since July 2004, six additional sessions for UC Service Center staff each are scheduled through October 2004. Additional sessions will be scheduled for L&I staff within the L&I building. Further additional sessions will be scheduled for UC Service Center staff in the future as required due to significant changes in staff. In addition, a notice will be sent in writing to all UC Service Centers advising staff to follow correct procedures in issuing TRA payments based on appropriate documentation.

The Department agrees to repay the questioned costs relating to Claimant D.

Finding 03-9: Lack of Supporting Documentation for Statistical Information on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #02-09)

- The US Department of Labor intends to streamline the reporting process for a number of employment/training reporting programs into one system known as EMILE. The reporting requirements and transmission process will change at that time. The US DOL proposes to implement EMILE in July 2005. The ETA 563 and the TAPR are two of the reports that will be subsumed into the EMILE system.

- For this reason, the Department has not undertaken a major re-write of the program that produces the ETA 563. The current program that generates the ETA 563 was written when both the Unemployment Compensation (UC) and employment and training data were stored on mainframe systems. While the UC remains on the mainframe, the employment and training data is now gathered and stored on a web-based CareerLink system.

- The Department has a workgroup that has examined each of the data elements required in the ETA 563 and has found that some of the data elements can be drawn directly from the CareerLink system; others require work arounds with files created from the CareerLink system being matched to files from the UC mainframe.

- The Department now has confidence that the ETA 563 is an accurate reflection of both UC and re-employment and training data.

- The reports for the second and third quarters of 2004 were submitted based on the work arounds and the US DOL has allowed the State to resubmit reports with updated data. Reports for the third and fourth quarter of 2003 have been resubmitted to the US DOL.

DEPARTMENT OF LABOR AND INDUSTRY (L&I) – Continued

Finding 03-10: Errors and Inadequate Controls in the WIA Annual Performance Report (A Similar Condition Was Noted in Prior Year Finding #02-13)

- BWDP staff will review wage record detail as much as possible as records are made available. BWDP will also pursue expanded access to wage record details for staff. Center for Workforce Information and Analysis (CWIA) staff will continue to review wage records received through WRIS and the MD Exchange.

- Prepare WIASRD report on a quarterly basis to review for errors and resolve in advance of the due date to DOL for the annual submission.

- Compare the size of the files or the number of records during the data migration process to ensure that all information was properly transferred from the CL to DART and to ensure consistency of data.

Finding 03-17: A Weakness Exists in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #02-18)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-18: Noncompliance and Weaknesses in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding #02-20)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-19: Internal Control Weaknesses Over Preparation and Submission of Vocational Rehabilitation Provider Claim Forms to SSA (A Similar Condition Was Noted in Prior Year Finding #02-21)

No additional information provided. See Agency Response in the body of the finding.

Finding 03-28: Noncompliance With OMB Circular A-133 Subrecipient Audit Requirements (A Similar Condition Was Noted in Prior Year Finding #02-34)

- Meet with new leadership at SEC and continue discussions with SEC officials and staff as appropriate, including the County Commissioners, new WIB Chairperson, Corporation Solicitor, newly hired WIB Director, Fiscal Agent, and Title I Operator. The next meeting is scheduled for August 30, 2004.

- Establish an internal Bureau of Workforce Development Partnership (BWDP) bi-weekly staff meeting to monitor current activity related to SEC. Attendees will include the Director, Deputy Director, Manager of Workforce Programs, Chief of Program Management, Supervisor of Financial Coordination Services, Supervisor and assigned SEC staff liaison of CareerLink Oversight Services, Supervisor of Planning Coordination Services, and the Supervisor of the Audit Division of the LECS Comptroller's Office, and any other staff necessary. These meetings are scheduled to begin September 3 and will review SEC's current status, issues and recommendations for resolution. They will be followed up with SEC representatives as appropriate.

- Establish a process to document ongoing activity related to SEC.

- Research possibility of peer assistance from another LWIA directly to SEC.

DEPARTMENT OF PUBLIC WELFARE (DPW)

Comment 03-1: Internal Control Weaknesses Result in Improper Payments in the Tobacco Settlement Fund

The Uncompensated Care (UCare) payments in question were expedited payments made to facilities experiencing financial hardships. After the expedited payments were made, the tobacco calculations were updated and the amounts for all hospitals were slightly lowered. There are funds remaining in the UCare appropriation for FYE 03 due to some hospitals being unable to overcome their hospital specific disproportionate share upper payment limit (DSH-UPL). When these funds are redistributed to all of the eligible hospitals, to include the hospitals questioned in Comment 03-1, the payments for these hospitals will be adjusted for the overpayments. The DPW continues to follow the requirements outlined in the Tobacco Settlement Act 77 of 2001. The DPW and the Pennsylvania Healthcare Cost Containment Council have developed extensive validation processes and protocols, in line with the auditor recommendation, since the first UCare payments were processed. Regarding the recommendation to develop an audit plan, the DPW is relying on audits conducted by the Department of the Auditor General, Bureau of State-Aided Audits, to finalize payments for the Act 77, Extraordinary Expense payments.

Finding 03-2: Internal Control Weaknesses at DPW Result in Noncompliance with Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #02-2)

In response to the recommendation for County Assistance Office (CAO) caseworker training and supervision, the Office of Income Maintenance (OIM) ensures that the CAO caseworkers receive additional training by utilizing the availability of E-learning modules that are offered through Staff Development. Staff members now have easy access to current information. Supervisors conduct periodic Comprehensive Supervisory Reviews and Targeted Supervisory Reviews to make sure the staff are following established DPW policies and procedures regarding determining eligibility and re-determinations, which are conducted on an ongoing basis.

Secondly, in order to strengthen procedures to ensure compliance with Act 1996-35 and ensure recipient compliance with court-ordered payment plans, OIM uses the Income Eligibility Verification System (IEVS) "Exchange 10," for communication with local courts and other authorities and the exchange of information. IEVS Exchange 10 screens have recently been revised to make it easier for the user to interpret the information on the screens.

Lastly, in regard to the recommendation to enhance or develop procedures to ensure that overpayments and over-issuances are processed completely and accurately, OIM has recently changed the process to verify information from employers who participate in the Work Number Verification Service. In addition to the CAO's having access to the Work number web site, OIM is currently reviewing the process statewide to enhance other procedures relating to overpayments.

The Automated Restitution and Computation Procedures releases and all other applicable regulations pertaining to overpayments are reviewed with Income Maintenance Caseworkers (IMCW) on a regular basis. The IMCWs have been advised of the necessity to comply with the requirements to ensure that overpayments and over-issuances are processed completely and accurately.

DEPARTMENT OF PUBLIC WELFARE (DPW) – Continued

Finding 03-20: Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #02-23)

The DPW assessment is to be documented in each file as the "RESET Participant Guide to Success and the Job Search Process" (Guide-PA 1680). An Operations Memorandum, OPO 020202, dated February 13, 2002, giving direction to carry this out and use the Guide was initially distributed to Area Managers. Since this Finding is recognized as a repeat finding from the previous year Single Audit, three points of action are now being implemented to ensure proper use and filing of the Guide.

First, additional direction has been issued to Area Managers to make the PA 1680 a part of the targeted supervisory review. Second, the OIM, Bureau of Employment and Training will have their program advisors review case files for PA 1680s during their monitoring visits. Third, the Bureau of Employment and Training will issue another Operations Memorandum on this issue.

Finding 03-21: Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #02-24)

A TANF reporting penalty was imposed on Pennsylvania as explained in an Administration for Children and Families (ACF) letter dated August 28, 2003. The penalty is a result of ACF's concurrence with the auditors' recommendation for the audit year ended June 30, 2001.

Pennsylvania submitted a corrective action compliance plan dated October 28, 2003 to correct the noncompliance that was accepted by ACF on December 18, 2003. DPW has until March 31, 2004 to achieve compliance. As a result, ACF will not impose the penalty on the Commonwealth if the DPW corrects the violation within the period covered by the plan.

Finding 03-22: Noncompliance and Internal Control Weakness Over the Processing of Interstate Registry Cases (A Similar Condition Was Noted in Prior Year Finding #02-25)

The Office of Income Maintenance, Bureau of Child Support Enforcement (BCSE) reviewed each of the reported sample cases selected by the auditors and found material errors within the Single Audit Finding conclusion. The audit sample is not representative of either the *interstate responding* case universe or the *interstate initiating case* universe for SFY ending June 30, 2003. BCSE was advised that the audit sample selection was not random, but instead specifically selected cases with initial date points that would support an audit finding of noncompliance with interstate time frames.

The BCSE disagrees with both components of the Finding as stated in the "Agency Response," hence no corrective action is warranted.

Finding 03-23: Internal Control Weaknesses and Noncompliance With Federal Earmarking Requirements Result in Questioned Costs of $3,224,570 (A Similar Condition Was Noted in Prior Year Finding #02-27)

The DPW, Office of Children, Youth and Families (OCY&F) has made changes in their internal control procedures for documenting infant-toddler earmark expenditures through subrecipients that will meet the federal documentation requirements. Auditors from the

DEPARTMENT OF PUBLIC WELFARE (DPW) – Continued

Department of the Auditor General will review the procedural changes regarding this issue during the subsequent audit.

Finding 03-24: Weaknesses in DPW Monitoring of Subgrantees Results in Over $7 Million in Excess Subgrantee Federal Cash at June 30, 2003 (A Similar Condition Was Noted in Prior Year Finding #02-26)

The DPW will continue to carefully review monthly service and expenditures from each subgrantee and will continue to move funds from non-spending subgrantees to subgrantees with waiting lists, similar to that which occurred during FY 2002-03. Also, during FY 2003-04, the DPW implemented the Child Care Management Information System (CCMIS) in 19 CCIS agencies statewide. In CCMIS, the DPW no longer provides advanced 1/12 payments each month to CCIS agencies for service delivery. Instead, CCMIS will project a payment for the upcoming month that is based on current service levels along with reconciliation of the prior month's payments to balance over- or under-payments to the CCIS agencies. The DPW will implement CCMIS statewide in the remaining CCIS agencies during FY 2004-05. This system will greatly reduce the amount of returned funds.

Lastly, on several occasions, the DPW attempted to engage in a dialog with the federal Department of Health and Human Services on the general cash management issue in an endeavor to resolve this long-standing audit finding. In that regard, the DPW's previously issued correspondence continues to remain unanswered. The DPW encourages federal resolution of this ongoing single audit finding.

DEPARTMENT OF TRANSPORTATION (PADOT)

Finding 03-27: An Internal Control Weakness Exists in PADOT's Subrecipient Audit Resolution Process

PADOT does have a formalized subrecipient program that has been in place for several years to review both the financial information and findings within all subrecipient single audit reports that are received by the Department. We receive approximately 185 single audit reports each year from the Bureau of Audits. We also have a very detailed database that provides various subrecipient information such as the data requested by the Department of Auditor General. Preceding and during the fiscal year 02-03 audit period, the Department simply fell behind reviewing and closing out subrecipient audit reports. We have the various processes in place to meet the requirements of OMB Circular A-133 but due to lack of staff in the Audit Resolution Section, which is assigned to work on the reports, and other higher placed priorities within the Department, we did not meet the requirement of closing out reports within the proper time period.

Our corrective action plan to resolve this issue actually started back in May 2003 when the Department made a decision to dedicate two staff members to decrease the large backlog of open files that had accumulated over the years. Personnel changes were also made and the direct responsibility to manage the subrecipient program was transferred to the Supervisor of the Audit Resolution Section in October 2003. Since these decisions were made we have reduced our backlog from approximately two years down to six weeks and we hope to be completely caught up by September 2004.

DEPARTMENT OF TRANSPORTATION (PADOT) – Continued

We specifically reviewed all audit reports with findings that were still open at the time of the audit. All five audit reports that included findings mentioned in the FY 02-03 audit have been resolved and all entities have received their closure letters. As of July 31, 2004, approximately 96% of all audit reports received in FY 02-03 have been closed.

We have also been working on closing out the 199 single audit reports received in the FY 03-04. As of July 31, 2004, approximately 96% of the audit reports received in FY 03-04 have been closed out. A total of four reports included findings that required action by PADOT. All four of those reports have been resolved and closure letters have been mailed to the entities. The length of time to resolve the four audits with findings was 195, 125, 114 and 70 days, respectively. Only one audit report took slightly longer than the six-month required time period.

PADOT takes its responsibility to ensure compliance with federal audit resolution requirements very seriously. Due to the efforts made since May 2003, we feel PADOT is currently in compliance with OMB Circular A-133. As a result of the management decisions and progress that have been made regarding the single audit reports, we feel this finding has been resolved.