SINGLE AUDIT REPORT

For Fiscal Year Ended June 30, 2004

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, 2004

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COMMONWEALTH OF PENNSYLVANIA
GOVERNOR'S OFFICE
HARRISBURG

MICHEAEL J. MASCH
SECRETARY
OFFICE OF THE BUDGET

August 31, 2005

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, 2004. 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, 2003 has received the Government Finance Officers Association's (GFOA's) Certificate of Achievement for Excellence in Financial Reporting. This represents the eighteenth 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, 2004 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 $18.7 billion of federal expenditures by the Commonwealth during the fiscal year ended June 30, 2004. 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 $18.7 billion expended, 93 percent, or $17.5 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, 2004. Most of the $18.7 billion in federal expenditures occurred in nine state agencies, as reflected in the following table:

AGENCY NAME	**FEDERAL EXPENDITURES (in thousands)**
Public Welfare	$10,771,107
Labor and Industry	3,839,797
Education	1,492,474
Transportation	1,354,721
Health	317,389
Community and Economic Development	178,161
Insurance	139,397
Aging	100,929
Pennsylvania Infrastructure Investment Authority	100,783
Subtotal	$18,294,758
Other Agencies (29)	438,943
Grand Total	$18,733,701

FINDINGS AND RECOMMENDATIONS - CURRENT YEAR

The accompanying report for the fiscal year ended June 30, 2004 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 69 findings remain unresolved from single audits for the years ended June 30, 1996 through June 30, 2003.

INDEPENDENT AUDIT

The Commonwealth's June 30, 2004 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

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, 2003

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.

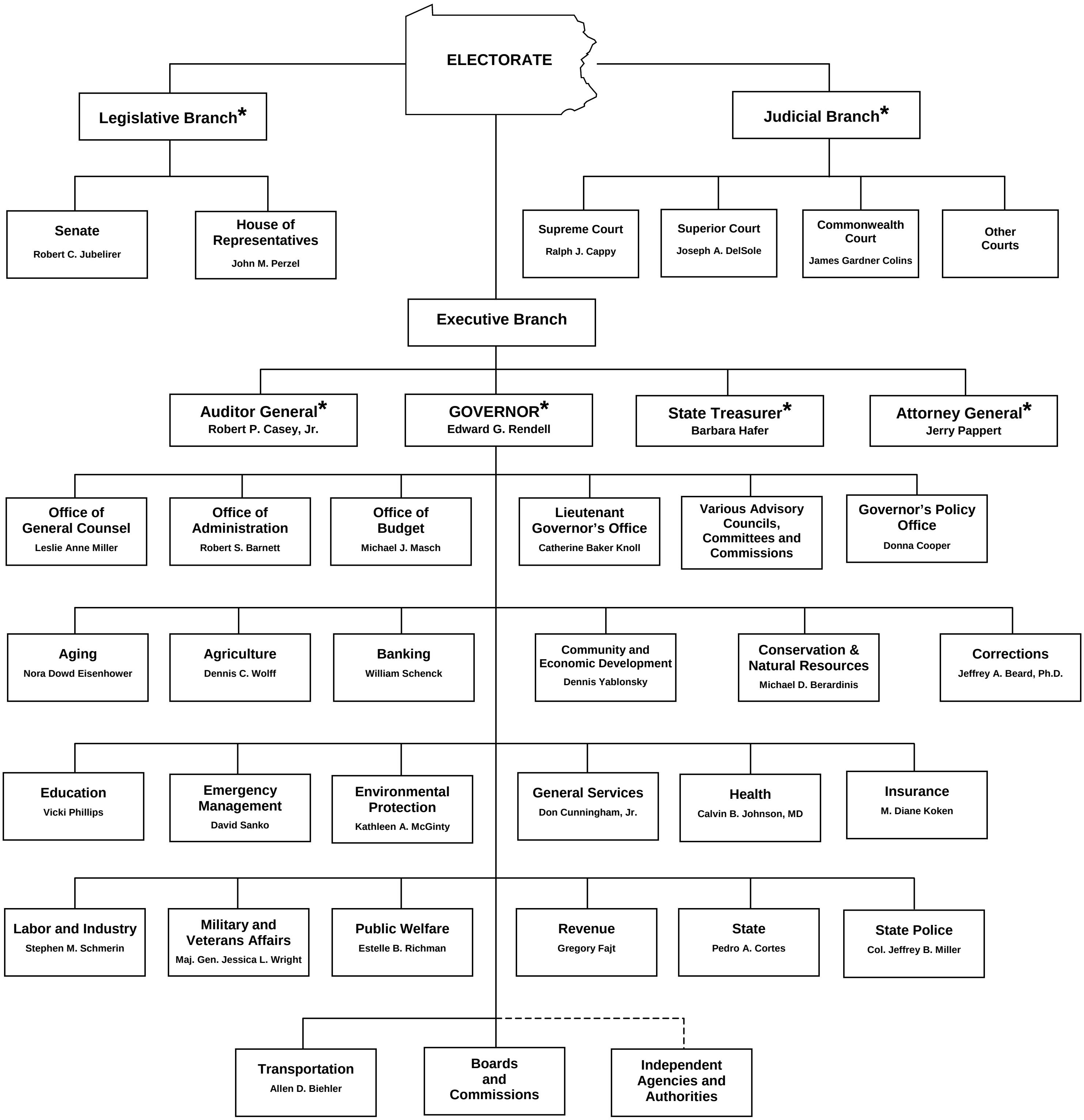
President

Executive Director

COMMONWEALTH OF PENNSYLVANIA

ORGANIZATION AND OFFICIALS CHART

June 30, 2004



* Independently Elected

COMMONWEALTH OF PENNSYLVANIA

Legend of Abbreviations - June 30, 2004

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

ABBREVIATION	DESCRIPTION
ACF	Administration for Children and Families
ADC	Average Daily Clearance
BFD	Bureau of Food Donation
BFM	Bureau of Financial Management
BFS	Basic Financial Statements
BOA	Bureau of Audits
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
CDBG	Community Development Block Grant
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
CRP	Contractor Responsibility Program
CS	Central Services
CSBG	Community Services Block Grant
CSE	Child Support Enforcement
CURE	Commonwealth Universal Research Enhancement
CWSRF	Clean Water State Revolving Fund
DCED	Department of Community and Economic Development
DEP	Department of Environmental Protection
DOH	Department of Health
DOI	United States Department of Interior
DOL	United States Department of Labor
DOR	Department of Revenue
DOT	United States Department of Transportation
DPW	Department of Public Welfare
DWSRF	Drinking Water State Revolving Fund
EBT	Electronic Benefits Transfer
EO	Executive Order
EPA	Environmental Protection Agency
ERP	Enterprise Resource Planning
ES	Employment Services
FD	Food Donation Program
FEMA	Federal Emergency Management Agency
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
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
IT	Information Technology

Legend of Abbreviations - June 30, 2004

ABBREVIATION	DESCRIPTION
L&I	Department of Labor and Industry
LEA	Local Educational Agency
LECS	Labor, Education and Community Services
MA	Medical Assistance Program
MD	Management Directive
MLF	Motor License Fund
MOE	Maintenance of Effort
NAFTA	North American Free Trade Agreement
NSLP	National School Lunch Program
OA	Office of Administration
OB	Office of the Budget
OIG	Office of Inspector General
OIM	Office of Income Maintenance
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
PLCB	Pennsylvania Liquor Control Board
PPR	Public Protection and Recreation
PTRR	Property Tax/Rent Rebate
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
SWIFF	State Workers' Insurance Fund
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
WIA	Workforce Investment Act
WIC	Women, Infants, and Children

Financial Section

Commonwealth of Pennsylvania

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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, 2004, 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, 99 percent of total net 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, 100 percent of total net assets, and 100 percent of the total revenues of the Pension (and Other Employee Benefit) Trust Funds. This comprises 90 percent of total assets, 96 percent of total net assets and 86 percent of total revenues of the aggregate remaining fund information. The financial statements of these component units and the Pension (and Other Employee Benefit) Trust 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 and the Pension (and Other Employee Benefit) Trust Funds, are based solely on the reports of the other auditors. Ernst & Young LLP has audited separately 21 percent of total assets, 28 percent of total net assets, and 15 percent of total operating revenues of the discretely presented component units.

The transactions of the Department of the Auditor General are included in the basic financial statements and are immaterial to the overall presentation of the basic financial statements. The expenses of the Department of the Auditor General equal less than 1 percent of the expenses reported for Governmental Activities on the Statement of Activities and less than 1 percent of the expenditures reported for the General Fund on the Statement of Revenues, Expenditures and Changes in Fund Balance. The Auditor General is the Commonwealth's independently-elected auditing officer. Article VIII, § 7, of the Pennsylvania Constitution mandates the Auditor General to act jointly with the Governor and State Treasurer to vote on the incurrence of debt. Title 72 of the Pennsylvania Statutes, § 1102, mandates the Department of the Auditor General to approve the disposition of petitions for corporation tax resettlements filed with the Pennsylvania Department of Revenue's Board of Appeals, which may be appealed to the Board of Finance and Revenue. Title 71 of the Pennsylvania Statutes, § 115, mandates the Auditor General to be one of the six members of the Board of Finance and Revenue, which is an independent board whose decisions may be appealed to Commonwealth Court. The above-mandated responsibilities are performed by personnel separate from those involved in the performance of the audit of the Commonwealth's basic financial statements. We believe these mandated responsibilities of the Department of the Auditor General, acting separately, do not impair the Auditor General's independence in the audit of the Commonwealth's basic financial statements and are being disclosed as required by and in accordance with auditing standards generally accepted in the United States.

We conducted our audit in accordance with auditing standards generally accepted in the United States 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. We were not engaged to perform an audit of the Commonwealth's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Commonwealth's internal control over financial reporting. Accordingly, we express no such opinion. 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 Tuition Account Investment Program, the PA Infrastructure Investment Authority, 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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, 2004, 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.

In accordance with *Government Auditing Standards*, we have also issued our report as of and for the year ended June 30, 2004 dated February 18, 2005 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

As described in Note A to the financial statements, the Commonwealth has implemented Governmental Accounting Standards Board (GASB) Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, and GASB Technical Bulletin No. 2004-01, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*.

Management's discussion and analysis and budgetary comparison information on pages 5 through 21 and 103 through 108 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors 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.

Jack Wagner　　　　Ernst + Young LLP

February 18, 2005

Management's Discussion and Analysis

Commonwealth of Pennsylvania

The Management's Discussion and Analysis (MD&A) of the Commonwealth of Pennsylvania's Comprehensive Annual Financial Report (CAFR) presents a review and analysis of the Commonwealth's financial performance for the fiscal year ended June 30, 2004. The MD&A should be reviewed in conjunction with the Commonwealth's financial statements, which follow.

Executive Summary

Government-wide Statements at-a-glance

Net Assets – Governmental activities net assets were $19.7 billion at June 30, 2004, compared to $18.2 billion at the end of the prior fiscal year.

Increase in Net Assets – During the fiscal year ended June 30, 2004, governmental activities increased by $1.5 billion; in the prior year, the increase was $.3 billion.

Long-Term Debt – During the fiscal year, general obligation bond indebtedness increased by less than $200 million.

Fund Statements at-a-glance

Governmental Funds – Fund Balances - Total governmental funds' fund balances at June 30, 2004 were $6.8 billion, compared to $5.6 billion at the end of the prior fiscal year. This represents a year-over-year increase of $1.2 billion.

General Fund – Fund Balance - $3.0 billion at June 30, 2004, compared to $2.4 billion at June 30, 2003.

Overview and discussion of basic financial statements

The Financial Section of the CAFR consists of several parts: the Independent Auditors' Report, Management's Discussion and Analysis, Basic Financial Statements (BFS), Required Supplementary Information, and Combining Financial Statements and Other Supplementary Information. The BFS includes two sets of statements that present different views of the Commonwealth – the government-wide financial statements and the fund financial statements. The Notes to the Financial Statements present additional details and clarification regarding the information presented in these statements.

Government-wide financial statements

Government-wide financial statements portray the Commonwealth's overall financial position (Statement of Net Assets) at June 30, 2004 and its aggregate revenues and expenses (Statement of Activities) for the fiscal year ended June 30, 2004. The Statement of Net Assets presents the assets, liabilities, and net assets for the Commonwealth as a whole. The Statement of Activities presents, by function or program, the expenses, offsetting revenues, and changes in net assets. Both statements classify amounts by Governmental Activities, Business-Type Activities, and Component Units. The component units are organizations that are legally separate from the Commonwealth's primary government. Information related to component units is not included in the 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 Commonwealth Comptroller (formerly Deputy Secretary for Comptroller Operations).

The government-wide financial statements are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This basis of accounting is similar to the basis used by most business entities and recognizes revenues and expenses when they occur, regardless of when related cash was received or paid.

Fund financial statements – governmental funds

Funds are groups of related accounts that are used to maintain control over resources that have been segregated for specific activities or objectives. The Commonwealth uses fund accounting to demonstrate compliance with finance related legal requirements. The Commonwealth's funds are categorized as governmental funds, proprietary funds or fiduciary funds. Further discussion of these fund categories can be found in Note A – Summary of Significant Accounting Policies. Fund financial 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, the fund statements reveal more detailed, 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) The governmental funds use the modified accrual basis of accounting and current financial resources measurement focus; whereas the proprietary funds and fiduciary funds use the accrual basis of accounting and economic resources focus.

Government–wide financial analysis

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

	Governmental Activities			Business-Type Activities			Total		
	2004	**2003**	**Change**	**2004**	**2003**	**Change**	**2004**	**2003**	**Change**
Assets:									
Cash and investments..................	$ 10.5	$ 8.5	$ 2.0	$ 4.8	$ 4.7	$ 0.1	$ 15.3	$ 13.2	$ 2.1
Capital assets (net).......................	20.8	19.8	1.0	-	-	-	20.8	19.8	1.0
All other assets............................	5.7	5.4	0.3	1.1	1.0	0.1	6.8	6.4	0.4
Total assets....................................	**37.0**	**33.7**	**3.3**	**5.9**	**5.7**	**0.2**	**42.9**	**39.4**	**3.5**
Liabilities:									
Accounts payable.........................	4.0	3.3	0.7	0.4	0.5	(0.1)	4.4	3.8	0.6
All other current liabilities...........	4.3	3.6	0.7	1.3	0.9	0.4	5.6	4.5	1.1
Total current liabilities................	**8.3**	**6.9**	**1.4**	**1.7**	**1.4**	**0.3**	**10.0**	**8.3**	**1.7**
Bonds payable.............................	6.7	6.6	0.1	-	-	-	6.7	6.6	0.1
All other long-term liabilities.......	2.3	2.0	0.3	2.1	1.8	0.3	4.4	3.8	0.6
Total long-term liabilities.............	**9.0**	**8.6**	**0.4**	**2.1**	**1.8**	**0.3**	**11.1**	**10.4**	**0.7**
Total liabilities..............................	**17.3**	**15.5**	**1.8**	**3.8**	**3.2**	**0.6**	**21.1**	**18.7**	**2.4**
Net assets:									
Invested in capital assets, net of related debt.....................	16.9	16.1	0.8	-	-	-	16.9	16.1	0.8
Restricted.....................................	3.0	2.5	0.5	2.1	2.5	(0.4)	5.1	5.0	0.1
Unrestricted.................................	(0.2)	(0.4)	0.2	-	-	-	(0.2)	(0.4)	0.2
							-	-	-
Total net assets..............................	**$ 19.7**	**$ 18.2**	**$ 1.5**	**$ 2.1**	**$ 2.5**	**$ (0.4)**	**$ 21.8**	**$ 20.7**	**$ 1.1**

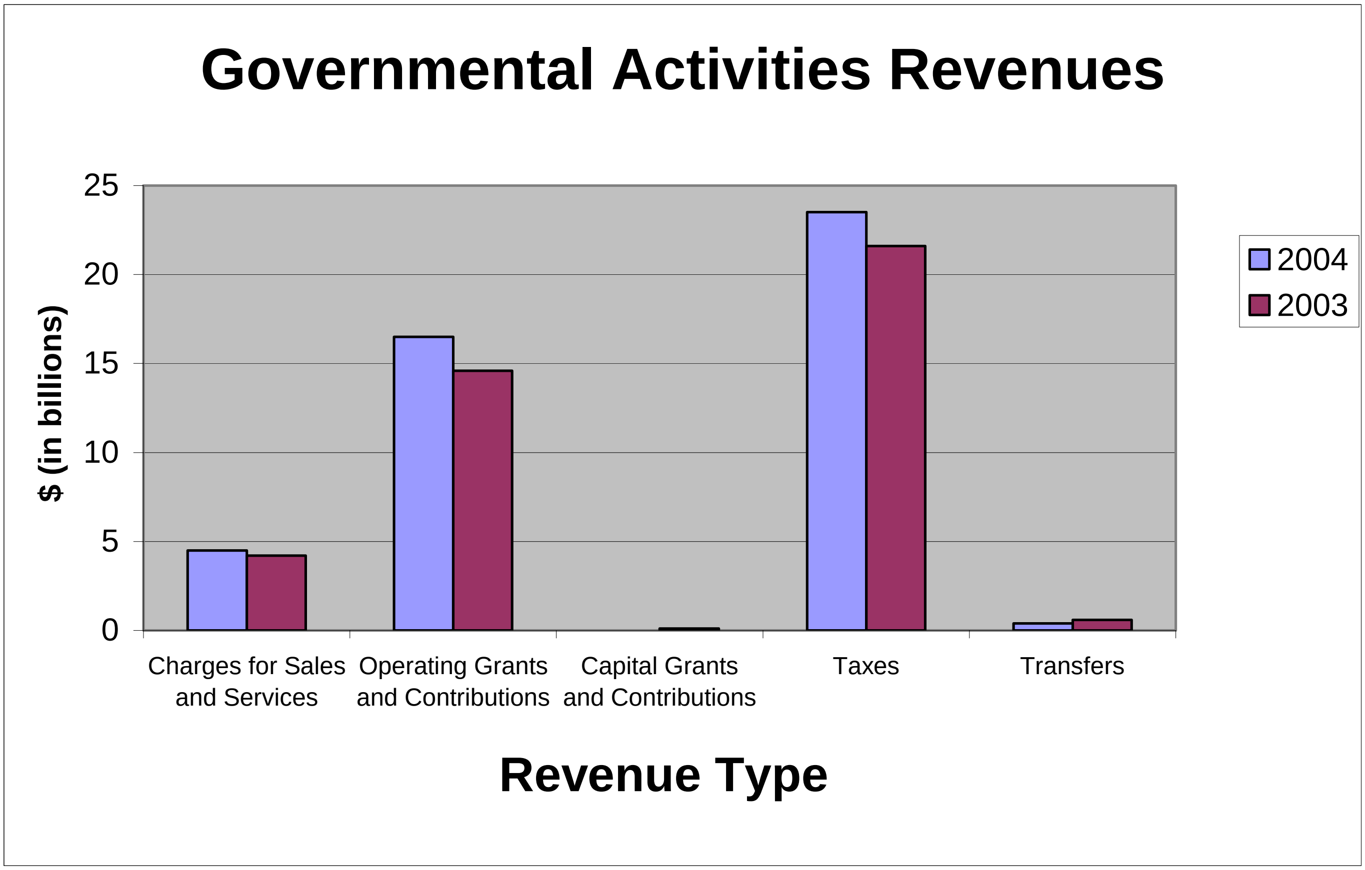
Changes in assets and liabilities

At June 30, 2004 governmental activities cash and investments increased by $2.0 billion (24 percent) over the prior year because of: higher tax collections in the General Fund (where cash and investments increased by $.1 billion and $1.4 billion, respectively), the relatively larger Treasury securities lending program and relatively higher investment fair values compared to the prior year. Investments for the Motor License Fund and the Tobacco Settlement Fund, which are treated as major Funds, each increased almost 10 percent during the fiscal year ended June 30, 2004, due in part to a larger securities lending program and relatively higher investment fair values. For governmental activities current liabilities, accounts payable and accrued liabilities increased ($.7 billion) because of a newly-reported liability to nursing homes and Intermediate Care Facilities for the Mentally Retarded and higher estimated unpaid medical assistance claims and amounts other than accounts payable increased ($.7 billion) largely because of higher securities lending program obligations ($.5 billion), higher amounts due to political subdivisions ($.07 billion), higher self-insurance liabilities ($.07 billion) and higher bonds payable (amounts due in one year) ($.03 billion) at June 30, 2004. Total general obligation bonds payable (including current and non-current portions) increased less than $.2 billion over the prior year. Year-over-year changes in business-type activities assets and liabilities were not significant, except for higher securities lending obligations ($.3 billion) and a higher insurance loss liability ($.2 billion) for the State Workers' Insurance Fund, which is treated as a major Fund.

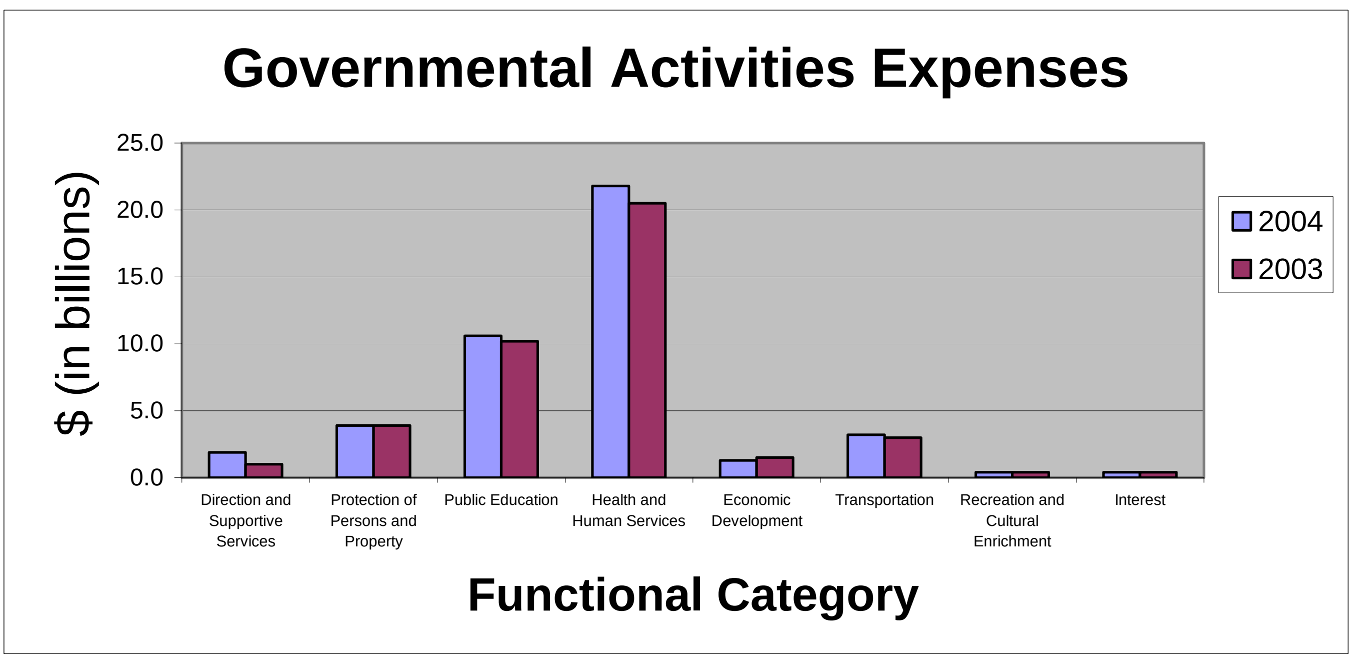
The following presents condensed financial statement information from the Statement of Activities (amounts in billions):

	Governmental Activities			Business-Type Activities			Total		
	2004	2003	Change	2004	2003	Change	2004	2003	Change
Revenues:									
Program revenues:									
Charges for sales and services	$ 4.5	$ 4.2	$ 0.3	$ 5.6	$ 5.1	$ 0.5	$ 10.1	$ 9.3	$ 0.8
Operating grants and contributions	16.5	14.6	1.9	0.8	1.2	(0.4)	17.3	15.8	1.5
Capital grants and contributions	-	0.1	(0.1)	-	-	-	-	0.1	(0.1)
Total program revenues	**21.0**	**18.9**	**2.1**	**6.4**	**6.3**	**0.1**	**27.4**	**25.2**	**2.2**
General revenues:									
Taxes and investment income	23.5	21.6	1.9	-	-	-	23.5	21.6	1.9
Total general revenues	**23.5**	**21.6**	**1.9**	**-**	**-**	**-**	**23.5**	**21.6**	**1.9**
Total revenues	**44.5**	**40.5**	**4.0**	**6.4**	**6.3**	**0.1**	**50.9**	**46.8**	**4.1**
Expenses:									
Governmental activities:									
Direction and supportive services	2.0	1.0	1.0	-	-	-	2.0	1.0	1.0
Protection of persons and property	3.9	3.9	-	-	-	-	3.9	3.9	-
Public education	10.6	10.2	0.4	-	-	-	10.6	10.2	0.4
Health and human services	21.7	20.5	1.2	-	-	-	21.7	20.5	1.2
Economic development	1.3	1.4	(0.1)	-	-	-	1.3	1.4	(0.1)
Transportation	3.2	3.0	0.2	-	-	-	3.2	3.0	0.2
Recreation and cultural enrichment	0.4	0.4	-	-	-	-	0.4	0.4	-
Interest	0.3	0.4	(0.1)	-	-	-	0.3	0.4	(0.1)
Business-type activities:									
State lottery	-	-	-	2.1	1.8	0.3	2.1	1.8	0.3
Unemployment compensation	-	-	-	2.6	3.5	(0.9)	2.6	3.5	(0.9)
Liquor control	-	-	-	1.0	0.9	0.1	1.0	0.9	0.1
Worker's compensation	-	-	-	0.4	0.2	0.2	0.4	0.2	0.2
Tuition payment	-	-	-	0.3	0.3	-	0.3	0.3	-
Total expenses	**43.4**	**40.8**	**2.6**	**6.4**	**6.7**	**(0.3)**	**49.8**	**47.5**	**2.3**
Excess/(deficiency) before transfers	1.1	(0.3)	1.4	-	(0.4)	0.4	1.1	(0.7)	1.8
Transfers	0.4	0.6	(0.2)	(0.4)	(0.6)	0.2	-	-	-
Increase (decrease) in net assets	1.5	0.3	1.2	(0.4)	(1.0)	0.6	1.1	(0.7)	1.8
Net assets, beginning	18.2	17.7		2.5	3.5		20.7	21.2	
Net assets, ending, before restatement	19.7	18.0		2.1	2.5		21.8	20.5	
Restatement related to implementation of GASB Technical Bulletin 2004-1	-	0.2		-	-		-	0.2	
Net assets, ending (restated)	**$ 19.7**	**$ 18.2**		**$ 2.1**	**$ 2.5**		**$ 21.8**	**$ 20.7**	

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



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



Overall changes in net assets

During the fiscal year ended June 30, 2004, the overall financial position (net assets) of the Commonwealth, including both governmental and business-type activities, increased by $1.1 billion or 5.3 percent of total beginning (as restated at July 1, 2003) net assets of $20.7 billion. For governmental activities, the net increase in net assets was $1.5 billion or 8.2 percent of beginning net assets of $18.2 billion. Total investments, excluding the State Employees' Retirement Fund and other fiduciary funds, were over $14.2 billion and total cash balances were over $1.1 billion. These amounts represent considerable liquidity for the current and future fiscal years. The increase in governmental activities net assets compares favorably relative to the prior year change, where revenues, transfers and special items exceeded expenses by $.3 billion. These increases represent year-over-year improvements in the Commonwealth's overall financial position during each of the fiscal years ended June 30, 2004 and 2003. On the other hand, the $.4 billion decrease in total net assets for business-type activities follows a $1.0 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, 2004 and 2003. During these fiscal years, unemployment compensation activities net assets decreased by $.4 and $.9 billion, respectively. Statutory contribution increases occurred during each of the fiscal years ended June 30, 2004 and 2003. Such increases are intended to eliminate net assets decreases in the unemployment compensation program. During the fiscal year ended June 30, 2004, net assets for all other business-type activities did not change significantly. During the prior fiscal year, those net assets decreased by approximately $80 million.

During the current fiscal year, total business-type activities revenues were equal to expenses; total expenses exceeded total revenues by $.4 billion in the prior fiscal year. Including net transfers to other funds of $.4 billion ($.6 billion in the prior year), business-type activities net assets decreased by over $.4 billion ($1.0 billion in the prior year). The primary reason for this decrease was that Unemployment Compensation Fund expenses exceeded revenues by $.4 billion ($.9 billion in the prior year). Current-year Fund revenues decreased by over $.3 billion and expenses decreased by $.9 billion compared to the fiscal year ended June 30, 2003.

Changes in revenues and expenses

For governmental activities, general revenues increased by $1.9 billion, largely as a result of increases in General Fund tax revenues during the fiscal year ended June 30, 2004. Program revenues for operating grants and contributions increased significantly ($1.9 billion, or 13 percent) because of increases in Federal participation in specific General Fund programs, primarily medical assistance and, to a degree, other programs. Program charges for business-type activities increased $.5 billion primarily because of state lottery ($.25 billion), unemployment compensation ($.1 billion), workers compensation ($.1 billion) and liquor and wine sales ($.1 billion) increases. Operating grants and contributions for business-type activities decreased by $.4 billion largely due to a $.4 billion decrease in the Temporary Extended Unemployment Compensation program, which receives significant Federal funding.

For governmental activities, total expenses increased $2.6 billion (over 6.3 percent) largely because of higher amounts appropriated for the General Fund and other governmental Funds. Almost half of the increase ($1.2 billion) is attributable to medical and other assistance reported as part of health and human services expenses. Also, certain personnel costs reported as part of direction and supportive services increased substantially because of increased employee healthcare and other benefit costs during the fiscal year. Probable losses resulting from tax litigation were also a factor in higher direction and supportive services expenses. Expenses for business-type activities decreased by $.3 billion overall (roughly 4.5 percent); expenses for unemployment compensation claims decreased by $.9 billion based on lower claims during the fiscal year. Expenses for state lottery increased ($.3 billion) along with higher ticket sales and expenses increased for workers compensation ($.2 billion) because of higher claims and changes in actuarial assumptions associated with the overall insurance loss liability.

Budgetary Comparison

Budgetary Comparison Schedules are included as required supplementary information for the General Fund and the Motor License Fund immediately following the Notes to the Financial Statements. Budgetary comparison schedules for nonmajor Special Revenue Funds are included as supplementary information following combining statements for Special Revenue Funds. These schedules provide a measurement of compliance with legally adopted budgets.

General Fund – economic factors during the fiscal year ended June 30, 2004

A rebounding national economy that exceeded preliminary estimates for growth resulted in improved economic conditions within portions of the national and Pennsylvania economies. Gains in government revenues, corporate profits, job creation and personal income were experienced. However, economic growth slowed significantly during the second quarter of 2004 in which real growth in gross domestic product slowed significantly. Consumer spending dropped to its lowest levels since the recession of 2001 and high energy prices and weak employment gains slowed overall growth significantly. Overall, economic growth was insufficient to enable state revenue growth to accommodate increased demand for governmental goods and services. Additional revenue enhancements were enacted within fiscal year 2004 to address the rising costs of government goods and services.

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, 2004 is presented immediately following the Notes to the Financial Statements. In the Final Budget, State Program revenues were adjusted to include revenues received by fiscal year-end (but not included in the Commonwealth's official revenue estimate), in an amount equal to 2003-04 supplemental appropriations passed on July 4, 2004 by Act 7A.

Final budgeted revenues for total state programs exceed the original budget by $937 million. The $937 million increase includes a $451 million increase in tax revenues related primarily to improving national and state economic conditions and the passage of Acts 45, 46, and 47 of 2003, which raised various state taxes and non-tax revenues. The $937 million increase also includes an increase of $105 million for unclaimed property attributable to the revisions enacted by Act 45 which changed the escheat holding period for insurance company demutualization conversions, and a $344 million increase in departmental services resulting primarily from transfers of $355 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).

The General Fund Schedule also discloses that the final budget includes $1.02 billion more expenditures than the original budget. The $1.02 billion increase includes $917 million in state program expenditure increases and $108 million of increased Federal participation in various programs. Of the $917 million state program difference, $565 million (62%) relates primarily to increased spending authority for medical assistance and cash grants programs due to increased costs and caseloads, and a $340 million (37%) increase in Protection of Persons and Property expenditures results primarily from a $355 million increase in spending authority for State Police protection of Commonwealth highways. The increase of $108 million in Federal programs relates primarily to supplemental appropriations passed by Act 7A of 2004.

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

Actual budgetary State Program revenues exceeded the final budgeted State Program revenues by $63 million. Budgetary lapses for a variety of specific appropriations and executive authorizations in the amount of $40 million were also posted to reduce State Program spending authority. Actual Federal revenues and corresponding expenditures were $276 million lower than budgeted for the following agencies: Public Welfare, $125 million; Education, $91 million; Health, $24 million; Executive Offices, $15 million; Labor and Industry, $8 million; and all other affected agencies, $13 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, 2004 and 2003 are as follows (amounts in millions):

			Increase	
	June 30, 2004	June 30, 2003	Amount	Percent
Assets:				
Cash and investments	$ 5,674	$ 4,131	$ 1,543	37%
Receivables, net	2,899	2,772	127	5%
Due from other funds/governments/advances/other	1,891	1,622	269	17%
Total assets	**$ 10,464**	**$ 8,525**	**$ 1,939**	
Liabilities:				
Accounts payable and tax refunds payable	$ 3,749	$ 2,996	$ 753	25%
Securities lending obligations	1,156	757	399	53%
Due to other funds/governments/advances/other	994	918	76	8%
Deferred revenue	1,558	1,496	62	4%
Total liabilities	**$ 7,457**	**$ 6,167**	**$ 1,290**	
Fund balance:				
Reserved	$ 881	$ 773	$ 108	14%
Unreserved:				
Designated	492	270	222	82%
Undesignated	1,634	1,315	319	24%
Total fund balance	**$ 3,007**	**$ 2,358**	**$ 649**	
Total liabilities and fund balance	**$ 10,464**	**$ 8,525**	**$ 1,939**	

During the fiscal year ended June 30, 2004, cash and investments increased by $1,543 million (37%) over the prior year. Higher tax receipts, combined with an expanded Treasury Department securities lending program, relatively higher investment fair values and higher accounts payable all contributed to the 37% increase. Amounts due from the Federal government increased 19% over the prior year, due to higher expenditures associated with Federal grants, which corresponds closely with the 17% increase related to amounts due from the Federal government and other Funds or organizations. Excluding a $10.8 million decrease in tax refunds payable, accounts payable increased by over $763 million during the fiscal year. Most of this increase, $679 million, was attributable to several factors related to Department of Public Welfare (DPW) programs: at fiscal year end, accounts payable includes a $455 million liability owed to nursing homes and Intermediate Care Facilities for the Mentally Retarded; a $112 million dollar increase in the liability for pharmaceutical rebates; and a $112 million increase in the reported liability for medical assistance claims. Another large year-over-year factor was a $35 million increase in unremitted payroll withholdings at fiscal year end.

Fund balance reservations increased by $108 million, most of which was attributable to a $82.7 million decrease in encumbrances and a $193.9 million increase in 'other' reservations, comprised of a $219.1 million increase for restricted revenue and a $25.2 million decrease for continuing programs. Fund balance designations increased by $222 million primarily because of a new $70 million designation for the Budget Stabilization Reserve Fund at June 30, 2004, a $97 million increase for group medical and life insurance, a $24 million increase for a judicial computer system, and a $27 million increase for agency construction projects.

Condensed General Fund operating statements for the fiscal years ended June 30, 2004 and 2003 follow (amounts in millions):

	June 30, 2004	June 30,2003	Increase (Decrease) Amount	Increase (Decrease) Percent
Revenues:				
Taxes, net of refunds	$ 21,191	$ 19,554	$ 1,637	8%
Intergovernmental	14,791	12,944	1,847	14%
Charges for sales and services	1,751	1,797	(46)	-3%
Licenses/fees/investment and other income	948	766	182	24%
Total revenues	**38,681**	**35,061**	**3,620**	
Expenditures:				
Direction and supportive services	1,412	855	557	65%
Protection of persons and property	2,958	2,941	17	1%
Health and human services	20,817	19,549	1,268	6%
Public education	10,521	10,175	346	3%
Recreation and cultural enrichment	225	324	(99)	-31%
Economic development	964	984	(20)	-2%
Transportation	352	407	(55)	-14%
Capital outlay	143	18	125	694%
Total expenditures	**37,392**	**35,253**	**2,139**	
Revenues over (under) expenditures	**1,289**	**(192)**	**1,481**	
Other financing sources (uses):				
Transfers in	134	426	(292)	-69%
Transfers out	(776)	(903)	127	-14%
Capital lease and installment			-	
purchase obligations	2	4	(2)	-50%
Net other financing sources (uses)	**(640)**	**(473)**	**(167)**	
Net change in fund balance	**649**	**(665)**	**$ 1,314**	
Fund balance, beginning	**2,358**	**3,023**		
Fund balance, ending	**$ 3,007**	**$ 2,358**		

General Fund tax revenues increased by 8.37 percent due to economic growth and specific statutory increases in certain tax bases and tax rates enacted in December 2003. Intergovernmental revenues increased by 14.27 percent due to increases in Federally-funded programs, particularly medical and other assistance, where expenditures increased over the prior year. Total General Fund revenues increased by 10.32 percent during the fiscal year. The overall increase in fund balance, $649 million, during the fiscal year was an improvement of $1,314 million over the prior year fiscal year decrease in fund balance $665 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 and, conversely, to increase during periods of economic growth. During periods of economic growth, General Fund revenues increase while certain significant expenditures, such as medical assistance, also increase, but at a slower rate.

Total General Fund expenditures increased by 6.0 percent during the fiscal year ended June 30, 2004, on a GAAP-reported basis, largely because of increases in expenditures for medical and other assistance (reported as part of health and human services). Expenditures for direction and supportive services increased due to significantly higher employer costs for active and retired employee healthcare benefits. Year-over-year expenditures for the health and human services function increased by 6.49 percent; all other expenditures, on a combined basis, increased by 5.49 percent, largely as a result of higher amounts appropriated throughout most of the General Fund. Actual, final General Fund expenditures (budgetary basis) increased by 6.1 percent over the prior fiscal year, while revenues (budgetary basis) increased 5.9 percent.

Motor License Fund

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

	2004		2003	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Investments	$ 1,281	70%	$ 1,151	$ 130	11%
Other Assets	547	30%	364	183	50%
Total Assets	**1,828**	**100%**	**1,515**	**313**	**21%**
Accounts Payable	401	54%	346	55	16%
Securities Lending Obligations	263	35%	205	58	28%
Other Liabilities	84	11%	71	13	18%
Total Liabilities	**748**	**100%**	**622**	**126**	**20%**
Total Fund Balance	**1,080**	**100%**	**893**	**187**	**21%**
Tax Revenues	1,742	42%	1,705	37	2%
License and Fees	867	21%	842	25	3%
Federal Revenues	1,323	32%	1,380	(57)	-4%
Other Revenues	177	4%	125	52	42%
Total Revenues	**4,109**	**100%**	**4,052**	**57**	**1%**
Direction and Supportive Services	50	1%	48	2	4%
Protection of Persons and Property	496	13%	514	(18)	-4%
Transportation	1,642	43%	3,206	(1,564)	-49%
Capital Outlay	1,668	43%	39	1,629	4177%
Other Expenditures	5	0%	5	-	0%
Total Expenditures	**3,861**	**100%**	**3,812**	**49**	**1%**
Net Transfers Out	(61)	100%	(60)	(1)	2%
Other Financing Sources (Uses)	-	0%	1	(1)	-100%
Net Other Financing Sources (Uses)	**(61)**	**100%**	**(59)**	**(2)**	**3%**
Net Change in Fund Balance	**$ 187**	**100%**	**$ 181**	**$ 6**	**3%**

Other assets increased by $183 million, net, due to $220 million in advances to other funds and by net decreases in receivables, primarily amounts due from the Federal government, of $37 million. Other revenues also increased by $52 million because of higher charges for sales and services ($13 million) and higher investment income ($34 million) and higher 'other' revenues ($5 million). The increase in investment income is primarily attributable to relatively higher investment fair values at fiscal year end June 30, 2004. The increase in capital outlay during the fiscal year was caused by a change in reporting classification for highway/bridge construction costs; offset by a corresponding decrease in reported transportation expenditures. In combination, the year-over-year increase for both classifications was $65 million, or 2%.

Tobacco Settlement Fund

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

	2004		2003	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Investments	$ 1,044	82%	$ 959	$ 85	9%
Other Assets	231	18%	289	(58)	-20%
Total Assets	**1,275**	**100%**	**1,248**	**27**	**2%**
Accounts Payable	125	33%	139	(14)	-10%
Securities Lending Asset/Liability	86	23%	84	2	2%
Other Liabilities	171	45%	206	(35)	-17%
Total Liabilities	**382**	**100%**	**429**	(47)	**-11%**
Total Fund Balance	**893**	**100%**	**819**	**74**	**9%**
Intergovernmental	120	21%	108	12	11%
Investment Income	87	15%	37	50	135%
Other Revenues	365	64%	427	(62)	-15%
Total Revenues	**572**	**100%**	**572**	**-**	**0%**
Protection of Persons and Property	102	22%	80	22	28%
Health and Human Services	359	78%	474	(115)	-24%
Economic Development	2	0%	100	(98)	-98%
Total Expenditures	**463**	**100%**	**654**	**(191)**	**-29%**
Net Transfers In (Out)	(35)	100%	(35)	-	0%
Net Other Financing Sources (Uses)	**(35)**	**100%**	**(35)**	**-**	**0%**
Net Change in Fund Balance	**$ 74**	**100%**	**$ (117)**	**$ 191**	**163%**

Investment income increased by $50 million during the fiscal year ended June 30, 2004, due to relatively higher investment fair values at June 30, 2004. Other revenues, consisting of Master Settlement Agreement (MSA) receipts, decreased by $62 million. MSA receipts are directly related to tobacco product sales and declined year-over-year. Total revenues were flat while total expenditures decreased by 29% during the fiscal year. The 24% decrease in Health and Human Services is due primarily to a non-recurring prior year Department of Public Welfare (DPW) appropriation. In accordance with Act 91 of 2002, Tobacco Settlement Funds were provided to the Long-Term Care appropriation in fiscal year 2002-2003. No Tobacco Settlement funding was authorized to support Long-Term Care services in fiscal year 2003-2004. The decrease in Economic Development is primarily due to a lower appropriation: $90 million was expended in 2003, $10 million in 2004. Other assets decreased by $58 million due primarily to a decrease in the amount due from the Federal government ($65 million), offset by an increase in other receivables ($7 million). Federal revenue is now recognized for DPW's Medical Assistance for Workers with Disabilities and Home and Community Based Services programs in the Tobacco Settlement Fund when Federal expenses are incurred; thus eliminating a Federal receivable for these programs. In 2004 an MSA receivable and offsetting deferred revenue of $160 million was recognized because GASB Technical Bulletin 2004-1 now requires the Commonwealth to estimate the amount of cigarette shipments made during the first six months of the participating manufacturer's calendar year (which are the last sixth months of the Commonwealth's fiscal year). The retroactive change in reported 2003 receivables and offsetting deferred revenues was $170 million.

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

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

	2004		2003	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Investments	$ 853	60%	$ 1,379	$ (526)	-38%
Other Assets	558	40%	496	62	13%
Total Assets	**1,411**	**100%**	**1,875**	**(464)**	**-25%**
Accounts Payable	103	94%	206	(103)	-50%
Other Liabilities	6	6%	5	1	20%
Total Liabilities	**109**	**100%**	**211**	**(102)**	**-48%**
Total Net Assets	**1,302**	**100%**	**1,664**	**(362)**	**-22%**
Sales and Services	1,627	74%	1,532	95	6%
Investment Income	52	2%	103	(51)	-50%
Other Revenues	522	24%	907	(385)	-42%
Total Revenues	**2,201**	**100%**	**2,542**	**(341)**	**-13%**
Cost of Sales and Services	2,563	100%	3,470	(907)	-26%
Total Expenses	**2,563**	**100%**	**3,470**	**(907)**	**-26%**
Decrease in Net Assets	**$ (362)**		**$ (928)**	**$ 566**	**-61%**

During the fiscal year ended June 30, 2004, unemployment compensation benefit claims continued at high levels, although lower levels than the previous fiscal year. During the current and the prior fiscal years, statutory contribution increases were triggered for employers and employees and improved the Fund's ability to make benefit payments. Cash and investments were reduced during the fiscal year ended June 30, 2004 because claimant expenses continued to outpace revenues. The current year net assets decrease of $362 million is a $566 million improvement compared to the previous fiscal year decrease of $928 million. The Temporary Extended Unemployment Compensation (TEUC) Program, established by Federal legislation during the fiscal year ended June 30, 2003, continued to provide an additional 13 weeks of benefit payments for qualified claimants during the current year. This program is supported by Federal funding, however, during the fiscal year ended June 30, 2004, the program was much smaller than the prior year, resulting in a decrease in other revenues. At June 30, 2004, except for coverage for displaced airline personnel, the TEUC Program had largely ended.

State Workers' Insurance Fund (December 31, 2003)

Comparative financial statement information for the State Workers' Insurance Fund is as follows (amounts in millions):

	2004		2003	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Short-Term Investments	$ 784	35%	$ 589	$ 195	33%
Long-Term Investments	1,390	63%	1,316	74	6%
Other Assets	50	2%	37	13	35%
Total Assets	**2,224**	**100%**	**1,942**	**282**	**15%**
Securities Lending Obligations	671	33%	510	161	32%
Deferred Revenue	89	4%	72	17	24%
Insurance Loss Liability	1,229	61%	1,040	189	18%
Other Liabilities	29	1%	22	7	32%
Total Liabilities	**2,018**	**100%**	**1,644**	**374**	**23%**
Net Assets	**206**	**100%**	**298**	**(92)**	**-31%**
Sales and Services	266	79%	181	85	47%
Investment Income	77	23%	97	(20)	-21%
Uncollectible provision	(7)	-2%	-	(7)	0%
Total Revenues	**336**	**100%**	**278**	**58**	**21%**
Cost of Sales and Services	423	99%	212	211	100%
Interest Expense	5	1%	6	(1)	-17%
Provision for Uncollectible Accounts	-	0%	8	(8)	-100%
Total Expenses	**428**	**100%**	**226**	**202**	**89%**
Increase (Decrease) in Net Assets	**$ (92)**		**$ 52**	**$ (144)**	**-277%**

During the fiscal year, temporary investments of the State Workers' Insurance Fund increased as premium revenues increased to $266.4 million from $180.7 million during the prior year. This growth was the result of an increase in policies: 41,311 in 2003 from 32,215 in 2002, an increase of 28.2%. As the State Worker's Insurance Fund had more funds available these funds were invested; securities lending obligations balances also increased. Insurance loss liability and related expenses also increased as a result of the growth in policies and as a result of changes in actuarial assumptions. The Fund processed an increase in injury reports received to 21,927, from 16,580 in 2002. Investment income decreased due to relatively lower investment fair values at year end.

State Lottery Fund

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

	2004		2003	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Short-Term Investments	$ 462	93%	$ 406	$ 56	14%
Long-Term Investments	12	2%	14	(2)	-14%
Other Assets	21	4%	24	(3)	-13%
Total Assets	**495**	**100%**	**444**	**51**	**11%**
Accounts Payable	233	69%	219	14	**6%**
Securities Lending Obligations	100	30%	76	24	32%
Other Liabilities	4	1%	7	(3)	-43%
Total Liabilities	**337**	**100%**	**302**	**35**	**12%**
Net Assets	**158**	**100%**	**142**	**16**	**11%**
Sales and Services	2,351	97%	2,100	251	12%
Other Revenues	74	3%	69	5	7%
Total Revenues	**2,425**	**100%**	**2,169**	**256**	**12%**
Cost of Sales and Services	1,982	97%	1,762	220	12%
Other Expenses	70	3%	65	5	8%
Total OperatingExpenses	**2,052**	**100%**	**1,827**	**225**	**12%**
Operating Income	**373**		**342**	**31**	**9%**
Nonoperating Revenues	**13**		**15**	**(2)**	**-13%**
Income Before Transfers	**386**		**357**	**29**	**8%**
Transfers	**(370)**		**(395)**	**25**	**6%**
Increase (Decrease) in Net Assets	**$ 16**		**$ (38)**	**$ 54**	**142%**

State Lottery Fund cash and investments increased during the fiscal year ended June 30, 2004, due to an increase in gross ticket sales and a higher securities lending portfolio at fiscal year end. Instant ticket sales increased $193 million, Powerball sales increased $18 million, and other sales increased by $40 million, for a year-over-year sales increase of $251 million or 12%. Operating expenses increased 12%, by $225 million, due to increased field paid prizes from instant ticket sales, advertising, and special services. Operating income increased by $31 million, or 9%, year-over-year. The current year statutory transfer from the Fund for the payment of benefits to the elderly amounted to $370 million, a decrease of $25 million over the prior fiscal year.

Tuition Payment Fund

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

	2004		2003	Increase (Decrease)	
Description	**Amount**	**Percent**	**Amount**	**Amount**	**Percent**
Cash and Short-Term Investments	$ 322	31%	$ 194	$ 128	66%
Long-Term Investments	698	68%	504	194	38%
Other Assets	3	0%	2	1	50%
Total Assets	**1,023**	**100%**	**700**	**323**	**46%**
Securities Lending Obligations	164	15%	87	77	89%
Tuition Benefits Payable	904	84%	658	246	37%
Other Liabilities	3	0%	7	(4)	-57%
Total Liabilities	**1,071**	**100%**	**752**	**319**	**42%**
Net Assets	**(48)**	**100%**	**(52)**	**4**	**8%**
Sales and Services	206	69%	234	(28)	-12%
Investment Income	92	31%	28	64	229%
Total Revenues	**298**	**100%**	**262**	**36**	**14%**
Cost of Sales and Services	294	100%	288	6	2%
Total Expenses	**294**	**100%**	**288**	**6**	**2%**
Increase (Decrease) in Net Assets	**$ 4**		**$ (26)**	**$ 30**	**115%**

The Tuition Payment Fund cash and investments balances increased during the fiscal year due to the investment of current year tuition credit receipts, an expansion in the Treasury Department securities lending program, and relatively higher investment fair values at fiscal year end, which also increased year-over-year investment income. The total tuition benefits payable liability, which incorporates a variety of actuarial assumptions, increased by $246 million, which corresponds with additional tuition credit purchases during the fiscal year.

Capital asset activity during the fiscal year ended June 30, 2004

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, 2004 amounted to $1.2 and $1.7 billion, respectively. Authorized but unissued general obligation bonds at June 30, 2004 totaled $45.5 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, 2004 amounted to $20.7 billion at actual or estimated historical cost, net of accumulated depreciation of $9.9 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, 2004.

Long-term debt activity during the fiscal year ended June 30, 2004

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, 2004 was $43.9 billion. Outstanding capital project debt at August 31, 2004 amounted to $6.2 billion, for a remaining legal debt margin of $37.7 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, 2004 was $7.225 billion. Total debt service fund transfers paid from General Fund and Motor License Fund appropriations to make principal and interest payments to bondholders during the fiscal year ended June 30, 2004 amounted to $669 million and $59 million, respectively. 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
1997	4.842
1998	4.841
1999	5.254
2000	5.367
2001	5.545
2002	6.072
2003	7.031
2004	7.225

Note K to the financial statements provides more specific details on long-term debt balances and activity during the fiscal year ended June 30, 2004.

Debt administration – fiscal year ending June 30, 2005

During the fiscal year ending June 30, 2005, the Office of the Budget currently plans general obligation bond issuances, excluding refundings, amounting to $1,012 million, an increase of $387 million as compared to actual bond issuances of $625 million, excluding refundings, during the fiscal year ended June 30, 2004. This plan reflects the need to make additional investments in the Commonwealth's capital infrastructure, local capital projects and mass transportation. Additionally, a significant portion of the projected increase in issuances for the 2005 fiscal year is attributable to two major environmental programs which would target capital improvements to water supply and sewage treatment facilities associated with economic development as well as general environmental capital improvement projects. Debt principal retirements of $460.2 million are currently planned for the fiscal year ending June 30, 2005.

The Commonwealth continues to evaluate refunding opportunities for its outstanding bonds to reduce interest costs. To date during the fiscal year ending June 30, 2005, $798.805 million of outstanding bonds have been refunded to produce over $42.1 million of interest savings over the remaining life of those bonds. As market conditions provide additional opportunities, the Commonwealth may pursue additional refundings.

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 were 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 six fiscal years and has no plans to issue any during the 2005 fiscal year. There were no changes in credit ratings and there were no debt limitations during the fiscal year ended June 30, 2004 that may affect the Commonwealth's plans during the fiscal year ending June 30, 2005.

Legislative changes during fiscal year 2004-2005

During the fiscal year that began July 1, 2004, the legislature approved several new laws which are expected to change the Commonwealth's financial position in the future. Of these laws one of the most significant is Act 71 of 2004. This Act authorizes slot machine gaming at approved venues and establishes five new Funds including the State Gaming Fund, the Property Tax Relief Fund, the Race Horse Development Fund, the Gaming Economic Development and Tourism Fund, and the Compulsive and Problem Gambling Treatment Fund. Expected tax revenues from the licensed gaming facilities are to provide funding for property tax relief, economic development, volunteer fire company grants, and other activities.

Act 72 of 2004 enacts the Homeowner's Tax Relief Act which would transfer funds from the Property Tax Relief Fund to school districts to be used for local property and wage tax reductions.

Act 220 of 2004 extends the Treasury Department's prudent person investment authority to December 31, 2006, two years beyond the date established in prior law.

General Fund fiscal year 2004-2005 budget

On July 4, 2004 the Commonwealth's fiscal year 2005 budget was enacted by the General Assembly and signed into law by the Governor. The fiscal year 2005 budget includes a projected increase, prior to reserves for tax refunds, in Commonwealth revenues of 4.5 percent over fiscal year 2004 receipts. Additional revenues are projected based upon full year collection of numerous tax rate and tax base changes enacted in December 2003 as part of the fiscal year 2004 budget. These increased revenues are based upon a projection that the national economic recovery will continue to demonstrate modest yet sustainable growth through the fiscal year 2005. The enacted fiscal year 2005 budget provides for an increase of appropriations of 4.5 percent over fiscal year 2004 appropriations.

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	$ 258,209	$ 20,296	$ 278,505	$ 301,622
Cash with fiscal agents—Note D	-	853,444	853,444	-
Temporary investments—Note D	9,257,075	1,859,016	11,116,091	1,683,495
Receivables (net):				
Taxes—Note G	2,115,709	-	2,115,709	-
Unemployment assessments	-	501,415	501,415	-
Accounts	420,153	70,752	490,905	111,831
Accrued interest	5,569	14,586	20,155	110,781
Loans—Note G	6,700	44,488	51,188	933,452
Lease rentals—Note G	1,178	-	1,178	1,469
Other	9,460	88	9,548	26,250
Due from pension trust funds—Note H	5,812	9	5,821	-
Due from primary government—Note H	-	-	-	6,660
Due from component units—Note H	27,177	783	27,960	108
Due from Federal government	1,959,083	8,688	1,967,771	17,455
Due from political subdivisions	7,126	8,425	15,551	-
Due from other governments	-	16,600	16,600	2,240
Advances to other funds—Note H	-	500	500	-
Inventory	91,182	193,476	284,658	29,871
Prepaid and deferred expenses	-	950	950	117,894
Total current assets	14,164,433	3,593,516	17,757,949	3,343,128
Noncurrent assets:				
Long-term investments—Note D	992,320	2,099,569	3,091,889	2,672,585
Advances to other funds—Note H	32,108	-	32,108	-
Receivables (net):				
Taxes—Note G	808,359	-	808,359	-
Loans—Note G	39,387	191,739	231,126	8,576,487
Lease rentals—Note G	-	-	-	19,037
Non-depreciable capital assets—Note E:				
Land	1,414,156	323	1,414,479	161,560
Construction in progress	2,846,522	7,827	2,854,349	685,032
Depreciable capital assets—Note E:				
Land improvements	453,765	-	453,765	184,968
Buildings and building improvements	4,031,803	30,545	4,062,348	1,708,579
Machinery and equipment	694,045	62,970	757,015	578,165
Library books and other	-	-	-	161,962
Turnpike infrastructure	-	-	-	3,789,194
Highway infrastructure	14,940,848	-	14,940,848	-
Bridge infrastructure	6,324,884	-	6,324,884	-
Waterway infrastructure	1,705	-	1,705	-
Infrastructure-other	4,509	-	4,509	-
Less: accumulated depreciation	(9,964,803)	(55,738)	(10,020,541)	(3,409,734)
Net depreciable capital assets	16,486,756	37,777	16,524,533	3,013,134
Other assets	223,059	10,329	233,388	219,471
Total non-current assets	22,842,667	2,347,564	25,190,231	15,347,306
TOTAL ASSETS	$ 37,007,100	$ 5,941,080	$ 42,948,180	$ 18,690,434

- 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	$ 4,003,312	$ 456,873	$ 4,460,185	$ 340,558
Tax refunds payable	565,440	-	565,440	-
Tuition benefits payable—Note F	-	79,822	79,822	-
Securities lending obligations	1,962,367	997,532	2,959,899	7,992
Internal balances—Note H	(82,811)	82,967	156	-
Due to pension trust funds—Note H	11,811	86	11,897	-
Due to primary government—Note H	-	-	-	10
Due to component units—Note H	7,846	-	7,846	-
Due to political subdivisions	860,290	2,089	862,379	-
Due to other governments	36,895	6,506	43,401	3
Interest payable	128,015	-	128,015	94,762
Deferred revenue	97,809	92,776	190,585	53,516
Notes payable—Note J	-	-	-	141,925
Bonds payable—Note K	491,263	-	491,263	25,019
Revenue bonds payable—Note K	-	-	-	245,291
Self insurance liabilities—Note M	93,144	3,468	96,612	-
Compensated absence liability—Note K	113,781	5,869	119,650	32,617
Other liabilities	45,634	15,280	60,914	80,655
Total current liabilities	8,334,796	1,743,268	10,078,064	1,022,348
Noncurrent liabilities:				
Tuition benefits payable—Note F	-	824,412	824,412	-
Deferred revenue	-	-	-	1,034
Advances from other funds—Note H	26,808	4,836	31,644	-
Demand revenue bonds payable—Note J	-	-	-	4,240,778
Insurance loss liability—Note F	-	1,229,395	1,229,395	-
Notes payable—Note J	-	-	-	590,294
General obligation bonds payable—Note K	6,733,902	-	6,733,902	-
Bonds payable—Note K	-	-	-	1,032,989
Revenue bonds payable—Note K	-	-	-	5,277,980
Capital lease/installment purchase obligations—Note K	53,951	-	53,951	-
Other financing obligations—Note J	100,000	-	100,000	240,288
Compensated absence liability—Note K	579,104	25,247	604,351	73,162
Self insurance liabilities—Note M	690,320	13,870	704,190	-
Other liabilities—Note K	802,576	-	802,576	932,132
Total non-current liabilities	8,986,661	2,097,760	11,084,421	12,388,657
TOTAL LIABILITIES	17,321,457	3,841,028	21,162,485	13,411,005
NET ASSETS—Note C				
Invested in capital assets, net of related debt	16,944,913	45,927	16,990,840	822,331
Restricted for:				
Transportation	775,900	33,227	809,127	-
Capital projects	245,926	-	245,926	969,883
Debt service	61,029	-	61,029	384,879
Unemployment/worker's compensation	-	1,506,877	1,506,877	-
Elderly programs	90,713	158,343	249,056	-
Environmental and conservation programs	430,071	-	430,071	-
Other purposes	1,366,072	403,527	1,769,599	2,838,168
Unrestricted (deficit)	(228,981)	(47,849)	(276,830)	264,168
TOTAL NET ASSETS	$ 19,685,643	$ 2,100,052	$ 21,785,695	$ 5,279,429

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

Functions/Programs	Expenses	Program Revenues: Charges for Sales and Services	Program Revenues: Operating Grants and Contributions	Program Revenues: Capital Grants and Contributions	Net (Expense) Revenue and Changes in Net Assets — Primary Government: Governmental Activities	Primary Government: Business-Type Activities	Primary Government: Total	Component Units
Primary government:								
Governmental activities:								
Direction and supportive services	$ 2,034,883	$ 1,097,730	$ 171,589	$ -	$ (765,564)	$ -	$ (765,564)	$ -
Protection of persons and property	3,873,972	925,502	558,240	15,583	(2,374,647)	-	(2,374,647)	-
Public education	10,571,307	3,514	1,415,675	-	(9,152,118)	-	(9,152,118)	-
Health and human services	21,750,153	1,297,338	12,310,992	-	(8,141,823)	-	(8,141,823)	-
Economic development	1,340,015	1,011	664,708	-	(674,296)	-	(674,296)	-
Transportation	3,164,086	1,008,886	1,404,203	13,685	(737,312)	-	(737,312)	-
Recreation and cultural enrichment	394,273	138,750	31,310	1,205	(223,008)	-	(223,008)	-
Interest	341,455	-	-	-	(341,455)	-	(341,455)	-
Total governmental activities	43,470,144	4,472,731	16,556,717	30,473	(22,410,223)	-	(22,410,223)	-
Business-type activities:								
State lottery	2,051,646	2,349,644	88,056	-	-	386,054	386,054	-
State workers' insurance	435,429	266,551	77,170	-	-	(91,708)	(91,708)	-
Tuition payment	293,737	206,739	91,501	-	-	4,503	4,503	-
Unemployment compensation	2,563,318	1,628,215	573,270	-	-	(361,833)	(361,833)	-
Liquor control	1,024,365	1,121,853	2,702	-	-	100,190	100,190	-
Economic development and other	13,980	21,467	8,064	1,121	-	16,672	16,672	-
Total business-type activities	6,382,475	5,594,469	840,763	1,121	-	53,878	53,878	-
Total primary government	$ 49,852,619	$ 10,067,200	$ 17,397,480	$ 31,594	(22,410,223)	53,878	(22,356,345)	-
Component units:								
Total component units	$ 3,579,437	$ 2,060,912	$ 1,442,246	$ 167,958	-	-	-	91,679
General revenues:								
Taxes:								
Personal income					7,352,877	-	7,352,877	-
Sales and use					7,654,405	-	7,654,405	-
Corporation					4,004,112	-	4,004,112	-
Liquid fuels and motor carriers					1,723,816	-	1,723,816	47,062
Inheritance					726,605	-	726,605	-
Cigarette					933,973	-	933,973	-
Other					893,589	-	893,589	-
Total taxes					23,289,377	-	23,289,377	47,062
Investment income					199,151	-	199,151	-
Other					-	-	-	164
Total general revenues					23,488,528	-	23,488,528	47,226
Transfers—Note H					422,786	(422,786)	-	-
Net general revenues and transfers					23,911,314	(422,786)	23,488,528	47,226
Change in net assets					1,501,091	(368,908)	1,132,183	138,905
Net assets, July 1, 2003 (restated)—Note B					18,184,552	2,468,960	20,653,512	5,140,524
Net assets, June 30, 2004—Note C					$ 19,685,643	$ 2,100,052	$ 21,785,695	$ 5,279,429

- 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	$ 200,709	$ 39,081	$ 1,228	$ 8,791	$ 249,809
Temporary investments—Note D	5,473,126	1,241,508	518,925	1,975,464	9,209,023
Long-term investments—Note D	-	-	523,929	468,391	992,320
Receivables, net:					
Taxes—Note G	2,747,292	151,996	-	24,780	2,924,068
Accounts	146,024	270	170,010	10,959	327,263
Accrued interest	77	-	1,166	4,326	5,569
Loans—Note G	6,283	-	-	39,804	46,087
Lease rentals—Note G	-	-	-	1,178	1,178
Other	-	7,804	-	3	7,807
Due from other funds—Note H	30,792	467	12,146	59,738	103,143
Due from pension trust funds—Note H	918	4,865	-	3	5,786
Due from component units—Note H	1,472	340	-	24,588	26,400
Due from Federal government	1,733,091	161,217	48,141	13,136	1,955,585
Due from political subdivisions	6,934	-	-	61	6,995
Advances to other funds—Note H	114,108	220,000	-	3,000	337,108
Other assets	3,000	-	-	-	3,000
TOTAL ASSETS	$ 10,463,826	$ 1,827,548	$ 1,275,545	$ 2,634,222	$ 16,201,141
LIABILITIES AND FUND BALANCES					
Liabilities:					
Accounts payable and accrued liabilities	$ 3,184,371	$ 399,989	$ 125,345	$ 266,145	$ 3,975,850
Tax refunds payable	564,317	1,123	-	-	565,440
Securities lending obligations	1,155,548	262,732	86,478	447,464	1,952,222
Due to other funds—Note H	69,931	31,383	90	16,301	117,705
Due to component units—Note H	972	6,874	-	-	7,846
Due to pension trust funds	3,953	4,415	-	3,435	11,803
Due to political subdivisions	794,943	22,027	4,614	38,708	860,292
Due to other governments	21,181	14,409	-	1,276	36,866
Deferred revenue	1,558,250	2,804	166,000	35,828	1,762,882
Advances from other funds—Note H	100,000	2,175	-	10,333	112,508
Other liabilities	3,846	-	-	-	3,846
TOTAL LIABILITIES	7,457,312	747,931	382,527	819,490	9,407,260
Fund balances:					
Reserved for:					
Encumbrances	259,178	591,598	128	853,149	1,704,053
Advances—Note C	114,108	220,000	-	3,000	337,108
Loans receivable	6,283	-	-	39,804	46,087
Other—Note C	501,901	662	493,033	66,589	1,062,185
Unreserved:					
Designated for:					
Budget Stabilization Reserve Fund	70,303	-	-	-	70,303
Capital projects	-	-	-	96,787	96,787
Debt service:					
Retirement of general obligation bonds	-	-	-	61,029	61,029
Highways	-	209,647	-	-	209,647
Other—Note C	421,415	-	-	-	421,415
Undesignated (deficit)-reported in:					
General Fund	1,633,326	-	-	-	1,633,326
Special Revenue Funds	-	57,710	399,857	1,062,669	1,520,236
Capital Projects Funds	-	-	-	(368,295)	(368,295)
TOTAL FUND BALANCES	3,006,514	1,079,617	893,018	1,814,732	6,793,881
TOTAL LIABILITIES AND FUND BALANCES	$ 10,463,826	$ 1,827,548	$ 1,275,545	$ 2,634,222	$ 16,201,141

- 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		$ 6,793,881
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	$ 1,414,150	
Land improvements	453,439	
Buildings and building improvements	4,027,740	
Machinery and equipment	602,578	
Infrastructure	21,271,946	
Construction in progress	2,846,522	
Accumulated depreciation	(9,911,054)	
Net general capital assets		20,705,321
Certain revenues are earned but not available at fiscal year-end and therefore are reported as deferred revenues in the governmental funds balance sheet		1,665,081
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		97,308
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		70,070
The Statement of Net Assets includes inventories that are not reported in the governmental funds balance sheet because they are not current financial resources		80,555
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	$ (7,225,165)	
Accrued bond interest payable	(128,015)	
Capital lease and installment purchase obligations	(53,951)	
Compensated absence liability	(692,885)	
Self-insurance liabilities	(782,203)	
Other liabilities	(802,576)	
Accounts payable	(41,778)	
		(9,726,573)
Total Net Assets---Governmental Activities		$ 19,685,643

- 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	$ 21,190,494	$ 1,742,332	$ -	$ 304,291	$ 23,237,117
Licenses and fees	275,898	866,552	-	333,498	1,475,948
Intergovernmental	14,790,701	1,323,005	119,541	145,849	16,379,096
Charges for sales and services	1,751,745	108,901	-	207,373	2,068,019
Investment income	160,774	60,719	87,264	93,375	402,132
Lease rental principal and interest	-	-	-	184	184
Other	511,130	7,290	364,875	74,015	957,310
TOTAL REVENUES	38,680,742	4,108,799	571,680	1,158,585	44,519,806
EXPENDITURES:					
Current:					
Direction and supportive services	1,412,250	49,693	2	76,784	1,538,729
Protection of persons and property	2,958,160	496,105	102,168	330,233	3,886,666
Health and human services	20,816,721	-	358,509	514,162	21,689,392
Public education	10,520,428	1,023	-	8,053	10,529,504
Recreation and cultural enrichment	225,367	4,199	-	152,613	382,179
Economic development	963,926	-	2,061	368,084	1,334,071
Transportation	351,911	1,641,755	-	316,768	2,310,434
Capital outlay	142,651	1,668,261	-	197,229	2,008,141
Debt service:					
Principal retirement	-	-	-	455,890	455,890
Interest and fiscal charges	-	-	-	311,686	311,686
TOTAL EXPENDITURES	37,391,414	3,861,036	462,740	2,731,502	44,446,692
REVENUES OVER (UNDER) EXPENDITURES	1,289,328	247,763	108,940	(1,572,917)	73,114
OTHER FINANCING SOURCES (USES):					
Bonds issued	-	-	-	625,247	625,247
Refunding bonds issued	-	-	-	459,223	459,223
Premium on bonds/refunding bonds issued	-	-	-	88,006	88,006
Transfers in—Note H	133,670	-	-	1,203,420	1,337,090
Transfers out—Note H	(775,732)	(61,279)	(34,531)	(42,762)	(914,304)
Payment to refunded bond escrow agent	-	-	-	(511,884)	(511,884)
Capital lease and installment purchase obligations	1,535	-	-	-	1,535
NET OTHER FINANCING SOURCES (USES)	(640,527)	(61,279)	(34,531)	1,821,250	1,084,913
NET CHANGE IN FUND BALANCES	648,801	186,484	74,409	248,333	1,158,027
FUND BALANCES, JULY 1, 2003-(restated)-Note B	2,357,713	893,133	818,609	1,566,399	5,635,854
FUND BALANCES, JUNE 30, 2004	$ 3,006,514	$ 1,079,617	$ 893,018	$ 1,814,732	$ 6,793,881

- 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, 2004

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, 2004. 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..		$ 1,158,027
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)...	$ 1,788,743	
Depreciation expense..	(833,763)	
Capital lease, installment purchase and related payments................	9,175	
Net excess of capital asset additions/installment purchase payments over depreciation expense...		964,155
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 $35,346.............	$ (660,592)	
Refunding bonds, including a premium of $52,661..........................	(511,884)	
Total bond proceeds...		(1,172,476)
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...	$ 455,890	
Payments to refunded bond escrow agent...	511,884	
Total long-term debt repayment..		967,774
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...		(19,888)
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.		22,448
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...		(418,949)
Net change in governmental net assets in the statement of activities...............................		$ 1,501,091

- 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 Workers' Insurance Fund (Dec. 31, 2003)	State Lottery Fund	Tuition Payment Fund	Nonmajor Funds	Total	Internal Service Funds
ASSETS							
Current assets:							
Cash	$ -	$ 3,267	$ 236	$ 765	$ 16,028	$ 20,296	$ 8,401
Cash with fiscal agents—Note D	853,444	-	-	-	-	853,444	-
Temporary investments—Note D	224	781,120	461,605	321,339	294,728	1,859,016	48,053
Receivables (net):							
Unemployment assessments	501,415	-	-	-	-	501,415	-
Accounts	22,424	36,559	8,203	-	3,566	70,752	14
Accrued interest	-	10,734	-	3,003	849	14,586	-
Loans—Note G	-	-	-	-	44,488	44,488	-
Other	-	-	13	-	75	88	717
Due from other funds—Note H	2,867	-	-	-	3,555	6,422	12,831
Due from pension trust funds	1	-	-	-	8	9	26
Due from component units—Note H	755	-	-	-	28	783	777
Due from Federal government	4,515	-	4,173	-	-	8,688	-
Due from political subdivisions	8,425	-	-	-	-	8,425	131
Due from other governments	16,600	-	-	-	-	16,600	-
Advances to other funds	-	-	-	-	500	500	-
Inventory	-	-	-	-	193,476	193,476	10,627
Prepaid expenses	-	-	-	-	950	950	-
Total current assets	1,410,670	831,680	474,230	325,107	558,251	3,599,938	81,577
Noncurrent assets:							
Long-term investments	-	1,389,930	12,041	697,598	-	2,099,569	-
Receivables (net):							
Loans—Note G	-	-	-	-	191,739	191,739	-
Non-depreciable capital assets—Note E:							
Land	-	-	-	-	323	323	6
Construction in progress	-	-	-	-	7,827	7,827	-
Depreciable capital assets—Note E:							
Land improvements	-	-	-	-	-	-	326
Buildings and building improvements	-	-	-	-	30,545	30,545	4,063
Machinery and equipment	-	3,214	424	-	59,332	62,970	91,467
Less: accumulated depreciation	-	(1,631)	(341)	-	(53,766)	(55,738)	(53,749)
Net depreciable capital assets	-	1,583	83	-	36,111	37,777	42,107
Other assets	-	1,029	9,300	-	-	10,329	59
Total noncurrent assets	-	1,392,542	21,424	697,598	236,000	2,347,564	42,172
TOTAL ASSETS	1,410,670	2,224,222	495,654	1,022,705	794,251	5,947,502	123,749
LIABILITIES							
Current liabilities:							
Accounts payable and accrued liabilities	103,130	9,162	232,687	2,675	109,219	456,873	27,471
Tuition benefits payable—Note F	-	-	-	79,822	-	79,822	-
Securities lending obligations	47	670,898	100,100	163,582	62,905	997,532	10,144
Due to other funds—Note H	164	-	222	14	3,989	4,389	458
Due to pension trust funds	-	-	-	-	86	86	8
Due to political subdivisions	-	-	2,089	-	-	2,089	-
Due to other governments	5,310	-	557	-	639	6,506	29
Deferred revenue	225	88,655	1,573	-	2,323	92,776	8
Self insurance	-	234	-	-	3,234	3,468	252
Compensated absences	-	342	-	6	5,521	5,869	-
Other liabilities	-	15,280	-	-	-	15,280	-
Total current liabilities	108,876	784,571	337,228	246,099	187,916	1,664,690	38,370
Noncurrent liabilities:							
Advances from other funds—Note H	-	1,836	-	-	88,000	89,836	14,300
Tuition benefits payable—Note F	-	-	-	824,412	-	824,412	-
Insurance loss liability—Note F	-	1,228,548	-	-	847	1,229,395	-
Compensated absences	-	1,666	-	43	23,538	25,247	-
Self insurance	-	935	-	-	12,935	13,870	1,009
Total noncurrent liabilities	-	1,232,985	-	824,455	125,320	2,182,760	15,309
TOTAL LIABILITIES	108,876	2,017,556	337,228	1,070,554	313,236	3,847,450	53,679
NET ASSETS							
Invested in capital assets, net of related debt	-	1,583	83	-	44,261	45,927	42,113
Restricted for:							
Transportation	-	-	-	-	33,227	33,227	-
Unemployment/workers' compensation	1,301,794	205,083	-	-	-	1,506,877	-
Elderly programs	-	-	158,343	-	-	158,343	-
Other purposes—Note C	-	-	-	-	403,527	403,527	42,976
Unrestricted (deficit)	-	-	-	(47,849)	-	(47,849)	(15,019)
TOTAL NET ASSETS	$1,301,794	$ 206,666	$ 158,426	$ (47,849)	$ 481,015	$ 2,100,052	$ 70,070

- 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, 2004

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Enterprise Funds						
	Unemployment Compensation Fund	State Workers' Insurance Fund (Dec. 31, 2003)	State Lottery Fund	Tuition Payment Fund	Nonmajor Funds	Total	Internal Service Funds
OPERATING REVENUES:							
Sales and services	$ 1,627,052	$ 266,405	$ 2,350,892	$ 206,739	$ 1,134,311	$ 5,585,399	$ 119,472
Investment income	52,389	77,170	-	91,501	7,368	228,428	-
Interest on loans	-	-	-	-	7,447	7,447	-
Other	522,044	146	73,681	-	1,301	597,172	-
OPERATING REVENUES BEFORE PROVISION FOR UNCOLLECTABLE ACCOUNTS	2,201,485	343,721	2,424,573	298,240	1,150,427	6,418,446	119,472
Provision for uncollectible accounts	-	(7,410)	-	-	(2,194)	(9,604)	-
NET OPERATING REVENUES	2,201,485	336,311	2,424,573	298,240	1,148,233	6,408,842	119,472
OPERATING EXPENSES:							
Cost of sales and services	2,563,318	422,880	1,981,368	293,737	1,031,524	6,292,827	129,323
Interest expense	-	4,764	-	-	-	4,764	-
Depreciation	-	375	5	-	4,531	4,911	10,188
Other	-	-	70,273	-	-	70,273	-
TOTAL OPERATING EXPENSES	2,563,318	428,019	2,051,646	293,737	1,036,055	6,372,775	139,511
OPERATING INCOME (LOSS)	(361,833)	(91,708)	372,927	4,503	112,178	36,067	(20,039)
NONOPERATING REVENUES (EXPENSES):							
Investment income	-	-	13,127	-	3,330	16,457	2,693
Other revenues	-	-	-	-	1,450	1,450	2
Other expenses	-	-	-	-	(96)	(96)	(2,544)
NONOPERATING REVENUES, NET	-	-	13,127	-	4,684	17,811	151
INCOME (LOSS) BEFORE TRANSFERS	(361,833)	(91,708)	386,054	4,503	116,862	53,878	(19,888)
TRANSFERS:							
Transfers in—Note H	-	-	-	-	200	200	-
Transfers out—Note H	-	-	(370,000)	-	(52,986)	(422,986)	-
NET TRANSFERS	-	-	(370,000)	-	(52,786)	(422,786)	-
INCREASE/(DECREASE) IN NET ASSETS	(361,833)	(91,708)	16,054	4,503	64,076	(368,908)	(19,888)
TOTAL NET ASSETS, JULY 1, 2003 (restated)—Note B	1,663,627	298,374	142,372	(52,352)	416,939	2,468,960	89,958
TOTAL NET ASSETS, JUNE 30, 2004	$ 1,301,794	$ 206,666	$ 158,426	$ (47,849)	$ 481,015	$ 2,100,052	$ 70,070

- 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 Workers' Insurance Fund (Dec. 31, 2003)	State Lottery Fund	Tuition Payment Fund	Nonmajor Funds	Total	Internal Service Funds
CASH FLOWS FROM OPERATING ACTIVITIES:							
Receipts from employers	$ 1,566,564	$ 270,699	$ -	$ -	$ -	$ 1,837,263	$ -
Receipts from customers	-	-	2,353,296	205,563	1,128,061	3,686,920	129,603
Receipts from borrowers	-	-	-	-	12,143	12,143	-
Payments to programs for the elderly	-	-	(442,341)	-	-	(442,341)	-
Payments to prize winners	-	-	(1,429,747)	-	-	(1,429,747)	-
Payments to participants	-	-	-	(52,475)	-	(52,475)	-
Payments to claimants	(2,666,287)	(231,842)	-	-	(3,720)	(2,901,849)	-
Payments to borrowers	-	-	-	-	(4,405)	(4,405)	-
Payments to suppliers	-	-	(98,175)	-	(1,067,519)	(1,165,694)	(132,567)
Other receipts	522,044	146	3,408	-	631	526,229	-
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	(577,679)	39,003	386,441	153,088	65,191	66,044	(2,964)
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES							
Net borrowings under advances from other funds	-	210	-	-	2,500	2,710	-
Transfers in	-	-	-	-	200	200	-
Transfers out	-	-	(370,000)	-	(52,986)	(422,986)	-
NET CASH PROVIDED BY (USED FOR) NON-CAPITAL FINANCING ACTIVITIES	-	210	(370,000)	-	(50,286)	(420,076)	-
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:							
Acquisition and construction of capital assets	-	(456)	-	-	(8,058)	(8,514)	(7,300)
Loss on disposition of capital assets	-	-	-	-	96	96	2,196
NET CASH USED FOR CAPITAL AND RELATED FINANCING ACTIVITIES	-	(456)	-	-	(7,962)	(8,418)	(5,104)
CASH FLOWS FROM INVESTING ACTIVITIES:							
Purchase of investments	(5,866)	(1,933,275)	(1,325,385)	(6,319,705)	(748,057)	(10,332,288)	(242,522)
Sales and maturities of investments	5,806	1,679,271	1,266,351	6,072,042	713,604	9,737,074	255,692
Investment income	52,389	54,505	18,156	17,538	10,806	153,394	1,995
Change in securities lending obligations	17	160,736	24,438	76,887	16,922	279,000	(670)
NET CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	52,346	(38,763)	(16,440)	(153,238)	(6,725)	(162,820)	14,495
NET INCREASE (DECREASE) IN CASH	(525,333)	(6)	1	(150)	218	(525,270)	6,427
CASH AT JULY 1, 2003	1,378,777	3,274	235	915	15,811	1,399,012	1,974
CASH AT JUNE 30, 2004	$ 853,444	$ 3,268	$ 236	$ 765	$ 16,029	$ 873,742	$ 8,401
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES							
Operating income (loss)	$ (361,833)	$ (91,708)	$ 372,927	$ 4,503	$ 112,175	$ 36,064	$ (20,039)
Depreciation and amortization	-	375	5	-	4,531	4,911	10,188
Provision for uncollectible accounts	-	7,410	-	-	2,194	9,604	-
Non-operating revenues	-	-	-	-	1,354	1,354	(2,542)
Reclassification of investment income	(52,389)	(77,170)	-	(91,501)	(7,368)	(228,428)	-
Changes in assets and liabilities:							
Accounts receivable	132	(12,242)	15,444	(1,176)	(3,391)	(1,233)	(74)
Unemployment compensation assessments receivable	(113,074)	-	-	-	-	(113,074)	-
Inventory	-	-	-	-	(31,826)	(31,826)	608
Due from other funds	241	200	-	-	(1,087)	(646)	8,773
Due from component units	(384)	-	-	-	(24)	(408)	656
Due from other governments	53,168	-	(3,740)	-	5	49,433	-
Due from political subdivisions	(796)	-	-	-	-	(796)	127
Other current assets	-	(654)	(9,300)	-	822	(9,132)	39
Accounts payable and accrued liabilities	(102,988)	812	13,306	(4,817)	14,612	(79,075)	(2,020)
Tuition benefits payable	-	-	-	246,093	-	246,093	-
Due to other funds	162	(3,948)	(62)	(6)	(20,323)	(24,177)	82
Due to component units	-	-	-	-	26	26	(1)
Due to other governments	(143)	(53)	(93)	(2)	144	(147)	(21)
Deferred revenue	225	16,990	(1,657)	-	22	15,580	-
Insurance loss liability	-	189,016	-	-	114	189,130	-
Other liabilities	-	9,975	(389)	(6)	(6,789)	2,791	1,260
Total Adjustments	(215,846)	130,711	13,514	148,585	(46,984)	29,980	17,075
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	$ (577,679)	$ 39,003	$ 386,441	$ 153,088	$ 65,191	$ 66,044	$ (2,964)
Increase (decrease) in fair value of investments during the fiscal year	$ -	$ 28,801	$ (1,461)	$ 66,708	$ 181	$ 94,229	$ 243

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 *June 30, 2004*

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Pension (and Other Employee Benefit) Trust Funds	Investment Trust Fund — INVEST Program for Local Governments (December 31, 2003)	Private Purpose Trust Fund — Tuition Account Investment Program	Agency Funds
ASSETS				
Cash—Note D	$ 2,463	$ -	$ 92	$ 48,515
Cash with fiscal agents—Note D	-	-	-	46,013
Temporary investments—Note D	8,643,376	832,239	412	1,694,258
Long-term investments—Note D	72,475,494	-	138,531	1,014,858
Receivables, net:				
Taxes—Note G	-	-	-	14,663
Accounts	-	-	77	395,081
Accrued interest	234,571	207	61	685
Loans—Note G	-	-	-	3,676
Pension contributions	350,950	-	-	-
Investment proceeds	649,454	-	18	-
Other	2,531	-	-	249,995
Due from other funds—Note H	4,076	-	-	-
Due from political subdivisions	1,029	-	-	-
Due from other governments	14,250	-	-	-
Advances to other funds—Note H	-	-	-	100,000
Depreciable capital assets:				
Capital assets	11,200	-	-	-
Less: accumulated depreciation	(9,686)	-	-	-
Net depreciable capital assets	1,514	-	-	-
Other assets	-	-	-	624,638
TOTAL ASSETS	82,379,708	832,446	139,191	4,192,382
LIABILITIES				
Accounts payable and accrued liabilities	283,632	657	138	39,105
Investment purchases payable	1,733,582	-	408	-
Securities lending obligations	6,073,219	-	-	157,801
Due to other funds—Note H	1,154	-	-	-
Due to political subdivisions	-	-	-	307,003
Due to other governments	-	-	-	11
Advances from other funds—Note H	-	-	-	220,000
Other liabilities	118	-	-	3,468,210
Self insurance liabilities	-	-	-	252
TOTAL LIABILITIES	8,091,705	657	546	4,192,382
NET ASSETS:				
Held in trust for:				
Pension and other employee benefits	72,875,598	-	-	-
Healthcare benefits	197,450	-	-	-
Employee salary deferrals	1,214,955	-	-	-
INVEST Program participants	-	831,789	-	-
Tuition Account Program participants	-	-	138,645	-
TOTAL NET ASSETS	$ 74,288,003	$ 831,789	$ 138,645	$ -

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

STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS
Fiduciary Funds *For the Fiscal Year Ended June 30, 2004*

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Pension (and Other Employee Benefit) Trust Funds	Investment Trust Fund: INVEST Program for Local Governments (December 31, 2003)	Private Purpose Trust Fund: Tuition Account Investment Program
ADDITIONS:			
Pension contributions:			
Employer	$ 475,391	$ -	$ -
Employee	1,382,433	-	-
Total contributions	1,857,824	-	-
Investment income:			
Net appreciation in fair value of investments	11,577,918	-	-
Interest income	912,022	10,796	9,935
Dividend income	670,618	-	-
Rental and other income	538,905	-	-
Total investment activity income	13,699,463	10,796	9,935
Less: investment expenses			
Investment activity expense	(379,687)	-	(657)
Net investment earnings	13,319,776	10,796	9,278
Securities lending activities:			
Income	62,238	-	-
Expenses	(40,233)	-	-
Total securities lending income	22,005	-	-
Total net investment income	13,341,781	10,796	9,278
Share transactions (at net asset value of $1.00 per share):			
Shares purchased	-	1,910,664	97,492
Shares issued in lieu of cash distributions	-	9,802	76
Shares redeemed	-	(2,107,966)	(17,666)
Net increase (decrease) in net assets from share transactions	-	(187,500)	79,902
TOTAL ADDITIONS	15,199,605	(176,704)	89,180
DEDUCTIONS:			
Benefit payments	5,126,541	-	-
Refunds of contributions	19,882	-	-
Administrative expenses	73,064	527	-
Other expenses	21,711	-	-
Distributions to participants	-	10,459	97
TOTAL DEDUCTIONS	5,241,198	10,986	97
CHANGE IN PLAN NET ASSETS HELD IN TRUST FOR:			
Pension and other employee benefits	9,932,496	-	-
Healthcare benefits	25,911	-	-
INVEST program participants	-	(187,690)	-
Tuition Account Program participants	-	-	89,083
Net assets, July 1, 2003 (restated)-Note B	64,329,596	1,019,479	49,562
Net assets, June 30, 2004	$ 74,288,003	$ 831,789	$ 138,645

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

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STATEMENT OF NET ASSETS
Discretely Presented Component Units

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	State Public School Building Authority	Philadelphia Shipyard Development Corporation (December 31, 2003)	Ben Franklin Technology Development Fund	Insurance Fraud Prevention Authority	Pennsylvania Higher Educational Facilities Authority	Patient Safety Trust Authority	Port of Pittsburgh Commission
ASSETS							
Current assets:							
Cash—Note D	$ -	$ 9,191	$ -	$ 2,637	$ -	$ -	$ 2
Temporary investments—Note D	13,541	-	30,937	-	-	6,957	2,065
Receivables:							
Accounts	17	-	-	2	15	-	38
Accrued interest	187	8	-	-	-	-	4
Loans—Note G	3,496	-	25,756	-	-	-	89
Lease rentals—Note G	-	-	-	-	-	-	-
Other	-	-	-	74	-	-	-
Due from primary government—Note H	-	-	-	-	-	-	-
Due from component units—Note H	-	-	-	-	-	-	-
Due from Federal government	-	-	-	-	-	-	-
Due from other governments	-	2,116	-	124	-	-	-
Inventory	-	-	-	-	-	-	-
Prepaid and deferred expenses	-	40	-	16	-	-	20
Total current assets	17,241	11,355	56,693	2,853	15	6,957	2,218
Noncurrent assets:							
Long-term investments—Note D	9,958	-	-	-	-	-	-
Receivables (net):							
Loans—Note G	5,764	28,815	-	-	-	-	-
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	538	-	-	64	-	-	2,108
Infrastructure	-	-	-	-	-	-	-
Library books	-	-	-	-	-	-	-
Other capital assets	-	-	-	-	-	-	-
Less: accumulated depreciation	(403)	-	-	(40)	-	-	(416)
Net depreciable capital assets	135	-	-	24	-	-	1,692
Other assets	-	-	-	6	-	-	-
Total noncurrent assets	15,857	28,976	-	30	-	-	1,692
TOTAL ASSETS	33,098	40,331	56,693	2,883	15	6,957	3,910
LIABILITIES							
Current liabilities:							
Accounts payable and accrued liabilities	607	2,196	7,951	146	15	2,334	107
Securities lending obligations	-	-	6,505	-	-	1,487	-
Due to primary government—Note H	-	-	-	-	-	-	-
Due to other governments	-	-	-	-	-	-	-
Interest payable	-	-	-	-	-	-	-
Deferred revenue	-	-	-	-	-	-	-
Notes payable—Note J	-	-	-	-	-	-	-
Bonds payable—Note K	-	-	-	-	-	-	-
Revenue bonds payable—Note K	-	-	-	-	-	-	-
Compensated absences	132	-	-	-	-	-	21
Other liabilities	60	-	-	-	-	3	-
Total current liabilities	799	2,196	14,456	146	15	3,824	128
Non-current liabilities:							
Deferred revenue	-	-	-	-	-	-	-
Demand revenue bonds payable—Note J	-	-	-	-	-	-	-
Notes payable—Note J	-	-	-	-	-	-	-
Bonds payable—Note K	-	-	-	-	-	-	-
Revenue bond payable—Note K	-	-	-	-	-	-	-
Other financing obligations—Note J	-	-	-	-	-	-	2,000
Compensated absences	215	-	-	-	-	-	-
Other liabilities	1,008	28,815	-	-	-	11	-
Total non-current liabilities	1,223	28,815	-	-	-	11	2,000
TOTAL LIABILITIES	2,022	31,011	14,456	146	15	3,835	2,128
NET ASSETS—Note C:							
Invested in capital assets, net of related debt	135	161	-	24	-	-	(308)
Restricted for:							
Capital projects	-	-	-	-	-	-	-
Debt service	-	-	-	-	-	-	-
Other purposes	30,941	9,159	42,237	2,713	-	3,122	2,090
Unrestricted	-	-	-	-	-	-	-
TOTAL NET ASSETS	$ 31,076	$ 9,320	$ 42,237	$ 2,737	$ -	$ 3,122	$ 1,782

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

Pennsylvania Turnpike Commission (May 31, 2004)	**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**
$ 77,823	$ 652	$ 38,014	$ 85,161	$ 504	$ 85,737	$ 1,901	$ 301,622
194,553	192,121	400,309	172,983	411,867	258,162	-	1,683,495
17,813	-	-	9,681	-	84,265	-	111,831
9,646	2,517	-	96,478	1,941	-	-	110,781
-	75,556	62,170	638,807	121,490	6,088	-	933,452
-	634	-	-	-	-	835	1,469
-	845	-	-	-	24,403	928	26,250
6,660	-	-	-	-	-	-	6,660
-	-	-	-	108	-	-	108
-	-	-	14,792	2,663	-	-	17,455
-	-	-	-	-	-	-	2,240
16,776	-	-	-	-	13,095	-	29,871
-	12,836	51,445	29,108	18,004	5,765	660	117,894
323,271	285,161	551,938	1,047,010	556,577	477,515	4,324	3,343,128
789,107	74,330	758,826	292,304	-	748,060	-	2,672,585
-	429,713	2,536,020	4,239,894	1,304,351	31,930	-	8,576,487
-	19,037	-	-	-	-	-	19,037
132,277	-	-	2,946	-	26,176	-	161,560
505,778	-	-	-	-	178,279	975	685,032
53,486	-	-	-	-	131,482	-	184,968
638,979	-	-	65,360	-	888,829	115,411	1,708,579
291,241	-	-	20,832	-	230,974	32,408	578,165
3,789,194	-	-	-	-	-	-	3,789,194
-	-	-	-	-	78,931	-	78,931
-	-	-	80,766	-	-	2,265	83,031
(2,736,350)	-	-	(92,439)	-	(507,670)	(72,416)	(3,409,734)
2,036,550	-	-	74,519	-	822,546	77,668	3,013,134
62,264	-	10,533	105,328	-	34,032	7,308	219,471
3,525,976	523,080	3,305,379	4,714,991	1,304,351	1,841,023	85,951	15,347,306
3,849,247	808,241	3,857,317	5,762,001	1,860,928	2,318,538	90,275	18,690,434
55,928	332	3,836	102,677	5,236	156,028	3,165	340,558
-	-	-	-	-	-	-	7,992
-	-	-	-	10	-	-	10
-	-	-	-	3	-	-	3
33,200	13,770	33,384	12,468	1,940	-	-	94,762
7,812	-	-	4,543	-	41,151	10	53,516
-	-	-	141,709	-	-	216	141,925
-	-	-	-	-	22,619	2,400	25,019
44,160	21,270	164,276	-	15,585	-	-	245,291
11,953	-	-	5,796	192	14,523	-	32,617
-	-	538	-	-	79,684	370	80,655
153,053	35,372	202,034	267,193	22,966	314,005	6,161	1,022,348
-	-	-	-	-	768	266	1,034
-	-	-	4,240,778	-	-	-	4,240,778
-	-	-	586,910	-	-	3,384	590,294
-	494,393	-	-	-	490,296	48,300	1,032,989
2,188,756	-	2,764,350	-	96,004	228,870	-	5,277,980
-	-	-	186,230	-	52,058	-	240,288
-	-	-	7,791	-	64,589	567	73,162
13,912	14,308	286,111	105,328	-	478,868	3,771	932,132
2,202,668	508,701	3,050,461	5,127,037	96,004	1,315,449	56,288	12,388,657
2,355,721	544,073	3,252,495	5,394,230	118,970	1,629,454	62,449	13,411,005
470,593	-	-	$3,776	-	326,375	21,575	822,331
934,108	-	-	-	-	35,686	89	969,883
-	-	85,713	293,621	-	-	5,545	384,879
88,825	-	519,109	70,374	1,741,958	327,023	617	2,838,168
-	264,168	-	-	-	-	-	264,168
$ 1,493,526	$ 264,168	$ 604,822	$ 367,771	$ 1,741,958	$ 689,084	$ 27,826	$ 5,279,429

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

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	State Public School Building Authority	Philadelphia Shipyard Development Corporation (December 31, 2003)	Ben Franklin Technology Development Fund	Insurance Fraud Prevention Authority	Pennsylvania Higher Educational Facilities Authority	Patient Safety Trust Authority
Expenses	$ 2,870	$ 31,693	$ 50,177	$ 10,526	$ 1,133	$ 4,266
Program revenues:						
Charges for goods and services	1,430	-	176	9,457	1,133	-
Operating grants and contributions	224	10,702	54,946	285	-	2,741
Capital grants and contributions	-	-	-	-	-	-
Total program revenues	1,654	10,702	55,122	9,742	1,133	2,741
Net (expense) revenue	(1,216)	(20,991)	4,945	(784)	-	(1,525)
General revenues:						
Taxes and other general revenues	-	-	-	-	-	-
Change in net assets	(1,216)	(20,991)	4,945	(784)	-	(1,525)
Net assets, July 1, 2003 (restated)—Note B	32,292	30,311	37,292	3,521	-	4,647
Net assets, June 30, 2004	$ 31,076	$ 9,320	$ 42,237	$ 2,737	$ -	$ 3,122

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

Port of Pittsburgh Commission	Pennsylvania Turnpike Commission (May 31, 2004)	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
$ 1,059	$ 582,935	$ 33,490	$ 489,226	$ 770,614	$ 57,711	$ 1,521,819	$ 21,918	$ 3,579,437
22	420,256	20,105	187,042	599,713	23,021	792,704	5,853	2,060,912
1,153	60,354	747	304,776	239,181	25,847	730,336	10,954	1,442,246
-	14,787	-	-	-	124,088	20,051	9,032	167,958
1,175	495,397	20,852	491,818	838,894	172,956	1,543,091	25,839	3,671,116
116	(87,538)	(12,638)	2,592	68,280	115,245	21,272	3,921	91,679
-	47,062	-	-	-	-	-	164	47,226
116	(40,476)	(12,638)	2,592	68,280	115,245	21,272	4,085	138,905
1,666	1,534,002	276,806	602,230	299,491	1,626,713	667,812	23,741	5,140,524
$ 1,782	$ 1,493,526	$ 264,168	$ 604,822	$ 367,771	$ 1,741,958	$ 689,084	$ 27,826	$ 5,279,429

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

INDEX TO NOTES

Page

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. Separate columns are presented for governmental and business-type activities within the primary government (defined below) and discretely presented 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, 2004. 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 component units. Fiduciary component unit balances are reported in the Statement of Fiduciary Net Assets and combining statements for all discretely presented 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 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, either by discrete presentation or as a Fiduciary Fund:

State Employees' Retirement System (SERS) (Fiduciary Fund) - 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 provides services and benefits almost exclusively to the PG.

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 PHEFA 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 Technology Development Authority (PTDA) - Similar to the predecessor Ben Franklin/IRC Partnership, the PTDA promotes economic development through interaction of technology development, modernization and training programs. Industrial resource centers and technology centers, established through the PTDA, also increase Pennsylvania business competitiveness. The PTDA works closely with the Department of Community and Economic Development (DCED) and includes a 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, 2003 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.

Patient Safety Trust Authority (PSTA) - The PSTA is charged with taking steps to reduce and eliminate medical errors by identifying problems and recommending solutions that promote patient safety in hospitals, ambulatory surgical facilities and birthing centers. The Board of Directors has 11 members: the Pennsylvania Physician General, who serves as the Board chair, six members appointed by the Governor for seats designated for specific professional occupations, and four members appointed by the General Assembly.

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, 2004.

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 Fund) - 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 Fund) - 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 Fund) - 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**, fiduciary funds, are included for their fiscal years ended December 31, 2003.

Financial Statements for Component Units and Investment Trust Fund

Audited financial statements for component units are available by writing to the Commonwealth Comptroller (formerly 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 Commonwealth Comptroller.

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 and certain of its employees pay 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. Other major Funds are displayed in bold print in the Notes to the Financial Statements.

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 Workers' 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 Workers' 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 Workers' Insurance Fund** is included for its fiscal year ended December 31, 2003.

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 29, 2004.

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. Expenses 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 another 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 largest Agency Fund, the Statutory Liquidator Fund, converts the assets of insolvent insurance companies to cash for remittance to creditors, policyholders and stockholders. The Underground Storage Tank Indemnification Fund holds assets on behalf of owners and operators of underground storage tanks who incur a liability for taking corrective actions associated with underground storage tank releases. The Municipal Pension Aid Fund holds a portion of casualty insurance company tax assessments, which are remitted to municipalities to help defray municipal police and fire fighter pension 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, 2003.

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 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 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 are 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 deaccessioning 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, depending on length of credited service, from between 2.7 percent to 10 percent of regular hours paid. Generally, 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. Generally, 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 primarily determined based on enabling legislation that provides for restrictions on how the resources of special (non-**General Fund**) funds may be used. At June 30, 2004, a portion of governmental activities net assets are restricted based on a Federal government purpose restriction. Practically all reported restricted net assets could become unrestricted based on possible future legislative changes.

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 is to be deposited by the end of the next succeeding quarter into this Fund. Act 7-A of 2004 superseded this requirement and provided for $190 million to be transferred from the **General Fund** to the new Fund; this transfer is included in the **General Fund** budgetary comparison schedule for the fiscal year ended June 30, 2004.

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, 2004 the **Tobacco Settlement Fund** reported revenues of $364.9 million from this source.

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

Bond Proceeds, Bond Proceeds Premium/Discount and Bond Issuance Costs: In governmental fund financial statements, the face amount of bonds issued and related premium/discount are separately reported. Bond issuance costs are reported as expenditures. In government-wide financial statements, the face amount of bonds issued is reported as a liability and related premium/discount is amortized over the life of the outstanding debt and is reported as interest expense as part of functional governmental activities expenses. Bond issuance costs are reported as expenses.

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 component units:

Statutory Transfer—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, 2004 and transfers in/out during the fiscal year ended June 30, 2004 are 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 – Adopted: Effective July 1, 2003 the Commonwealth adopted the Governmental Accounting Standards Board's (GASB's) Statement No. 39, "Determining Whether Certain Organizations Are Component Units." GASB No. 39 amends GASB No. 14 and the State System of Higher Education (SSHE) has included several previously-unreported SSHE component units in its financial statements as of July 1, 2003. Effective July 1, 2003 the Commonwealth adopted the GASB's Technical Bulletin 2004-1, "Tobacco Settlement Recognition and Financial Reporting Issues." The June 30, 2004 governmental fund balance sheet for the **Tobacco Settlement Fund** includes a receivable and deferred revenue for the estimated amount due to the Commonwealth based on the original participating tobacco product manufacturer projected payment schedule in the Master Settlement Agreement (MSA). The reported June 30, 2003 governmental activities net assets has been restated and increased by $170 million at July 1, 2003 to include a receivable based on a portion of MSA proceeds received in April 2004.

New Accounting Pronouncements – To Be Adopted: 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. In May 2004 the GASB issued Statement No. 44, "Economic Condition Reporting: The Statistical Section." GASB No. 44 amends the National Committee on Governmental Accounting's Statement No. 1 which provided requirements for the statistical section of the CAFR. GASB No. 44 establishes five categories of information and is intended to improve the understandability and usefulness of statistical section information. In June 2004 the GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions." GASB No. 45 changes how other postemployment benefits (OPEB) costs are reported by employer governments, so that employer OPEB costs are charged during the periods when employees render services. In December 2004 the GASB issued Statement No. 46, "Net Assets Restricted by Enabling Legislation." GASB No. 46 establishes and modifies requirements related to restrictions of net assets and provides that changes to enabling legislation could cause changes in how, or if, net assets are restricted and for which purpose. The Commonwealth must adopt the new standards as follows:

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
GASB No. 44	Effective July 1, 2005, for financial statements for the fiscal year ending June 30, 2006
GASB No. 45	Effective July 1, 2007, for financial statements for the fiscal year ending June 30, 2008
GASB No. 46	Effective July 1, 2005, for financial statements for the fiscal year ending June 30, 2006

NOTE B – RESTATEMENT OF PREVIOUSLY REPORTED FUND BALANCES/NET ASSETS AT JUNE 30, 2003

Primary Government

Governmental Funds/Governmental Activities and Enterprise Funds/Business-Type Activities

The previously-reported fund balances/net assets for aggregate non-major Special Revenue, Debt Service and Enterprise fund types have been restated and increased, respectively, by $13,689, $145, and $1,777 from $1,216,623, $32,685 and $415,162 to $1,230,312, $32,830 and $416,939 as of July 1, 2003 to include previously-unreported Commonwealth funds. Similarly, the previously-reported fund balance for the Capital Projects fund type has been restated and increased by $1,628 from $301,629 to $303,257 as of July 1, 2003. Total governmental fund balance has been restated and increased by $15,462 from $5,620,392 to $5,635,854 at July 1, 2003. Total business type activities net assets has been restated and increased by $1,777 from $2,467,183 to $2,468,960 at July 1, 2003 (amounts in thousands).

The previously-reported governmental activities net assets has been restated and increased by $15,462 based on the above; further, in accordance with the provisions of the Governmental Accounting Standards Board's Technical Bulletin 2004-1, governmental activities net assets has been restated and increased by $170,000 to report a previously-unreported receivable associated with unremitted Tobacco Master Settlement Agreement proceeds at July 1, 2003 (amounts in thousands).

In total, previously-reported governmental activities net assets has been increased by $185,462 from $17,999,090 at June 30, 2003 to $18,184,552 at July 1, 2003 (amounts in thousands).

Fiduciary Funds

In accordance with applicable standards, the previously-reported net assets reported by the INVEST Program for Local Governments, Investment Trust Fund, at December 31, 2002 has been restated and reduced by $14,820 from $1,034,299 to $1,019,479 at January 1, 2003 to omit amounts invested by discretely presented component unit organizations in the INVEST Program (amounts in thousands).

Discretely Presented Component Units

In accordance with GASB No. 39, the previously-reported net assets for the Pennsylvania State System of Higher Education (SSHE) have been restated and increased by $157,544 from $510,268 to $667,812, as of July 1, 2003 to include previously-unreported SSHE component unit organizations as of June 30, 2003. Total net assets for discretely presented component units have been restated and increased, from $4,982,980 to $5,140,524 at July 1, 2003 (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, 2004, governmental and business-type activities, respectively, reported $16,944,913 and $45,927 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, 2004, governmental and business-type activities, respectively, reported $2,969,711 and $2,101,974 in restricted net assets. Governmental Activities net assets restricted for "other purposes" of $1,366,072 include $1,065,938 for smoking cessation and other health-related programs, $100,579 for the Federal Help America Vote Act and $199,555 for a variety of specific restricted purposes. 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, 2004, governmental activities reported an unrestricted net assets deficit of $228,981. Business-type activities reported an unrestricted net assets deficit of $47,849 at June 30, 2004 (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 Workers' 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 **Motor License Fund**, a Special Revenue Fund, reports a reservation of $220 million for an advance to the MCARE Fund, an Agency Fund.

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 $1,062,185 at June 30, 2004. This amount consists of $501,901 reserved in the **General Fund**, $429,322 for restricted revenue and $72,579 for continuing programs; $662 reserved in the **Motor License Fund** for transportation-related programs; $493,033 reserved in the **Tobacco Settlement Fund** for various health-related programs; and $66,589 reserved in nonmajor Funds for the following programs: (amounts in thousands):

Land reclamation and other mining operations	$ 32,261
Pharmaceutical assistance	4,359
Recreation	1,941
Conservation, recycling and economic development	5,128
Workers compensation	13,659
Hazardous materials response/activities	5,747
Total nonmajor Special Revenue programs	63,095
General State Authority maintenance in the Capital Facilities Fund	1,857
Land and water reclamation	1,637
Total nonmajor Capital Projects programs	3,494
Total nonmajor funds other reservations	$ 66,589

NOTE C – NET ASSETS/FUND EQUITY (continued)

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, 2004 the Commonwealth has included the following amounts as "Designated—Other" for the **General Fund** (amounts in thousands):

General Fund:	
Group medical and life insurance	$ 191,010
Job creation tax credits	49,999
Judicial computer system	79,555
Agency construction projects	93,246
Other	7,605
Total **General Fund**	$ 421,415

Governmental Fund Balance Deficits: Individual funds have reported fund balance deficits in governmental funds balance sheets. The Vocational Rehabilitation Fund and the State Racing Fund, both Special Revenue Funds, reported a fund balance deficit of $3,061 and $490 at June 30, 2004 (amounts in thousands).

The Capital Facilities Fund, a Capital Projects Fund, reported a deficit unreserved/undesignated fund balance of $368,271 at June 30, 2004. In total, the Capital Facilities Fund reported a fund balance of $343,132 at June 30, 2004. The Land and Water Development Fund, a Capital Projects Fund, reported a deficit unreserved/undesignated fund balance of $24 at June 30, 2004. Total Capital Projects Funds reported reservations for encumbrances of $748,105; other reservations of $3,494; designations for Capital Projects of $96,787; and a deficit unreserved/undesignated fund balance of $368,295; for total combined fund balances of $480,091 at June 30, 2004 (amounts in thousands).

Proprietary Fund Net Assets: Nonmajor funds reported total restricted net assets for "other purposes" of $403,527 at June 30, 2004 for the following programs: economic development loans, $197,853; emergency services loans, $121,182; mine subsidence insurance, $40,280; liquor control, $25,256; vocational rehabilitation, $10,325; and $8,631 for other programs (amounts in thousands).

The **Tuition Payment Fund**, an Enterprise Fund, reported an unrestricted net assets deficit of $47,849 at June 30, 2004. The Purchasing Fund, an Internal Service Fund, reported an unrestricted net assets deficit of $15,019 at June 30, 2004 (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.

As of June 30, 2004, the Treasury Department manages the Treasury Investment Program (TIP). Practically all Commonwealth Funds of the primary government 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. The TIP investment pool structure invests in both domestic equity securities and domestic fixed income securities to achieve the investment objects of the funds of the Treasury Investment Program. Asset allocation targets between equity securities and fixed income securities are established in order to meet these overall objectives.

The Treasury Investment Program consists of two types of pools, currently known as The Common Investment Pool and the Treasury Liquid Asset Pool.

The Common Investment Pool consists of three portfolios as follows: The Short-Term Diversified Portfolio which is comprised of domestic fixed income investments in a Short-Term Funds segment and a 2 Year Duration Target segment; the Extended Term Diversified Portfolio which consists of domestic fixed income, including high yield, and domestic equity investments; and the Discretionary Assets Portfolio which includes certain economically targeted investments deemed appropriate by the State Treasurer.

The Treasury Liquid Asset Pool is made up of a Short-Term Funds segment and a 1.5 Year Duration segment, both consisting of domestic fixed income investments.

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, 2004 (amounts in thousands).

Primary Government

	Category 1	Category 2	Category 3	Total Bank Balance	Carrying Amount
Cash	$ 338,875	-	$ 7,405	$ 346,280	$ 322,411
Cash with fiscal agents	853,444	-	46,013	899,457	899,457
Certificates of deposit and related items	141,642	252	12,882	154,776	154,776

The bank balance for cash does not include $215,570 in available cash resulting from 'float' for outstanding checks at June 30, 2004, 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 $2,463, $92 and $48,515 respectively, of cash at June 30, 2004. Agency Funds reported $46,013 of cash with fiscal agents at June 30, 2004. These amounts are not included in the Statement of Net Assets. The above-listed $154,776 in certificates of deposit and related items is reported as part of primary government temporary investments at June 30, 2004 (amounts in thousands).

Discretely Presented Component Units

	Category 1	Category 2	Category 3	Total Bank Balance	Carrying Amount
Cash	$ 106,901	$ 1,898	$ 146,473	$ 255,272	$ 240,212

Fiduciary component units reported $7,164 of cash at their fiscal years ended December 31, 2003. These amounts are not included in the Statement of Net Assets. Additionally, component unit organizations of the State System of Higher Education reported $68,574 of cash at June 30, 2004 (amounts in thousands).

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, 2004 (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, 2004.

Commercial paper ($83,674 is Category 3)	$ 355,641
Common and preferred stocks ($152,671 is Category 3)	8,825,820
Corporate bonds and notes ($419,843 is Category 3)	3,667,365
International fixed income ($11,872 is Category 3)	671,326
International equities	44,590
Mortgage loans	133,615
Real estate	442,638
Repurchase agreements ($314,927 is Category 3)	3,012,024
State and municipal obligations ($7,699 is Category 3)	598,628
U.S. Treasury obligations ($201,997 is Category 3)	473,324
U.S. Government agency obligations ($240,341 is Category 3)	2,779,256
Total categorized investments	21,004,227
Investments not susceptible to credit risk categorization:	
Securities lent by the **State Lottery Fund** at June 30, 2004	2,911
Investments held by the **Tuition Payment Fund** at June 30, 2004:	
Mortgage loans	12,201
Securities lent	151,662
Treasury Department global pool	65,625
Investments owned by the Deferred Compensation Fund at December 31, 2003:	
Money market funds	31,287
Mutual funds	1,174,789
Investments owned by the State Employes' Retirement System (SERS) at December 31, 2003:	
Treasury Department global pool	465,247
Mortgage loans	72,289
Mutual funds	3,123,620
Short-term investment funds	312,780
Venture capital	9,031,708
Securities lent by the SERS at December 31, 2003:	
Common and preferred stocks	572,199
Corporate bonds and notes	360,767
International fixed income	46,619
U.S. Government agency obligations	13,794
U.S. Treasury obligations	528,030
Investments owned by the Statutory Liquidator Fund at June 30, 2004:	
Annuities	1,776
Money market funds	141,322
Mortgage loans, partnership interests and subsidiaries	685
Treasury Department global pool	78,731
Subtotal forwarded to next page	$ 37,192,269

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

Subtotal forwarded from previous page	$ 37,192,269
Investments of the Underground Storage Tank Indemnification Fund at June 30, 2004:	
Securities lent	26,505
Treasury Department global pool	3,242
Investments of the Worker's Compensation Security Trust Fund at June 30, 2004:	
Securities lent	93,668
Treasury Department global pool	31,814
Investments owned by the **State Workers' Insurance Fund** at December 31, 2003:	
Securities lent	713,566
Treasury Department global pool	46,527
Investments owned by the **Tobacco Settlement Fund** at June 30, 2004:	
Short-term investment funds	24,024
Venture capital-limited partnerships	8,853
Investments owned by the Treasury Common Investment Pool at June 30, 2004:	
Money market funds	272,377
Securities lent	2,231,567
Mutual funds owned by the Tuition Assistance Investment Fund at June 30, 2004	138,943
Subtotal	$ 40,783,355
Certificates of deposit and related items	154,776
Securities lending collateral reported by participating Funds	4,685,490
Amount financially reported by discretely presented component units in Pennsylvania Treasury Common Investment Pool at June 30, 2004	(454,084)
Total primary government temporary and long-term investments	$ 45,169,537

The above-listed $154,776 in certificates of deposit and related items is financially reported as part of temporary investments at June 30, 2004, but are treated as deposits for a determination of the level of credit risk associated with them. Fiduciary funds reported $30,961,557 and non-fiduciary funds reported $14,207,980 of the above $45,169,537 of total primary government investments at June 30, 2004. Non-fiduciary funds reported temporary and long-term investments, respectively, of $11,116,091 and $3,091,889 at June 30, 2004 (amounts in thousands). Primary government fiduciary funds investments are not reported in government-wide financial statements.

The State Employees' Retirement System owns 72 percent of the common and preferred stocks, over 51 percent of the corporate bonds and notes, over 92 percent of the international fixed income, over 46 percent of the U.S. Government agency obligations, 100 percent of the real estate, over 67 percent of the Treasury Department global pool, over 33 percent of the securities lending collateral, over 33 percent of the mortgage loans, and over 70 percent of the mutual fund investments disclosed in the above summary. The Treasury Common Investment Pool owns 74 percent of the commercial paper, over 27 percent of the corporate bonds and notes, over 65 percent of the repurchase agreements and over 27 percent of the U.S. Government agency obligations. The **Tobacco Settlement Fund** owns 100 percent of the international equities. The Deferred Compensation Fund owns over 26 percent of the mutual fund investments.

At December 31, 2003 and during the year then ended the **State Workers' Insurance Fund** owned more equity securities than allowed by applicable statutory authority. Based on the reported book value of all assets at December 31, 2003, the excess amounted to $35.5 million of equity investments at cost. The cost value of long term equity investments amounted to $140.1 million at December 31, 2003. The cost value of short term equity investments in Treasury's short-term investment pool amounted to $8.4 million at December 31, 2003. Statutory remedy for this condition, which remained at February 18, 2005, is being pursued.

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.

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

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, 2003, the SERS had contracts to purchase foreign currencies for a total notional amount of $4,450,498 and contracts to sell foreign currencies for a total notional amount of $4,296,531 for a total notional amount of $8,747,029. The net unrealized loss on foreign currency contracts was approximately $40,845 at December 31, 2003 (amounts in thousands).

Futures contracts are standardized, exchange-traded contracts to purchase or sell a specific financial instrument at a predetermined price. Gains/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, 2003 is as follows:

	Buy Contracts	Sell Contracts
Eurodollar futures	$ -	$ 9,631
Euro bond futures	59,491	24,399
Japan bond futures	42,462	-
Treasury futures	119,114	119,683
S&P futures	272,652	-

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, 2003 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 2003, 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 2003, 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, 2004 through March 23, 2005.

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

	Notional value	Receivable/(Payable)
Goldman Sachs Commodity Index	$ 479,324	$ 29,841
Interest rate	-	-
S&P 500 Total Return Index	4,315,510	264,408

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.

Investment Commitments: At December 31, 2003, the System had contractual commitments totaling approximately $2.5 billion to fund future alternative investments and $181 million to fund future real estate investments.

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	$ -	$ 114,993	$ -	$ 114,993
Commercial paper	-	170,951	-	170,951
Common and preferred stocks	17,246,856	1,316	-	17,248,172
Corporate bonds and notes	3,109,639	158,661	118,110	3,386,410
Guaranteed investment contracts	100,031	-	-	100,031
International equities	7,076,125	-	-	7,076,125
International fixed income	1,362,950	-	-	1,362,950
Mortgage-backed securities	4,605,426	77,937	-	4,683,363
Repurchase agreements	96,997	80,639	32,511	210,147
State and municipal obligations	-	32,685	-	32,685
U.S. Treasury obligations	58,890	620,386	4,624	683,900
U.S. Government agency obligations	790,624	275,680	173,743	1,240,047
Various short-term investments	663,643	-	4,029	667,672
Total categorized investments	$ 35,111,181	$1,533,248	$ 333,017	$ 36,977,446

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, 2004	24,432
Securities lending collateral	6,505
Investments owned by the Pennsylvania Housing Finance Agency at June 30, 2004:	
Investment agreements	307,966
Mutual funds	73,644
Money market funds	391,856
Investments owned by the Pennsylvania Higher Education Assistance Agency at June 30, 2004:	
Guaranteed investment contracts	112,171
Investment agreements	176,663
Money market funds	133,693
Pennsylvania Treasury Common Investment Pool	42,760
Investments owned by the Pennsylvania Infrastructure Investment Authority in	
Pennsylvania Treasury Common Investment Pool at June 30, 2004	379,356
Guaranteed investment contracts owned by the	
Pennsylvania Turnpike Commission at May 31, 2004	247,930
Investments owned by the Public School Employees' Retirement System at June 30, 2004:	
Invested with Pennsylvania Treasury Department	2,664,990
Mutual funds	639,474
Private debt	1,314,044
Private equity	3,004,550
Real estate	2,209,767
Securities lending collateral	4,505,428
Securities lending investments	4,374,160
Venture capital	366,259
Investments owned by the State Public School Building Authority in	
Treasury INVEST Program at June 30, 2004	13,541
Investments owned by the Port of Pittsburgh Commission in Pennsylvania	
Treasury Common Investment Pool at June 30, 2004	2,065
Mutual funds and other investments owned by the State System of Higher Education and by its	
component units at June 30, 2004	218,036
Investments owned by the Patient Safety Trust Authority at June 30, 2004:	
Pennsylvania Treasury Common Investment Pool	5,470
Securities lending collateral	1,487
Total temporary and long-term investments	$58,193,693

The total amount reported by discretely presented component units in the Pennsylvania Treasury Common Investment Pool is $454,084 at June 30, 2004; Common Investment Pool disclosures are included as part of Primary Government investment

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

disclosures. Of the $58,193,693 in total temporary and long-term investments, non-fiduciary component units reported $1,683,495 in temporary investments and $2,672,585 in long-term investments; fiduciary component units reported $8,117,515 in temporary investments and $45,720,098 in long-term investments at June 30, 2004 (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, 89 percent of the corporate bonds and notes, 100 percent of the international equities, 100 percent of the international fixed income, over 98 percent of the mortgage-backed securities and 100 percent of the real estate investments included in the above summary. The Pennsylvania Turnpike Commission owns 54 percent of the guaranteed investment contracts, 76 percent of the state and municipal obligations and 89 percent of the U.S. Treasury obligations. The State System of Higher Education owns 100 percent of the commercial paper and 100 percent of the asset-backed securities. There were no violations of statutory authority or contractual provisions for investments during the fiscal year ended June 30, 2004.

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, 2004 (in thousands):

Futures contracts – long	$ 6,307,135
Futures contracts – short	2,316,670
Foreign exchange forward and spot contracts, gross	2,671,009
Options – calls purchased	58,171
Options – puts purchased	-
Options – calls sold	58,691
Options – puts sold	25,791

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 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, 2004 represent a restriction on the amount of assets available as of year-end to use for other purposes.

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

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 $2,671,009,000 of foreign currency contracts outstanding at June 30, 2004 consists of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of $1,757,164,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of $913,845,000. The $2,792,438,000 of foreign currency contracts outstanding at June 30, 2003 consists of "buy" contracts of $1,766,479,000 and "sell" contracts of $1,025,959,000. The unrealized (loss) / gain on contracts of ($144,000) at June 30, 2004 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, 2004 is $1,903,901,000.

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 Citigroup Financial Products, Inc. (counterparty) in connection with the planned refunding of the Series 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. Effective July 10, 2003, the counterparty exercised its right under the Swaption. Under the Swap, commencing on September 1, 2003 and ending on September 1, 2020, the Authority began paying a fixed rate of interest of 5.19% on the notional amount of the Series 2003 refunding Lease Revenue Bonds then outstanding to the counterparty, 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 Series 2003 Lease Revenue Bonds unless certain events occur which would permit the counterparty to pay an alternate floating rate of interest, as defined. The notional amount as to which the floating and fixed rates of interest are computed is initially $53,900,000 and will be amortized at the same time and in the same amounts as the principal amortization of the Series 2003 Bonds.

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 with 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 6, 2004. This transaction monetizes the call option embedded within the 1994 Economic Development Revenue Bonds as of the execution date. Effective January 6, 2004, J.P. Morgan exercised their option which requires 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, 2004, which is $14,308,021. 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 July 2003, the Commission entered into two 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 2003 Series C Oil Company Franchise Tax Revenue Bonds with two 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 $160 million at May 31, 2004. The $160 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.

Following is a summary of the swaps in place as of May 31, 2004. 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)	4.214%	$ (8,471,500)
	42,455,000	12/01/2019			(2,823,900)
	72,066,250	12/01/2030	67% of 1 mo. LIBOR (1)	4.403%	(7,728,200)
Series A 2002	144,070,000	12/01/2030			(15,449,700)
	72,066,250	12/01/2030			(7,728,200)
	32,921,250	12/01/2012	BMA (2)	4.538%	(1,640,200)
Series B 2002	65,842,500	12/01/2012			(3,280,400)
	32,921,250	12/01/2012			(1,640,200)
	48,000,000	12/01/2032	63% of 1 mo. LIBOR (1)	3.838%	
Series C 2003			plus 20 basis points		(1,936,000)
	112,000,000	12/01/2032			(829,700)
Total	$749,707,500				$ (51,528,000)

(1) 1 month LIBOR was 1.11375% at May 31, 2004
(2) BMA was 1.06% at May 31, 2004

- **Credit Risk** – As of May 31, 2004, 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. Government Agency Securities. The Commission had five counterparties at May 31, 2004. The credit ratings of the swap providers as of May 31, 2004 were AAA to AA- and Aaa to Aa3 to Standard and Poor's and Moody's, respectively.

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

- **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. The underlying variable rates for the Commission's 2003 Series C bonds are based on auction rates. The auction rates approximate BMA. The Series C swaps, with a combined notional value of $160 million, are based on a percentage of LIBOR plus 20 basis points. Therefore, the Commission is exposed to basis risk to the extent auction rates exceed 63% of one month LIBOR plus 20 basis points.

- **Termination Risk** – The swap document may be terminated due to a number of circumstances and the Commission retains the option to terminate the swaps 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, 2004 (December 31, 2003 for the **State Workers' Insurance Fund (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, 2004 (December 31, 2003 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
State Lottery Fund……………………………….	$ 2,911	$ 2,911	$ -	$ -	$ -
State Workers' Insurance Fund………………	713,566	583,847	112,324	10,906	6,489
Tuition Payment Fund…………………………...	151,662	75,638	27,762	7,104	41,158
Workers' Compensation Security Trust Fund….	93,668	46,543	13,436	17,331	16,358
State Employees' Retirement System....................	1,521,409	528,030	13,794	407,386	572,199
Public School Employees' Retirement System	4,374,160	-	1,716,711	628,242	2,029,207
Underground Storage Tank Indemnification Fund	26,505	13,855	3,566	2,425	6,659

At June 30, 2004 the Treasury Common Investment Pool (TIP) lent $2,231,567 in securities; the related cash collateral received was $2,298,975. On a pro-rata basis, TIP participants collectively reported cash collateral of $2,150,220 as part of temporary investments and related securities lending obligation of $2,150,220 associated with TIP securities lending balances at June 30, 2004. The composition of the lent securities of $2,231,567 was: U.S. Treasury obligations, $982,831; U.S. government agencies, $946,032; corporate bonds and notes, $48,730; and common and preferred stocks, $253,974 (in thousands).

NOTE E – CAPITAL ASSETS

A summary of capital assets by category at June 30, 2004 is as follows (amounts in thousands):

	Primary Government				Discretely Presented Component Units
	Governmental Activities			Business-Type Activities	
	General Capital Assets	Internal Service Funds	Total Governmental Activities	Enterprise Funds	
Land	$ 309,350	$ 6	$ 309,356	$ 323	$ 161,560
Highway right-of-way	1,104,800	-	1,104,800	-	-
Buildings	4,027,740	4,063	4,031,803	30,545	1,708,579
Improvements other than buildings	453,439	326	453,765	-	184,968
Machinery and equipment	602,578	91,467	694,045	62,970	578,165
Library books and other	-	-	-	-	161,962
Turnpike infrastructure	-	-	-	-	3,789,194
Highway infrastructure	14,940,848	-	14,940,848	-	-
Bridge infrastructure	6,324,884	-	6,324,884	-	-
Waterway infrastructure	1,705	-	1,705	-	-
Other infrastructure	4,509	-	4,509	-	-
Construction in progress	1,184,622	-	1,184,622	7,827	685,032
Highway and bridge construction in progress	1,661,900	-	1,661,900	-	-
Total	$ 30,616,375	$ 95,862	$ 30,712,237	$ 101,665	$ 7,269,460

Changes in general capital assets for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Non-Depreciable General Capital Assets:				
Land	$ 297,855	$ 12,664	$ 1,169	$ 309,350
Highway right-of-way	1,027,800	77,000	-	1,104,800
Construction in progress	1,159,378	176,487	151,243	1,184,622
Transportation construction in progress	1,875,700	1,461,700	1,675,500	1,661,900
Subtotal	4,360,733	1,727,851	1,827,912	4,260,672
Depreciable General Capital Assets:				
Buildings	3,949,138	138,573	59,971	4,027,740
Improvements other than buildings	412,780	44,143	3,484	453,439
Machinery and equipment	583,086	58,619	39,127	602,578
Highway infrastructure	13,814,760	1,126,088	-	14,940,848
Bridge infrastructure	5,758,394	566,490	-	6,324,884
Waterway infrastructure	1,700	5	-	1,705
Other infrastructure	8,614	-	4,105	4,509
Subtotal	24,528,472	1,933,918	106,687	26,355,703
Total general capital assets	$ 28,889,205	$ 3,661,769	$ 1,934,599	$ 30,616,375

NOTE E – CAPITAL ASSETS (continued)

Changes in general capital assets accumulated depreciation for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Buildings	$ 1,715,971	$ 85,893	$ 36,496	$ 1,765,368
Improvements other than buildings	171,725	12,374	629	183,470
Machinery and equipment	308,425	39,924	32,845	315,504
Highway infrastructure	5,784,706	574,523	-	6,359,229
Bridge infrastructure	1,164,862	120,742	-	1,285,604
Waterway infrastructure	30	-	30	-
Other infrastructure	1,572	307	-	1,879
Total accumulated depreciation	$ 9,147,291	$ 833,763	$ 70,000	$ 9,911,054

Depreciation expense, by function, related to general capital assets for the fiscal year ended June 30, 2004 is as follows (amounts in thousands):

Direction and supportive services	$ 18,388
Protection of persons and property	53,637
Public education	19,874
Health and human services	11,949
Transportation	723,190
Recreation and cultural enrichment	6,725
Total depreciation expense	$ 833,763

Changes in Internal Service funds capital assets for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Non-Depreciable Capital Assets:				
Land	$ 6	$ -	$ -	$ 6
Subtotal	6	-	-	6
Depreciable Capital Assets:				
Buildings	3,997	66	-	4,063
Improvements other than buildings	291	35	-	326
Machinery and equipment	95,034	5,960	9,527	91,467
Subtotal	99,322	6,061	9,527	95,856
Total Internal Service fund capital assets	$ 99,328	$ 6,061	$ 9,527	$ 95,862

NOTE E – CAPITAL ASSETS (continued)

Changes in Internal Service fund capital assets accumulated depreciation for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Buildings	$ 1,896	$ 114	$ -	$ 2,010
Improvements other than buildings	435	15	218	232
Machinery and equipment	48,215	10,406	7,114	51,507
Total accumulated depreciation	$ 50,546	$ 10,535	$ 7,332	$ 53,749

Changes in Enterprise fund capital assets for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Non-Depreciable Capital Assets:				
Land	$ 323	$ -	$ -	$ 323
Construction in progress	6,708	1,119	-	7,827
Subtotal	7,031	1,119	-	8,150
Depreciable Capital Assets:				
Buildings	25,727	4,818	-	30,545
Machinery and equipment	71,243	2,574	10,847	62,970
Subtotal	96,970	7,392	10,847	93,515
Total Enterprise fund capital assets	$ 104,001	$ 8,511	$ 10,847	$ 101,665

Changes in Enterprise fund capital assets accumulated depreciation for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Retirements	Balance June 30, 2004
Buildings	$ 11,047	$ 2,562	$ 2,017	$ 11,592
Machinery and equipment	50,533	5,615	12,002	44,146
Total accumulated depreciation	$ 61,580	$ 8,177	$ 14,019	$ 55,738

NOTE E – CAPITAL ASSETS (continued)

Construction in progress included in general capital assets at June 30, 2004 includes project information as follows (amounts in thousands):

	Project Authorization	Amounts Expended but not Capitalized at June 30, 2004	Authorization Available
Capitol Complex	$ 686,357	$ 328,521	$ 357,836
Department of Corrections Institutions	625,891	477,193	148,698
Educational Institutions	306,452	93,104	213,348
State Parks and Forests	125,172	76,654	48,518
State-wide Radio Project	109,596	99,130	10,466
Veterans Homes and Military Armories	57,142	20,931	36,211
Department of Public Welfare Institutions	52,458	10,181	42,277
Transportation Facilities	48,357	19,908	28,449
Historical and Museum Commission Facilities	46,357	19,336	27,021
State Police Facilities	43,327	26,919	16,408
Agriculture Facilities	8,735	8,099	636
Other	8,225	4,646	3,579
Total	$ 2,118,069	$ 1,184,622	$ 933,447

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, 2004 the amount of general capital assets related to the initial 1986 valuation amounts to $1,691 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 $904,234 of the **Tuition Payment Fund**, an Enterprise Fund, at June 30, 2004, 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, 2004 actuarial analysis includes the effects of a minor change in assumptions for expenses from the June 30, 2003 analysis. Per-unit tuition credit expense continues to decline as the Program expands. The per-unit credit expense assumption was increased from 38 to 51 cents. The effect of this change decreased 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 Workers' 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 discount rate of 2.5 and 4.0 percent at December 31, 2003 and 2002, respectively. One of the effects of the lower 2003 discount rate was a significant increase in the reported liability. 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, 2003 and 2002, the following summary provides information on prior year reported insurance loss liability, incurred claims and payments, and current year reported insurance loss liability.

Year Ended	Prior Year	Incurred Claims		Payments		Current Year
December 31	Liability	Current	Prior	Current	Prior	Liability
2003	$1,039,532	$ 246,883	$ 123,183	$ 41,335	$ 139,715	$1,228,548
2002	$1,032,506	$ 205,952	$ (41,264)	$ 31,034	$ 126,628	$1,039,532

Additionally, nonmajor Enterprise funds reported $847 of insurance loss liability at June 30, 2004 (amounts in thousands).
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NOTE G - TAXES, LOANS AND LEASE RENTALS RECEIVABLE

Taxes Receivable: Taxes receivable at June 30, 2004 consisted of the following (amounts in thousands):

Statement of Net Assets	Governmental Activities
Sales and use	$ 996,616
Personal income	521,394
Corporation	740,424
Liquid fuels	151,996
Inheritance	427,063
Cigarette	57,046
Other	29,529
Total	$ 2,924,068

Governmental activities taxes receivable includes $808,359 expected to be collected after June 30, 2005 (amounts in thousands).

	Fund Balance Sheets			
	General	Motor License	Nonmajor Governmental Funds	Fiduciary Funds
Sales and use	$ 996,616	$ -	$ -	$ 14,658
Personal income	521,394	-	-	-
Corporation	740,424	-	-	-
Liquid fuels	-	151,996	-	5
Inheritance	427,063	-	-	-
Cigarette	57,046	-	-	-
Other	4,749	-	24,780	-
Total	$ 2,747,292	$ 151,996	$ 24,780	$ 14,663

General Fund taxes receivable includes $808,359 expected to be collected after June 30, 2005 (amounts in thousands).

Loans Receivable: Loans receivable at June 30, 2004 consisted of the following (amounts in thousands):

	Primary Government		
	Governmental Activities	Business Type Activities	
	Special Revenue Funds	Enterprise Funds	Discretely Presented Component Units
Mortgage loans	$ -	$ -	$ 2,751,104
Student loans	-	-	4,929,352
Economic development loans	51,955	158,512	588,015
Drinking water, storm water and sewer system loans	10,499	-	1,454,002
Volunteer fire company loans	-	113,589	-
Other notes and loans	18,516	-	9,260
	80,970	272,101	9,731,733
Less: allowance for uncollectible amounts	41,166	35,874	221,794
Loans receivable, net	$ 39,804	$ 236,227	$ 9,509,939

Special Revenue funds report $34,672 in loans due after June 30, 2005 and the Enterprise funds report $191,739 in loans due after June 30, 2005. Discretely presented component units reported $8,576,487 in loans receivable due after June 30, 2005 (amounts in thousands).

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

The **General Fund** reported $6,283 in loans receivable for program objectives, of which $6,173 represents governmental activities lending and of which $4,715 is due after June 30, 2005. Agency Funds reported $3,676 in loans receivable to replace underground storage tanks, all of which are due after June 30, 2005 (amounts in thousands).

Lease Rentals Receivable: The Capital Facilities Fund, a Capital Projects fund, reports expenditure 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, 2004 the total remaining minimum lease payments to be received were $1.3 million, consisting of principal present value of $1.2 million and interest of $.1 million.

The Pennsylvania Industrial Development Authority, a discretely presented component unit, reported a lease rental receivable with total remaining minimum payments to be received of $27.0 million, consisting of principal present value of $19.7 million and interest of $7.3 million at June 30, 2004.

Minimum lease payments receivable for the five fiscal years succeeding June 30, 2004 are as follows (amounts in thousands):

Fiscal Year Ending June 30	Primary Government	Discretely Presented Component Units
2005.......................	$ 193	$ 634
2006.......................	194	2,923
2007.......................	193	5,212
2008.......................	194	5,212
2009......................	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, 2005 (amounts in thousands).

NOTE H – INTERNAL/INTERFUND BALANCES AND TRANSFERS

Internal Balances

In the Statement of Net Assets, reported internal balances assets/liabilities for governmental activities/business-type activities include $85 million borrowed between the **General Fund** and the State Stores Fund, an Enterprise Fund, at June 30, 2004 and differ because the **State Workers' Insurance Fund**, an Enterprise Fund, reports for its fiscal year ended December 31, 2003.

Interfund Balances

The composition of governmental and proprietary funds interfund balances reported at June 30, 2004 is as follows, with Major Fund titles in bold. Aggregate nonmajor governmental funds receivables from other funds and from component units, respectively, amount to $59,741 and $24,588; aggregate nonmajor enterprise funds receivables amount to $3,563 and $28; aggregate internal service funds receivables amount to $12,857 and $777 (amounts in thousands):

FUND TYPE/FUND PRIMARY GOVERNMENT	DUE FROM		DUE TO	
	OTHER FUNDS	COMPONENT UNITS	OTHER FUNDS	COMPONENT UNITS
General Fund	$ 31,710	$ 1,472	$ 73,884	$ 972
Special Revenue:				
Motor License Fund	5,332	340	35,798	6,874
Tobacco Settlement Fund	12,146	-	90	-
Hazardous Sites Clean-up Fund	-	-	2,897	-
State Racing Fund	-	-	7,110	-
Vocational Rehabilitation Fund	-	-	3,164	-
Pharmaceutical Assistance Fund	6,128	-	-	-
Agricultural Conservation Easement Fund	10,243	-	-	-
Public Transportation Assistance Fund	6,308	-	373	-
Other Funds	1,338	-	4,417	-
	41,495	340	53,849	6,874
Debt Service:				
Land and Water Development Sinking	3	-	-	-
	3	-	-	-
Capital Projects:				
Capital Facilities Fund	28,632	24,588	116	-
Keystone Recreation, Park and Conservation Fund	7,089	-	1,659	-
	35,721	24,588	1,775	-
Enterprise:				
Unemployment Compensation Fund	2,868	755	164	-
State Lottery Fund	-	-	222	-
Tuition Payment Fund	-	-	14	-
State Stores Fund	354	-	3,066	-
Rehabilitation Center Fund	3,047	-	26	-
Other Funds	162	28	983	-
	6,431	783	4,475	-
Internal Service:				
Purchasing Fund	7,118	771	412	-
Manufacturing Fund	5,739	6	54	-
	12,857	777	466	-
Fiduciary - Pension Trust:				
State Employees' Retirement System	1,226	-	-	-
	1,226	-	-	-
Total primary government	$ 129,443	$ 27,960	$ 134,449	$ 7,846

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

COMPONENT UNITS	DUE FROM Primary Government	DUE FROM Component Units	DUE TO Primary Government	DUE TO Component Units
Pennsylvania Turnpike Commission................	$ 6,660	$ -	$ -	$ -
Pennsylvania Infrastructure Investment Authority	-	108	10	-
	6,660	108	10	-
Fiduciary - Pension Trust:				
Public School Employees Retirement System .	2,850	-	1,154	-
Total component units....................................	$ 9,510	$ 108	$ 1,164	$ -

The amount of total reported interfund receivables of $167,021 does not agree with total reported interfund payables of $143,459 at June 30, 2004 due to different fiscal year ends and reporting differences for certain Funds included in the Fund Financial Statements at June 30, 2004. The amount reported for the Pennsylvania Turnpike Commission, a discretely presented component unit, is reported at its fiscal year ended May 31, 2004 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 Workers' Insurance Fund** and State Stores Fund, Enterprise Funds, are reported at their fiscal years ended December 31, 2003 and June 29, 2004. The following presents a reconciliation of interfund balances reported at June 30, 2004 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, 2004	$ 123,622
Due from fiduciary funds at June 30, 2004	5,821
Due from primary government at June 30, 2004..	9,510
Due from component units at June 30, 2004	28,068
Reported Interfund Receivables...	167,021
State Employees' Retirement System decrease in receivables from January 1, 2004 through June 30, 2004 (includes adjustment)..........................	(490)
Pennsylvania Turnpike Commission increase in receivables from June 1, 2004 through June 30, 2004...	214
Interfund receivables reported as accounts receivable by component units........	63
Interfund receivables recorded as tax receivables..	829
Interfund receivables reported as accounts receivable by Fiduciary Funds	7,439
Payroll accrual at June 30, 2004 – receivables attributable to State Employees' Retirement System and **State Workers' Insurance Fund**...............................	3,635
Adjustments	(11)
Reconciled Interfund Receivables	$ 178,700

Due to other funds at June 30, 2004	$ 122,552
Due to fiduciary funds at June 30, 2004	11,897
Due to primary government at June 30, 2004..	1,164
Due to component units at June 30, 2004	7,846
Reported Interfund Payables...	143,459

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

State Employees' Retirement System increase in payables from January 1, 2004 through June 30, 2004	2,685
Deferred Compensation Fund increase in payables from January 1, 2004 through June 30, 2004	7
Pennsylvania Turnpike Commission increase in payables from June 1, 2004 through June 30, 2004	372
State Workers' Insurance Fund increase in payables from January 1, 2004 through June 30, 2004	580
Interfund payables reported as accounts payable by component units	26,518
Interfund payables reported as accounts payable by Fiduciary Funds	5,079
Reconciled Interfund Payables	$ 178,700

Advances – Fund Financial Statements

At June 30, 2004 the **General Fund** reported Advances to Other Funds of $114,108. Specifically, this amount has been advanced as follows: $2,300 to the **State Workers' Insurance Fund** and $85,000 to the State Stores Fund, Enterprise Funds; $2,175 to the **Motor License Fund** and $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 Workers' Insurance Fund**, which reported an advance of $1,836 at its fiscal year ended December 31, 2003. At June 30, 2004 the Hazardous Sites Cleanup Fund, a Special Revenue Fund, 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 to the **General Fund** at June 30, 2004. The State Stores Fund, an Enterprise Fund, reported Advances to Other Funds of $500 to the **General Fund** at its fiscal year ended June 29, 2004. At June 30, 2004 the **Motor License Fund** has reported an advance to the MCARE Fund, an Agency Fund, in the amount of $220,000 (amounts in thousands); the MCARE Fund repaid the **Motor License Fund** during July 2004.

Advances – Statement of Net Assets

At June 30, 2004, governmental activities reports an other noncurrent asset of $220,000 related to a loan to the MCARE Fund, an Agency Fund, and reports an other financing obligation of $100,000 related to a loan from the Underground Storage Tank Indemnification Fund, an Agency Fund (amounts in thousands).

Transfers

A summary of transfers reported for the fiscal year ended June 30, 2004 is as follows, with Major Fund titles in bold. Aggregate nonmajor governmental fund transfers from other funds amount to $1,203,420 during June 30, 2004 and include a $370,000 transfer from the **State Lottery Fund** to the Pharmaceutical Assistance Fund. Aggregate nonmajor governmental transfers to other funds amount to $42,762. Aggregate nonmajor proprietary transfers from other funds and transfers to other funds, respectively, amount to $200 and $52,986 (amounts in thousands):

PRIMARY GOVERNMENT	Transfers In	Transfers Out
General Fund	$ 133,670	$ 775,732
Special Revenue:		
Tobacco Settlement Fund	-	34,531
Motor License Fund	-	61,279
Hazardous Sites Clean-up Fund	-	-
State Racing Fund	-	6,960
Vocational Rehabilitation Fund	38,083	-
Pharmaceutical Assistance Fund	399,557	-
Water Facilities Loan Fund	-	-
Environmental Stewardship Fund	15,000	15,851
Other Funds	22,417	19,751
	475,057	138,372

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

TRANSFERS (continued from previous page)

	Transfers In	Transfers Out
Debt Service:		
Land and Water Development Sinking Fund	400	-
Water Facilities Loan Redemption Fund	6,287	-
Capital Debt Fund	688,331	-
Local Criminal Justice Sinking Fund	7,431	-
Agricultural Conservation Easement Sinking Fund	4,446	-
Keystone Recreation, Park and Conservation Fund	3,156	-
Disaster Relief Redemption Fund	2,735	-
Pennsylvania Economic Revitalization Sinking Fund	1,652	-
Volunteer Company Loan Sinking Fund	1,388	-
Pennsylvania Infrastructure Investment Authority Redemption Fund	12,046	-
Other Funds	491	-
	728,363	-
Capital Projects:		
Capital Facilities Fund	-	-
Keystone Recreation, Park and Conservation Fund	-	200
	-	200
Enterprise:		
State Lottery Fund	-	370,000
State Stores Fund	-	51,986
Minority Business Development Authority Fund	200	-
Other Funds	-	1,000
	200	422,986
Total primary government	$1,337,290	$1,337,290

Total primary government governmental funds transfers between governmental funds of $914,504 have been eliminated in the Statement of Activities; total business-type activities transfers of $422,786 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	$ 28
Liquid Fuels Tax	**Motor License**	Legal/contractual	126
Land and Water Development	Land and Water Development Sinking	Legal/contractual	21
Remining Financial Assurance	Land and Water Development Sinking	Other than legal/contractual	112
PA Economic Revitalization	PA Economic Revitalization Sinking	Other than legal/contractual	3
Fire Insurance Tax	State Insurance	Legal/contractual	489

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. Generally, Commonwealth employees are members of the State Employees' Retirement System (SERS) and public school employees are members of the Public School Employees' Retirement System (PSERS). Both the SERS and the PSERS are reported as Pension Trust Funds, Fiduciary funds. 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, 2003 there were 106 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.

On December 10, 2003, Governor Rendell signed Act 2003-40 ("Act 40") into law. The significant provisions of the law were to change certain actuarial methods used to amortize the unfunded liabilities. The selection of actuarial methods has a significant impact in developing employer contribution rates. Immediately, Act 40 is expected to reduce employer contributions over a 10-year period by approximately $5 billion. Under Act 40, employer contribution rates are expected to climb from 2.0 percent of payroll at July 1, 2004 to approximately 8.8 percent at July 1, 2008; this compares to the contribution rates rising from 3.5 percent to 20.3 percent over the respective period under the previous 10-year amortization period.

NOTE I - RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS (continued)

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
2003	$ 55,079	123.4
2002	$ 22,906	221.9
2001	$ 52,104	147.2

At December 31, 2003, 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) consists 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, 2003, approximately $371 million, or 16.6 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 $1,068 million of high-yield bonds at December 31, 2003.

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, 2004 there were 733 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.

NOTE I - RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS (continued)

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.

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 and the Commonwealth pay the employer contribution equally to the PSERS; no Commonwealth reimbursement occurs.

Act 40 of 2003 amended the actuarial cost method in three areas that affect employer contribution rates. Act 40 changed the amortization period from 10 years to 30 years for: unfunded liabilities accrued as a result of Act 9 of 2001; outstanding balances of net actuarial losses the fiscal years ended June 30, 2001 and 2002; and net gains and losses in future years. Act 40 continued a 10-year amortization period for unfunded liabilities accrued prior to Act 9 of 2001; any future active member improvements; and any retiree cost-of-living adjustments. Finally, Act 40 established an employer contribution rate 'floor' of 4 percent, exclusive of the premium assistance contribution rate, beginning July 1, 2004.

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
2004	$ 321,091	100
2003	$ 20,831	100
2002	$ 539	100

At June 30, 2004, the PSERS disclosed that $115,900 of $214,599 (in thousands) of member receivables for purchases of service credit is due subsequent to June 30, 2005.

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.

Collective trust fund investments (CTF) consist primarily of domestic and international institutional 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. CTF are managed by state chartered banks for which various state banking departments have regulatory oversight and investment advisors for which the Securities and Exchange Commission has regulatory oversight.

NOTE I - RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS (continued)

Investment Concentration: At June 30, 2004, 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 $345 million for the fiscal year ended June 30, 2004. Approximately 98,000 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, 2004.

NOTE J - NOTES AND DEMAND REVENUE BONDS PAYABLE

Primary Government

During the fiscal year ended June 30, 2004, 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, 2004 and 2003, no short-term debt was outstanding. A noncurrent other financing obligation is reported as a governmental activities liability for $100,000 (in thousands) which is owed to the Underground Storage Tank Indemnification Fund, an Agency Fund, at June 30, 2004.

Discretely Presented Component Units

The Pennsylvania Higher Education Assistance Agency (PHEAA), a discretely presented component unit, has reported $4,240,778 of demand revenue bonds outstanding and $914,849 of notes payable, consisting of student loan financing of $728,619, capital financing of $74,000, term financings of $81,119 and lines of credit of $32,000, net of unamortized discount of $889 at June 30, 2004 as follows (amounts in thousands):

	Balance June 30, 2003	Additions	Reductions	Add: Remarketing	Balance June 30, 2004
Student loan demand revenue bonds due 2017-2044, at weighted average interest rates of 1.31 and 1.14 percent at June 30, 2004 and 2003, respectively	$3,471,000	$ 470,000	$ 25	$ 312,925	$4,253,900
Deferred amount on current refundings of student loan demand revenue bonds.…......	-	(2,526)	(799)	(11,395)	(13,122)
Total………………………………………	$3,471,000	$ 467,474	$ (774)	$ 301,530	$4,240,778
Notes payable:					
Student loan financing, due 2005-2008, at weighted average interest rates of 1.60 and 1.65 percent at June 30, 2004 and 2003, respectively…………………………...	$ 550,619	$ 453,000	$ 275,000	$ -	$ 728,619
Capital and other financing obligations:					
Capital financings, due 2005-2011 at weighted average interest rates of 6.09 and 6.23 percent at June 30, 2004 and 2003, respectively……………..……………..	76,592	1,116	3,708	-	74,000
Term financings, due 2005-2031, at weighted average interest rates of 5.17 and 5.22 percent at June 30, 2004 and 2003, respectively……...	87,022	-	5,903	-	81,119
Lines of credit, due on demand at weighted average interest rates of 3.01 and 3.47 percent at June 30, 2004 and 2003, respectively	46,000	10,000	24,000	-	32,000
Subtotal	$ 760,233	$ 464,116	$ 308,611	$ -	$ 915,738
Less: unamortized discount	(956)	-	(67)	-	(889)
Total notes payable.......................................	$ 759,277	$ 464,116	$ 308,544	$ -	$ 914,849

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

The note and bond indentures, among other things, require the 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 the PHEAA on demand of the bondholders upon seven days prior irrevocable written notice. Under the irrevocable letters of credit, 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 2004 through 2010. The PHEAA is required to pay annual commitment fees ranging from 18 to 33 basis points on the stated amount of the letter of credit coverage. At June 30, 2004 total letter of credit coverage was $1.5 billion.

All student loan financing notes payable, student loan demand revenue bonds payable and student loan revenue bonds payable are collateralized by student loans and investments. At June 30, 2004, $5.0 billion of debt is collateralized by $4.9 billion of student loan principal and related interest receivable, and $303.8 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, 2004 the PHEAA had $139 million of available credit under student loan financing arrangements and $23 million available under other lines of credit.

Debt service requirements subsequent to June 30, 2004, based upon stated maturities of notes payable, bonds payable and other financings and obligations are as follows (amounts in thousands):

	Student Loan Bonds and Notes		Capital and Other Financings	
Year of Maturity	Principal	Interest	Principal	Interest
2005…………………	$ 141,709	$ 65,496	$ 47,934	$ 8,030
2006…………………	-	55,819	3,570	7,571
2007…………………	586,910	55,819	3,235	7,289
2008…………………	-	55,819	3,385	7,116
2009…………………	-	55,819	3,330	6,956
2010-14……………..	-	279,094	74,735	20,269
2015-19……………..	538,900	270,503	9,380	12,566
2020-24……………..	445,000	245,433	16,160	9,202
2025-29……………..	600,000	215,335	20,625	4,834
2030-34……………..	150,000	185,386	4,765	451
2035-39……………..	470,000	173,568	-	-
2040-44……………..	2,050,000	79,947	-	-
Total……………..	$ 4,982,519	$1,738,038	$ 187,119	$ 84,284

	Student Loan Bonds and Notes	Capital and Other Financings
Reported as:		
Demand revenue bonds payable…………….	$ 4,240,778	-
Notes payable -current………………………	141,709	-
Notes payable - noncurrent………………….	586,910	
Deferred amount on current refundings……..	13,122	-
Other financing obligations………………….	-	$ 186,230
Unamortized discount……………………….	-	889
Total………….. .. ……………………….	$ 4,982,519	$ 187,119

The PHEAA has $5.0 billion of student loan bonds and notes that are variable-rate debt, of which $1.4 billion resets based upon auctions every seven days, $2.2 billion resets based upon auctions every 28 days, $620 million resets based upon auctions every 35 days, $586.9 million is indexed to 91-day Treasury bills, and the remaining $141.7 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.

Additionally, the Philadelphia Regional Port Authority respectively reported current and non-current notes payable of $216 and $3,384 (in thousands) at June 30, 2004; the State System of Higher Education and the Port of Pittsburgh Commission, respectively, reported other financing obligations of $52,058 and $2,000 (in thousands) at June 30, 2004.

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

Long-term obligations of the Commonwealth's governmental activities at June 30, 2004 and changes for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

GENERAL LONG-TERM OBLIGATIONS	Issue Dates	Interest Rates	Maturity Dates Through	Bonds Authorized But Unissued	Balance July 1, 2003	Additions	Reductions	Balance June 30, 2004
General Obligation Bonds Payable From Tax Revenues:								
Capital Facilities	1992-04	3.12-6.60%	2024	$ 44,995,497	$ 4,611,525	$ 622,500	$ 437,080	$ 4,796,945
Disaster Relief	2000-01	4.60- 5.56%	2021	105,908	21,625	-	9,605	12,020
Land and Water Development	1992	6.02%	2012	300	2,260	-	505	1,755
Nursing Home Loan Development	-	-	-	31,000	-	-	-	-
Volunteer Companies Loan	1992-98	4.84-6.02%	2018	50,000	9,010	-	2,350	6,660
Vietnam Conflict Veterans Compensation	-	-	-	3,000	480	-	480	-
Water Facilities Loan	1992-97	5.00- 6.02%	2017	11,500	30,725	-	10,710	20,015
Pennsylvania Economic Revitalization	1992-95	5.12- 6.02%	2015	14,000	6,065	-	1,855	4,210
Pennsylvania Infrastructure Investment Authority	1992-01	4.62- 6.02%	2021	267,000	81,255	-	27,215	54,040
Agricultural Conservation Easement Purchase	1992-98	4.47- 6.60%	2018	-	23,405	-	3,740	19,665
Local Criminal Justice	1994-04	3.86-6.60%	2024	5,500	24,725	2,500	10,745	16,480
Keystone Recreation, Park and Conservation	1994-98	4.84- 6.60%	2018	-	20,630	-	6,540	14,090
Refunding Bonds	1992-04	2.64-5.73%	2017	-	1,969,136	460,838	422,410	2,007,564
Total principal				45,483,705	6,800,841	1,085,838	933,235	6,953,444
Unamortized premium on bonds issued				-	254,261	88,007	14,442	327,826
Unamortized deferred net refunded loss				-	(24,483)	(34,786)	(3,165)	(56,104)
Total general obligation bonds payable				45,483,705	7,030,619	1,139,059	944,512	7,225,166
Other General Long-Term Obligations Payable From Tax and Other Revenues:								
Installment Purchase Obligations	-	-	-	-	10,449	653	3,949	7,153
Capital Lease Obligations	-	-	-	-	51,682	882	5,766	46,798
Self-Insurance—Note M *	-	-	-	-	760,490	152,371	97,353	815,508
Compensated Absences *	-	-	-	-	740,255	382,013	429,383	692,885
Catastrophic Motor Vehicle Losses	-	-	-	-	123,215	-	10,066	113,149
Other	-	-	-	-	445,352	386,220	132,401	699,171
Subtotal				-	2,131,443	922,139	678,918	2,374,664
TOTAL GENERAL LONG-TERM OBLIGATIONS				$ 45,483,705	$ 9,162,062	$ 2,061,198	$ 1,623,430	$ 9,599,830

* The estimated current portion of self-insurance and compensated absence liabilities, respectively, is $93,144 and $113,781.

Revenue bond obligations of discretely presented component units at June 30, 2004 (May 31, 2004 for the Pennsylvania Turnpike Commission) and changes for the fiscal year then ended are as follows (amounts in thousands):

REVENUE BONDS PAYABLE	Issue Dates	Interest Rates	Maturity Dates Through	Bonds Authorized But Unissued	Balance July 1, 2003	Additions	Reductions	Balance June 30, 2004
Pennsylvania Higher Education Assistance Agency	-	-	-		$ 387,925	$ -	$ 387,925	$ -
Philadelphia Regional Port Authority	2003	Variable	2021		50,605	53,900	53,805	50,700
Pennsylvania Housing Finance Agency	1982-04	1.15-10.88%	2034		3,075,311	883,665	988,332	2,970,644
Pennsylvania Industrial Development Authority	1994-04	4.00-7.00%	2021		531,810	99,150	131,030	499,930
Pennsylvania Turnpike Commission	1998-03	2.50-5.60%	2041		2,130,550	482,685	386,360	2,226,875
Pennsylvania Infrastructure Investment Authority	1990-03	4.10-6.00%	2014		132,630	21,590	41,825	112,395
					6,308,831	1,540,990	1,989,277	5,860,544
Less: Bond discounts/(premiums)	-	-	-		(372)	6,176	18,201	(12,397)
Deferred costs of refunding	-	-	-		31,581	13,140	14,254	30,467
Deferred refunding loss	-	-	-		1,568	1,952	540	2,980
TOTAL REVENUE BONDS PAYABLE					$ 6,276,054	$ 1,519,722	$ 1,956,282	$ 5,839,494

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

Additionally, component unit organizations of the State System of Higher Education reported $228,870 of revenue bonds payable at June 30, 2004.

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, 2004, respectively, these two Funds transferred $629,338 and $58,993 to the Capital Debt fund, which reported $724,127 (over 94 percent) of total Debt Service funds principal and interest expenditures of $767,576 (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 $1,139,059 for General Obligations Bonds Payable from Tax Revenues at June 30, 2004 consists of total bond and refunding bond proceeds of $660,592 and $511,884, 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 $1,369 less deferred net refunded loss of $34,786 during the fiscal year ended June 30, 2004. Total Governmental Fund bond/refunding bond proceeds of $1,172,476 equal “Additions” of $1,085,838 plus premium on bonds issued of $88,007, less net principal accretion on maturing debt for capital appreciation bonds of $1,369. During the fiscal year ended June 30, 2004 $14,442 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, 2004 is $327,826. Also, during the fiscal year ended June 30, 2004 $3,165 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, 2004 is $56,104 (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, 2004 for general obligation refunding bonds includes $29.6 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 workers’ compensation assessments and **General Fund** tax revenues are the following at June 30, 2004 (amounts in thousands):

Workers’ Compensation Security Trust Claims	$ 509,426
Public Utility Realty Tax Act (PURTA)	22,177
Litigation—Note N	167,483
Arbitrage Rebate Tax	85
	$ 699,171

The Workers’ Compensation Security Trust Fund provides for payment of valid claims under the Workers’ 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, 2004 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)

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 $43.9 billion as of August 31, 2004, with net debt outstanding of $6.2 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, 2004 (May 31, 2004 for the PTC) include bond premiums, deferred costs of refunding, and deferred refunding losses of $12.4 million, $30.5 million, and $3 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, 2004 (May 31, 2004 for the Pennsylvania Turnpike Commission) (amounts in thousands):

PRIMARY GOVERNMENT

	2005	2006	2007	2008	2009	2010-14	2015-19
GENERAL OBLIGATION BONDS:							
Capital Facilities	$ 523,573	$ 517,432	$ 497,347	$ 479,033	$ 454,985	$ 2,109,281	$ 1,605,164
Disaster Relief	2,170	2,091	2,009	1,927	1,844	4,095	948
Land and Water Development	257	253	253	253	251	1,016	-
Nursing Home Loan Development	-	-	-	-	-	-	-
Volunteer Companies Loan	857	840	827	809	590	2,899	2,312
Vietnam Conflict Veterans Compensation	-	-	-	-	-	-	-
Water Facilities Loan	3,424	3,295	3,263	2,800	2,003	8,955	2,185
Pennsylvania Economic Revitalization	642	639	629	627	522	2,194	210
Pennsylvania Infrastructure Investment Authority	8,785	8,458	8,278	6,740	4,562	21,694	12,094
Agricultural Conservation Easement Purchase	2,684	2,642	2,199	2,156	2,111	9,178	5,343
Local Criminal Justice	4,160	3,739	1,403	1,071	1,044	4,811	3,879
Keystone Recreation, Park and Conservation	3,003	2,819	2,336	1,078	1,044	4,694	3,125
Refunding Bonds	283,848	292,924	283,593	275,669	275,803	1,025,220	115,093
Total Principal and Interest	833,403	835,132	802,137	772,163	744,759	3,194,037	1,750,353
Less: Interest Payments	342,140	321,968	295,614	270,324	245,192	838,975	349,673
	491,263	513,164	506,523	501,839	499,567	2,355,062	1,400,680
Other General Long-Term Obligations	161,336	137,357	136,863	135,310	184,946	611,507	596,122
TOTAL GENERAL LONG-TERM OBLIGATIONS	$ 652,599	$ 650,521	$ 643,386	$ 637,149	$ 684,513	$ 2,966,569	$ 1,996,802

The portion of Total General Long-Term Obligations due by June 30, 2005 amounts to $652,599 (in thousands).

	2020-24	2025-29	2030-34	2035-39	2040-44	Total
GENERAL OBLIGATION BONDS:						
Capital Facilities	$ 760,535	$ -	$ -	$ -	$ -	$ 6,947,350
Disaster Relief	224	-	-	-	-	15,308
Land and Water Development	-	-	-	-	-	2,283
Nursing Home Loan Development	-	-	-	-	-	-
Volunteer Companies Loan	-	-	-	-	-	9,134
Vietnam Conflict Veterans Compensation	-	-	-	-	-	-
Water Facilities Loan	-	-	-	-	-	25,925
Pennsylvania Economic Revitalization	-	-	-	-	-	5,463
Pennsylvania Infrastructure Investment Authority	747	-	-	-	-	71,358
Agricultural Conservation Easement						

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

	2020-24	2025-29	2030-34	2035-39	2040-44	Total
Purchase	-	-	-	-	-	26,313
Local Criminal Justice	1,374	-	-	-	-	21,481
Keystone Recreation, Park and Conservation	-	-	-	-	-	18,099
Refunding Bonds	-	-	-	-	-	2,552,150
Total Principal and Interest	762,880	-	-	-	-	9,694,864
Less: Interest Payments	77,534	-	-	-	-	2,741,420
	685,346	-	-	-	-	6,953,444
Other General Long-Term Obligations	411,223	-	-	-	-	2,374,664
TOTAL GENERAL LONG-TERM OBLIGATIONS	$ 1,096,569	$ -	$ -	$ -	$ -	$ 9,328,108

DISCRETELY PRESENTED COMPONENT UNITS

	2005	2006	2007	2008	2009	2010-14	2015-19
Philadelphia Regional Port Authority	$ 4,979	$ 4,850	$ 4,330	$ 4,428	$ 4,406	$ 22,186	$ 21,970
Pennsylvania Housing Finance Agency	290,002	285,780	283,056	262,224	205,362	982,345	872,934
Pennsylvania Industrial Development Authority	42,930	45,943	48,940	52,705	66,258	241,675	158,231
Pennsylvania Turnpike Commission	123,421	126,079	126,677	127,324	127,998	648,530	634,119
Pennsylvania Infrastructure Investment Authority	18,433	19,498	18,452	17,063	16,112	39,747	8,381
Total Principal and Interest	479,765	482,150	481,455	463,744	420,136	1,934,483	1,695,635
Less: Interest Payments	232,074	227,321	219,342	211,241	202,521	864,886	619,911
TOTAL REVENUE BONDS	$ 247,691	$ 254,829	$ 262,113	$ 252,503	$ 217,615	$ 1,069,597	$ 1,075,724

	2020-24	2025-29	2030-34	2035-39	2040-44	Total
Philadelphia Regional Port Authority	$ 8,848	$ -	$ -	$ -	$ -	$ 75,997
Pennsylvania Housing Finance Agency	680,945	530,047	256,717	5,389	-	4,654,801
Pennsylvania Industrial Development Authority	57,668	-	-	-	-	714,350
Pennsylvania Turnpike Commission	543,304	556,185	409,888	137,376	82,074	3,642,975
Pennsylvania Infrastructure Investment Authority	-	-	-	-	-	137,686
Total Principal and Interest	1,290,765	1,086,232	666,605	142,765	82,074	9,225,809
Less: Interest Payments	414,192	239,994	95,029	32,855	5,899	3,365,265
TOTAL REVENUE BONDS	$ 876,573	$ 846,238	$ 571,576	$ 109,910	$ 76,175	$ 5,860,544

Additionally, component unit organizations of the State System of Higher Education reported $228,870 of revenue bonds payable at June 30, 2004.

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, 2004 (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			
2005	$ 8,526	$ 3,181	$ 43,750
2006	7,524	1,588	43,216
2007	6,667	988	43,059
2008	6,282	680	42,571
2009	6,178	595	58,181
2010-14	30,891	2,757	192,375
2015-19	12,356	-	187,540
2020-24	-	-	129,365
Total minimum lease payments	78,424	9,789	740,057
Less: amount representing estimated executory cost included in minimum lease payments	9,722	-	-
Net minimum lease payments and Installment purchases	68,702	9,789	740,057
Less: amount representing interest	21,904	2,636	227,142
Total Capital Lease and Installment Purchase Obligations	$ 46,798	$ 7,153	$ 512,915

At June 30, 2004 general capital assets included $95.8 million of buildings and $12.1 million of equipment being procured by capital leases. A total of $28.5 million in general capital assets is being procured by vendor-financed installment purchase arrangements.

Capital lease obligations outstanding as of June 30, 2004 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 $68.5 million of construction in progress related to capital leases at June 30, 2004.

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, 2004 the SPSBA has $1.4 billion 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, 2004 the PHEFA has $4.5 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, 2004 the PEDFA has $1.67 billion 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 $77.77 million in revenue bonds outstanding at June 30, 2004. 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, 2004 the Commonwealth issued $459.5 million in general obligation bonds, First Series of 2004 with an average interest rate of 5.15 percent to current refund $262.9 million and to advance refund $214.4 million of previously issued general obligation bonds with an average interest rate of 5.44 percent. The net refunding bond proceeds of $511.9 million (including bond premium of $52.6 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 bonds. As a result, the bonds refunded are considered to be defeased and have been removed from the Commonwealth's financial statements. The Commonwealth refunded its previously issued bonds to reduce debt service payable on its general obligation bonds by $36.5 million and to obtain an economic gain of $32.3 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, 2004, $589.7 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 to refund $225 million of outstanding student loan revenue bonds. On July 25, 2002, $150 million of bonds were refunded, decreasing the effective interest rate from 6.22 percent to variable-rate bonds with a weighted-average interest rate of 1.28 percent for the year ended June 30, 2003. An additional $75 million was refunded on July 1, 2003 decreasing the effective interest rate from 6.05 percent to variable-rate bonds with a weighted-average interest rate of 1.05 percent for the year ended June 30, 2004. For the year ended June 30, 2004, interest payments were reduced by $3.7 million because of the refundings. The refundings resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $2.5 million in 2004 and $4 million in 2003. This difference, reported in the accompanying statement of net assets as a deduction from 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, 2004 the Pennsylvania Housing Finance Agency (PHFA) redeemed prior to maturity $2 million of Multi-Family Housing Bonds and $715 thousand of Residential Development Bonds, Issues 1985A and 1993, using mortgage prepayments. An extraordinary loss of $35 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 $141.6 million of Residential Development Bonds issue 1993 using bond issuance proceeds. Although a deferred loss of $4.5 million resulted from the refundings, the PHFA in effect obtained an economic gain of $21.4 million and was able to reduce its aggregate debt service payments as a result of these transactions by a total of $28.4 million over the next 30 years.

Also during the fiscal year ended June 30, 2004, the PHFA redeemed prior to maturity $178.5 million of Single Family Mortgage Revenue Bonds, Series 1992-35, 1993-36, 1993-37, 1994-38, 1994-39, 1994-41, 1994-42, 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, 2000-70, 2001-72, and 2002-73, using mortgage prepayments. Extraordinary losses of $2 million resulted from the redemptions as unamortized bond discount and related costs of issuance for the bonds redeemed were expensed. Additionally, during this year, the PHFA redeemed prior to maturity $584.5 million of Single Family Mortgage Revenue Bonds, Series 1992-35, 1993-36, 1993-37, 1994-38, 1994-39, 1994-40, 1994-41, 1994-42, 1994-43, 1994-44, 1994-45, 1995-46, 1996-48, 1996-49, 1996-50, 1996-51, 1996-52, 1996-53, 1997-54, 1997-56, 1997-57, and 2000-69 using bond issuance proceeds. Although a deferred loss of $8.6 million resulted from the refundings, the PHFA in effect obtained an economic gain of $324.5 million and was able to reduce its aggregate debt service payments as a result of these transactions by a total of $381 million over the next 30 years.

During the fiscal year ended June 30, 2004, the Pennsylvania Infrastructure Investment Authority (PENNVEST) issued $21.6 million in Revenue Refunding Bonds Series 2003A to current refund the outstanding Series 1991A and 1992A Revenue Bonds, to fund a debt service reserve fund for the Revenue Refunding Bonds Series 2003A, and to pay the costs of issuance. The refunding resulted in the recognition of an accounting loss of $663 thousand for the fiscal year ended June 30, 2004. PENNVEST, in effect, reduced its aggregate debt service payments by $2.3 million over the next 5 years and obtained an economic gain of $1.96 million.

NOTE L - REFUNDED DEBT (continued)

At May 31, 2004, $424.5 million of bonds outstanding that were previously accounted for in the financial statements of the Pennsylvania Turnpike Commission have been defeased through refundings.

During the fiscal year ended June 30, 2004, the Pennsylvania Industrial Development Authority (PIDA) defeased $11.9 million of the Series 1996 Economic Development Revenue Bonds using unrestricted net assets. The PIDA issued $99.1 million of Series 2004 Economic Development Revenue Bonds, which was used to redeem $97.1 million of Series 1994 Economic Development Revenue Bonds. These actions resulted in an extraordinary loss of $.7 million and a deferred loss on refunding of $1.4 million.

A portion of the Series 1996 Bonds was deposited into an irrevocable trust with an escrow agent to provide for certain future principal and interest payments on the Series 1996 Bonds. As a result, that portion of the Series 1996 Bonds are considered to be defeased and the liability for those bonds has been removed from the PIDA's financial statements.

At June 30, 2004, $11.9 million of bonds outstanding that were previously accounted for in the financial statements of the PIDA have been defeased through refundings.

During the fiscal year ended June 30, 2004, the Philadelphia Regional Port Authority (PRPA) issued $53.9 million of Series 2003 Commonwealth Lease Revenue Bonds (Series 2003 Bonds) with a variable interest rate to current refund and defease the Series 1993 Bonds. The PRPA has entered into an interest rate swap agreement with Citigroup in connection with the Series 2003 Bonds and pays a fixed rate of interest of 5.19 percent on the notional amount of the Series 2003 Bonds then outstanding. The current refunding reduced total debt service payments over the next eighteen (18) years by $1.9 million, and resulted in an economic gain of $1.4 million.

At June 30, 2004, $67.2 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, 2004. No settlements exceeded commercial insurance coverage during any of the past three fiscal years.

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, 2004. No accrued liability has been reported for property losses.

At June 30, 2004, none of the accrued liabilities for governmental activities were payable from current expendable available financial resources. It is anticipated that the **General Fund** and the **Motor License Fund**, respectively, will fund governmental activities liabilities of $269,669 and $308,097. Business-type activities liabilities are primarily owed by the **State Workers' Insurance Fund** ($1,169) and the State Stores Fund ($14,004), Enterprise Funds. All accrued self-insurance liabilities at June 30, 2004 are summarized as follows (amounts in thousands):

	Governmental Activities		**Business Type Activities**		**Fiduciary Fund Types**	
	Current	**Non-current**	**Current**	**Non-current**	**Current**	**Non-current**
Employee disability	$ 75,477	$ 301,909	$ 3,468	$ 13,870	$ 53	$ 213
Annuitant medical/hospital	32,044	-	-	-	-	-
Automobile tort	3,145	17,165	-	-	-	-
Employee tort	2,900	27,288	-	-	-	-
General tort	1,420	46,058	-	-	-	-
Transportation	10,200	297,897	-	-	-	-
Totals	$125,186	$ 690,317	$ 3,468	$ 13,870	$ 53	$ 213

The following summary provides aggregated information on June 30, 2003 reported self-insurance liabilities; incurred claims and payments during the fiscal year ended June 30, 2004 and reported self-insurance liabilities at June 30, 2004 (amounts in thousands):

	June 30, 2003 Liability	**Incurred Claims**		**Payments**		**June 30, 2004 Liability**
		Current	**Prior**	**Current**	**Prior**	
Employee disability	$ 377,094	$ 58,777	$ 27,362	$ 8,362	$ 59,881	$ 394,990
Annuitant medical/hospital	38,447	321,918	-	289,874	38,447	32,044
Automobile tort	21,108	6,511	(4,469)	1,072	1,768	20,310
Employee tort	28,480	711	2,788	25	1,766	30,188
General tort	43,901	8,540	(3,760)	60	1,143	47,478
Transportation	289,907	54,637	(28,093)	438	7,916	308,097
Totals	$ 798,937	$ 451,094	$ (6,172)	$ 299,831	$ 110,921	$ 833,107

NOTE M - SELF-INSURANCE (continued)

The following summary provides aggregated information on June 30, 2002 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	Incurred Claims		Payments		June 30, 2003
	Liability	Current	Prior	Current	Prior	Liability
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 N – COMMITMENTS AND CONTINGENCIES

Construction and Other Commitments: At June 30, 2004, the Department of Transportation and at May 31, 2004, the Pennsylvania Turnpike Commission, a discretely presented component unit, have contractual commitments of approximately $2,028.9 million and $751 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 $5.9 billion at June 30, 2004. Actual expenditures are contingent upon approved spending authority and/or availability of financial resources.

Loan Commitments: At June 30, 2004, the following discretely presented component units had approved loans that had not been disbursed (amounts in millions):

Pennsylvania Housing Finance Agency	$ 36
Pennsylvania Industrial Development Authority	$ 142
Pennsylvania Infrastructure Investment Authority	$ 520

Operating Lease Commitments: The Commonwealth and its discretely presented component units have commitments to lease certain buildings and equipment. Future minimum rental commitments for non-cancelable operating leases as of June 30, 2004 were as follows (amounts in thousands):

Fiscal year ending June 30:	Primary Government	Discretely Presented Component Units
2005	$ 284,697	$ 6,604
2006	163,367	5,057
2007	130,873	3,488
2008	101,593	989
2009	69,277	277
2010-2014	134,110	174
Total Minimum Lease Payments	$ 883,917	$16,589

Rental expenditures/expenses for all operating leases for the fiscal year ended June 30, 2004 amounted to $275.2 million ($265.7 million for primary government and $9.5 million for discretely presented component units).

Child Support Payments: At June 30, 2004, the Commonwealth is contingently liable for approximately $39 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, 2004 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 $167.5 million for which the likelihood of an unfavorable outcome is probable.

Additionally, the Commonwealth is currently involved in certain legal proceedings for which the likelihood of an unfavorable outcome is reasonably possible, for which liabilities have not been accrued as of June 30, 2004. Unfavorable outcomes for such cases, which the Commonwealth is vigorously contesting, could range from approximately $49 million to $414 million for the **General Fund**; $.2 million to $387 million for Special Revenue Funds; $7.5 million to $33.2 million for the Capital Facilities Fund, a Capital Projects fund; zero to $.7 million for the **Unemployment Compensation Fund**, an Enterprise Fund; and $.3 million to $1.1 billion of possible additional liabilities for the State Employees' Retirement System, a fiduciary fund. The range for the **Motor License Fund**, a Special Revenue Fund, is from $.2 million to $267 million. One additional **General Fund** case, for which the likelihood of an unfavorable outcome is remote, relates to the distribution of certain state funding for public education in an approximate range from $200 million to $1 billion.

The range of potential liability for governmental and business-type activities, respectively, is between $293 million and $1.9 billion and zero to $.7 million at June 30, 2004.

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 basic 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 $144 million at June 30, 2004. 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 $24 billion at June 30, 2004. 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, 2004, 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, 2004, the amount of future payments owed to prizewinners is $1.2 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, 2004, prizewinners have voluntarily assigned future payments of $444 million.

NOTE O - CERTAIN AGENCY FUND CLAIMS LIABILITIES

The Pennsylvania Medical Care Availability and Reduction of Error Fund, an Agency Fund, acts 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 levies healthcare provider surcharges, as a percentage of insurance premiums for basic coverage, to pay claims and administrative expenses paid on behalf of healthcare providers during the prior year. The actuarially computed liability to the healthcare providers for claims outstanding at June 30, 2004 totals $2.4 billion. The claims will be funded exclusively through surcharge assessment in future years as claims are settled and paid.

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 $4.3 billion at June 30, 2004. 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, 2004. 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 $1,215 million in assets reported in the Deferred Compensation Fund, a Pension Trust Fund, at December 31, 2003, $1,172 million relates to primary government employees and $38 million relates to employees of discretely presented component units. The remaining balance of $5 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 has, in its collective bargaining agreements with unions subject to the agreement, obligated itself to provide certain contributions on behalf of all bargaining unit employees. The Commonwealth also remits contractually established contributions on behalf of non-union employees and other employees covered by contracts between the Commonwealth and other unions. During the fiscal year ended June 30, 2004, total contributions amounted to approximately $1,034 million. Neither the Commonwealth nor the unions have an equity interest in the PEBTF.

At June 30, 2004, the PEBTF reported total assets of $123 million, total liabilities and benefit obligations of $129 million, and a deficiency of net assets over benefit obligations of $6 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, 2004 the PEBTF reported an increase in net assets available for benefits of $15 million for the Active Plan program. This was caused by an increase in the contribution rate from $190 per employee per pay period to $235 per employee per pay period and benefit plan changes for pharmaceutical benefits and medical benefits effective August 16, 2003 and October 1, 2003, respectively.

In order to maintain the Trust Fund's liquidity in early fiscal year 2003-04, the collective bargaining agreement negotiated by the Commonwealth and the Unions effective July 1, 2003, provided for the Commonwealth to contribute $80 million, over and above the biweekly contribution to the Trust Fund, during the first 3 months of fiscal year 2004. The Commonwealth's supplemental budget for fiscal year 2003-04 included an appropriation for the Commonwealth's **General Fund** share of this lump sum contribution. However, as the approval of this appropriation was delayed, the Commonwealth, through the Pennsylvania Department of Transportation's **Motor License Fund**, entered into a loan agreement with the Trust Fund for $80 million. In December 2003, upon passage of the supplemental budget, the Commonwealth contributed the $80 million to the Active Plan, and the Trust Fund repaid the loan, with interest, to the **Motor License Fund**.

On July 15, 2004, the PEBTF received $30 million from the Commonwealth of Pennsylvania as an interest-free advance payment of the Commonwealth's active employee contribution. Repayment of this advance by the PEBTF will occur when the PEBTF's financial resources are sufficient to meet its ongoing cash flow needs.

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 September 28, 2004, the Commonwealth issued $798.8 million of General Obligation Bonds, Third Series of 2004, with an interest rate of 3.7 percent. The Commonwealth issued the bonds to refund all or a portion of twelve separate issues of previously issued general obligation bonds in order to reduce debt service on its general obligation bonds.

On December 21, 2004, the Commonwealth issued $670.5 million and $201 million of General Obligation Bonds, Third Refunding Series of 2004 and Fourth Series of 2004, respectively, with interest rates of 3.9 percent and 4.1 percent. The Commonwealth issued the bonds to fund transportation assistance, redevelopment assistance, and flood control projects, and to reduce debt service payable on its general obligation bonds.

Discretely Presented Component Units

On January 20, 2004, the **Pennsylvania Turnpike Commission (PTC)** approved a resolution to adopt a new fare rate schedule. The new fare rate schedule is effective August 1, 2004 and is the first toll increase since June 1, 1991. Rates on average will increase 1.8 cents per mile for cars and 5.3 cents per mile for trucks. On June 7, 2004, the **PTC** issued 2004 Series A Revenue Bonds in the amount of $269,245,000. The bond interest rate varies from 5.00 percent to 5.50 percent, due in varying installments through December 1, 2034. The proceeds of the bonds will be used to fund various capital expenditures included in the Commission's 10-year capital plan.

In July 2004, the **Pennsylvania Higher Educational Facilities Authority (PHEFA**) issued Series AA tax-exempt bonds in the amount of $28,750,000 and Series AB tax-exempt bonds in the amount of $20,970,000. In connection with the bond issuance, **Pennsylvania State System of Higher Education (PASSHE**) entered into a loan agreement with PHEFA under which PASSHE pledged its full faith and credit for repayment of the bonds. The bonds were issued to provide funds to undertake various capital projects at the universities within PASSHE.

On August 4, 2004, the **Pennsylvania Housing Finance Agency (PHFA)** issued $127,510,000 Single Family Mortgage Revenue Bonds, Series 2004-83. The proceeds of the bonds will be used to finance new loan purchases and refund existing bonds. On September 17, 2004, the **PHFA** issued $100 million Single Family Revenue Bonds, Series 2004-84. The proceeds from these bond issuances were used to finance new loan purchases and refund existing bonds.

On November 17, 2004, the **Pennsylvania Higher Education Assistance Agency** issued $300,000,000 of student loan revenue bonds.

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Required Supplementary Information

Commonwealth of Pennsylvania

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Taxes, net of refunds	$ 20,533,600	$ 450,653	$ 20,984,253	$ 47,164	$ 21,031,417
Liquor store profits transfer	50,000	-	50,000	-	50,000
Licenses and fees	119,700	(13,093)	106,607	(1,434)	105,173
Fines, penalties and interest	29,000	5,484	34,484	601	35,085
Investment income	110,370	(1,347)	109,023	(148)	108,875
Unclaimed property	218,100	105,439	323,539	11,548	335,087
Departmental services	2,077,621	343,537	2,421,158	-	2,421,158
Miscellaneous	95,830	46,787	142,617	5,124	147,741
TOTAL STATE PROGRAMS	23,234,221	937,460	24,171,681	62,855	24,234,536
Federal Programs	14,556,243	107,566	14,663,809	(276,216)	14,387,593
TOTAL REVENUES	37,790,464	1,045,026	38,835,490	(213,361)	38,622,129
EXPENDITURES:					
State Programs:					
Direction and supportive services	941,473	19,050	960,523	(5,180)	955,343
Protection of persons and property	2,616,521	340,090	2,956,611	(6,827)	2,949,784
Health and human services	8,852,602	565,444	9,418,046	(12,733)	9,405,313
Public education	9,118,337	(11,159)	9,107,178	(193)	9,106,985
Recreation and cultural enrichment	277,974	(7,329)	270,645	(1,300)	269,345
Debt service	669,827	(460)	669,367	-	669,367
Economic development	580,877	18,919	599,796	(13,963)	585,833
Transportation	372,461	(7,690)	364,771	(217)	364,554
TOTAL STATE PROGRAMS	23,430,072	916,865	24,346,937	(40,413)	24,306,524
Federal Programs	14,556,243	107,566	14,663,809	(276,216)	14,387,593
TOTAL EXPENDITURES	37,986,315	1,024,431	39,010,746	(316,629)	38,694,117
REVENUES OVER/(UNDER) EXPENDITURES	(195,851)	20,595	(175,256)	103,268	(71,988)
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	142,511	142,511	-	142,511
Transfer to Budget Stabilization Reserve Fund	-	-	-	(190,000)	(190,000)
TOTAL OTHER FINANCING SOURCES (USES)	-	142,511	142,511	(190,000)	(47,489)
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	(195,851)	163,106	(32,745)	(86,732)	(119,477)
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003, RESTATED	196,227	-	196,227	-	196,227
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2004	$ 376	$ 163,106	$ 163,482	$ (86,732)	$ 76,750

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

BUDGETARY COMPARISON SCHEDULE
Budgeted Major Funds
Special Revenue Fund-Motor License

For the Fiscal Year Ended June 30, 2004

COMMONWEALTH OF PENNSYLVANIA
(Expressed in Thousands)

	Original Budget	Difference	Final Budget	Difference	Actual (Budgetary Basis)
REVENUES:					
State Programs:					
Taxes, net of refunds	$ 1,119,608	$ -	$ 1,119,608	$ (6,580)	$ 1,113,028
Licenses and fees	837,350	-	837,350	5,824	843,174
Fines, penalties and interest	30,550	-	30,550	1,552	32,102
Investment income	14,000	-	14,000	15,076	29,076
Departmental services	50,129	286,572	336,701	-	336,701
Miscellaneous	24,840	-	24,840	43,390	68,230
TOTAL STATE PROGRAMS	2,076,477	286,572	2,363,049	59,262	2,422,311
Federal Programs	1,543,780	39,000	1,582,780	(363,958)	1,218,822
TOTAL REVENUES	3,620,257	325,572	3,945,829	(304,696)	3,641,133
EXPENDITURES:					
State Programs:					
Direction and supportive services	68,197	(200)	67,997	(7,300)	60,697
Protection of persons and property	493,869	17,475	511,344	(15,292)	496,052
Public education	1,230	-	1,230	-	1,230
Recreation and cultural enrichment	1,000	-	1,000	-	1,000
Debt service	38,736	-	38,736	(142)	38,594
Transportation	1,494,932	269,297	1,764,229	(2,474)	1,761,755
TOTAL STATE PROGRAMS	2,097,964	286,572	2,384,536	(25,208)	2,359,328
Federal Programs	1,543,780	39,000	1,582,780	(363,958)	1,218,822
TOTAL EXPENDITURES	3,641,744	325,572	3,967,316	(389,166)	3,578,150
REVENUES OVER (UNDER) EXPENDITURES	(21,487)	-	(21,487)	84,470	62,983
OTHER FINANCING SOURCES (USES):					
Prior year lapses	-	20,158	20,158	-	20,158
TOTAL OTHER FINANCING SOURCES	-	20,158	20,158	-	20,158
REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	(21,487)	20,158	(1,329)	84,470	83,141
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2003	30,449	-	30,449	-	30,449
UNRESERVED/UNDESIGNATED FUND BALANCES (BUDGETARY BASIS), JUNE 30, 2004	$ 8,962	$ 20,158	$ 29,120	$ 84,470	$ 113,590

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

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 (Workers' 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	
	General Fund	Motor License Fund
Budgetary basis — revenues and other sources over (under) expenditures and other uses…………………………	$(119,477)	$83,141
Adjustments:		
To adjust revenues, other financing sources and related receivables and deferred revenue…….…………...	51,307	447,508
To adjust expenditures, other financing uses and related accounts payable and and accrued liabilities………………...	716,971	(344,165)
Net adjustments………………………	768,278	103,343
Modified accrual basis – net change in governmental fund balance…………	$648,801	$186,484

The above revenue adjustments include net revenue accruals/deferrals, 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 $695.3 million in supplemental appropriations approved during the fiscal year ended June 30, 2004.

A separately available report, the "*Status of Appropriations*," demonstrates budgetary expenditure compliance for the **General Fund** for the fiscal year ended June 30, 2004. 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**, Workers' Compensation Administration, Banking Department and Milk Marketing. Both "*Status*" reports are available online at the Office of the Budget internet site: http://www.budget.state.pa.us 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 – Budgeted Major Funds are based on appropriation, augmentation and lapse amounts reported in the respective June 30, 2004 "*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	6[1]	$ 22,940,479	$ 2,421,158	$ 40,413	$ 25,321,224
Less: tax refunds..................	6[1]	(1,014,700)	-	-	(1,014,700)
Amount reported..................		$ 21,925,779	$ 2,421,158	$ 40,413	$ 24,306,524
Special Revenue Funds:					
Motor License Fund...............	48	$ 2,802,062	$ 1,561,231	$ 96,770	$ 4,266,523
less: reductions[2]		(754,227)	(1,224,542)	(71,562)	(1,907,207)
Amount reported..................		$ 2,047,835	$ 336,689	$ 25,208	$ 2,359,316

Total actual expenditures for "Federal Programs" for the **General Fund** are derived from the **General Fund** "*Status*," page no. 228 "Summary of All Current Federal Ledgers by Character of Expenditure" as follows (in thousands): Commitments of $727,208 and Expenditures of $12,173,016, for a total of $12,900,224.

Total actual expenditures for "Federal Programs," Special Revenue funds, are derived from the Special Funds "*Status*" as follows (in thousands): **Motor License** - $1,012,012 (calculated in footnote 3 below).

[1] Page no. 6, "Summary of All Current State Ledgers by Character of Expenditure," **General Fund** "*Status of Appropriations*."

[2] Excludes the following appropriation symbols, beginning on page 51, Special Funds "*Status of Appropriations***:**" 010-78-571-03-10; 010-78-572-03-10; 010-78-579-03-10; 010-73-132-03-20; 010-38-226-03-20; 010-78-172-03-20; 010-78-173-03-20; 010-78-174-03-20; and 010-78-177-03-20 through 010-78-185-03-20.

[3] Consists of $1,218,822 in Year-to-Date "Total Federal Funds" on page 116 of the "*Report of Revenues and Receipts*" less $206,810 in Year-to-Date Federal Funds amounts for the following revenue codes (also on page 116 of the "*Report*"): 010811-008051-101; 010811-008181-101; 010811-008181-108; 010811-008232-101; 010811-008284-101; 010811-008289-101; and 010811-008289-102.

Note 5 – Restatement of June 30, 2003 Unreserved/Undesignated General Fund Fund Balance (Budgetary Basis)

The Budgetary Comparison Schedule reflects a restatement of minus $13.1 million to the June 30, 2003 budgetary basis Unreserved/Undesignated fund balance. The restatement includes in fund balance, the results of $12.2 million of additional funds appropriated to Pennsylvania Senate and House of Representatives 2002-03 fiscal year appropriations, $1 million transferred from the Senate Special Leadership Account (D) for the 2003-04 fiscal year to the Senate Incidental Expenses appropriation for the 2002-03 fiscal year, and $100 thousand transferred from the 1999 Drought Disaster Relief appropriation to the July 2003 Storm Relief appropriation for the Pennsylvania Emergency Management Agency.

Schedule of Expenditures Of Federal Awards

Commonwealth of Pennsylvania

Schedule of Expenditures of Federal Awards - June 30, 2004

CFDA #	CFDA Program Name		Federal Expenditures (000's)
10.551	Food Stamps	900,852	
10.561	State Admin Matching Grants for Food Stamp Program	125,703	
	Total Food Stamp Cluster		1,026,555
10.553	School Breakfast Program	44,527	
10.555	National School Lunch Program	199,118	
10.556	Special Milk Program for Children	677	
10.559	Summer Food Service Program for Children	10,483	
	Total Child Nutrition Cluster		254,805
10.568	Emergency Food Assistance Program (Admin Costs)	1,976	
10.569	Emergency Food Assistance Program (Food Commodities)	12,274	
	Total Emergency Food Assistance Cluster		14,250
10.025	Plant & Animal Disease, Pest Control & Animal Care		1,309
10.162	Inspection Grading and Standardization		139
10.353	National Rural Development Partnership		65
10.450	Crop Insurance		540
10.550	Food Donation		29,193
10.557	Special Supplemental Nutrition Program for WIC		141,276
10.558	Child and Adult Care Food Program		50,487
10.560	State Administrative Expenses for Child Nutrition		3,598
10.565	Commodity Supplemental Food Program		1,127
10.572	WIC Farmers' Market Nutrition Program (FMNP)		4,191
10.574	Team Nutrition Grants		69
10.664	Cooperative Forestry Assistance		969
10.665	Schools and Roads - Grants to States		6,202
	Total - Department of Agriculture		**$1,534,775**
11.407	Interjurisdictional Fisheries Act of 1986		13
11.419	Coastal Zone Management Administration Awards		2,145
11.457	Chesapeake Bay Studies		52
11.474	Atlantic Coastal Fisheries Cooperative Management Act		101
	Total - Department of Commerce		**$2,311**
12.112	Payments to States in Lieu of Real Estate Taxes		186
12.400	Military Construction, National Guard		(57)
12.401	National Guard Military Operations and Maintenance Projects		26,303
	Total - Department of Defense		**$26,432**
14.228	Community Development Block Grants/State's Program		57,017
14.231	Emergency Shelter Grants Program		2,624
14.235	Supportive Housing Program		108
14.239	HOME Investment Partnerships Program		14,103
14.241	Housing Opportunities for Persons with AIDS		1,412
14.401	Fair Housing Assistance Program - State & Local		1,437
	Total - Department of Housing and Urban Development		**$76,701**

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2004

CFDA #	CFDA Program Name		Federal Expenditures (000's)
15.605	Sport Fish Restoration	6,246	
15.611	Wildlife Restoration	3,695	
	Total Fish and Wildlife Cluster		9,941
15.250	Regulation of Surface Coal Mining		9,164
15.252	Abandoned Mine Land Reclamation Program		21,459
15.612	Endangered Species Conservation		4
15.616	Clean Vessel Act		66
15.622	Sportfishing and Boating Safety Act		200
15.625	Wildlife Conservation and Restoration		403
15.634	State Wildlife Grants		192
15.808	U.S. Geological Survey - Research and Data Collection		6
15.810	National Cooperative Geologic Mapping Program		69
15.904	Historic Preservation Fund Grants-In-Aid		1,044
15.916	Outdoor Recreation - Acquisition, Development and Planning		2,616
	Total - Department of the Interior		**$45,164**
16.004	Law Enforcement Asst - Narcotics & Dangerous Drugs Training		122
16.007	State Domestic Preparedness Equipment Support Program		20,635
16.523	Juvenile Accountability Incentive Block Grants		5,652
16.540	Juvenile Justice & Delinquency Prevention - Alloc to States		2,444
16.548	Title V - Delinquency Prevention Program		620
16.549	Part E - State Challenge Activities		326
16.550	State Justice Statistics Prgm for Statistic Analysis Centers		35
16.554	National Criminal History Improvement Program (NCHIP)		750
16.560	National Inst of Justice Research, Eval & Devel Project Grants		130
16.564	Crime Lab Improvement - DNA Index System Backlog Reduction		383
16.572	State Criminal Alien Assistance Program		1,188
16.574	Byrne Evaluation Partnership Program		7,623
16.575	Crime Victim Assistance		15,736
16.576	Crime Victim Compensation		1,000
16.579	Byrne Formula Grant Program		22,002
16.580	Ed Byrne Memorial St & Local Law Enforce Asst Disc Grants		924
16.582	Crime Victim Assistance/Discretionary Grants		329
16.588	Violence Against Women Formula Grants		5,200
16.592	Local Law Enforcement Block Grants Program		1,851
16.609	Community Prosecution and Project Safe Neighborhoods		348
16.710	Public Safety Partnership and Community Policing Grants		393
16.727	Enforcing Underage Drinking Laws Program		1
16.999	Miscellaneous		310
	Total - Department of Justice		**$88,002**
17.207	Employment Service	31,926	
17.801	Disabled Veterans' Outreach Program (DVOP)	3,041	
17.804	Local Veterans' Employment Representative Program	3,162	
	Total Employment Service Cluster		38,129
17.258	WIA Adult Program	33,402	
17.259	WIA Youth Activities	33,363	
17.260	WIA Dislocated Workers	59,279	
	Total WIA Cluster		126,044

- See Notes to Schedule of Expenditures of Federal Awards -

CFDA #	CFDA Program Name		Federal Expenditures (000's)
17.002	Labor Force Statistics		3,321
17.005	Compensation and Working Conditions		35
17.203	Labor Certification for Alien Workers		763
17.225	Unemployment Insurance		3,294,500
17.235	Senior Community Service Employment Program		3,937
17.245	Trade Adjustment Assistance - Workers		57,337
17.246	Employment and Training Assistance - Dislocated Workers		324
17.253	Welfare-to-Work Grants to States and Localities		6,547
17.255	Workforce Investment Act		1,532
17.257	One-Stop Career Center Initiative		432
17.261	Employment & Training Admin Pilots, Demos, Research Projects		650
17.262	Employment and Training Administration Evaluations		215
17.600	Mine Health and Safety Grants		246
17.802	Veterans' Employment Program		607
	Total - Department of Labor		**$3,534,619**
20.205	Highway Planning and Construction	1,203,101	
23.003	Appalachian Development Highway System	101,424	
	Total Highway Planning and Construction Cluster		1,304,525
20.600	State and Community Highway Safety	9,195	
20.601	Alcohol Traffic Safety & Drunk Driving Prevention Grants	155	
	Total Highway Safety Cluster		9,350
20.005	Boating Safety Financial Assistance		1,334
20.106	Airport Improvement Program		14,097
20.217	Motor Carrier Safety		517
20.218	National Motor Carrier Safety		5,108
20.219	Recreational Trails Program		627
20.500	Federal Transit - Capital Investment Grants		7,659
20.505	Federal Transit - Metropolitan Planning Grants		3,107
20.509	Formula Grants for Other Than Urbanized Areas		15,018
20.513	Capital Assistance Program for Elderly and Disabled Persons		3,331
20.514	Transit Planning and Research		493
20.700	Pipeline Safety		347
20.703	Interagency Hazardous Materials Training & Planning Grants		424
	Total - Department of Transportation		**$1,365,937**
23.002	Appalachian Area Development		411
23.008	Appalachian Local Access Roads		3,713
23.011	Appalachian State Research, Technical Asst & Demo Projects		98
	Total - Appalachian Regional Commission		**$4,222**
30.002	Employment Discrimination - State & Local Agency Contracts		1,879
	Total - Equal Employment Opportunity Commission		**$1,879**

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2004

CFDA #	CFDA Program Name	Federal Expenditures (000's)
39.003	Donation of Federal Surplus Personal Property	13,478
39.011	Election Reform Payments	6,709
	Total - General Services Administration	**$20,187**
45.025	Promotion of the Arts - Partnership Agreements	625
45.026	Promotion of the Arts - Leadership Initiatives	77
45.310	State Library Program	6,210
	Total - National Foundation on the Arts and Humanities	**$6,912**
64.010	Veterans Nursing Home Care	490
64.014	Veterans State Domiciliary Care	3,766
64.015	Veterans State Nursing Home Care	21,106
64.111	Veterans Education Assistance	851
	Total - Department of Veterans Affairs	**$26,213**
66.001	Air Pollution Control Program Support	4,382
66.032	State Indoor Radon Grants	205
66.419	Water Pollution Control - State & Interstate Program Support	5,702
66.432	State Public Water System Supervision	3,698
66.438	Construction Management Assistance	127
66.454	Water Quality Management Planning	619
66.458	Capitalization Grants for Clean Water State Revolving Funds	89,312
66.460	Nonpoint Source Implementation Grants	5,868
66.461	Wetland Program Grants	70
66.463	Water Quality Cooperative Agreements	186
66.466	Chesapeake Bay Program	2,255
66.467	Wastewater Operator Training Grant Program (Technical Asst)	8
66.468	Capitalization Grants for Drinking Water State Revolving Funds	17,423
66.471	State Grants to Reimburse Operators of Small Water Systems	192
66.472	Beach Monitoring and Notification Prgm Implementation Grants	19
66.474	Water Protection Grants to the States	61
66.500	Environmental Protection - Consolidated Research	141
66.606	Surveys, Studies, Investigations & Special Purpose Grants	688
66.608	Environmental Information Exchange Network Grant Program	41
66.700	Consolidated Pesticide Enforcement Cooperative Agreements	612
66.707	TSCA Title IV State Lead Grants Certification	426
66.708	Pollution Prevention Grants Program	58
66.716	Surveys, Studies, Investigations, Demos & Educ Outreach	22
66.801	Hazardous Waste Management State Program Support	4,948
66.804	State and Tribal Underground Storage Tanks Program	140
66.805	Leaking Underground Storage Tank Trust Fund Program	1,271
	Total - Environmental Protection Agency	**$138,474**

- See Notes to Schedule of Expenditures of Federal Awards -

CFDA #	CFDA Program Name		Federal Expenditures (000's)
81.041	State Energy Program		320
81.042	Weatherization Assistance for Low-Income Persons		14,918
81.105	Natl Industrial Competitiveness through Energy, Envir & Econ		180
81.117	Energy Efficiency & Renewable Energy Info Dissemination		56
81.119	State Energy Program Special Projects		212
81.999	Miscellaneous		162
	Total - Department of Energy		**$15,848**
83.105	Community Asst Program - State Support Services Element		73
83.536	Flood Mitigation Assistance		241
83.544	Public Assistance Grants		30,452
83.547	First Responder Counter-Terrorism Training Assistance		22
83.548	Hazard Mitigation Grant		1,734
83.550	National Dam Safety Program		7
83.552	Emergency Management Performance Grants		2,351
83.557	Pre-Disaster Mitigation		248
83.562	State & Local All Hazards Emergency Operations Planning		1,643
83.563	Emergency Operations Centers		37
83.564	Citizens Corps		399
83.999	Miscellaneous		(1,254)
	Total - Federal Emergency Management Agency		**$35,953**
84.027	Special Education - Grants to States	316,363	
84.173	Special Education - Preschool Grants	13,493	
	Total Special Education Cluster (IDEA)		329,856
84.002	Adult Education - State Grant Program		22,866
84.010	Title I Grants to Local Educational Agencies		423,844
84.011	Migrant Education - State Grant Program		7,599
84.013	Title I Program for Neglected and Delinquent Children		896
84.048	Vocational Education - Basic Grants to States		42,373
84.063	Federal Pell Grant Program		615
84.126	Rehabilitation Services - Vocational Rehab Grants to States		122,834
84.162	Immigrant Education		200
84.169	Independent Living - State Grants		833
84.177	Rehab Serv - Indep Living Services for Older Blind Indiv		1,631
84.181	Special Educ - Grants for Infants & Families with Disabilities		13,583
84.184	Safe & Drug-Free Schools & Communities - National Programs		889
84.186	Safe & Drug-Free Schools & Communities - State Grants		18,194
84.187	Supported Employment Serv for Indiv with Severe Disabilities		1,978
84.196	Education for Homeless Children and Youth		1,917
84.206	Javits Gifted and Talented Students Education Grant Program		349
84.213	Even Start - State Educational Agencies		8,543
84.215	Fund for the Improvement of Education		6,281
84.216	Capital Expenses		2
84.224	Assistive Technology		1,271
84.243	Tech-Prep Education		4,173
84.265	Rehab Training - State Voc Rehab Unit In-Service Training		246
84.276	Goals 2000 State & Local Educ System Improvement Grants		(7)
84.281	Eisenhower Professional Development State Grants		3,704

Schedule of Expenditures of Federal Awards - June 30, 2004

CFDA #	CFDA Program Name		Federal Expenditures (000's)
84.282	Charter Schools		8,201
84.287	Twenty-First Century Community Learning Centers		8,815
84.298	Innovative Education Program Strategies		14,461
84.314	Even Start - Statewide Family Literacy Program		37
84.318	Education Technology State Grants		21,281
84.323	Spec Educ - State Prgm Imp Grants for Child with Disabilities		1,349
84.326	Spec Educ - Tech Asst & Dissemin for Child with Disabilities		401
84.330	Advanced Placement Program		99
84.331	Grants to States for Incarcerated Youth Offenders		164
84.332	Comprehensive School Reform Demonstration		10,508
84.336	Teacher Quality Enhancement Grants		2,851
84.338	Reading Excellence		1,002
84.340	Class Size Reduction		3,177
84.346	Voc Ed - Occupational & Employment Info State Grants		265
84.348	Title I Accountability Grants		3,877
84.352	School Renovation Grants		15,836
84.357	Reading First State Grants		19,261
84.358	Rural Education		583
84.365	English Language Acquisition Grants		6,682
84.366	Mathematics and Science Partnerships		599
84.367	Improving Teacher Quality State Grants		111,934
84.368	Grants for Enhanced Assessment Instruments		517
84.369	Grants for State Assessments and Related Activities		1,568
84.999	Miscellaneous		18
	Total - Department of Education		**$1,248,156**
89.003	National Historical Publications and Records Grants		14
	Total - National Archives and Records Administration		**$14**
93.044	Special Programs for the Aging - Title III, Part B	23,355	
93.045	Special Programs for the Aging - Title III, Part C	23,918	
93.053	Nutrition Services Incentive Program	8,032	
	Total Aging Cluster		55,305
93.575	Child Care and Development Block Grant	194,630	
93.596	Child Care Mandatory and Matching Funds of the CCDF	120,095	
	Total CCDF Cluster		314,725
93.775	State Medicaid Fraud Control Units	3,502	
93.777	State Survey & Cert of Health Care Providers & Suppliers	8,680	
93.778	Medical Assistance Program	8,069,121	
	Total Medicaid Cluster		8,081,303
93.003	Public Health and Social Services Emergency Fund		845
93.041	Special Programs for the Aging - Title VII, Chapter 3		293
93.042	Special Programs for the Aging - Title VII, Chapter 2		773
93.043	Special Programs for the Aging - Title III, Part D		1,122
93.048	Special Programs for the Aging - Title IV and Title II		193
93.051	Alzheimer's Disease Demonstration Grants to States		396

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2004

CFDA #	CFDA Program Name	Federal Expenditures (000's)
93.052	National Family Caregiver Support	6,663
93.103	Food and Drug Administration - Research	18
93.110	Maternal and Child Health Federal Consolidated Programs	1
93.116	Project Grants & Coop Agreements for Tuberculosis Control	853
93.127	Emergency Medical Services for Children	124
93.130	Primary Care Services - Resource Coordination & Development	222
93.136	Injury Prevention and Control Research	1,784
93.150	Projects for Asst in transition from Homelessness (PATH)	1,556
93.162	National Health Service Corps Loan Repayment Program	46
93.165	Grants for State Loan Repayment	158
93.197	Childhood Lead Poisoning Prevention Projects	622
93.230	Consolidated Knowledge Development & Application Program	1,193
93.234	Traumatic Brain Injury - State Demonstration Grant Program	7
93.235	Abstinence Education	166
93.240	State Capacity Building	320
93.241	State Rural Hospital Flexibility Program	357
93.243	Substance Abuse & Mental Health Services - Projects	1,141
93.251	Universal Newborn Hearing Screening	242
93.259	Rural Access to Emergency Devices Grant	520
93.268	Immunization Grants	8,566
93.283	Centers for Disease Control & Prevention - Investigations	22,870
93.556	Promoting Safe and Stable Families	10,582
93.558	Temporary Assistance for Needy Families	776,546
93.563	Child Support Enforcement	115,104
93.566	Refugee & Entrant Assistance - State Administered Programs	8,001
93.568	Low-Income Home Energy Assistance	132,407
93.569	Community Services Block Grant	30,293
93.571	Community Services Block Grant - Discretionary Awards	152
93.576	Refugee and Entrant Assistance - Discretionary Grants	1,211
93.584	Refugee and Entrant Assistance - Targeted Assistance	639
93.585	Empowerment Zones Program	5,536
93.590	Community-Based Family Resource and Support Grants	632
93.597	Grants to States for Access and Visitation Programs	286
93.600	Head Start	225
93.602	New Assets for Independence Demonstration Program	637
93.603	Adoption Incentive Payments	630
93.630	Developmental Disabilities Basic Support & Advocacy Grants	2,791
93.631	Developmental Disabilities Projects of National Significance	108
93.645	Child Welfare Services - State Grants	10,924
93.658	Foster Care - Title IV-E	358,533
93.659	Adoption Assistance	63,337
93.667	Social Services Block Grant	104,875
93.670	Child Abuse and Neglect Discretionary Activities	90
93.671	Family Violence Prevention and Services	3,000
93.674	Chafee Foster Care Independent Living	4,963
93.767	State Children's Insurance Program	139,118

- See Notes to Schedule of Expenditures of Federal Awards -

Schedule of Expenditures of Federal Awards - June 30, 2004

CFDA #	CFDA Program Name	Federal Expenditures (000's)
93.768	Medicaid Infrastructure Grants to Support Competitive Employ	592
93.779	CMS Research, Demonstrations and Evaluations	788
93.889	National Bioterrorism Hospital Preparedness Program	10,245
93.917	HIV Care Formula Grants	33,996
93.919	Coop Agreements for State-Based Cancer Early Detection Prgms	3,174
93.938	Coop Agreements to Support School Health Programs	37
93.940	HIV Prevention Activities - Health Department Based	4,690
93.944	HIV/AIDS Surveillance	427
93.945	Assistance Programs for Chronic Disease Prevention & Control	18
93.952	Improving EMS/Trauma Care in Rural Areas	59
93.958	Block Grants for Community Mental Health Services	16,979
93.959	Block Grants for Prevention and Treatment of Substance Abuse	57,792
93.977	Preventive Health Serv - Sexually Trans Diseases Control Grant	3,018
93.988	Coop Agreements for State-Based Diabetes Control Programs	498
93.991	Preventive Health and Health Services Block Grant	5,905
93.994	Maternal and Child Health Services Block Grant to the States	25,995
93.999	Miscellaneous	1,792
	Total - Department of Health and Human Services	**$10,439,009**
94.003	State Commissions	432
94.004	Learn & Serve America - School & Community Based Programs	1,063
94.006	AmeriCorps	4,642
94.007	Planning and Program Development Grants	307
94.009	Training and Technical Assistance	71
	Total - Corporation for National and Community Service	**$6,515**
96.001	Social Security - Disability Insurance	72,226
	Total - Social Security Administration	**$72,226**
97.013	State Access to the Oil Spill Liability Trust Fund	57
97.032	Crisis Counseling	36
97.035	Individual and Family Grants	688
97.036	Public Assistance Grants	70
97.042	Emergency Management Performance Grants	3,262
	Total - Department of Homeland Security	**$4,113**
99.999	Miscellaneous	40,039
	Total - Miscellaneous	**$40,039**
	GRAND TOTAL	**$18,733,701**

- See Notes to Schedule of Expenditures of Federal Awards -

Notes to the Schedule of Expenditures of Federal Awards - June 30, 2004

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), which are discretely presented component units, elect to have their own single audits and their expenditures of federal awards 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 CFDA #20.205, Highway Planning and Construction, 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, 2002.

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, 2004.

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 Program, 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.

The remaining expenditures included in the schedule of expenditures of federal awards are presented on the cash plus invoices payable basis. Invoices 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, 2004. 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, 2004 reflects CFDA changes issued through December 2003.

Notes to the Schedule of Expenditures of Federal Awards - June 30, 2004

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 $196 thousand under CFDA #81.041, State Energy Program; $113 thousand under CFDA 93.568, Low-Income Home Energy Assistance; and $162 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, 2004, the Commonwealth had unexpended oil overcharge funds including interest of approximately $2.8 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, 2004, the Authority had gross outstanding federal loans of $613.9 million for CFDA #66.458 and $116.7 million for CFDA #66.468. No losses were incurred by the Authority on these loans during the fiscal year ended June 30, 2004.

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	$2,574,284
Federal UC Benefits	580,224
Federal Admin.	139,992
Total Expenditures	$3,294,500

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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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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters 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, 2004, which collectively comprise the Commonwealth's basic financial statements, and have issued our report thereon dated February 18, 2005.

We did not jointly audit the financial statements of certain component units, which represent 99 percent of total assets, 99 percent of total net 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, 100 percent of total net assets, and 100 percent of the total revenues of the Pension (and Other Employee Benefit) Trust Funds. This comprises 90 percent of total assets, 96 percent of total net assets and 86 percent of total revenues of the aggregate remaining fund information. The financial statements of these component units and the Pension (and Other Employee Benefit) Trust 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 and the Pension (and Other Employee Benefit) Trust Funds, are based solely on the reports of the other auditors. Ernst & Young LLP has audited separately 21 percent of total assets, 28 percent of total net assets, and 15 percent of total operating revenues of the discretely presented component units.

The transactions of the Department of the Auditor General are included in the basic financial statements and are immaterial to the overall presentation of the basic financial statements. The expenses of the Department of the Auditor General equal less than 1 percent of the expenses reported for Governmental Activities on the Statement of Activities and less than 1 percent of the expenditures reported for the General Fund on the Statement of Revenues, Expenditures and Changes in Fund Balance. The Auditor General is the Commonwealth's independently-elected auditing officer. Article VIII, § 7, of the Pennsylvania Constitution mandates the Auditor General to act jointly with the Governor and State Treasurer to vote on the incurrence of debt. Title 72 of the Pennsylvania Statutes, § 1102, mandates the Department of the Auditor General to approve the disposition of petitions for corporation tax resettlements filed with the Pennsylvania Department of Revenue's Board of Appeals, which may be appealed to the Board of Finance and Revenue. Title 71 of the Pennsylvania Statutes, § 115, mandates the Auditor General to be one of the six members of the Board of Finance and Revenue, which is an independent board whose decisions may be appealed to Commonwealth Court. The above-mandated responsibilities are performed by personnel separate from those involved in the performance of the audit of the Commonwealth's basic financial statements. We believe these mandated responsibilities of the Department of the Auditor General, acting separately, do not impair the Auditor General's independence in the audit of the Commonwealth's basic financial statements and are being disclosed as required by and in accordance with auditing standards generally accepted in the United States.

We conducted our audit in accordance with auditing standards generally accepted in the United States 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 Tuition Account Investment Program, the PA Infrastructure Investment Authority, 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*.

<u>Internal Control Over Financial Reporting</u>

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 an opinion 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 04-01 through 04-19.

A material weakness is a reportable 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 caused by error or fraud 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 04-01, 04-03 to 04-10, 04-12 to 04-16, and 04-18 to be material weaknesses.

Compliance and Other Matters

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 grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as Comment 04-11.

We also noted certain additional matters that we reported to the management of the Commonwealth of Pennsylvania in a separate letter dated February 18, 2005.

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.

Jack Wagner   Ernst + Young LLP

February 18, 2005

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

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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, 2004. 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, 2004. 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.

The transactions of the Department of the Auditor General are included in the basic financial statements and are immaterial to the overall presentation of the basic financial statements. The expenses of the Department of the Auditor General equal less than 1 percent of the expenses reported for Governmental Activities on the Statement of Activities and less than 1 percent of the expenditures reported for the General Fund on the Statement of Revenues, Expenditures and Changes in Fund Balance. The Auditor General is the Commonwealth's independently-elected auditing officer. Article VIII, § 7, of the Pennsylvania Constitution mandates the Auditor General to act jointly with the Governor and State Treasurer to vote on the incurrence of debt. Title 72 of the Pennsylvania Statutes, § 1102, mandates the Department of the Auditor General to approve the disposition of petitions for corporation tax resettlements filed with the Pennsylvania Department of Revenue's Board of Appeals, which may be appealed to the Board of Finance and Revenue. Title 71 of the Pennsylvania Statutes, § 115, mandates the Auditor General to be one of the six members of the Board of Finance and Revenue, which is an independent board whose decisions may be appealed to Commonwealth Court. The above-mandated responsibilities are performed by personnel separate from those involved in the performance of the audit of the Commonwealth's basic financial statements. We believe these mandated responsibilities of the Department of the Auditor General, acting separately, do not impair the Auditor General's independence in the audit of the Commonwealth's basic financial statements and are being disclosed as required by and in accordance with auditing standards generally accepted in the United States.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted in the United States, 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 of the Commonwealth's compliance with those requirements.

As explained in Basic Financial Statements Comment 04-10 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 04-10, 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 all major federal award programs 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) did not comply with subrecipient monitoring requirements as reported in Finding 04-1, and did not comply with allowable costs requirements, federal reporting requirements, and special tests and provisions related to processor recordkeeping and on-site monitoring of in-state processors as reported in Finding 04-2.

- The Food Stamps Program (CFDA #10.551) did not comply with eligibility and allowable costs requirements as reported in Finding 04-3.

- The Community Development Block Grants/State's Program (CFDA #14.228) did not comply with subrecipient monitoring requirements as reported in Finding 04-6.

- The HOME Investment Partnerships Program (CFDA #14.239) did not comply with subrecipient monitoring requirements as reported in Finding 04-6.

- The Employment Service Cluster (CFDA #17.207, #17.801, and #17.804) did not comply with cash management regulations as reported in Finding 04-7, and did not comply with allowable costs/cost principles requirements as reported in Finding 04-8.

- The Trade Adjustment Assistance - Workers Program (CFDA #17.245) did not comply with federal reporting requirements as reported in Findings 04-9 and 04-10, and did not comply with eligibility requirements, allowable costs requirements, and period of availability requirements as reported in Finding 04-11.

- The Vocational Education – Basic Grants to States Program (CFDA #84.048) did not comply with federal reporting requirements as reported in Finding 04-19, and did not comply with subrecipient eligibility requirements as reported in Finding 04-20.

- The Rehabilitation Services – Vocational Rehabilitation Grants to States Program (CFDA #84.126) did not comply with allowable costs/cost principles requirements as reported in Finding 04-22.

- The Temporary Assistance for Needy Families Program (CFDA #93.558) did not comply with eligibility and allowable costs requirements as reported in Finding 04-3, did not comply with a special test and provision related to individual assessment requirements as reported in Finding 04-23, and did not comply with federal reporting requirements as reported in Finding 04-24.

- The Child Support Enforcement Program (CFDA #93.563) did not comply with a special test and provision related to the timeliness of processing on interstate registry cases as reported in Finding 04-25.

- The Community Services Block Grants (CFDA #93.569) did not comply with federal reporting requirements as reported in Finding 04-26, and did not comply with subrecipient monitoring requirements, allowable costs requirements, and period of availability requirements as reported in Finding 04-27.

- The CCDF Cluster (CFDA #93.575 and #93.596) did not comply with eligibility and allowable costs requirements as reported in Finding 04-3, and did not comply with subrecipient monitoring requirements as reported in Finding 04-29.

- The Social Services Block Grant Program (CFDA #93.667) did not comply with subrecipient monitoring requirements as reported in Finding 04-29.

- The Medical Assistance Program (CFDA #93.778) did not comply with eligibility and allowable costs requirements as reported in Finding 04-3.

- The HIV Care Formula Grants Program (CFDA #93.917) did not comply with eligibility and allowable costs requirements as reported in Finding 04-33.

- The Social Security - Disability Insurance Program (CFDA #96.001) did not comply with allowable costs/cost principles requirements as reported in Finding 04-35.

- For all major federal programs covered by CMIA as reported in Finding 04-37, 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 its major federal programs, 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, 2004. 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 04-4, 04-5, 04-28, and 04-34.

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 04-1 through 04-33 and Findings 04-35 through 04-37.

A material weakness is a reportable 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 caused by error or fraud 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 04-1 to 04-3, 04-5 to 04-12, 04-14, 04-16, 04-19, 04-20, 04-22 to 04-27, 04-29 to 04-31, 04-33, and 04-35 to 04-37, 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.

Jack Wagner

Ernst + Young LLP

July 29, 2005

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Schedule of Findings
And Questioned Costs

Commonwealth of Pennsylvania

Summary of Auditors' Results - June 30, 2004

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? _X_ yes ____ 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)
Community Development Block Grants/State's Program (CFDA #14.228)
HOME Investment Partnerships Program (CFDA #14.239)
Employment Service Cluster (CFDA #17.207, #17.801, and #17.804)
Trade Adjustment Assistance – Workers (CFDA #17.245)
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)
Community Services Block Grant (CFDA #93.569)
CCDF Cluster (CFDA #93.575 and #93.596)
Social Services Block Grant (CFDA #93.667)
Medical Assistance Program (CFDA #93.778)
HIV Care Formula Grants (CFDA #93.917)
Social Security – Disability Insurance (CFDA #96.001)
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	$ 29,193
10.551 and 10.561	Food Stamp Cluster	1,026,555
10.557	Special Supplemental Nutrition Program for WIC	141,276
14.228	Community Development Block Grants/State's Program	57,017
14.239	HOME Investment Partnerships Program	14,103
15.252	Abandoned Mine Land Reclamation Program	21,459
17.207, 17.801, and 17.804	Employment Service Cluster	38,129
17.225	Unemployment Insurance	3,294,500
17.245	Trade Adjustment Assistance – Workers	57,337
17.258, 17.259, and 17.260	WIA Cluster	126,044
20.205 and 23.003	Highway Planning and Construction Cluster	1,304,525
66.458	Capitalization Grants for Clean Water State Revolving Funds	89,312
66.468	Capitalization Grants for Drinking Water State Revolving Funds	17,423
83.544	Public Assistance Grants	30,452
84.010	Title I Grants to Local Educational Agencies	423,844
84.027 and 84.173	Special Education Cluster	329,856
84.048	Vocational Education – Basic Grants to States	42,373
84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	122,834
84.367	Improving Teacher Quality State Grants	111,934
93.044, 93.045, and 93.053	Aging Cluster	55,305
93.558	Temporary Assistance for Needy Families	776,546
93.563	Child Support Enforcement	115,104
93.569	Community Services Block Grant	30,293
93.575 and 93.596	CCDF Cluster	314,725
93.658	Foster Care Title IV-E	358,533
93.667	Social Services Block Grant	104,875
93.767	State Children's Insurance Program	139,118
93.775, 93.777 and 93.778	Medicaid Cluster	8,081,303
93.917	HIV Care Formula Grants	33,996
93.959	Block Grants for Prevention and Treatment of Substance Abuse	57,792
96.001	Social Security – Disability Insurance	72,226
99.999	Miscellaneous – Temporary State Fiscal Relief	40,039
	Total Federal Expenditures – Major Programs	$ 17,458,021

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

Auditee qualified as low-risk auditee? ____yes __X__no

Index to Basic Financial Statement Comments - June 30, 2004

Comment No.	Comment	Impacted State Agency	Comment Page	CAP Page
04-1**	Internal Control Weakness Over Financial Reporting for Lottery Fund's Property Tax Rent Rebate Accrual (A Similar Condition Was Noted in Prior Year Comment #03-4)	OB/CS	**136**	329
04-2*	DOH Did Not Comply with Annual Contractor and Service Provider Audit and Annual Reporting Requirements for the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-8)	DOH	**137**	335
04-3**	Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed by DCED (A Similar Condition Was Noted in Prior Year Comment #03-10)	DCED	**140**	331
04-4**	Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance (A Similar Condition Was Noted in Prior Year Comment #03-9)	DOH	**142**	336
04-5**	Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-11)	OB/BFM	**144**	329
04-6**	Internal Control Weaknesses Result in Improper Payments in the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-1)	DPW	**146**	338
04-7**	Internal Control Weakness Over Financial Reporting in the Department of Education GAAP Template (A Similar Condition Was Noted in Prior Year Comment #03-7)	OB/LECS	**149**	329
04-8**	Inadequate Review and Testing of Data Conversion Programs From the FMIS Legacy System to SAP Resulted in Undetected Material Errors in the Motor License Fund Basic Financial Statements	PADOT	**150**	340
04-9**	Weaknesses in Internal Controls and Inadequate SAP Financial Reporting Led to Undetected Material Errors in the Motor License Fund Financial Statements	OB/TRANS	**153**	340
04-10**	Lack of Documentation and Internal Control Weaknesses Over Contracting and Procurement (A Similar Condition Was Noted in Prior Year Comment #03-16)	OB/OA	**156**	329
04-11*	Noncompliance With Statutory Limits for Equity Investments	L&I	**161**	336

Index to Basic Financial Statement Comments - June 30, 2004

Comment No.	Comment	Impacted State Agency	Comment Page	CAP Page
04-12**	Internal Control Weaknesses Over Reporting Inter- and Intrafund Activity in the Basic Financial Statements (A Similar Condition Was Noted in Prior Year Comment #03-5)	OB/BFM	**163**	329
04-13**	Errors and Internal Control Weaknesses in Accruing and Reporting Intergovernmental Revenues and Receivables in the Basic Financial Statements	OB/BFM	**165**	329
04-14**	The Bank Shares Tax Liability and Related Expense was Understated in the Department of Revenue GAAP Template	OA	**167**	329
04-15**	Cash and Investment Balances in the Statutory Liquidator Fund Were Misstated in the Preparation of the GAAP Template (A Similar Condition Was Noted in Prior Year Comment #03-2)	INS OB/CS	**168**	329
04-16**	Internal Control Weaknesses Over Agency Accounting for Capital Assets (A Similar Condition Was Noted in Prior Year Comment #03-14)	OB/BFM	**169**	330
04-17*	Internal Control Weaknesses in PLCB's Financial Reporting from the New SAP Accounting System	LCB	**171**	337
04-18**	Statewide Weaknesses in Segregation of Duties and System Security Within the SAP Accounting System (A Similar Condition Was Noted in Prior Year Comment #03-13)	OB/BFM	**174**	330
04-19*	Internal Control Weakness in the Financial Accounting Records	OB/BFM	**177**	330

* - Reportable Condition
** - Material Weakness
CAP - Corrective Action Plan

Comment 04 – 1:

Central Services Comptroller Office

Internal Control Weakness over Financial Reporting for Lottery Fund's Property Tax Rent Rebate Accrual (A Similar Condition Was Noted in Prior Year Comment #03-4)

Condition: The Central Services Comptroller Office prepared the Lottery Fund's GAAP template with a duplicate liability accrual for the Property Tax/Rent Rebate (PTRR) Program. Because of this double-posting, liabilities were overstated by $100 million and an auditor adjustment was necessary to correct this balance in the CAFR. We also noted a $3.7 million overstatement in receivables and accrued revenue from Lottery's game sales which also resulted in an auditor adjustment to those balances 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 above-noted misstatements were caused by clerical/methodology errors and by inadequate preparation and review of the GAAP template. Neither the Lottery GAAP template preparer nor the reviewer performed a comparison of current year liabilities to the prior year to detect unusual changes.

Effect: 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 and revise its preparation and internal review procedures for the Lottery GAAP template.

Agency Response: In the previous year (June 30, 2003) a manual accrual entry was required to report the liability accrual for the Property Tax/Rent Rebate Program, therefore, we assumed a manual entry was required to book the liability at June 30, 2004. We did not realize that a new procedure had been implemented to book this entry automatically based on value dates.

The overstatement of receivables and accrued revenue from Lottery's game sales was the result of Treasury's receipting revenue on June 30, 2004 and the information not being booked in SAP until after June 30, 2004. The transfer and receipt of information from legacy systems to SAP will require Revenue Accounting to perform a comprehensive assessment of the information provided by Treasury to confirm the true status of year-end accounts receivables.

In the future, the Lottery template preparer will compare current year liabilities to the prior year to detect unusual changes. In addition, an extensive review of the information provided by Treasury will be instituted to confirm the validity of accounts receivable at year-end, and appropriate entries will be made in SAP.

Also, the aforementioned comparison and review procedures will become part of the written Lottery template instructions, and a copy of this finding and the related response will be inserted into the template file for future reference. This change in procedures will improve internal controls and help minimize the risk of misstatements in the CAFR.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review 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 04 – 2:

Department of Health

DOH Did Not Comply With Annual Contractor and Service Provider Audit and Annual Reporting Requirements for the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-8)

<u>Condition</u>: Our testing of the receipt of contractor audits during the SFYE June 30, 2004 under the Tobacco Use Prevention and Cessation program disclosed that DOH did not ensure an annual audit was conducted or followed up on for Tobacco Settlement funding received for the SFYE June 30, 2003 by three of five contractors we selected for testing. The three entities (Montgomery County Drug & Alcohol Commission, Philadelphia Department of Public Health, and York City Bureau of Health) received $7.8 million of the $48.6 million in Tobacco Use Prevention and Cessation funding awarded to 64 different contractors during the SFYE June 30, 2003. Further, DOH did not receive an annual report or audit of a service provider funded by the City of York where fraud was alleged by a former employee of the service provider.

A similar internal control weakness was reported in our prior-year audit with inadequate follow-up by DOH to correct this weakness in the current year.

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

Section 707. Service Providers

(b) Service Provider Annual Report. – A service provider awarded a grant under this chapter shall annually report to the primary contractor and to the Department all of the following:

1. *Expenditures made with grant awards.*
2. *Whether the goals set by the primary contractor have been met and the methodology utilized to measure program results.*

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.

<u>Cause</u>: DOH personnel indicated that the lack of audits for these contractors for the SFYE June 30, 2003 was an oversight, and that audit monitoring procedures to ensure compliance with Section 709 of the Tobacco Settlement Act were being implemented during the SFYE June 30, 2005. Regarding the service provider annual report and audit, DOH personnel indicated they are currently attempting to receive these reports.

<u>Effect</u>: Since DOH personnel did not receive an audit for three of five contractors tested for the SFYE June 30, 2003, DOH did not comply with Section 709(a) of the Tobacco Settlement Act. Due to the overall internal control weakness, without audits of these contractors, DOH cannot be assured the funds are being spent in compliance with the Act. Also, DOH is not in compliance with Section 707 and 709 of the Tobacco Settlement Act as it relates to the service provider where fraud was alleged, and it cannot be assured that fraud did not occur at the service provider.

<u>Recommendation</u>: DOH should ensure that all annual reports and audits required by Section 707(b) and 709(a) of the Tobacco Settlement Act are completed, received, and followed up on as necessary.

<u>Agency Response</u>: To ensure future audit and reporting requirements are met, the Department has taken the following steps:

Comment 04 – 2: (continued)

- A letter was issued March 16, 2005 to all Primary Contractors clarifying and reminding them of their audit requirements.

- A revised ***AUDIT REQUIREMENTS*** appendix that is specific to the Tobacco Use Prevention and Cessation program was incorporated into the new contractual documents, effective July 1, 2005. The audit threshold for the tobacco prevention and cessation program-specific audit of state funds has been lowered from $300,000 to $100,000 to ensure compliance by all contractors.

Specific to the three counties cited as non-compliant for SFYE 6/30/03, please refer to the following:

- Montgomery County – The audit for the period July 1, 2002 to June 30, 2003 was received by DOH on December 29, 2004.

- Philadelphia County - The Department contacted Philadelphia concerning the audit that had not been submitted. Philadelphia stated that they thought the tobacco funds were included in their single audit. The DOH informed them that these are state funds and are therefore not included in their single audit, and must be audited in accordance with the terms of their contract with DOH. Philadelphia stated that they would comply and have the funds audited. They anticipate issuing the audit before December 31, 2005.

- City of York - The Department also contacted the City of York concerning the audit that had not been submitted. The City of York stated that they would issue a program audit report by the end of May 2005 to cover the audit period of May 1, 2002 through June 30, 2004. The audit report will include separate Schedules of Contractual Performance for each of the program audit periods included in the report. The City of York explained that their delay in submitting the reports in a timelier manner was caused by a change in audit firms performing the work and preparing the reports.

The Department fulfills the requirements of Section 709 of the Tobacco Settlement Act for service providers by requiring audits of the primary contractors, since the service providers are subcontractors of the primary contractors. DOH ensures compliance with this requirement as part of its site visits to the primary contractors.

On April 4, 2005, the City of York sent a letter to the DOH regarding the issue of alleged fraud activities for one of their service providers. The letter enclosed a copy of an audit performed by a local accountant of the service provider in question. The letter states, "From our Health Bureau's perspective, we do not feel further investigation or action by us is indicated. [The service provider] (and [former employee of the service provider who made the allegations of fraud]) produced the PSA tapes that they had proposed to do for the agreed upon amount. The [service provider] Board, for reasons totally unrelated to this grant, has since dissolved and [service provider] is now out of business. If there were any issues between [service provider] and [former employee of the service provider who made the allegations of fraud] concerning expenditures, then that was between the two of them and not, in our opinion, between [service provider] and the City of York." The DOH program office reviewed the City of York's response, concurred with it, and considers the issue resolved.

Auditors' Conclusion: We received the audit of Montgomery County for the period July 1, 2002 to June 30, 2003 and it was date stamped received by DOH December 29, 2004. However, DOH personnel stated that it was not provided in response to previous requests because the audit could not be located by DOH. Furthermore, the audit included a finding disclosing a weakness that Montgomery County's subcontractors were not being audited in accordance with TSA audit requirements, with no follow up by DOH to ensure Montgomery County implemented corrective action. Therefore, DOH's internal controls in its audit enforcement process are weak.

Regarding the fraud allegation against the service provider at the City of York, we do not consider the issue resolved based on the April 4, 2005 letter from the City of York. The documentation provided with this letter was not an audit and contained no auditor opinion, but was simply a one-page summary of receipts and disbursements prepared for the use of the service provider, which disclosed that 60 percent of the receipts were disbursed to the Grant Administrator

Comment 04 – 2: (continued)

who was the subject of the fraud allegation. There is no evidence that anyone independent of the Grant Administrator reviewed any documentation supporting any of the grant expenditures at the service provider. Therefore, in order to ensure adequate follow up on fraud allegations, DOH should obtain an audit from the service provider that is conducted in accordance with generally accepted government auditing standards as required by Section 709 on Accountability as noted above.

Based on the agency response, our finding and recommendation with the above clarifications 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 04 – 3:

Department of Community and Economic Development

Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed by DCED (A Similar Condition Was Noted in Prior Year Comment #03-10)

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. We noted this same internal control weakness in our prior audit with inadequate corrective action by DCED in the current year.

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: Although certain performance information was presented in the annual reports submitted by each Center 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. DCED personnel indicated that they contracted with a consultant during July 2004 to assist in the preparation of procedures for annual performance reviews of the Regional Biotechnology Research Centers. DCED provided a February 2005 draft of program guidelines for the Regional Biotechnology Research Centers; however, since these procedures were not finalized, DCED could not complete the required performance reviews as of the date of our audit report.

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 cannot verify whether each Center is meeting and achieving their goals and functions on a timely basis.

Recommendation: DCED should continue in its efforts to establish procedures to ensure that proper 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: Since responding to the prior report finding in July 2004 and following up with a corrective action plan in August 2004, DCED staff engaged PricewaterhouseCoopers, LLC (PwC) to perform a financial and operational review of the three Regional Biotechnology Centers. DCED staff worked with PwC and the Centers and the report was made final April 27, 2005. DCED continues to attend each of the board meetings of the three Regional Biotechnology Centers and maintains open communication with all of the Centers. Through these exchanges and participation in meetings DCED continues to be involved with the activities of each of the Centers. DCED is currently working with the Centers staff to improve the program guidelines. DCED staff has reviewed the Annual Reports submitted by the Regional Biotechnology Centers. Once the enhancements to the guidelines are complete, from the past two years of experience, DCED staff will be able to better document and perform the procedures to verify whether each Center was meeting and achieving their goals and functions on a timely basis.

Comment 04 – 3: (continued)

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. Annual performance reviews were required to be submitted during our current fiscal year ended June 30, 2004 by November 30, 2003. These reviews should have covered the centers' performance during the fiscal year ended June 30, 2003. However, these required performance reviews were not done. The report referred to in the agency response was prepared for the fiscal year ended June 30, 2004, so the reviews required to be performed in our current audit period have still not been done. Furthermore, the report for June 30, 2004 was due by November 30, 2004, but as indicated in the agency response, was not completed until April 27, 2005, or about five months late. As a result, there are unresolved internal control weaknesses in DCED's process for ensuring these reviews are performed and completed timely in accordance with the Act. 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 04 – 4:

Department of Health

Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance (A Similar Condition Was Noted in Prior Year Comment #03-9)

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 each fiscal year's grant. However, the majority of contracts with the 44 CURE grant recipients extend beyond the end of the fiscal year and up to four years in length. In addition, as reported in the 2003-2004 Annual CURE Report maintained on the DOH website, since the inception of the CURE grants in 2001, only $92.7 million of $228.4 million, or 40.6 percent of all CURE funds distributed in the aggregate have been expended by grant recipients as of June 30, 2004. Since the Commonwealth no longer has jurisdiction over this cash, internal controls are weak over the $135.7 million in unexpended grant funds being held by outside grant recipients, which are at risk of loss to the Commonwealth.

Our prior-year audit disclosed a similar internal control weakness over this CURE finding with no corrective action by DOH in the current year.

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 $135 million in Tobacco Settlement funds remain unexpended in the possession of grantees as of June 30, 2004, 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. We noted, for example, that if DOH at least monitored the cash needs of its larger grantees, which are small in number, internal control would be strengthened for a large percent of the CURE funding being paid out. 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

Comment 04 – 4: (continued)

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.

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. 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. Thus, the Commonwealth ultimately may lose more money than it gains if the system is changed to a cost reimbursement system. Furthermore, 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: We acknowledge the points made in DOH's agency response, but our conclusion that there is a weak control environment over these funds has not changed. Sixty percent of the funds remain unspent after three years of DOH's payouts, so the funds have obviously not been needed by the grantees to operate their programs. In addition, since the $135.7 million in TSF cash sitting in grantee accounts represents 24 percent of total TSF revenues in the current year and over 15 percent of TSF net assets at year end, we consider this total to be unreasonable to the TSF overall. Lastly, we would like to point out that the DOH response failed to address the point in our recommendation about strengthening controls over at least its larger grantees to mitigate the potential financial impact of this control weakness, and at the same time minimize the additional cost to the parties implementing corrective action.

Accordingly, our comment 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 04 – 5:

Executive Offices
Office of the Budget – Bureau of Financial Management
Public Health and Human Services Comptroller Office
Labor, Education, and Community Services Comptroller Office
Central Services Comptroller Office

Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund (A Similar Condition Was Noted In Prior Year Comment #03-11)

Condition: Our audit of the Commonwealth's Tobacco Settlement Fund (TSF) for the fiscal year ended June 30, 2004, 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. Similar errors were noted in our prior audit, with inadequate corrective action by the Office of the Budget in the current year. Material auditor adjustments were necessary to ensure TSF amounts were presented in accordance with GAAP as detailed below.

Accounts payable at the Department of Insurance were overstated by $17.4 million due to invoices being recorded by the Central Services Comptroller Office on the SAP accounting system with incorrect value dates of service.

Expenditures were overstated by $7.2 million due to disbursements for venture capital investments at DCED being recorded by the LECS Comptroller Office on the SAP accounting system inappropriately as expenditures.

The Due from Other Funds balance was understated by $12.1 million since this balance, which represented Intergovernmental (i.e., federal) Revenue collected by DPW in the General Fund, owed to the TSF, but not yet transferred to the TSF as of June 30, 2004, was not recorded by the PHHS Comptroller Office on the SAP accounting system as of June 30, 2004. The Due To Other Funds balance was understated in the General Fund by the same amount.

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: OB-BFM and the Comptroller Offices did not develop procedures to ensure that value dates which trigger accounts payable are accurately recorded on the SAP accounting system. The LECS Comptroller Office posted disbursements for venture capital investments to the incorrect General Ledger Account Number 6600200, State Payments for Grants to For-Profit Entities, instead of General Ledger Account Number 1202010, Long-Term Investment Purchases – Non Treasury BA.

BFM and PHHS personnel could not explain why the $12.1 million in funds due to the TSF did not appear on the SAP accounting system as a Due from Other Funds within the TSF at June 30, 2004. However, we noted that as federal funds are transferred to the TSF from the General Fund throughout the year, an entry to General Ledger Account Number 1300460, Due from Other Funds, is not recorded; therefore, revenue due to the TSF from other funds is not being properly accrued on SAP at year end. Further, since Comptroller Offices are not required to perform periodic reconciliations of the FI module (accrual basis) to the FM module (budgetary basis) of the SAP accounting system, account balances such as Intergovernmental Revenue and interfund accruals are misstated in the FI module.

Also, 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.

Comment 04 – 5: (continued)

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

Recommendation: We recommend that OB-BFM and 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: The overstatement of accounts payable for the Department of Insurance was created by eight manually processed invoices for the Adult Basic Health Insurance Program. Document Review & Control staff manually enters the coding on these invoices, including the "value date" field that determines the accounting period the expense is booked to. Staff does receive training and reminders each year in determining and entering appropriate value dates. Also, a management report is generated after the close of each fiscal year to attempt to identify and correct this type of problem but these eight invoices were not detected using that report.

Central Services Document Review & Control is assigning accountant-level staff to develop, implement, and track quality control issues. The function of this position will be to identify invoice processing issues, identify or develop management reports that assist in monitoring the issue, and perform periodic quality control reviews of all invoice processing staff to detect and correct errors as they occur. We believe this will greatly reduce the risk of similar errors going undetected in the future.

Auditors' Conclusion: Based on the agency response, our 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 04 – 6:

Department of Public Welfare

Internal Control Weaknesses Result in Improper Payments in the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-1)

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

When calculating TSA Section 1103 payments, the number of Medicare SSI days as a percentage of total inpatient days, which is one of three key percentages used to determine a qualified hospital, DPW inappropriately used different fiscal years in the numerator vs. the denominator. For budget year 2002-03, 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 total impact of the overall inconsistency on Section 1103 payments could not be determined by DPW or the auditors.

In addition, the Department of Auditor General, in a separate audit engagement performed by the Bureau of State-Aided Audits dated January 12, 2005 of Section 1105 extraordinary expense claims for Budget Year 2002-03, disclosed that, due to the improper reporting of extraordinary expense claim data to DPW by hospitals and inadequate verification of this claim data by DPW, out of the $14,352,130 in payments received by hospitals, only $7,081,253 was actually eligible for reimbursement in accordance with the Act.

We also noted that the same audit exceptions that existed for the 2002-03 budget year also existed for DPW's 2003-04 budget year UC payments. Further, beginning with the 2003-04 year payment calculations, DPW was required by a change in the law to use data from the immediate preceding three years; thus DPW should have used data from the fiscal years 01, 02 and 03 but did not.

The above inconsistencies would likely have caused improper eligibility determinations and Section 1103 UC payments to the hospitals in question. Further, DPW has not yet resolved the significant discrepancies in data provided by hospitals to support the calculation of Section 1105 UC payments as disclosed in the separate audit by the Department of Auditor General, Bureau of State-Aided Audits. Nor has DPW developed an internal audit or monitoring plan to prevent, detect, and resolve the submission of erroneous data by hospitals prior to Section 1105 payments.

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 04 – 6: (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.

(f) Three-Year Average. -- …For fiscal years 2003-2004 and thereafter, the term "three-year average" shall be the average of the immediately preceding three years.

Section 1105. Reimbursement for extraordinary expense.

(d) Payment methodology. -- Payment to a hospital under this section shall equal the lesser of the cost of:

(1) The extraordinary expense claim; or

(2) The prorated amount of each hospital's percentage of extraordinary expense costs as compared to all eligible hospitals' extraordinary expense costs, as applied to the total funds available in the hospital extraordinary expense program for the fiscal year.

Cause: Regarding the use of inconsistent fiscal years in the calculation of Medicare SSI percentages, and not using data from the immediate preceding three years for the 2003-04 year, DPW personnel stated that in all cases 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 has not had time to address the separate Tobacco Settlement audit mentioned above. Further, no audit plan was developed because DPW decided to rely on the above-mentioned audit of the various hospitals performed by the Department of Auditor General, Bureau of State-Aided Audits.

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 will continue into the future.

Recommendation: DPW should establish procedures to ensure that UC claim data submitted by hospitals is valid and properly supports Section 1105 payments per the Tobacco Settlement Act. This should include an internal audit or monitoring plan that will ensure data submitted by hospitals is accurate, and includes appropriate audit resolution when inaccurate data is submitted. 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 Section 1103 UC payments should be based on a methodology which is reasonable and avoids the inconsistencies in fiscal years identified above. For fiscal years 2003-04 and thereafter, the calculations should be based on the average of the immediate preceding three years as required by the new law.

Agency Response: The Extraordinary Expense (EE) payments audits performed by the Auditor General's Bureau of State-Aided Audits have been reviewed by the Department. We have begun to collect overpayments, after which we will make payments to those hospitals that received underpayments to reconcile with the findings.

Comment 04 – 6: (continued)

The Legislation requires staff to utilize data from the Pennsylvania Health Care Cost Containment Council (PHC4). The PHC4 has taken steps to improve their data validation system and has demonstrated to our staff their process. For Fiscal Year Ending (FYE) 05, all hospitals have been given the opportunity to verify their claims data prior to its inclusion in the Department's tobacco calculations. It is the Department's and PHC4's hope that this new validation process will significantly improve the accuracy of the claim data used for the EE payments.

As stated in the Tobacco Settlement Act 77 of 2001, Section 1104 (c) (2), the Department was to use the most recent data available in its calculations for Uncompensated Care (UC). Originally, the decision was made to use differing years in an attempt to provide the most up-to-date data available. Regarding the auditors' comment that using different years for the SSI calculations, the median UC score is not fixed, it is relative. One hospital's drop in UC score would change the median.

The Department's goal is to use consistent data when available. For FYE 05, the Department is using FYE 01, FYE 02, and FYE 03 as both the numerator and denominator for all data points. Also, the Department is aware of the requirement for the UC payments to use data from the three immediate preceding years starting in Fiscal Year 2003-2004. It is not possible to comply with this provision of the Act. Hospitals are not required to submit their cost reports until November 30th following the end of the Fiscal Year. For example, FYE 04 cost reports have not all been desk reviewed at this time and could contain substantial errors leading to incorrect tobacco calculations. SSI data is also not available in a timeframe that would facilitate the payments within established timelines. Consequently, a decision was made to use the best available data to ensure the most accurate outcome in calculations.

The Department continues to follow the criteria outlined in the Tobacco Settlement Act of 2001 and will strive to consistently use the best available data. As noted in earlier responses, the Department has initiated an internal and external validation process. Beginning with FYE 02 tobacco payments, the Department implemented an internal validation process that includes computer programming cross checks to ensure the accuracy of data outcomes and a core team of personnel who individually analyze the calculations for facilities. As an external validation, all data is sent to each facility for verification and the final calculations are reviewed and accepted by the hospital industry.

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 04 – 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 (A Similar Condition Was Noted in Prior Year Comment #03-7)

Condition: As in the prior audit, the Commonwealth's Basic Financial Statements (BFS) contained material undetected misstatements that required adjusting entries by the auditors. Because of errors and oversights in the Department of Education GAAP template preparation, amounts due from political subdivisions were understated and revenue and accounts receivable were overstated by $4.8 million, expenditures were overstated by $54.0 million, amounts due to political subdivisions were overstated by $49 million, and encumbrances were understated by $5.1 million.

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

Cause: The undetected misstatements were again caused by inadequate preparation and review of the GAAP template by the LECS Comptroller. The GAAP template preparer was unfamiliar with SAP and did not make sure the necessary accruals were made.

Effect: The government-wide and fund financial statements for the Department of Education were misstated and required auditor adjustment. 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 preparation and issuance of the CAFR.

Recommendation: The LECS 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 methodologies and internal procedures need to be reviewed to ensure accuracy when preparing GAAP templates. To reduce the risk of such errors happening again, additional staff members have been assigned to prepare templates for 2005. Also, staff responsible for preparing the template and for compiling the receivable and payable amounts now attend SAP user meetings and any other available GAAP training. As staff become more familiar with SAP and its intricacies, these overstatements/understatements should no longer occur.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 8:

Department of Transportation

Inadequate Review and Testing of Data Conversion Programs From the FMIS Legacy System to SAP Resulted in Undetected Material Errors in the Motor License Fund Basic Financial Statements

Condition: The conversion of expenditure data from PADOT's FMIS legacy system to the newly-implemented SAP system was incorrect for the Motor License Fund (MLF) during SFYE June 30, 2004. The FMIS system was operational throughout the fiscal year ended June 30, 2004, during which the FMIS data was being loaded to SAP on a regular basis. During the period July 1, 2003 to February 28, 2004, the Statewide ICS System was still operational, so FMIS data was flowing in summary to ICS. The summary data was then being loaded from ICS to SAP using an ICS-to-SAP coding table. ICS was decommissioned at the end of February 2004 and replaced by SAP. To accommodate the conversion for the balance of the year (March 1, 2004 to June 30, 2004), FMIS was loading directly to SAP at a detailed level for financial reporting purposes. Based on discussions with PADOT management, we determined that there were coding errors in SAP that were the result of problems identified in the data conversion process as follows:

- FMIS and ICS expenditure data for July 1 through February 28 was recorded into SAP at a summarized level which was not detailed enough for financial reporting out of SAP. Therefore, to allow for full financial reporting from SAP, a data conversion file from FMIS was subsequently created after the original postings to record detailed transactions into SAP for July through February. PADOT Comptroller's Office provided the necessary data to IES to load into SAP. The error occurred because an incorrect conversion table was utilized by IES for the conversion. IES used an ICS to SAP table to convert and code the data into SAP instead of a FMIS table. FMIS and ICS code tables differ which led to numerous undetected errors. After auditors detected the conversion errors, several hundred correcting entries were required to be posted to period 14 by PADOT Comptroller personnel.

- A second error occurred during the routine data uploads from FMIS to SAP for the period March 1 through June 30, 2004. The correct code table was utilized; however, upon further investigation PADOT determined that incorrect coding was used within the conversion table. As a result, additional errors in data were identified between FMIS and SAP that required later corrections by the PADOT Comptroller Office. PADOT had to calculate a second series of adjustments to correct SAP, which were posted in period 14 as well.

In addition, according to the test results of our information technology (IT) auditors' review of the PADOT data conversion at the time of SAP implementation, the following exceptions were noted:

- The open receivables interface to SAP was not verified to ensure that the conversion to SAP was accurate. Also, the documentation for the accounts payable and budget conversions to SAP was not available for review so as a result, the adequacy of the verification could not be determined. In addition, based on our sample of test scripts, we noted that the data was not verified or no documentation was present in order to determine if the system was working properly.

- The beginning balances from ICS to SAP were not verified by IES or Comptroller personnel, which impacted the data conversions from the start of the audit period through February 28, 2004. Also, the daily accounting file interfacing FMIS to SAP in the conversions starting on March 1 through fiscal year end were not being verified. After auditor inquiry, the coding table was later determined to have errors causing the anomalies in SAP noted above.

- No analytical procedures were performed by the PADOT Comptroller's Office after the conversion; therefore, they were not aware of any errors that might have occurred.

Criteria: Good business practice dictates adequate testing and review should be performed prior to running the data conversions from the legacy systems (FMIS/ICS) to SAP in the production environment. In addition, the results of the data conversions in production should be timely verified by adequate review and reconciliation in order to detect any errors in the data recorded in SAP as a regular part of processing.

Comment 04 – 8: (continued)

Cause: Testing and verification of the data conversion programs, data coding tables, and output to SAP performed by IES and/or Comptroller staff prior to going into production was inadequate. Furthermore, the review and verification of the data conversion results from SAP was inadequate, and the errors went undetected throughout the balance of the audit period.

Effect: Expenditures recorded on SAP for the fiscal year ended June 30, 2004 were incorrectly classified amongst the various general ledger accounts in SAP, and the errors were not timely detected and corrected by PADOT or the Comptroller Office. These undetected errors ranged in amount up to $300 million, and were discovered after auditor inquiries regarding the unusual variances found during the audit. Several hundred adjustments had to be made by the PADOT Comptroller to correct the expenditure balances. These errors by the auditee caused significant delays in the preparation and issuance of the CAFR.

Recommendation: Adequate testing and review of data should be planned and performed in a test environment by the users of the data prior to implementation or conversion in the production environment. Also, as part of regular operations, adequate reconciliations and review of daily account activity should be performed to verify that accounting data in the SAP system is accurate and complete. The verification of accounting data should be sufficient to ensure that errors are identified at the time they occur and corrected in a timely manner.

Agency Response: The Department agrees in principal with the comment. The Department was handed a monumental task of converting data from FMIS directly to SAP for the period March 1, 2004 to June 30, 2004. This was quite an undertaking for PADOT since it required our mainframe system to be converted. It also provided a challenge to IES and everyone else involved in the conversion to SAP since FMIS was unique to only PADOT. While working with existing personnel, the Comptroller's office, under tremendous time constraints, reconciled the expenditure data at the highest appropriation level. Consequently, some misclassifications at the lower levels, caused by errors in the FMIS to SAP crosswalk table used by the FMIS to SAP interface during the March 1, 2004 to June 30, 2004 time period and the use of the wrong crosswalk table for the March 1, 2004 reclassification of expenditure data, went undetected. All errors pertaining to expenditure data were corrected immediately, once they were identified, by reclassifying the data in SAP to match the data in FMIS, which was the Department's official book of record for detailed financial reporting through 6/30/2004. We agree that good business practice dictates that adequate testing and review should be done in these situations. The controls that were in place during this time period were sufficient to verify the data at the appropriation and SAP fund level. Department and Comptroller resources available during this time period were deployed to satisfy multiple competing priorities to ensure that ongoing accounting operations in FMIS and ICS were properly supported, to ensure that the expectations of the Department's external customers pertaining to the SAP system were met and that the implementation of the SAP system would occur on schedule on July 1, 2004.

We would like to note that the FMIS to ICS and the ICS to SAP interfaces in production from the start of the audit period through February 28, 2004 did not cause any errors whatsoever. At this point in time the FMIS to ICS interface had been in production for approximately sixteen years and the ICS to SAP interface had been in use for two years. The controls established by the Transportation Comptroller's Office pertaining to the transfer of accounting information to ICS through the FMIS to ICS interface and the controls established by the Bureau of Financial Management pertaining to the transfer of accounting information to SAP through the ICS to SAP interface were sufficient to ensure the integrity of SAP accounting data.

As for the conversion of the accounts receivable database, the data load was verified by comparing the record count and total dollar amount of receivables populated on the SAP database to the record count and dollar amount of receivables on the FMIS accounts receivable database.

We would also like to state that all documentation that was requested by the auditors was provided if it was available. At no time did the Department withhold any documentation.

Comment 04 – 8: (continued)

In summary, we did not anticipate that IES would use the wrong crosswalk when reclassifying our data on March 1, 2004 or that the IES crosswalk table used by the FMIS to SAP interface would contain assignment anomalies, and we did not implement controls to address these risks. We will be certain to include an evaluation of these risks in future system implementation projects.

Auditors' Conclusion: Regarding the conversion errors between July 1 and February 28, we agree with the agency response that the original FMIS-to-ICS and ICS-to-SAP interfaces functioned properly. The errors occurred as a result of management's one-time attempt to record more detailed data from FMIS into SAP from this period, and the use of the incorrect conversion table by IES. The errors in SAP went undetected by management until notified by the auditors, so our finding still stands in this regard.

Regarding the accounts receivable interface, we agree that total record counts and dollar amounts from FMIS to SAP were verified. However, these verifications were not sufficient since they were not at a detailed enough level to detect the errors in SAP accounts.

Management did not provide any additional information to mitigate or resolve any of the other exceptions noted in the comment. As a result, our comment and recommendation, with the above clarification, 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 04 – 9:

Department of Transportation Comptroller's Office
Office of the Budget – Bureau of Financial Management

Weaknesses in Internal Controls and Inadequate SAP Financial Reporting Led to Undetected Material Errors in the Motor License Fund Financial Statements

Condition: During our review of the Department of Transportation (PADOT), Motor License Fund's (MLF) systems and internal controls in the SAP environment, we noted material errors, misstatements, and weaknesses in the GAAP financial reporting as follows:

Several material adjustments were identified by the auditors in the MLF and posted to correct undetected errors in the BFS:

- The liquidation of the reserve for encumbrances balance for accounts payable in the amount of $224 million was unreliable and could not be supported by the client. PADOT Comptroller's Office ran an SAP report to record the $224 million liquidation entry according to BFM guidelines, but the report did not include detail transactions and was only a summary of activity. We requested a detail report to support the booking, but neither the Comptroller's Office nor BFM could provide sufficient detail from SAP to support the entry. Upon further audit testing, it was determined that the balance was incorrect and the SAP summary report was incorrect. The PADOT Comptroller Office determined that it would take extensive research to correct the liquidation report in detail, and that using an estimate was the most reasonable approach to correct the error. The estimate was based on historical trends and resulted in an $85 million adjusting entry. Prior to correction, the MLF reserve for encumbrances was understated by $85 million.

- We determined that $47.5 million out of $212 million in federal receivables recorded in a period 15 adjustment by BFM actually represented billings-in-transit which was already accrued as Due From the Federal Government by the PADOT Comptroller's Office in a period 14 entry during GAAP Template preparation. As a result, the $47.5 million was recorded twice in the BFS causing an overstatement of the Due From Federal Government balance and requiring auditor adjustment.

- The initial Cash-in-Transit balance of $800,000 was understated by $37 million and required an auditor adjustment. Due to a shortfall in SAP implementation, revenue deposits at year-end were not properly recorded into the Basic Financial Statements (BFS).

- The Due To Other Funds account was overstated by $18.5 million. BFM inadvertently recorded this interfund liability to the MLF when it should have been posted to the Capital Facilities Fund. This error was discovered as a result of auditors' request of supporting documentation for the SAP account.

We also noted internal control weaknesses that contributed to the errors disclosed above:

- The level of adjustments in period 14 and period 15 posted by the Commonwealth to correct errors in SAP was unreasonable and contributed to the lack of ability of a user to follow the audit trail in a reasonable and timely fashion. PADOT recorded over 1,900 journal entries in period 14 and 15 (excluding auditor adjustments) which totaled over 12,700 lines (records) of adjustments. This equated to approximately a 1,900 percent increase in adjusting entries for GAAP reporting over the prior year. The previous year had just over 100 entries for GAAP reporting.

Comment 04 – 9: (continued)

- There was a lack of PADOT Comptroller Office involvement in the preparation of the current BFS for the MLF due to the increased roles of BFM and IES in the financial reporting process. As a result, the specialized knowledge of the PADOT Comptroller Office was lost in the process and internal controls have deteriorated from prior years. In several instances in the audit, we were unable to gain sufficient information from PADOT Comptroller Office to follow the audit trail due to their lack of involvement in many facets of financial reporting.

- We noted that PADOT's decommissioning of FMIS and replacement by SAP on July 1, 2004, right after the end of our current audit period, resulted in a breakdown in internal controls since management's familiarity with the FMIS system in posting GAAP accruals was immediately lost after year-end.

- We noted unwarranted reliance on SAP by Office of the Budget without the preparation of relevant detailed reports for proper review and approval to ensure MLF amounts were accurate during the BFS preparation process. The inability to create useful and relevant reports led to over reliance on SAP reporting tools by BFM and PADOT.

- Per our observation, internal pressure caused by unrealistic timelines placed on the PADOT Comptroller to meet CAFR reporting deadlines resulted in inadequate preparation and review time for the preparers of the MLF GAAP template. The Office of the Budget initially set a goal of December 31, 2004 for CAFR completion, which was clearly unrealistic and placed extreme pressure on both BFM and the PADOT Comptroller's Office to complete the MLF template on time. The GAAP template for the MLF was not completed until Mid-December and client prepared adjustments were posted as late as March 2, 2005, which was over three months after the planned CAFR completion date. Furthermore, period 14 in SAP contains the Commonwealth's GAAP adjustments for the financial statements. Period 14 did not close until late December and was unavailable to the auditors until subsequent to the Commonwealth's planned completion date. As noted previously, client adjustments continued into period 15, which in the SAP reporting model is designated for auditor's adjustments only.

- The reporting process and audit trail in SAP for MLF was inadequate for timely financial reporting. The GAAP template and supporting SAP reports were lacking useful and relevant presentation necessary for a user to easily follow the audit trail of an account balance. In prior years, the manual GAAP packages presented the financial statements in an informative and easy to follow format which allowed the user to trace closed-out account balances from the financial statements (i.e., statement of net assets) to the supporting journal entries via the T-accounts. Furthermore, the GAAP packages presented the journal entries in a user-friendly format with informative descriptions. In the SAP MLF GAAP template, the excessive number of journal entries were difficult to follow, the SAP journal entry report lacked informative descriptions and were not presented in reasonable order with T-accounts for the related entries. The actual financial statements which reside in SAP Business Warehouse (BW) were subject to changes on a daily basis by the client during our audit. This made Business Warehouse reports unreliable until the very end of the audit, causing untimely financial reporting. To properly audit BW accounts, the auditors had to generate various reports from SAP data files in order to create an adequate audit trail.

Criteria: A key component of sound business practices for financial reporting includes strong internal controls to ensure the organization has the ability to initiate, record, process, and report financial data consistent with the assertions of management in the BFS. The system of internal controls should safeguard against undetected material errors in the accounting system and financial reporting. Sound business practices should include a financial reporting model that has adequate and relevant reports, such that the user can ascertain the validity and provide support for the account balances being presented in the BFS. Furthermore, the timeframe to complete the BFS should allow for adequate time to complete, review, and verify the account balances for accuracy and completeness.

Cause: Inherent limitations in the design and operation of internal control in the SAP environment adversely affected the client's ability to record, process, summarize and report financial data consistent with the assertions of management in the MLF financial statements. The SAP Reporting model for MLF was not an effective tool for financial reporting. In several instances we noted the audit trail was not complete and the financial records at the disposal of the users were not adequate and relevant for the users' needs. In several instances, to verify the account balances, the audit trail could not be prepared by the auditee at all, but had to be completed by computer-generated reports created by the auditors.

Comment 04 – 9: (continued)

Effect: The BFS for the MLF were materially misstated and required auditor adjustments. These material misstatements will continue into the future if the related control weaknesses are not corrected. Furthermore, management's BFS errors and control weaknesses like those disclosed above caused significant delays in the preparation and issuance of the CAFR.

Recommendation: Office of the Budget should improve the controls over financial reporting in SAP to reasonably minimize the number of necessary adjustments after year-end. Improved controls should include better records to support financial statement amounts, along with strengthened and more timely reviews of SAP balances and related adjustments to ensure that the account balances in the BFS are accurate and complete. Financial reporting should include the capability to provide detail reports for accounts and adjustments and provide an adequate and timely audit trail from the account balance to the support. Also, the reports should be presented in a format that is relevant, easy to follow, and is sufficient to meet user needs.

In addition, SAP period 14 should be closed in a timely manner to allow for the GAAP template to include a complete audit trail. Deadlines imposed on the Comptroller's Office and BFM should allow reasonable time to complete and review all necessary reports, data, and adjustments with appropriate PADOT Comptroller involvement to ensure the GAAP templates are reasonably accurate and complete as presented at the close of period 14. Period 15 adjustments should, therefore, be minimized.

MLF GAAP template preparation should be improved to provide closed-out B/W trial balances, Comptroller cross-walks to the journal entries (e.g., T-accounts) and journal entries that are informative, presentable and organized to sufficiently support the trial balance.

Agency Response: We have conferred with our Comptroller's Office and they have acknowledged they are in agreement in principal with comment 04-9. As we have previously stated in our response to comment 04-8, PADOT was handed a monumental task of preparing for the conversion from our Financial Information System (FMIS) to SAP effective July 1, 2004. It also provided a challenge to IES and the Office of Budget, Bureau of Financial Management. PADOT's conversion to SAP was more difficult due to the fact that the unique aspects of FMIS were not present with any other agencies conversion to SAP. All the conditions noted in your comment were a direct result of the many problems encountered by the conversion to SAP. PADOT and Comptroller Office resources available during this time period were deployed to satisfy multiple competing priorities to ensure ongoing accounting operations in FMIS and ICS were properly supported and that the expectations of the Department's external customers continued to be met. Another challenge was to ensure implementation of SAP occurred on schedule, July 1, 2004.

We have been working diligently over the past year to identify weaknesses and improve our controls over financial reporting in SAP. We also have improved our ability to produce detailed reports for accounts and adjustments which will provide an adequate audit trail. We also expect to close future SAP periods in more timely manners.

Implementation of SAP has been a learning experience for all parties involved. We take your recommendations very seriously. Everyone continues to work on the various problems noted in your comment and we feel as we become more familiar with SAP the problems that you noted will not recur for GAAP financial reporting in future years.

In summary, SAP was a huge undertaking, particularly for PADOT. Overall, we feel we handled the conversion to SAP well but agree that mistakes were made.

Auditors' Conclusion: Based on the agency response the finding and recommendation remain as stated above. 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 04 – 10:

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 #03–16)

<u>Condition</u>: 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, 2003, 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. 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, 2004, 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 the prior year, 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:

- 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 internal control weaknesses, which were identified in a separate audit engagement by the Department of the Auditor General and disclosed in a report issued in December 2002, 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 04 – 10: (continued)

- We found significant unresolved inconsistencies, without management follow-up, 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 large statewide telecommunications contract, does not document or analyze billing rates for reasonableness, does not adequately track contract change requests for increasing costs and maintain a contract log when required, and did not implement a reasonable 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 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 04 – 10: (continued)

For the internal control issues above, management indicated that its position on these issues has not changed from the prior year. Management believes 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.

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 up through 2003. However, the separate audit engagement referred to above noted far more in outstanding tax and other liabilities owed the Commonwealth than this amount claimed as collected, without proper internal controls to monitor and ensure collection from contractors. Management further stated that the CRP should be strengthened with the statewide implementation of its new ERP system involving automated key controls and maintaining better suspension and debarment records. No evidence of strengthened internal controls through the new ERP system was provided for our current year.

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.

It should be further noted that management's refusal also prevents us from performing a proper Single Audit of the Commonwealth's major federal programs in accordance with OMB Circular A-133. Procurement is one of the key compliance requirements that is required by the federal government to be tested as part of the Single Audit, and since we cannot audit the Commonwealth's compliance with procurement regulations in certain federal programs, our OMB A-133 Compliance Opinion must be qualified for this scope limitation.

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. We also cannot ascertain whether proper controls are in place to prevent fraud, abuse, or other inappropriate activity from occurring during the contract procurement process. 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. Any errors in change-order documents should be detected and corrected during a proper review prior to management approval. 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.

Comment 04 – 10: (continued)

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; and vendor 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 response for the last two years. 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. Furthermore, the FYE June 30, 2003 auditor's comment regarding this same matter is considered resolved, according to the March 23, 2005 letter received from our cognizant federal agency, the U.S. Department of Health and Human Services.

Regarding the CRP issues, our response to the above condition is the same as our response for the prior two years. To reiterate, 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, which letter was provided to the auditors as part of our prior year's response. Furthermore, we wish to reiterate that the CRP has benefited the Commonwealth by collecting roughly $83 million since its inception. The auditors state "No evidence of strengthened internal controls through the new ERP system was provided for our current year." In fact, the ERP system now includes a direct link to the Contractor Responsibility File (CRF) and blocks payments over $10,000 that are being made to a vendor listed in the CRF.

Regarding RFP's, our response to the above condition is the same as our response for the prior two years.

Our response regarding contract amendments has not changed from that of the prior two years. Management provided a response to the fiscal year ended June 30, 2002 Audit Comment #02-8 which we believe 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 prior audit engagement with audit objectives and reporting requirements that were different than our audit of the Commonwealth's BFS. Management claims that this so-called "agreement" resolves the issues to enable us to verify compliance with procurement regulations in our BFS audit. We noted, however, in our current-year audit of the BFS that this is not the case since management continues in its refusal to provide any documentation, summary or otherwise, related to the specific procurement items noted in the condition above. Our comment, therefore, does not change in this regard.

Comment 04 – 10: (continued)

Management also refers to a letter from HHS stating that HHS considered this matter reported in a prior-audit comment to be resolved. For Commonwealth compliance with state procurement regulations, however, the HHS letter has no impact on our comment since a violation of state regulation is outside the jurisdiction of the federal cognizant agency. Furthermore, during our recent implementation of a new auditing standard related to testing fraud and abuse in federal programs, we noted that management's refusal to provide adequate information on its procurement activities is significant to at least one major federal program (CFDA #93.778 – Medical Assistance) which is by far the largest federal program in the Commonwealth, and a separate finding to report fraudulent activity in MA has been issued in the Single Audit section of this report. Therefore, our comment and conclusions related to the current year have not changed 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 $83 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 comment were corrected.

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 comment 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 04 – 11:

Department of Labor and Industry

Noncompliance With Statutory Limits for Equity Investments

Condition: In accordance with Article XV of the Pennsylvania Workers' Compensation Act (Act 338 of 1915, as amended), SWIF is limited in the amount of equity securities it may own. As indicated in the criteria section below, SWIF's investment in equity securities is limited to the lesser of seven and one-half percent of the book value of its assets or seventy-five percent of its unassigned surplus.

As of December 31, 2003, SWIF's book value of its assets was $1,507,561,000 and the unassigned surplus totaled $164,707,000. Using the lesser of these limitations noted, SWIF was statutorily limited to $113,067,000 in equity securities at year end. However, as of December 31, 2003, SWIF held a total of $148,538,000 in equity securities (actual cost of long-term investments of $140,145,000 in SWIF's separate long-term investment pool plus $8,393,000 in Treasury's short term investment pool). Therefore, SWIF's equity investments exceeded the legal limit by approximately $35,471,000 at December 31, 2003. We also noted that SWIF exceeded this statutory limit on equity securities by approximately the same amount at December 31, 2002 and throughout the years under audit.

In addition, based on our inquiries of LECS Comptroller Office, L&I Office of Chief Counsel, and SWIF personnel, SWIF has no formal process in place to regularly monitor compliance with these investment limitations.

Criteria: The Pennsylvania Workers' Compensation Act (Act 338 of 1915, as amended), Article XV, Section 1512 provides the following regarding SWIF's investments:

The board may invest any of the surplus or reserve belonging to the fund in such securities and investments as are authorized for investment by savings banks.

The Banking Code of 1965, Section 504(b)(vi) provides the following with respect to investments in equity securities:

(vi) shares of preferred stock, guaranteed stock or common stock of a corporation or similar entity existing under the laws of the United States, any state or the District of Columbia, subject to:

> *(B) a limit for the aggregate cost of all shares acquired pursuant to this subsection of the lesser of seven and one-half percent of the book value of the assets of the savings bank or seventy-five percent of the aggregate of its:*
>
> *(I) surplus, unallocated reserves, undivided profits and subordinated securities, in the case of a mutual savings bank, or*
>
> *(II) capital, surplus and capital securities, in the case of a stock savings bank at the time of acquisition of each of such shares*

Strong internal controls should ensure that statutory requirements are monitored throughout the year and any non-compliance with these requirements is corrected in a timely manner.

Cause: Based on our discussions with LECS Comptroller Office, L&I Office of Chief Counsel and SWIF personnel, it appears that SWIF is aware of the limitation on equity investments. However, no one at the State level is monitoring for compliance with these investment limitations on an ongoing basis. L&I Office of Chief Counsel personnel indicated that they rely on the investment advisor (Saloman Smith Barney) to monitor for compliance. Management further stated that SWIF's main contact at the investment advisor recently left the firm and no other individual at the investment advisor was knowledgeable about SWIF's compliance with this requirement.

Comment 04 – 11: (continued)

Effect: SWIF is in violation of the PA Workers' Compensation Act, since it was over-invested in equity securities by approximately $35,471,000 at December 31, 2003 and 2002 and throughout these years under audit. In addition, since SWIF does not have adequate procedures in place to monitor compliance with these requirements, there is limited assurance that SWIF will be in compliance with the PA Workers' Compensation Law in future periods.

Recommendation: We recommend that internal controls be strengthened in SWIF's monitoring of investments to ensure compliance with the applicable State laws. In addition, SWIF should take the appropriate action to rectify the non-compliance noted above.

Agency Response: In accordance with Article XV of the Pennsylvania Workers' Compensation Act (Act 338 of 1915, as amended), when SWIF initially began its investment program nine years ago, only 7.5% was invested in equities. However, because of the growth in value of those equity investments, the SWIF equities have also grown.

Cognizant of this, SWIF has a twofold process in an effort to control the cap of further increases in equities investments. The first is to not allocate any additional funds to equity investment. Newly acquired investment income, such as that produced from increased premiums in response to more insurance being written, is applied to fixed income investment, not equities. Likewise, applying necessary liquidations against the equities also helps to reduce the assets and restrain variances. Over the history of the program, when volatile increases in the market have created marked variances in the percentage of investment, equities have been liquidated through sales.

Contrary to what was cited within the finding, this is monitored by Executive Staff, investment advisors and financial personnel on a monthly basis and is reported for review to the State Workers' Insurance Board, as well as SWIF management. Monthly monitoring of compliance within the program allows for sound investment policies and is felt to be fiscally responsible in avoiding bad timing in large liquidations of equities.

Auditors' Conclusion: SWIF management's response does not resolve the condition in the finding. Since the statutory limit disclosed above is based solely on the cost of equity investments and the book value of total investments, growth in fair or market value of these investments would not impact SWIF's compliance. Furthermore, although management claims that monthly monitoring of statutory compliance for SWIF's equities is taking place, SWIF did not provide any documentation to support their statement. As a result, 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 04 – 12:

Executive Offices
Office of the Budget – Bureau of Financial Management

Internal Control Weaknesses Over Reporting Inter– and Intrafund Activity in the Basic Financial Statements (A Similar Condition Was Noted in Prior Year Comment #03-5)

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 outside parties, they are not revenues to the Commonwealth as a whole. In addition, where one fund/agency is reimbursing another fund/agency for costs incurred on its behalf, these reimbursements cause a "doubling-up" of expenditures/expenses since the costs of both funds/agencies are reported in the Commonwealth Basic Financial Statements (BFS). Therefore, GAAP mandates that these transactions not be reported in the BFS.

Our detail testwork identified internal transactions which were incorrectly reported 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 GAAP. Several examples of internal activity auditor adjustments to properly report revenue and expenditure activity in the BFS were as follows:

- $17.5 million of PDE revenues from various other state agencies and corresponding PDE expenditures in the General Fund were incorrectly included in the BFS, requiring an auditor elimination entry.

- $35.8 million of L&I interagency federal revenue from DPW and corresponding L&I expenditures in the General Fund were incorrectly included in the BFS, requiring an auditor elimination entry.

- $23 million of DEP revenue from several external sources was incorrectly eliminated via client adjustment in the General Fund, along with the same amount in corresponding DEP expenditures, necessitating an auditor entry to re-book the amount to these accounts.

- $24.6 million of restricted receipts for the Governor's Executive Offices in the General Fund, which are not reported at all in the BFS GAAP templates, were incorrectly eliminated via client adjustment, necessitating an auditor adjustment to re-book the corresponding revenues and expenditures to the BFS.

- $27 million in statutory transfers into the Vocational Rehabilitation Fund were inappropriately eliminated in the BFS, necessitating an auditor adjustment to re-book this amount to the operating transfers-in and expenditures accounts.

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.

In addition, our testing of internal activity in asset and liability accounts disclosed that BFM erroneously reported interfund loans in the government-wide Statement of Net Assets, necessitating auditor-proposed adjustments. About $300 million in Advances To Other Funds and $100 million in Advances From Other Funds within the Governmental Activities column should have been eliminated but were not, and an $85 million PLCB interfund loan had to be reclassed to Internal Balances between Governmental Activities and Business Type Activities.

Comment 04 – 12: (continued)

Criteria: GAAP requires internal activity to be accurately and properly excluded from the Commonwealth's BFS. Internal controls should ensure that these accounting transactions are properly eliminated from 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 internal transactions were accounted for in accordance with GAAP. In addition, the new financial reporting process using SAP has caused continuing difficulty in trying to ensure all necessary internal activity is properly booked.

Effect: As a result of the internal control weaknesses, the BFS were not correct with regard to internal activity, and adjustments were necessary to correct the BFS. If the internal control weaknesses are not corrected, the BFS will continue to be misstated in the future. The accurate reporting of internal activity is especially critical in the government-wide Statement of Activities. 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.

Agency Response: Our understanding of the requirement, following lengthy discussions during the June 30, 2002 and 2003 audits, is that almost all internal activity must be eliminated from both fund and government-wide financial statements. We point out that, in relation to the prior year, there was significant improvement in identifying and eliminating the necessary amounts. Finally, in relation to governmental funds, our opinion is that the sum of the dollar amounts shown above is not that significant and that only gross revenues and expenditures are affected by the necessary elimination, with no effect on total assets, liabilities or fund balance.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. While we agree there has been improvement in management's reporting of internal activity, internal control weaknesses are still present which could cause BFS errors in the future. 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 04 – 13:

Office of the Budget – Bureau of Financial Management
Labor, Education and Community Services Comptroller Office
Public Health and Human Services Comptroller Office
Central Services Comptroller Office

Errors and Internal Control Weaknesses in Accruing and Reporting Intergovernmental Revenues and Receivables in the Basic Financial Statements

Condition: We noted several material errors and control weaknesses in our audit of intergovernmental (i.e., federal funds) accruals in the Basic Financial Statements (BFS) requiring auditor-proposed adjustments as follows:

- In DPW's General Fund GAAP template, PHHS Comptroller preparers failed to book $99.9 million in intergovernmental revenues and receivables for federal-related accrued expenses as of June 30, 2004. This amount represented the available balances in prior fund ledgers as of August 31, 2004, which should have been accrued as intergovernmental revenue when the expense was accrued.

- In the Department of State's General Fund GAAP template, CS Comptroller preparers did not adequately review a $100.6 million intergovernmental revenues balance on the Revenue Accounting System from the federal Help America Vote Act program, and incorrectly reported $77.7 million of these intergovernmental revenues in the deferred revenue account as a result. In addition to the revenue adjustment needed for this error, we also noted that additional auditor adjustments to the BFS were necessary to increase reservations of fund balance and net assets restrictions because of purpose restrictions on these federal funds.

- In the General Fund GAAP template for the Governor's Executive Offices, the CS Comptroller did not report $167.2 million in intergovernmental revenues received in the current year as a result of the Federal Jobs and Growth Tax Relief Reconciliation Act of 2003. CS Comptroller personnel did not properly review these revenues on the Revenue Accounting System and incorrectly reported these as deferred revenues, necessitating an auditor adjustment to the BFS.

- In PDE's General Fund GAAP template, LECS Comptroller preparers accrued $103.3 million in federal program-related payables and receivables from open commitment balances as of August 31, 2004. Although our audit found these open commitment postings to be materially correct in the current year, we noted that LECS personnel did not examine any detailed support at the time the payable and receivable entries were booked. There is an internal control weakness in that LECS template preparers are not adequately ensuring that these year-end accruals are valid. We also noted a similar internal control weakness for these accruals throughout the Comptroller offices statewide.

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

Cause: Regarding the errors in the GAAP templates for Department of State and Executive Offices, template preparer and reviewer procedures were not effective to ensure intergovernmental revenues and related deferred revenues were accurately reported in the BFS. For DPW's GAAP template, PHHS template preparer and reviewer procedures were not thorough enough to detect the missing federal receivable. Regarding the internal control weakness in the Comptroller Offices related to open commitment balances, Comptroller personnel believed that their current procedures were adequate based on historical practice and their understanding of intergovernmental accruals in their agencies.

Comment 04 – 13: (continued)

Effect: Intergovernmental revenues, receivables, deferred revenues, and related payables were misstated in the BFS, requiring auditor adjustments. Due to the internal control weaknesses reported above, similar BFS errors will continue into future years. In addition, because of the BFS preparation errors like those disclosed above, issuance of the CAFR was significantly delayed.

Recommendation: GAAP template preparer and reviewer procedures should be strengthened to ensure all intergovernmental accruals are accurately reflected in the BFS. BFM should also review statewide procedures for accruing open commitment balances in all GAAP templates to ensure Comptrollers are properly verifying these year-end accruals are valid.

Agency Response: We accept the finding as written and will take appropriate corrective action to address the conditions noted.

Auditors' Conclusion: Based on the Agency Response the finding and recommendation remain as stated above. 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 04 – 14

Executive Offices – Office of General Counsel
Department of Revenue

The Bank Shares Tax Liability and Related Expense was Understated in the Department of Revenue GAAP Template

Condition: The Commonwealth's BFS contained a material misstatement in DOR's General Fund GAAP Template that required a material adjusting entry by the auditors. Because of a lack of communication of additional Commonwealth-wide exposure with respect to an adverse court ruling on DOR's bank shares tax, expenses and contingent liabilities were understated by $116 million.

Criteria: Commonwealth-wide impact of court decisions must be properly considered to avoid material misstatements to the Commonwealth Financial Statements.

Cause: Legal counsel, in response to the auditor's letter of legal inquiry did not communicate the Commonwealth-wide impact of a court ruling adverse to the Commonwealth.

Effect: Accrued expenses and liabilities in the BFS were materially misstated. In addition, the noted weakness in the letter of legal inquiry process could result in material misstatements in the future. These misstatements contribute to delays in the issuance of the CAFR.

Recommendation: The Commonwealth General Counsel should communicate with all appropriate departmental legal counsel and strengthen procedures to ensure that Commonwealth-wide exposure is properly considered when evaluating a particular legal case for the reporting of contingent liabilities in the BFS.

Agency Response: The agencies did not provide a response.

Auditors' Conclusion: 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 04 – 15:

Insurance Department
Central Services Comptroller Office

Cash and Investment Balances in the Statutory Liquidator Fund Were Misstated in the Preparation of the GAAP Template (A Similar Condition was Noted in Prior Year Comment #03-02)

Condition: The balances for cash with fiscal agents, temporary investments, and long-term investments were misstated in the preparation of the GAAP template for the Statutory Liquidator Fund. 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 in the GAAP Template for two of the insurance companies in liquidation, the CS Comptroller simply reported the amounts per the companies' accounting departments. No additional review was performed by the comptroller or DOI to determine that the balances reported by the companies were correct. Furthermore, assumptions were made 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 $11 million and temporary investments of $75 million and an overstatement of long-term investments of $26 million. Misstatements will continue into the future if the internal control weaknesses are not corrected. Furthermore, errors in the preparation of the BFS like those 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: CS Comptroller staff will put procedures in place to ensure that cash and investments of insurance companies are reported correctly, both in dollars reported and classification. A request has been made to the auditor who issued this finding to obtain copies of detailed work papers as a starting point for developing internal procedures. In addition, a copy of this finding and the related response will be inserted into the GAAP template file for future reference during the preparation and review of the 2004-05 template.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 16:

Executive Offices
Office of the Budget – Bureau of Financial Management

Internal Control Weaknesses Over Agency Accounting for Capital Assets (A Similar Condition was Noted in Prior Year Comment #03-14)

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 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.

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: 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 with additional training for Agency Fixed Asset Coordinators. These misstatements contribute to untimely issuance of the CAFR.

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: The Commonwealth has taken action to improve the accuracy and internal controls over SAP's fixed assets sub-module. Quarterly requests are submitted to agency deputy secretaries for administration asking them to confirm all additions and deletions entered in the SAP fixed assets sub-module during the previous quarter and BFM is working with agencies to ensure the completion and submission of these confirmations. BFM has developed and disseminated SAP reports that enable agencies to readily review their additions and deletions to the fixed asset sub-module. Furthermore, BFM has conducted training sessions for Fixed Asset Coordinators to strengthen their understanding and use of the SAP fixed assets sub-module and to emphasize their responsibilities as outlined in the directive. These actions evidence the Commonwealth's ongoing commitment to ensure the accuracy and timeliness of Capital Asset information in SAP.

Comment 04 – 16: (continued)

Auditors' Conclusion: We agree that BFM has improved its efforts in the Capital Assets area of financial reporting. However, significant errors continued to occur in our current audit period, and training sessions to provide for correction of those errors occurred in 2005 after the end of the current reporting period. As a result, our comment and recommendation remain as stated above, and we will review the 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 04 – 17:

Liquor Control Board

Internal Control Weaknesses in PLCB's Financial Reporting From the New SAP Accounting System

Condition: The Pennsylvania Liquor Control Board (PLCB) implemented SAP in July 2003 as part of Wave 3B of the overall Commonwealth-mandated implementation schedule. During our review of PLCB's systems and internal controls, we noted significant weaknesses in financial reporting from the new SAP accounting system as follows:

PLCB operated in a complex, volatile, dual-system control environment that incorporated both SAP and its carry-forward legacy accounting systems. The PLCB State Stores Fund legacy system operates on a fifty-two week fiscal year, composed of thirteen four-week periods (i.e., 364 days) ending on the Tuesday nearest June 30. However, SAP operates on the basis of twelve calendar months and cannot accommodate LCB's thirteen period fiscal year. Therefore, the decision was made to utilize SAP to process payments through Treasury, but continue using the legacy system for financial reporting.

As such, PLCB enters payments into SAP which are then submitted to Treasury for payment. The SAP data is transmitted back to PLCB and interfaced into the legacy accounting system. The data is converted from the SAP coding into PLCB's legacy object coding, and PLCB prepared their current-year financial reports from their legacy system. To ensure reasonableness of the financial data, PLCB had to implement numerous time consuming reconciliations, reviews, and oversight procedures. PLCB procedures included seven separate reconciliations for operating expenses, liquor payments, supplies, payroll, fixed assets, revenue, and Treasury cash. Our review of PLCB's reconciliations for operating expenses, liquor payments, and Treasury cash disclosed that every period had significant variances and reconciling items, some of which were carried forward from period to period, and not resolved or adjusted during the fiscal year, with several differences remaining unresolved at year end. Due to the intricacies of these processes the potential exists that, without improvement, significant errors or misstatements could occur in financial reporting in the future.

In addition, according to the test results of our information technology (IT) auditors' review of the PLCB data conversion at the time of SAP implementation, documentation of the verifications of the liquor vendor data and budget information was not available; therefore, management could not support that these verifications were performed or if they were adequate in ensuring that the data was loaded into SAP correctly.

Furthermore, our IT auditors' limited test of SAP USER IDs (approval of payments) disclosed the following exceptions:

- Three employees of PLCB Comptroller Office have the permissions to post both Accounts Payable and Accounts Receivable transactions which creates a segregation of duties issue; however, PLCB Comptroller management indicated that PLCB does not utilize the Accounts Receivable module in SAP. PLCB Comptroller management stated that during SAP implementation, employee user role descriptions were vague and not fully understood. As a result, employees were assigned SAP roles without an adequate review. PLCB Comptroller management stated that the Accounts Receivable permissions should be removed from these employees.

- One employee from Central Services (CS) Comptroller Office who posted expenses for PLCB has the permission to post both Accounts Payable and Accounts Receivable transactions which creates a segregation of duties issue. Per Central Services Comptroller management the Accounts Receivable permission should be changed to display only for this employee.

These internal control weaknesses related to segregation of duties issues are compounded when affected users are entering direct payments into SAP with no subsequent review of the payment for accuracy and propriety. We noted that this is the case with PLCB's operating lease payments. LCB users with similar segregation of duties issues noted above were responsible for entering or adjusting funds commitments (i.e., annual lease contract amounts) and entering lease dates for payments (known as a "reoccurring shell") in order to generate automatic monthly and supplemental lease

Comment 04 – 17: (continued)

payments in SAP. However, there was no review after the reoccurring shell was entered into SAP to ensure that it was entered correctly, that funds commitments remained correct, and the monthly payments are being properly made. Any errors in the reoccurring shell would be discovered only if the payments exceed the funds commitment or if the vendor notifies PLCB of incorrect payment.

In addition, PLCB failed to enter its contracts into SAP so that the purchase order, goods receipt, and payment of invoices would have been subject to SAP three-way match controls. PLCB Comptroller management stated that for PLCB contracts in existence prior to SAP implementation and contracts that are deemed too complex for the three-way match such as the PLCB warehouse contracts, fund commitments were set up in SAP for these contracts and payments are made using a direct payment transaction (FB60 series of transaction codes) in SAP which would not be subject to the three-way match controls.

Criteria: The conditions stated in this finding represent significant deficiencies in the design and operation of PLCB's internal control which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. In addition, the internal control does not reduce to a relatively low level the risk that errors or misstatements could occur without being detected in a timely manner by PLCB management.

Cause: According to management, PLCB was mandated by the Governor's Office to implement SAP which, as explained above, involved a complex control environment that incorporated both SAP and its legacy accounting system. PLCB management stated that there was not enough time to convert their legacy system, including all of their subsystems, into a twelve month fiscal year prior to going live with SAP. PLCB had to implement numerous time consuming reconciliations, applications, and review procedures to incorporate both SAP and its legacy accounting systems.

Effect: Due to the fact that PLCB is operating in a complex, dual-system control environment, the potential exists that significant errors and misstatements in financial reporting could occur without being detected in a timely manner. The necessity of performing numerous complex reconciliations and follow-up on significant variances has made PLCB's accounting system less efficient. Furthermore, without proper testing and verification of the PLCB data conversion at the time of SAP implementation, PLCB cannot be reasonably assured that the system will work properly, and the interfaces between SAP and PLCB's legacy system are adequate.

The lack of segregation of duties among user roles of PLCB and CS Comptroller employees, along with lack of review of direct payments entered into SAP for lease payments, increases the risk that errors could be made without being detected.

PLCB is accounted for as an Enterprise Fund in the Commonwealth's financial statements because its retail operations are separate and distinct from other government operations, and are conducted in a manner similar to retail operations in the private sector. Since SAP was an ERP system originally designed for use primarily in the private sector, in not utilizing the three-way match feature, PLCB did not maximize SAP's functionality and control environment by subjecting its contract payments to this key automated control in the new SAP software.

Recommendation: PLCB should take measures to improve its major legacy-SAP automated interfaces and explore options of updating their current legacy accounting system to be compatible with SAP to reduce the potential risk of errors and misstatements. In addition, PLCB should review user roles of all its employees and ensure that segregation of duties issues do not exist or are removed. Furthermore, PLCB should evaluate and implement appropriate procedures to maximize SAP's functionality and control environment by entering contract related data into SAP and process payments according to three-way match procedures.

Agency Response:

- The PLCB is embarking on a project to implement the Retail Module of SAP to address the compatibility issues with SAP and the legacy systems. The planned implementation date for this system is July 1, 2007.

Comment 04 – 17: (continued)

- The PLCB has reviewed the user role of employees to ensure proper segregation of duties. The PLCB Comptroller's Office has removed the Accounts Receivable roles from the three employees mentioned in the audit finding.

- Due to limitations in the recurring payment process in the IES implementation of SAP, it is not efficient to utilize the three-way match for payment of our store rents. To compensate for this, individuals not involved in the original payment process will perform a sample post audit of the rental payments; documentation of the post audit will be maintained. This control was instituted for the June 2005 Rent payment. All other payments against a funds commitment undergo a manual three-way match pre-audit.

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 04 – 18:

Executive Offices
Office of the Budget – Bureau of Financial Management

Statewide Weaknesses in Segregation of Duties and System Security Within the SAP Accounting System (A Similar Condition Was Noted in Prior Year Comment #03-13)

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. We noted that there were a number users who were granted excessive user access within the SAP system. One user has over 1130 authorizations/transactions assigned, 17 users have over 500 authorizations/transactions assigned, 12 users have over 400 authorizations/transactions assigned, and 96 users have over 300 authorizations/transactions assigned. This excessive number of assigned authorizations/transactions allows users to perform tasks that create segregation of duties conflicts and significant override capabilities within the SAP system.

We noted that several IES users have multiple user accounts. We also noted that four outside consultants were granted access to the operating system in the SAP environment. In addition, there were 675 users having segregation of duties conflicts in relation to posting expenditures and 56 users having segregation of duties conflicts in relation to posting revenue transactions.

We noted that employees had the ability to delete unpaid leave absences after a supervisor had approved the absence, which would allow an employee to be paid for that time. Although manual controls exist outside of SAP, in certain situations where manual reviews are not always occurring, supervisors may not be aware of these deleted absences, nor is there a formal tracking mechanism in SAP to log such activity.

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 HP/Payroll, tolerance settings, and other functions. This 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.

Finally, we noted that there is no formal procedure for monitoring the SAP security log on a regular basis to ensure that there are no potential user access issues and to mitigate the control weaknesses noted above.

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 efficiently provide assistance 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 current and prior audit periods.

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

Comment 04 – 18: (continued)

enhanced monitoring, review, and verification of SAP activities and transactions. These weaknesses also cause an increase in audit time and contribute to delays in issuance of the CAFR.

Recommendation: We recommend that the segregation of duties issues noted above be investigated and excessive access within SAP be revoked as deemed necessary by management. If specific business justification exists (i.e. administrators, short term needs, etc.), a minimal number of staff should be assigned administrative roles, rather than granting an excessive number of authorizations/transactions, which could provide the same administrative level access. Further, consultant access should not include the ability to amend the operating system parameters in SAP. SAP roles in revenue and expenditure postings should be closely monitored, and segregation of duties conflicts should be appropriately justified in writing on an as-needed basis. We recommend that there be a documented review of the SAP Security Log on a regular basis to ensure that there are no potential user access issues.

We also recommend a periodic review of the controls surrounding the ability to delete unpaid absences, to ensure that the proper authorizations and segregation of duties are defined. We finally recommend a periodic review of the system security settings to ensure that users do not have authorization to transactions that are inconsistent with the user's job function.

Agency Response:

Condition: Paragraph 1

Currently, the highest number of authorizations/transactions assigned is 578, which is actually only 48 profiles (28 of those timekeeping profiles). 50% of them are for the same role (no more authority, just handles more time administers).

Paragraph 2

We currently do not have any consultants and only one contractor in Production. We currently do not have duplicate IES user ids in production. Management Directive 205.37 issued June 13, 2005 governs who has responsibility for segregation of duties.

Paragraph 3

Resolution for the issues related to leave processing was moved to production on August 1, 2005.

Paragraph 4

BOA and IES have reviewed activity logs and are currently in the process of procuring a user monitoring and SOD software package to better detect, report and mitigate SOD issues and improve role mapping and assignments.
The IES Security Team has implemented procedures that include:

- Monthly maintenance of withdrawn users
- Monthly review of inactive users, locking them and reporting them to HR
- Delimiting users with blank SNC fields
- Checking for duplicate or invalid SNC addresses daily (prevents access to another user's information)
- Run weekly comparisons of HR type 105 records with user records to ensure accuracy of user creation
- Perform periodic comparisons of SNC data across all production systems

Paragraph 5

We have reviewed the SAP Security Log and found it too large to store and analyze. We do not have the resources to contact each user who entered incorrect transactions and passwords to inquire about their intent. If a user is suspected

Comment 04 – 18: (continued)

of malicious intent, we can then review the log for that information. The user monitoring software that we hope to procure will detail which transactions are being used and be able to provide real-time alerts and custom reporting for inappropriate role assignment or activity.

Criteria:

EIS is in the process of trying to procure a highly functional and customizable SOD software product that will provide all of the tools that we need to monitor, detect and mitigate SOD issues. In addition it will allow us to effectively monitor transactional use by anyone in the system. There are no consultants in the production system.

Cause:

This paragraph pertains to the APPS_ALL roles which were used by the EIS Functional Teams during implementations. These roles have been removed and replaced with support versions of each production role in the systems. Risky transactions such as SM30, SE16, SM37 and SE38 have been removed from their production access.

Effect:

To the best of our knowledge there have been no misappropriations of assets, inappropriate changes to data and unauthorized activity occurring in our production systems.

Auditors' Conclusion: Based on our review of the agency response, management indicates that it has restricted user access and has implemented several corrective actions subsequent to the end of our current audit period. Therefore, the finding and recommendation for our current audit period remain as previously stated, and we will review management's corrective actions 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 04 – 19:

Office of the Budget – Bureau of Financial Management

Internal Control Weakness in the Financial Accounting Records

Condition: In performing our review of the Commonwealth's internal control procedures with respect to the GAAP financial reporting system, we noted that there were numerous Balance Sheet accounts which were not reconciled, analyzed or reviewed on a timely basis. Fundamental to any system of internal control over accounting records is a required process where significant Balance Sheet accounts are reconciled to subsidiary records or analyzed/reviewed at the account line item level if a particular account does not have a subsidiary ledger. Failure to perform such a reconciliation/analysis on a timely basis could allow for material errors to exist in the financial records that would go unidentified, ultimately resulting in misstated financial statements.

Criteria: An effective internal control environment over financial accounting and reporting should contain a structured process where significant balance sheet accounts are timely reconciled/analyzed on a periodic basis, and such reconciliations/analyses are subject to supervisor review.

Cause: The SAP implementation did not include a process whereby all significant Balance Sheet accounts would be "open item managed" and automatically cleared. This functionality would enable an analyst to determine easily on a detailed level what discrete transaction or groups of transactions comprise a particular Balance Sheet account, and make corrections as appropriate. Current tools available do not provide analysts with adequate information to determine with relative speed and ease open line items of a Balance Sheet account.

Effect: Primarily as a result of not implementing a method to open item manage Balance Sheet accounts, numerous accounts were not reconciled/analyzed, resulting in several GAAP template adjustments. Also, the weakness noted above significantly increased the audit effort required contributing to the significant delay in issuing the CAFR.

Recommendation: Procedures should be established whereby each Balance Sheet account is reviewed, and significant accounts are reconciled/analyzed on a monthly basis. The Commonwealth should work to provide the ability to "open item manage" and autoclear each significant Balance Sheet account. SAP should be configured to provide for automatic clearing of accounts where appropriate. Additionally, all reconciliations/analyses should be performed and documented monthly and prior to the finalization of the GAAP templates. Finally, monthly and prior to template finalization, the reconciliations/analyses should be timely reviewed by a knowledgeable supervisor, and this review should also be documented.

Agency Response: We accept this comment as presented and have begun efforts to address the auditors' concerns. Several significant balance sheet accounts are already monitored on an ongoing basis. However, the autoclear functionality in SAP will significantly enhance these existing efforts. We are currently pursuing the expansion of this functionality within SAP. We will ensure that our initiatives address all of the auditors' recommendations.

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.

COMMONWEALTH OF PENNSYLVANIA

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
04-1**	10.550	Food Donation Program	Internal Control Weakness and Noncompliance in BFD's Subrecipient Monitoring		AGRI	**183**	331
04-2**	10.550	Food Donation Program	Internal Control Weaknesses and Noncompliance With Processor Recordkeeping and Reporting Requirements Result in Inaccurate SEFA Reporting and Questioned Costs of $52,917 (A Similar Condition Was Noted in Prior Year Finding #03-1)	$52,917	AGRI	**185**	331
04-3**	10.551 93.558 93.575 93.596 93.778	Food Stamps Program Temporary Assistance for Needy Families Child Care and Development Block Grant Child Care Mandatory and Matching Funds Medical Assistance	Internal Control Weaknesses at DPW County Assistance Offices Result in Noncompliance With Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #03-2)		DPW	**193**	338
04-4*	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance and Internal Control Weaknesses in DOH Systems Result in $26,719 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-3)	$26,719	DOH	**198**	336
04-5**	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance in DOH Submission of WIC Financial Management and Participation FNS-798 Report Results in $774,331 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-4)	$774,331	DOH	**201**	336
04-6**	14.228 14.239	Community Development Block Grant Program HOME Investment Partnerships Program	DCED Did Not Perform Adequate During-the-Award Monitoring of Subrecipients (A Similar Condition Was Noted in Prior Year Finding #03-5)		DCED	**204**	331
04-7**	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 (A Similar Condition Was Noted in Prior Year Finding #03-6)		OB/LECS	**207**	330

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
04-8**	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	Weaknesses Exist in the FARS and SAP FARS Replacement Systems Resulting in an Undetermined Amount of Questioned Costs up to $4,484,751	$4,484,751	L&I OB/LECS	**209**	336
04-9**	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 #03-7)		L&I	**213**	336
04-10**	17.245	Trade Adjustment Assistance – Workers	Lack of Supporting Documentation and Inaccurate Reporting on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #03-9)		L&I	**218**	337
04-11**	17.245	Trade Adjustment Assistance – Workers	Unallowable Training and Benefit Payments Result in Questioned Costs of $4,318 (A Similar Condition Was Noted in Prior Year Finding #03-8)	$4,318	L&I	**223**	337
04-12**	20.205 23.003	Highway Planning and Construction Appalachian Development Highway System	Internal Control Weakness Over Expenditure Information Reported on the SEFA		TRANS	**228**	330
04-13*	66.458 66.468	Capitalization Grants for Clean Water State Revolving Funds Capitalization Grants for Drinking Water State Revolving Funds	Internal Control Improvements Needed in Subrecipient Loan Monitoring System		PENN-VEST	**229**	336
04-14**	83.544	Public Assistance Grants	Weaknesses in PPR Comptroller Office Internal Controls Over Federal Reporting		OB/PPR	**231**	330
04-15*	84.010 84.027 84.048 84.367	Title I–Grants to Local Educ Agencies Special Education – Grants to States Voc. Education – Basic Grants to States Improving Teacher Quality State Grants	Internal Control Weakness Over the Reconciliation of the U. S. Department of Education's Grant Administration and Payment System (EDGAPS) to Revenue on the SAP System		OB/LECS	**233**	330

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

COMMONWEALTH OF PENNSYLVANIA

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
04-16**	84.010	Title I – Grants to Local Educational Agencies	Internal Control Weakness in Monitoring Subrecipient Compliance With Maintenance of Effort Requirements		PDE	**234**	331
	84.367	Improving Teacher Quality State Grants					
04-17*	84.010	Title I – Grants to Local Educational Agencies	Inadequate Controls in PDE's On-Site Monitoring of Subrecipients		PDE	**236**	332
	84.367	Improving Teacher Quality State Grants					
04-18*	84.010	Title I – Grants to Local Educational Agencies	Inadequate Controls Over PDE's Consolidated State Performance Report and the Annual State Report Card		PDE	**238**	333
04-19**	84.048	Vocational Education – Basic Grants to States	Errors and Internal Control Weaknesses in PDE's VOC ED Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE (A Similar Condition Was Noted in Prior Year Finding #03-15)		PDE	**241**	334
04-20**	84.048	Vocational Education – Basic Grants to States	PDE Allocated VOC-ED Funds to Subrecipients Based on Outdated Statistical Data		PDE	**245**	335
04-21*	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 #03-17)		L&I	**247**	337
04-22**	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding #03-18)		L&I	**249**	337
04-23**	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 #03-20)		DPW	**251**	338
04-24**	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 #03-21)		DPW	**253**	339

CAP - Corrective Action Plan
*   - Reportable Condition
**   - Material Weakness

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
04-25**	93.563	Child Support Enforcement	Noncompliance and Internal Control Weakness Over the Processing and Reporting of Interstate Cases (A Similar Condition Was Noted in Prior Year Finding #03-22)		DPW	**256**	339
04-26**	93.569	Community Services Block Grant	LECS Comptroller Office Did Not Submit Required Federal Reports Within the CSBG Program		OB/LECS	**260**	330
04-27**	93.569	Community Services Block Grant	Weaknesses in Internal Controls Over Subgrantees Result in $47,722 in Questioned Costs	$47,722	DCED	**262**	331
04-28*	93.575 93.596	Child Care and Development Block Grant Child Care Mandatory and Matching Funds	Internal Control Weaknesses and Inadequate Support for Federal Earmarking Requirements Result in Questioned Costs of $3,220,142 (A Similar Condition Was Noted in Prior Year Finding #03-23)	$3,220,142	DPW	**264**	339
04-29**	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 $4.8 Million in Excess Subgrantee Federal Cash at June 30, 2004 (A Similar Condition Was Noted in Prior Year Finding #03-24)		DPW	**268**	339
04-30**	93.658	Foster Care – Title IV-E	Internal Control Weaknesses Over Reviewing and Approving Supplemental Payments to Subrecipients		DPW	**272**	339
04-31**	93.778 93.917	Medical Assistance HIV Formula Care Grants	Internal Control Weakness and Known Fraud Affecting Federal Awards at DPW		DPW	**275**	340
04-32*	93.778	Medical Assistance	Internal Control Weaknesses in the Administration of the MA Program		DPW	**278**	340
04-33**	93.917	HIV Formula Care Grants	Weaknesses in Internal Controls Over Eligibility Determinations Result in an Undetermined Amount of Questioned Costs Up To $20,792,266	$20,792,266	DPW	**281**	340

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	Impacted State Agency	Finding Page	CAP Page
04-34	93.959	Block Grants for Prevention and Treatment of Substance Abuse	DOH Did Not Meet Maintenance of Effort Requirements for State Expenditures Resulting in Questioned Costs of $230,000	$230,000	DOH	**289**	336
04-35**	96.001	Social Security – Disability Insurance	Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs		L&I	**291**	337
04-36**	Various	Various Major Programs	OB Did Not Have Adequate Procedures in Place to Ensure the Accuracy of the Subrecipient Audit Universe		OB/BFM OB/BOA	**293**	331
04-37**	Various	All Major Programs Covered by CMIA	Weaknesses in Cash Management System Cause Noncompliance with CMIA and at Least $624,042 Understatement of the CMIA Interest Liability (A Similar Condition Was Noted in Prior Year Findings #03-29 and #03-30)		OB/BFM	**296**	331
			Total Questioned Costs	$29,633,166			

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

Finding 04 – 1:

CFDA #10.550 – Food Donation Program

Internal Control Weakness and Noncompliance in BFD's Subrecipient Monitoring

Condition: BFD is required to enter into written permanent agreements with the subrecipients who receive donated commodities under the FD Program. These agreements are required to contain terms and conditions to properly communicate applicable program requirements to subrecipients and to ensure subrecipient compliance. As part of our audit of the FD Program, we randomly selected a sample of 51 subrecipients receiving donated commodities during the year under audit to ensure the subrecipient had a permanent agreement with BFD. Our testing revealed that BFD was unable to provide the permanent agreements for five of the 51 subrecipients in our sample, or 9.8 percent. As a result, we were unable to determine if BFD properly communicated specific federal program compliance requirements to these 5 subrecipients to reasonably ensure subrecipient compliance.

Although BFD was unable to provide copies of the permanent agreements for five subrecipients in our FD program sample, we determined that these subrecipients participate in the National School Lunch Program and, therefore, in accordance with federal program regulations, were automatically eligible to receive donated commodities during the year under audit.

Criteria: 7 CFR, Part 3016.37 regarding subgrants, states in part:

(a) States shall follow state law and procedures when awarding and administering subgrants of financial assistance to local and Indian tribal governments. States shall:

(1) Ensure that every subgrant includes any clauses required by Federal statute and executive orders and their implementing regulations;
(2) Ensure that subgrantees are aware of requirements imposed upon them by Federal statute and regulation;

In addition, 7 CFR, Part 250.12 states, in part:

(b) Distributing agency agreements. Distributing agencies shall enter into written agreements with all subdistributing agencies, recipient agencies, warehouses, carriers, or other entities to which distributing agencies deliver donated foods under their distribution program. …All agreements shall contain such terms and conditions as the distributing agency deems necessary to ensure that:

(1) The distribution and use of donated foods is in accordance with this part,
(2) Subdistributing agencies, recipient agencies, warehouses, carriers, or other persons to whom donated foods are delivered by the distributing agency are responsible to the distributing agency for any improper distribution or use of donated foods or for any loss of, or damage to, donated foods caused by their fault or negligence,
(3) Subdistributing agencies and recipient agencies have and preserve a right to assert claims against other persons to whom donated foods are delivered for care, handling or distribution, and
(4) Subdistributing agencies and recipient agencies will take action to obtain restitution in connection with claims for improper distribution, use or loss of, or damage to, donated foods.

(c) Duration of distributing agency agreements-(1) Recipient agencies. Distributing agency agreements with recipient agencies shall be considered permanent, with amendments to be made as necessary.

Cause: BFD personnel indicated that the five subrecipients cited above do have permanent agreements with BFD but they were unable to locate the agreements. Further, since the schools are currently not in session, BFD could not request copies of the agreements from the schools.

Effect: Since BFD could not provide copies of permanent agreements for five of the subrecipients in our sample, a control weakness exists with respect to BFD's documentation of its communication of specific federal program requirements to its FD subrecipients to ensure subrecipient compliance.

Finding 04 – 1: (continued)

Recommendation: We recommend that BFD strengthen internal controls over subrecipient monitoring by ensuring that all subrecipients receiving donated commodities have a written permanent agreement on file with BFD as evidence that BFD has provided adequate communication of specific federal program regulations to its FD subrecipients.

Agency Response: The Bureau staff responsible for maintaining files on the agreements with recipient agencies was transferred in the Fall of 2004. For several years prior, the Bureau had been implementing permanent agreements for eligible participating agencies when permanent agreements were authorized by USDA. With the change in staff, however, the process was interrupted, but has now been resumed. It is believed that the "missing" agreements were misfiled. It must be noted that for each agency for which there was a missing agreement, there was confirmation from Pennsylvania's Child Nutrition office, i.e., the Pennsylvania Department of Education, that each agency (school district) was authorized to participate in the National School Lunch Program (NSLP) and, therefore, eligible to receive commodity from the Bureau.

Nevertheless the Bureau has initiated a complete review of files for all recipient agencies (over 1,500) to ensure: 1) that each agency has a written and current agreement in the Bureau's files; and 2) full implementation of "permanent agreements" for affected recipient agencies.

In addition, Bureau field staff, as part of their field review will confirm that each recipient agency has a copy of its valid agreement on site at the time of the each review and that the copy matches Bureau files. In the fall, Bureau staff will visit the specific recipient agencies for which agreements were found to be missing by the audit, to secure copies of those agreements for inclusion in the Bureau's files. Hopefully, the Bureau's review of the files will uncover the "misfiled" agreements earlier, although that is not guaranteed.

The Bureau will also, when executing permanent agreements with school districts, send a copy of the fully executed permanent agreement to the district superintendent (or other responsible individual) and provide yet another copy to the school food service director so that a "back up" copy is available in the food service office, where most of the BFD review activity occurs.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 2:

CFDA #10.550 – Food Donation Program

Internal Control Weaknesses and Noncompliance With Processor Recordkeeping and Reporting Requirements Result in Inaccurate SEFA Reporting and Questioned Costs of $52,917 (A Similar Condition Was Noted in Prior Year Finding #03-1)

Condition: As part of the FD Program, 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 information submitted electronically from the processors to record distributions of donated commodities used in end products by individual recipient agencies for the year. The total processor distributions to all recipient agencies recorded on BFD's system and reported by BFD on the June 30, 2004 SEFA was $10,011,079.

In our prior year audit, our testwork revealed questioned costs and major weaknesses in BFD's system used to accumulate and report inventory information from the processors monthly performance reports. Although BFD did implement a new system on July 1, 2003 to accumulate the processor information in a standardized electronic format, our follow up and testwork for the current year disclosed that similar weaknesses existed 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 on the SEFA, we selected a sample of 25 recipient agencies receiving end products from processors. Our sample was selected from the excel spreadsheets that BFD uses to record inventory information that is electronically transmitted to BFD from processors and from hard copies of processor monthly performance reports. 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 2004 that were used in the production of the end product distributed to the recipient agency. The total dollar value of donated commodities tested for our 25 items was $131,449 out of the $10 million population for processors disclosed above. For 12 of the 25 recipient agencies, BFD was unable to support the total distributions of the sampled commodity reported on the SEFA, as shown below, resulting in questioned costs of $52,917 (or 40.26 percent of the amount tested):

School Number	Distributions Reported by BFD on SEFA	Distributions Supported by Processor Usage Reports	Questioned Costs
2-04-02-830	$10,741	$ 2,109	$ 8,632
2-02-41-510	2,578	2,344	234
2-08-46-450	11,732	7,880	3,852
2-08-09-135	10,213	6,128	4,085
2-06-01-375	7,899	2,192	5,707
2-08-09-130	1,917	1,086	831
2-03-40-660	5,295	2,032	3,263
2-02-47-180	4,411	0	4,411
2-08-46-850	2,558	0	2,558
2-08-46-830	1,168	460	708
2-08-23-550	3,621	0	3,621
2-03-40-330	17,711	2,696	15,015
Total	$79,844	$26,927	$52,917

Finding 04 – 2: (continued)

In addition to these unsupported expenditures reported on the SEFA, we also noted under-reporting of processor expenditures on the SEFA for two additional items in the above sample. Distributions based on processor usage reports for 1 of the 25 recipient commodities in our sample were $2,542 higher than the distributions reported by BFD on the SEFA, and an additional processor reported distributions to the recipient agency in the amount of $850, but BFD did not include this commodity code on the recipient agency's report supporting the SEFA. For these two additional discrepancies, a total of $3,392 in distributions was not reported on the SEFA. As a result of all the above errors from our sampling, in addition to the unsupported costs, we determined that the SEFA for the FD program is not accurate.

BFD is required to submit an Annual Processor Reconciliation Report to USDA for each processor participating in the FD Program which reports all inventory activity for each donated commodity on hand at the processor location. In order to test the accuracy and completeness of the Annual Processing Reconciliation Report submitted to USDA for the year under audit, we selected a sample of 5 processors and 16 related commodities included on the report. We then compared the inventory activity (i.e., beginning inventory balances, receipts, usage, etc.) reported for each processor and related commodity to the processor monthly performance reports. Based on our testing of the report, we noted the following:

- For 2 of the 16 commodities tested, BFD was unable to provide any processor performance reports to support the amounts reported by BFD. Additionally, for 8 of the 16 commodities, there were discrepancies between the amounts reported by BFD and the amounts contained in the processor performance reports. Also, for 2 of the 16 commodities, BFD was only able to provide usage information from the processor, which did not agree to the amounts reported by BFD. No other information on beginning inventory, receipts, etc. could be provided.

- In testing the usage dollar value on the report, we noted that two of the commodities in our sample had no dollar value for usage even though a usage quantity was reported for the commodities. Also, we noted unresolved discrepancies for two other commodities between the unit price used to calculate the usage dollar value and the unit price from the USDA price list.

- The total distributions (usage dollar value) on the Annual Processor Reconciliation Report of $12,575,018 do not agree to the total distributions from processors reported on the SEFA of $10,011,079. The $2,586,097 difference remains unresolved.

- BFD has no procedures in place for the supervisory review and approval of the amounts contained on the Annual Processing Reconciliation Report to ensure amounts reported are accurate, complete and tie to its books and records.

In the prior year, we noted 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 during the prior year under audit. Our current year follow up revealed that BFD did perform monitoring for a sufficient number of its in-state processors. However, based on our testing, we noted that BFD's on-site monitoring did not address two of the four areas that are required by federal regulations. Specifically, BFD's on-site monitoring did not include procedures to review the processor's production and quality control records to support the figures on the processor's end product data schedule and did not include procedures to ensure adequate measures and procedures are in place to protect the donated food.

In addition to the noncompliance and internal weaknesses identified during our Single Audit testing, we also noted several related internal control weaknesses cited by USDA in their Management Evaluation Report conducted during the year under audit as follows:

- BFD is required to monitor processor's inventories to ensure the inventories are not more than a six-month level. Further, the processor must obtain approval from BFD to carry any inventory in excess of a six-month level. USDA noted that BFD had no procedures in place to ensure compliance with this requirement. Also, USDA indicated that BFD had numerous processors with inventory levels in excess of a six-month level as of June 30, 2004 but there was no documentation to support BFD's approval of these excess levels.

Finding 04 – 2: (continued)

- BFD issued a directive to its processors stating that effective July 1, 2003, the processors were no longer required to submit monthly performance reports to BFD. Instead, BFD implemented a new system to obtain monthly inventory receipts, distributions and transfers from the processors in an electronic format. However, USDA indicated that the processor information submitted to BFD under the new system does not satisfy this federal requirement relative to submission of monthly processor performance reports.

- BFD does not have any procedures in place to review monthly processor performance reports and grading certificates to ensure the guaranteed minimum return has been met.

- BFD does not have a process in place to formally communicate results of its on-site monitoring reviews to its processors.

- For processors participating in the net off invoice program, BFD is required to perform a re-verification of 10 percent of the distributions to recipient agencies verified by the processor for net off invoice sales. USDA indicated that BFD did not have any procedures in place to perform this re-verification.

- BFD does not have adequate staffing resources dedicated to the processing portion of the FD program.

Criteria: 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 250.30 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.

USDA Memo #04-011 dated April 8, 2004 regarding the Policy on the Submission of Quarterly Processing Performance Reports states:

We will discontinue the requirement to submit quarterly processing performance reports to the Regional Office and will use the reconciliation reports to verify beginning inventory levels, shipments, usage and excess inventory levels.

The USDA State Processing Program Handbook, page 57, provides the following guidance regarding on-site reviews of processors:

On-Site Reviews: Every year each distributing agency must conduct on-site reviews of 50 percent of the processors whose total operations are conducted within that State. This means that a review of all "In-State" processors must be completed by the distributing agency every two years.

Finding 04 – 2: (continued)

Planning the Review: The following four areas must be evaluated during each review:

- *Adequate records are being maintained to ensure program compliance;*
- *The sales documentation supports the inventory reductions reported on the monthly performance reports;*
- *The production and quality control records support the figures on the end product data schedules; and*
- *Adequate measures and procedures are in place to protect the donated food.*

7 CFR, Part 250.30 regarding processor inventory controls states:

(n) Distributing agencies shall monitor processor inventories to ensure that the quantity of donated foods for which a processor is accountable is the lowest cost-efficient level but in no event more than a six-month supply based on the processor's average monthly usage, unless a higher level has been specifically approved by the distributing agency on the basis of a written justification submitted by the processor.

7 CFR, Part 250.30 (g) regarding meat and poultry inspection programs states in part:

All donated meat and poultry processing shall be performed under AMS acceptance service grading.

7 CFR, Part 250.19 (b) (2) (vi) regarding review systems for distributing agencies states in part:

(C) Review the processor's findings and select a random sub-sample of at least 10 percent of all sales verified by the processor and reverify the same by contacting the recipient agency.

7 CFR, Part 250.2 regarding personnel states:

(c) Each distributing agency shall provide adequate personnel to administer the program in accordance with this part.

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. . .

<u>Cause</u>: Regarding the differences in commodity distributions reported on the SEFA for the 25 sampled recipient agencies, BFD indicated that the differences were primarily due to distributions of the same commodity to a school by more than one processor. However, BFD was unable to provide a report to detail the breakdown of the distributions of the commodity by processor for each recipient agency in our sample and, therefore, could not provide any additional documentation from the processors to support any of the differences. As explained above, effective July 1, 2003, BFD issued a Directive to its processors instructing them that they were no longer required to complete monthly processor performance reports. In lieu of these reports, BFD had implemented a new system whereby the processors submit a standard report electronically to BFD on a monthly basis, via an excel spreadsheet, which contains receipts, distributions

Finding 04 – 2: (continued)

by school and transfers, which are subsequently downloaded into the BFD system. As a result, even though some of the processors continued to submit the monthly performance reports to BFD, differences were noted during our testing since certain of the processor performance reports, which we used to support the distributions on the SEFA, were not available. Further, BFD does not have any supervisory review procedures in place to verify the accuracy of the processor information that is electronically transmitted from the processors and reported on the SEFA.

Regarding the discrepancies cited for the Annual Processor Reconciliation Report, the lack of supporting documentation was also due to the unavailability of processor monthly performance reports in connection with the Directive issued by BFD to its processors as mentioned above. Also, the information that was being transmitted electronically by the processors to BFD did not include beginning and ending inventory balances. BFD informed us that they rescinded this directive at the request of USDA and are now requiring submission of monthly performance reports from their processors. Further, BFD does not have any supervisory review procedures in place to verify the accuracy of the information that is included in this report prior to submission to USDA.

With respect to the on-site monitoring of in-state processors, BFD did not believe it was necessary to perform all of the procedures outlined in the USDA Handbook.

Further, as noted in BFD's response to USDA's Management Evaluation, the staffing changes that have taken place in the last several years and the related development of new computer software to handle the volume of data associated with the FD Program have contributed to the internal control weaknesses and errors cited in the condition.

Effect: BFD did not provide adequate processor documentation to support the allowability of processor distributions for 12 of the 25 recipient agency commodities tested, which represented an error rate of 40.26 percent in our sample. Based on the lack of supporting documentation for our sample testwork, total processor distributions reported by BFD on the SEFA of $52,917 are questioned. In addition, our sampling and testing of processor distributions disclosed that FD program expenditures on the SEFA are not accurate.

Further, BFD did not have an adequate system in place during the year under audit for the proper recording, reporting, and monitoring of inventory information that was transmitted electronically from the processors, including the preparation and submission of the Annual Processor Reconciliation Report to USDA. Further, BFD's on-site monitoring procedures of in-state processors are not adequate since BFD is not following the established procedures in the USDA Handbook. As a result, BFD has little assurance that these processors are complying with program requirements. Additionally, there is an overall 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 $52,917 in questioned costs with USDA.

Further, we recommend that BFD establish adequate supervisory review procedures to verify the accuracy of the processor information reported on BFD's system and in the Annual Processing Reconciliation Report submitted to USDA. Also, BFD should ensure that the information being transmitted by the processors can be sorted in such a manner that all processors distributing the same commodity to a specific school district can be readily identified. We understand that BFD may have such a report available for our subsequent audit period. Additionally, BFD should retain copies of all processor monthly performance reports to adequately support processor distributions reported on the SEFA and to comply with federal regulations. Further, we recommend that BFD expand their existing on-site monitoring procedures of in-state processors to adequately address all areas specifically identified in the USDA Handbook.

Finally, we recommend that BFD implement the corrective action outlined in their letter dated May 26, 2005, which specifically addresses the internal control weaknesses identified by USDA during their Management Evaluation.

Agency Response: The finding appropriately noted that the Bureau of Food Distribution (BFD) implemented procedural and processor reporting changes on July 1, 2003. Unfortunately, the finding failed to acknowledge that the computerized Commodity Tracking System (CTS) which BFD would use to implement those changes, was not

Finding 04 – 2: (continued)

operational until February 2004. The effect, of course, was that seven (7) months of activity, from over 70 processors serving the Commonwealth's 872 schools, had to be downloaded into the new system, and the new system tested, with any identified glitches corrected before the 03-04 program year could be closed.

Therefore, BFD's focus during the initiation of CTS was to ensure that Agency Summary Reports (ASRs), which annually reported to participating recipient agencies USDA commodity value received, fairly represented USDA commodity activity for the year, including commodity-processing activity. Stated another way, BFD's primary concern was to capture commodity activity or "usage" as reported by each processor for client recipient agencies, and ensure the activity was properly reflected on each agency's ASR for the year.

The focus of BFD's activity in that "shortened" program year was <u>not</u> on the reliability of auxiliary reports that CTS would eventually provide, nor on individual processor inventories and how reported activity or usage impacted each processor's book inventory; that was a lower priority that could be addressed later with the software developers. CTS <u>reliably and effectively</u> captured reported usage each month from each processor and recorded that data each month on individual ASRs, the report that BFD has used for over 15 years to report to each affected recipient agency its federal financial assistance received through the Commonwealth's USDA commodity program.

The $12,575,018 figure which the finding suggests created a $2,586,097 "difference" that "remains unresolved" was taken from one of the "auxiliary reports" mentioned above: the Processor Inventory Report (PIR). However BFD did not rely on that report because it: 1) was strictly a "processor inventory" report **<u>not</u>** critical to individual recipient agency data files; 2) included inventory carryover amounts from the previous year which were not verifiable for a variety of reasons; 3) included inventory adjustments and transfers of backhauled product which BFD is not required to track; and most importantly, 4) was known to have significant deficiencies in its underlying software. CTS did not (during the 03-04 year) properly capture inventory data for that report.

Notwithstanding the software deficiencies that made the PIR unreliable, BFD understands the importance of maintaining reliable book inventories of all commodities held by each processor. However, the time constraints of completing a year's worth of work in less than five months with the newly developed CTS required BFD to focus its efforts on compiling reliable data for the ASRs; and that was successfully accomplished.

Accordingly, BFD believes the ASRs for individual recipient agencies, which in total reflects the $10,011,079 reported by BFD on its Year-End Reconciliation Report for 2004 <u>fairly represents BFD's commodity processing activity</u>. The "difference" that "remains unresolved" was not a discrepancy at all; it was only evidence of a software glitch that had to be (and subsequently was) corrected.

BFD also raises deep concern about how the narrative of this finding chose to deal with the findings of a USDA Management Evaluation (ME) of Pennsylvania's processing program for the same year as the audit (03-04) and the 04-05 year, which was conducted in the winter and early spring of 2005. The citation was clearly offered to support the conclusions of this finding.

However, what was conspicuously absent from the narrative was BFD's Corrective Action Plan (CAP) to the ME, and USDA's response to that CAP; and that is deemed to be measurably unfair. The response from USDA (dated July 1, 2005), as well as USDA's response to the previous year's audit (02-03) clearly establishes that USDA: 1) does not share the position of the auditors on "Questioned Costs"; 2) appreciates BFD's effort to develop new and more effective and efficient procedures to track commodity processing, realizing that those changes will take several years to fully implement; and 3) understands that Pennsylvania has become the leader in a new pilot program offered by USDA, which <u>effectively negates many of the "non-compliance" issues identified or implied by both the ME and the current and previous audit</u>. With USDA as the final "arbiter" of audit reports on its commodity programs, BFD questions why USDA's responses to the 02-03 Audit Report and the 2005 ME were not mentioned in the narrative.

Nevertheless, BFD will investigate the $52,917 in questioned costs for the entities identified in the finding. However, since CTS collects processing data from its 70+ processors monthly, and the data recorded on the ASR of all agencies is compiled and reported in total by commodity code on the ASR, it is unlikely that there will be any material discrepancy.

Finding 04 – 2: (continued)

What the auditor expected for the 03-04 audit year was for BFD to be able to breakdown a "total amount" reported on an ASR by commodity code into its individual parts, i.e., the amounts by each processor whose monthly usage report contributed to the total of the affected agency. That was not possible in the 03-04 year; it was not part of CTS, nor had BFD ever tracked such data.

The only way for a processing commodity total to be analyzed in 03-04 was to identify which processors use the commodity code in question, and manually review each of the 12 monthly reports for those processors to determine if they showed usage for that code to the affected agency. That capability, however, had been added to CTS in the 04-05 year and should prove very helpful in the future.

In addition, BFD will continue with the corrective actions outlined to USDA in its May 24, 2005 response to USDA's Management Evaluation since it addressed most, if not all, of the areas identified in this finding.

Auditors' Conclusion: We understand that BFD's main priority during the year under audit was ensuring that processor usage was properly reflected on the agency summary reports. However, we must audit BFD's compliance with federal regulations, which require that BFD maintain accurate and complete records with respect to receipt, distributions/usage and inventory of donated foods including end products processed from donated foods.

Regarding the $12,575,018 figure reported on the Annual Processor Reconciliation Report (or Processor Inventory Report), BFD stated that they did not rely on this "auxiliary report" and it was "not critical" to agency data files. However, we determined through correspondence with USDA that this Annual Report replaced the previous Quarterly Processor Performance Reports that BFD was required to submit to USDA. We are required to audit this federal report based on specific federally-mandated audit objectives and procedures outlined under Part 3, Requirement L of the federal OMB Circular A-133 Compliance Supplement. According to the Compliance Supplement, information on this report should be accumulated and summarized in accordance with the federal regulations and be supported by and agree to underlying data. Further, the Compliance Supplement requires all A-133 audits to specifically verify that auditees have adequate internal controls in place over preparation and submission of this report to USDA. If we encounter audit exceptions, like the $2,586,097 difference mentioned above, OMB A-133 requires us to report them in a finding.

With respect to the results of the USDA ME, we determined that the issues cited by USDA in their ME represented significant internal control weaknesses that were relevant to the federally-mandated audit objectives for this major program, so we are required to consider and report on them as part of an audit. The USDA ME issues cited in the condition were not simply meant to support the conclusions in our finding but rather were included to satisfy our reporting requirements under A-133. We acknowledge that USDA did respond to BFD's CAP on July 1, 2005 and indicated that BFD's written CAP adequately addressed the ME's findings and observations. As of our current FYE June 30, 2004, however, BFD's CAP has not as yet been properly implemented.

Regarding the $52,917 in questioned costs cited in the finding, we concur with BFD's decision to investigate these audit exceptions. Without a breakdown of the commodity usage totals by processor on the ASRs, BFD could not provide an adequate audit trail to support the $10,011,079 in costs reported on the SEFA.

OMB Circular A-133 defines questioned costs as "a cost that is questioned by the auditor because of an audit finding that resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match Federal funds; where the costs at the time of the audit, are not supported by adequate documentation…." Further, A-133 specifically requires that auditors report all known questioned costs that are greater than $10,000. We understand that our designation of a cost as questioned does not necessarily mean that USDA will disallow the cost as was the case in the USDA management resolution issued in connection with our prior year finding. However, the results of our current year audit indicate known questioned costs greater than $10,000 and, therefore, we are required to report these questioned costs in our current year schedule of findings and questioned costs in order to comply with federal requirements in OMB A-133.

Any corrective action cited by BFD will be evaluated 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 04 – 3:

CFDA #10.551 – Food Stamps Program
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 County Assistance Offices Result in Noncompliance With Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #03-02)

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, 2004), 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 auditors' 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 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 CAO caseworkers are not using proper budgeting methods with respect to calculation of the recipient's monthly income. The monthly income is used to determine the eligibility of the recipient as well as the amount of the grant award.

Finding 04 – 3: (continued)

- 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.

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.

As part of the Welfare-to-Work program under TANF, DPW employed individuals receiving Cash and Food Stamp assistance. In a separate investigation conducted by DPW and the Pennsylvania Inspector General's Office, we were informed that some individuals employed under the Welfare-to-Work program were assigned to CAOs and given improper access to the Cash and Food Stamp benefits authorization system; as a result, these individuals had the ability to fraudulently grant themselves and other family members additional Cash and Food Stamp benefits for which they were not eligible. Since DPW had no overall policy in place restricting the access of these benefit recipients within the benefits authorization system, an internal control weakness is present.

In addition to the internal control weaknesses identified by other auditors above, we also performed testing of DPW's Comprehensive Supervisory Review (CSR) and Targeted Supervisory Review (TSR) processes at the County Assistance Offices. The CSR documents the review of the propriety of eligibility determinations made by the CAO caseworkers while the TSR focuses on specific problem areas identified in caseworker compliance with established DPW procedures. The CSR is to be performed on a monthly basis by an individual independent of the CAO caseworker who initially determined eligibility. A CSR is required to be performed for a CAO in any month in which a more selective TSR is not performed.

We randomly selected a sample of 25 CAOs to ensure that required CSRs and TSRs were performed by DPW for the period under audit. For each CAO in our sample, we haphazardly selected one month and requested a certain number of CSRs or TSRs based on the number that were required to be completed by the CAO for the month. Our testing disclosed that of the 661 CSRs and TSRs that were required to be completed by the 25 CAOs, a total of 48 or 7.3 percent, in 3 CAOs were not completed as follows:

CAO	Month Selected	Number of CSRs or TSRs not Completed
Susquehanna District of Allegheny County	July 2003	20
Nursing Home District of Philadelphia	January 2004	25
Susquehanna County	March 2004	3
	TOTAL	48

We noted this to be an internal control weakness over eligibility determination since CAOs are not following established control procedures.

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.*

Finding 04 – 3: (continued)

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:

5. *Initiate or update the budget group information based on the completed PA 600 and the facts presented during the interview:*

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:

- *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.

The DPW Supplemental Handbook, Chapter 910, "Overpayment Recovery" Section 910.11, "Responsibilities of the CAO," stipulates that "*The CAO is responsible for:*

Finding 04 – 3: (continued)

- *determining if a budget group or FS household has been overpaid;*
- *obtaining verification of the income or resource and documenting the circumstances which caused the overpayment; and*
- *furnishing the OIG with any current information which may affect action on the overpayment."*

Additionally, Section 910.4 of the DPW Supplemental Handbook, "What Actions Follow a Discovery of a Possible Overpayment," states:

The CAO will take the following actions upon discovery of a possible overpayment: enter the overpayment data into the Automated Restitution Referral and Computation (ARRC) system; explore the facts that caused the overpayment; obtain verification to decide if an overpayment did or did not occur; determine the type of error that caused the overpayment; update the ARRC system and refer the overpayment to the OIG.

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: As disclosed in our prior-year finding, 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 primarily the result of caseworkers not being adequately trained and supervised in the performance of their duties. Regarding the weak system access controls for Welfare-to-Work employees, DPW management was not aware of this weakness until they called for the Pennsylvania OIG investigation.

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.

With respect to the CSRs and TSRs that were not completed for the three CAOs cited above, we were informed that the Susquehanna District in Allegheny County did not complete all of their required TSRs due to staffing shortages. For the Nursing Home District of Philadelphia, DPW indicated that the district was responsible for processing COLA changes and that the supervisors concentrated on these COLA cases and were not able to complete the CSRs for the selected month. For Susquehanna, DPW stated that all 25 CSRs had been completed but they were only able to provide documentation to support the completion of 22 CSRs.

Effect: Due to the control weaknesses identified at the DPW CAOs, 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. Errors are occuring in eligibility determinations for MA, TANF and FS and not being detected by DPW on a timely basis.

Recommendation: We recommend that 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 system access controls for Welfare-to-Work participants employed at the CAOs, and establish procedures to ensure DPW's compliance with Act 1996-35 and ensure recipient compliance with court-ordered payment plans.

Further, we recommend that DPW's CAOs comply with the requirement mandating that all CAOs perform CSRs or TSRs on a monthly basis since the completion of these reviews is designed to identify specific problem areas with respect to caseworkers eligibility determinations and to implement corrective action to address the deficiencies.

Finding 04 – 3: (continued)

Agency Response: The Office of Income Maintenance (OIM) concurs with the four audit findings that recommend that DPW and the CAOs: 1) Ensure the caseworkers receive additional training and are more thoroughly supervised; 2) Strengthen system access controls for Welfare-To-Work participants employed at the CAOs; 3) Establish procedures to ensure DPW's compliance with Act 1996-35 and ensure recipient compliance with court-ordered payment plans; and 4) Comply with the requirement mandating CAOs perform CSRS or TSRS on a monthly basis.

In reference to the first recommendation for CAO caseworker training and supervision, DPW has ensured that the caseworkers receive additional training by utilizing e-learning modules offered through the Staff Development program. Staff has easy access to updated information. Management will reinforce to staff the importance of following established DPW policies and procedures regarding eligibility determination and redeterminations. Supervisors do in fact conduct periodic Comprehensive Supervisory Reviews and Targeted Supervisory Reviews to make sure the staff is following established DPW policies and procedures regarding determining eligibility and redeterminations. These periodic reviews are done on an ongoing basis.

Secondly, in response to the recommendation that DPW and its CAOs strengthen system access controls for welfare-to-work participants employed at the CAOs, an Operations Memorandum 050705, dated July 7, 2005, to Executive Directors provides a process for each CAO to review internal procedures. The Security Process Overview is a self-assessment tool to be used by CAO management staff. Statewide security standards for the CAOs will be issued by year's end.

In the related recommendation to strengthen procedures that will ensure compliance with Act 1996-35 and ensure recipient compliance with the court-ordered payment plans, OIM uses the Income Eligibility Verification System (IEVS) 'Exchange 10' which allows for communication with local courts and other authorities and the exchange of information. IEVS Exchange 10 screens have recently been revised which has made it easier for the worker to interpret the information on the screens. Policy clarifications and a desk guide have also been issued to staff to strengthen compliance in this area.

OIM agrees with the intent of the recommendation that all CAOs perform Comprehensive Supervisory Reviews (CSRs) on a monthly basis, but would like to clarify certain aspects of the cited Condition which led to the recommendation.

First, in reference to the statement in the Condition that cited the Philadelphia CAO, Nursing Home District for failure to respond to the request for the Comprehensive or Targeted Supervisory Reviews (CSR/TSRs), further clarification is required. Philadelphia CAO, Nursing Home District had a waiver granted by the Area Manager for the months of November and December 2003 and January 2004. OPS Memorandum #980303 provides that a request for a waiver for multiple months can be obtained from the Area Manager, which is the case in this instance.

In addition, the Susquehanna CAO completed a CSR for the month of March 2004; however, the supervisor who performed the review retired in June 2004 and destroyed his individual files, including the CSRs, when he left. A corrective action plan has been developed to ensure the completed CSR forms are retained for two years per OPS Memorandum #980303. OIM concurs that Allegheny CAO, Susquehanna District, did not complete CSR's for the month of July 2003. A corrective action plan has been developed to ensure that future CSRs are completed by these respective CAO's.

Auditors' Conclusion: With respect to the Philadelphia CAO, Nursing Home District, we understand that waivers of this requirement can be granted to CAOs. However, since this CSR and TSR process is the key internal control in place at the CAOs relative to eligibility determinations and redeterminations, we believe these reviews should be performed on a monthly basis by each CAO as stated in our recommendation.

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 04 – 4:

CFDA #10.557 – Special Supplemental Nutrition Program For Women, Infants, and Children

Noncompliance and Internal Control Weaknesses in DOH Systems Result in $26,719 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding # 03-3)

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 that corrective action to our prior-year finding was not fully implemented by DOH since there were 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, 2004. 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. The total FI redemptions for these 10 days was $6,486,055, or an average of $648,600 in FI redemptions per day. Our testing disclosed that for the 10 days tested, $26,719 in total payments were made without supporting RFIs recorded on the database, or an average of $2,672 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, 2004 these error reports were not reviewed to ensure that the RFIs are validly redeemed.

- **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. 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.

Regarding Food Instrument redemptions and disposition, 7 CFR 246.12(q) states:

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

Finding 04 – 4: (continued)

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:

(g) 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.

(h) 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.

(i) 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:

(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. . . .

<u>Cause</u>: In regard to FI redemption, WIC personnel stated that for SFYE June 30, 2004 the RFI Monthly Error Reports were not reviewed to ensure that the RFIs were validly redeemed. WIC personnel stated that the reports are currently being revised to be put into a format for easier review to resolve this finding.

Finding 04 – 4: (continued)

In regard to FI disposition, DOH relies on the WIC computer system to report FIs as issued or voiced, 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.

Effect: We question $26,719 in unallowable WIC payments which are not supported by the WIC database redemption files and have not been properly investigated and are, therefore, unallowable. 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 in the future.

Recommendation: DOH should pursue appropriate settlement of the $26,719 in questioned costs with FNS, and review its WIC system for additional questioned costs due to the discrepancies in food instrument disposition 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.

Agency Response: It is important to note there were no Food Instruments (FIs) that were posted to the accounting system that were not appropriately produced and processed through DOH's banking contractor. The discrepancy was identified on the FI error reports. In a resolution of the prior year finding, DOH agreed to start reviewing the Redeemed/Voided, Lost or Stolen FI Monthly Report by April of 2004. This was done ahead of schedule. In reviewing the various reports, DOH determined that a new, more comprehensive report should be developed, then produced and reviewed. DOH will begin the review of the new report as soon as possible.

DOH, through the Division of WIC, will pursue resolution of the questioned costs in this finding with USDA's Food and Nutrition Service (FNS).

Auditors' Conclusion: Since DOH personnel did not review all FI error reports during SFYE June 30, 2004, 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 04 – 5:

CFDA #10.557 – Special Supplemental Nutrition Program For Women, Infants, and Children

Noncompliance in DOH Submission of the WIC Financial Management and Participation FNS-798 Report Results in $774,331 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-4)

Condition: Our review and testing of the WIC Financial Management and Participation FNS-798 Closeout Report for Federal fiscal year ended September 30, 2003 (FFY 2003), submitted to FNS in February of 2004, revealed that the amount reported for the Net Federal Food Outlays on Line 12 does not agree to the Commonwealth's general ledger used to prepare the SEFA (i.e., SAP grant accounting records) for the FFY 2003 WIC Grant. Therefore, DOH did not fully implement corrective action to our prior-year finding on this issue. The current-year discrepancy is as follows:

Net Federal Food Outlays Line 12:

As reported on the FFY 2003 FNS-798 Closeout Report	$87,352,355
SAP Grant Accounting for the FFY 2003 WIC Grant	86,616,644
Difference	$ 735,711

The amounts we utilized from the SAP Grant Accounting System in the above comparison was as of the end of our current audit period at June 30, 2004. Since $735,711 in expenditures reported on the FNS-798 Closeout Report are not supported by the Commonwealth's general ledger on SAP, these costs are unallowable for the WIC program.

Our testwork also disclosed that expenditures continued to be posted in SAP during SFYE June 30, 2004 to the prior-year FFY 2002 Administrative Expense Grant Y21057 in which the final FNS-798 Closeout Report was submitted in March 2003. Expenditures posted to FFY 2002 Grant Y21057 during SFYE June 30, 2004 amounted to $38,620. Since these expenditure postings occurred after the March 31, 2003 closeout date, they are not in compliance with Federal Regulation 7 CFR 246.17 and are, therefore, unallowable.

Furthermore, our testing of other line items in the above FNS-798 Report disclosed additional discrepancies which, although they are immaterial and require no adjustment to amounts originally reported, point to internal control weaknesses at DOH in the preparation of this report.

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.*

Finding 04 – 5: (continued)

(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;

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 expenditures being recorded in SAP Grant Accounting and reported on the SEFA agree to what is reported to FNS.

WIC management stated that there were several reruns of reports from QuickWIC, the DOH system that processes WIC Food Instruments, that contributed to possible errors. In addition, adjustments requested by WIC to be made by the Comptroller's Office may not have posted and other amounts may have been posted to the grants in error. WIC management also stated that they are looking at revising the closeouts for FFY 2002 to 2004; however, it will be some time until the analysis is complete.

Effect: Federal WIC expenditures recorded in the Commonwealth's SAP Grant Accounting system (and reported on the SEFA) do not support, and are less than, amounts reported on DOH's WIC FNS-798 closeout report for FFY 2003 for Line 12, Net Federal Food Outlays. As a result, we question the difference of $735,711 between the amount reported on the FNS-798 and SAP for Net Federal Outlays. In addition, we question $38,620 in expenditures posted during SFYE June 30, 2004 to the FFY 2002 grant after the grant closed in March 2003. Total questioned costs are $774,331. Without proper corrective action on the control weaknesses causing FNS-798 reporting errors, these errors will continue into future years.

Recommendation: DOH should pursue appropriate settlement of the $774,331 in questioned costs with FNS. We also recommend that WIC implement sufficient controls over the preparation of the FNS-798 and 798A Reports and grant closeout process to ensure that accurate expenditures are reported to FNS which are properly supported by the SAP grant accounting records used to report expenditures on the SEFA.

Agency Response: DOH agrees that the FNS-798 Report should agree with the Commonwealth's grant accounting system and appropriate adjustments are being made to both SAP and the FNS-798 Report to ensure expenditures are properly recorded. Since adjustments are often needed to correct incorrect postings, procedures were implemented to track adjustments and reduce the chance of unwanted postings in the future. DOH's Comptroller Office will now send DOH's Division of WIC confirmation of adjustment postings to ensure better tracking of them. In addition, DOH's Comptroller Office will put a stop on certain codes to reduce unwanted posting after grant closings.

DOH, through the Division of WIC, will pursue resolution of the questioned costs in this finding with USDA's Food and Nutrition Service (FNS).

Finding 04 – 5: (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 04 – 6:

CFDA #14.228 – Community Development Block Grant
CFDA #14.239 – HOME Investment Partnerships Program

DCED Did Not Perform Adequate During-the-Award Monitoring of Subrecipients (A Similar Condition Was Noted in Prior Year Finding #03-5)

Condition: DCED performs during-the-award monitoring of the CDBG and HOME subrecipients primarily through on-site visits, conducted on a cyclical basis. The subrecipients to be monitored in a given year are identified on a monitoring schedule along with the projects and specific compliance areas.

As part of our audits of the CDBG and HOME Programs, we performed procedures to determine if DCED's during-the-award monitoring procedures were adequate on-site. Based on our review of the DCED 2003-2004 Monitoring Schedule, we noted that a total of 96 CDBG subrecipients and 48 HOME subrecipients were scheduled for on-site visits. However, our inquiry revealed that on-site visits were completed for 40 CDBG subrecipients and 24 HOME subrecipients. Accordingly, DCED only completed 42 percent and 50 percent of the on-site visits scheduled for the CDBG and HOME Programs, respectively. Further, the results of our testing within the HOME Program disclosed that for one township, DCED Contract #22-190-0058, which was one of five subrecipients selected from the 24 subrecipients DCED claimed to be monitored, on-site monitoring was not actually completed. Therefore, DCED's during-the-award monitoring of its subrecipients was not adequate to provide reasonable assurance of the subrecipients' compliance with federal regulations.

During the year ended June 30, 2004, DCED reported subrecipient expenditures for the CDBG and HOME Programs of $56,184,000 and $13,435,000, respectively. These expenditures represented approximately 98 percent of the total CDBG program expenditures and 95 percent of the total HOME program expenditures. There were a total of 325 and 115 subrecipients with current year expenditures for the CDBG and HOME Programs, respectively.

In addition, DCED only closed out 2 HOME subrecipient projects during SFYE June 30, 2004 compared to 47 and 79 projects closed out during prior SFYE June 30, 2003 and June 30, 2002, respectively. DCED cannot closeout out the projects until monitoring is performed.

Within our testing of A-133 subrecipient audits, we found a material amount of subrecipients under both the CDBG and HOME programs received less than $300,000 during SFYE June 30, 2003 and would not have been required to submit an A-133 Single Audit to the Commonwealth during SFYE June 30, 2004. As a result, we consider inadequate during-the-award monitoring noted above to be a material weakness in each program.

Furthermore, we could not follow up on DCED's corrective action to prior year finding #03-5 due to the fact that neither of the two subrecipient projects closed during SFYE June 30, 2004 were Community Housing Development Organization (CHDO) operating grants. Our prior year finding disclosed that DCED does not perform on-site monitoring for CHDO operating grants. 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 at closeout which was to be reviewed by DCED for compliance with HOME regulations and eligibility of operating costs. Additional documentation should 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. As of prior year June 30, 2003 DCED had not yet implemented procedures HUD approved in May 2003.

During SFYE June 30, 2004, CHDO operating grants were $355,000, or 2.5 percent of total DCED HOME program expenditures of $14,103,000.

Finding 04 – 6: (continued)

Criteria: Regarding subrecipient monitoring, 24 CFR Section 85.40 (a) states:

Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

The OMB Circular A-133 Compliance Supplement Part 3, M. Subrecipient Monitoring, states:

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.

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 indicated that staffing shortages prevented DCED from completing all of the on-site visits that were scheduled in their monitoring cycle. Further, DCED indicated that the on-site visits that were not completed on the 2003-2004 Monitoring Schedule will be added to the 2004-2005 Monitoring Schedule. Due to monitoring not being completed, DCED could not closeout the subrecipient projects.

Regarding monitoring of CHDO operating grants, DCED procedures were not approved by HUD until May 2003 and no CHDO operating grants were closed during SFYE June 30, 2004, and therefore, we could not verify that the procedures approved by HUD have been properly implemented by DCED.

Effect: DCED did not adequately perform during-the-award monitoring of the CDBG and HOME subrecipients to ensure compliance with federal regulations. Further, both the CDBG and HOME Programs have a material amount of subrecipient expenditures each year that are not subject to the audit requirements of OMB Circular A-133. Therefore, the timely completion of these on-site visits is vital in providing DCED with reasonable assurance that the program's subrecipients are complying with federal regulations and that DCED is fulfilling its responsibilities under OMB Circular A-133 with respect to subrecipient monitoring. In addition, DCED will accumulate a large backlog of subrecipient projects to be closed out.

Recommendation: We recommend that DCED ensure that all on-site visits are completed within the scheduled monitoring cycle to provide reasonable assurance that subrecipients are complying with federal regulations and subrecipient projects get closed out in a timely manner. In addition, we recommend that DCED strengthen its monitoring of CHDO operating grants by implementing the procedures approved by HUD in May 2003.

Agency Response: During the Audit Period of July 1, 2003 through June 30, 2004, significant personnel reductions prevented the accomplishment of the monitoring schedule. These reductions are described as follows:

1. Two Grant Managers retired in April 2003 and June 2003.

2. Replacement Grant Managers were hired in November 2003 and January 2004. However, from February through May each year the Grant Manager's time is consumed by CDBG Application reviews, so little monitoring is completed then.

3. A third Grant Manager was retiring in June 2004, further reducing work accomplishments.

The Audit Report documents that approximately 42 percent and 50 percent of the scheduled CDBG and HOME monitorings were completed, respectively. These percentages accurately reflect the personnel reductions that occurred during the audit period.

Finding 04 – 6: (continued)

Now that DCED is fully staffed with five Grant Managers, it is anticipated that the 2004-05 monitoring schedule will be completed during 2005. This schedule includes those monitoring visits not completed during the past year and a half. Additionally, being fully staffed will allow for catching up on closeouts for both CDBG an HOME, including CHDO Operating grants in which the HUD approved updated May 2003 procedures will be utilized.

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 04 – 7:

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 (A Similar Condition Was Noted in Prior Year Finding #03-6)

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 ES Cluster, TAA, and UI administrative costs and the 064 Fund for UI and TAA 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 33 draws for the year ended June 30, 2004 under the ES Program. For 3 of the 5 draws in our sample, or 60 percent, LECS violated CMIA cash management rules as follows:

- On September 12, 2003, LECS made a draw of $3,000,000 for ES grant #2053. The amounts drawn under this grant are based primarily on a cash needs amount calculated on an Excel spreadsheet developed by LECS. The cash needs amount is based on various inputs including the cash drawn to date and targeted expenditures. LECS provided us with their cash needs spreadsheet to support the amount drawn. However, this spreadsheet was dated as of June 30, 2003 and showed a positive cash balance for this grant of $105,000, so LECS could not support the amount drawn of $3,000,000, resulting in a $3,105,000 overdraw for ES. LECS was unable to provide any additional documentation to support the amount drawn. Further, based on our review of the applicable month-end FARS GA-17 Report, which included the above draw, we noted that the cumulative drawdowns for this grant were unreasonable since they exceeded the cumulative expenditures by $2,111,023 as of September 30, 2003.

- On October 10, 2003, LECS made a draw of $4,457,770 for ES grant #2053. LECS provided us with their cash needs spreadsheet dated as of August 31, 2003 to support the amount drawn. However, the cash needs amount calculated for this grant of $2,500,977 did not support the amount drawn of $4,457,770, resulting in a $1,956,793 overdraw for ES. LECS was unable to provide any additional documentation to support the amount drawn. Further, based on our review of the applicable month-end FARS GA-17 Report, which included the above draw, we noted that the cumulative drawdowns for this grant were unreasonable since they exceeded the cumulative expenditures by $4,001,172 as of October 31, 2003.

- On June 4, 2004, LECS made of draw of $1,000,000 for ES grant #2053. However, LECS was unable to provide any detail in support of the amount drawn in violation of cash management regulations. Further, based on our review of the applicable month-end SAP GA-11 Report and the manual ledger of draws, which included the above draw, we noted that as of June 30, 2004, the cumulative drawdowns for this grant were unreasonable since they exceeded the cumulative expenditures by $7,093,454.

In addition, we also noted that LECS subsequently netted a total of $5,600,000, including the overdrawn funds mentioned above, against future draws under ES grant #2053, returning the cash to the federal government during the period from August 20, 2004 through September 24, 2004, after the end of our current audit period.

In the prior year audit, we also noted that LECS had no procedures in place for supervisory review and approval of ES Cluster, UI, and TAA drawdowns for the 026 or the 064 Funds during the year under audit. Based on our follow up and current year testing, we noted that this same weakness existed during the year under audit.

Finding 04 – 7: (continued)

Criteria: US Treasury Regulations in 31 CFR Part 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, 29 CFR 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: With respect to the ES overdraws on September 12, 2003 and October 10, 2003, LECS stated that ES federal funds were drawn to cover ES program expenditures as well as payroll expenditures for the UI Program since UI federal funds were not yet available due to the federal budget not being passed on a timely basis. With respect to the ES overdraw on June 4, 2004, LECS stated that due to the SAP conversion on February 1, 2004, there was a significant learning curve for LECS personnel and they were having difficulty in obtaining the necessary information from SAP and had not updated their cash needs spreadsheet since January 2004.

Additionally, LECS stated that supervisory review and approval procedures of the 026 Fund and 064 Fund drawdown information were implemented subsequent to the year under audit. Therefore, these procedures were not in place during the audit period.

Effect: LECS violated cash management standards since material overdraws for ES were not based on the program's actual immediate needs. However, since ES is not included in the Treasury-State Agreement, there is no CMIA interest liability with respect to the ES drawdowns. In addition, UI program funds were drawn under the wrong program in noncompliance with CMIA, with an undetermined interest impact. 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.

Recommendation: We recommend that LECS update the cash needs spreadsheet in a timely manner in order to reflect the most recent financial information available from the SAP accounting system when calculating the 026 Fund drawdown amounts for the ES Program. We also recommend that LECS consult with U.S. Treasury and/or USDOL officials to resolve the issue relative to their handling of the funding shortfalls for the UI administrative grants and the CMIA interest impact. In addition, we recommend that LECS ensure that adequate supervisory review procedures exist over the 026 and 064 Fund drawdown processes to prevent undetected errors in the future.

Agency Response: This repeat finding from SFYE June 30, 2003 is being addressed in a USDOL Initial Determination letter dated June 14, 2005. The USDOL is requesting evidence that procedures are implemented in accordance with the original finding recommendation. We have recently submitted additional documentation indicating the supervisors sign off on the documents and that draw procedures have improved since daily data is now available. We are now waiting for a management decision from USDOL to see if the documentation submitted is adequate to resolve this issue.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action plan 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 04 – 8:

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 Representative Program

Weaknesses Exist in the FARS and SAP FARS Replacement Systems Resulting in an Undetermined Amount of Questioned Costs up to $4,484,751

Condition: From February 2004 until the state fiscal year ended June 30, 2004, $4,484,546 in salaries, benefits, and non-personnel service costs were allocated to the ES Program Cluster as Assigned Staff and Technical (AS&T) Services and Cost Center Overhead (CC O/H) charges by L&I's new SAP FARS replacement system. Although USDOL tentatively approved the methodology for allocating costs using this new system, we were unable to determine whether the system was working as intended. Specifically, as part of our testing of this new system, we selected seven charges from the allocated (AS&T and CC O/H) salaries and benefits expenditure categories. For six of our seven sample items, neither IES nor LECS Comptroller Office personnel could recalculate or provide documentation to support the amount charged to the program cluster. Without the recalculation, we were unable to trace the cost back to the original cost posting. Therefore, we were unable to determine whether the items were allowable under program regulations. For the one cost that could be recalculated (CC O/H), only one person on the IES development team was able to perform the recalculation. Furthermore, neither IES nor LECS personnel could provide a breakout of the AS&T costs versus the CC O/H charged during the audit period.

In addition, the Commonwealth did not establish written policies to guide LECS personnel in the recalculation of the allocated amounts. Further, the manual for the old FARS system has not been updated or replaced. Nor did LECS or IES provide evidence of functional testing approval for the FARS replacement system in SAP, which has been through several versions since "go live" on February 1, 2004.

Under the old FARS system, the LECS Comptroller Office performed and documented a manual verification of allocated cost distributions each month to ensure that all costs posted to the cost pools were allocated to the various grants. However, our procedures disclosed that, under the new SAP FARS replacement system, LECS no longer performs this verification.

As added evidence of the possible misallocations under the new SAP FARS replacement system, we noted several large variances in our analytical review procedures. In the ES Cluster programs, non-personnel costs decreased 57 percent from $8,264,849 in fiscal year June 30, 2003 to $3,562,899 in fiscal year June 30, 2004. In addition, in the UI program, non-personnel costs decreased 40 percent from $47,023,230 in fiscal year June 30, 2003 to $28,123,028 in fiscal year June 30, 2004. Our inquiries of LECS Comptroller Office personnel disclosed that they could not provide a reasonable explanation for these significant variances.

In addition, as part of our testing of the costs charged under the old FARS system between July 1, 2003 and January 31, 2004, we noted that ES Cluster programs incurred $11,631,348 of Direct Personnel and $4,248,770 of Direct Personnel Benefit expenditures during the current fiscal year. Under the FARS system, hard-copy timesheets were prepared and maintained in support of the direct personnel costs charged to the ES Cluster. In order to test the accuracy of these charges under the FARS system, we sampled 17 direct personnel charges totaling $1,724 in salaries representing approximately 90 hours charged to the ES Cluster programs. Our testing revealed that for one of these charges, totaling $152, or 6 hours, the LECS Comptroller's Office was unable to provide a timesheet to support the direct personnel charge. Given the current-year average personnel benefit rate of 35 percent, a total of approximately $205 (including salaries and benefits) was charged to the ES Cluster programs for this unsupported item.

Finding 04 – 8: (continued)

Criteria: 29 CFR 97, Subpart C states:

97.20 Standards for financial management systems.

(a) A state must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to –

(2) Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

(3) Internal control. Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets….

With respect to record retention, 29 CFR 95.53 states:

(a) This section sets forth requirements for record retention and access to records for awards and recipients.

(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 data of submission of the final expenditure report….

In addition, OMB Circular A-87, Attachment A, Section C.1., regarding the factors affecting allowability of costs states in part:

a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

j. Be adequately documented.

OMB Circular A-87, Attachment B, Section 8(h), pertaining to the support of salaries and wages also states, in part:

(4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation . . .

Cause: The old FARS System was developed by the Interstate Conference of Employment Security Agencies (ICESA) to allocate Employment Service Agency indirect costs among the various Employment Service grants and programs. As part of implementation in February 2004, the Commonwealth customized several SAP programs to function in the same manner as the old FARS system and to perform two monthly cost allocations: an AS&T cost allocation and a CC O/H Cost allocation.

During our testing of the seven allocated cost items, we were able to recalculate the one CC O/H item in our sample. However, the remaining six sampled items were AS&T allocations that could not be recalculated. We learned that during the monthly AS&T allocations, certain values needed to recalculate the costs were overwritten. While these values were saved in "internal tables" which allowed the IES system developers to recalculate amounts during unit testing, these "internal tables" were not properly maintained and were not available at the time of audit. Therefore, neither IES nor the LECS Comptroller Office could recalculate the AS&T items in our sample.

Regarding the lack of written procedures, LECS personnel cited a lack of time as the reason that they have not developed written policies and procedures for the SAP FARS replacement.

As for the verification of the completeness of the monthly allocations, IES development personnel stated that they perform an informal, undocumented review each month to make sure that all costs were allocated. However, a formal documented process has not yet been developed for use by LECS.

Finding 04 – 8: (continued)

With respect to the one missing timesheet, LECS personnel stated that this employees' timesheet could not be provided because the district office where this employee was located apparently did not submit a paper copy of the timesheet to the Comptroller's Office. LECS personnel indicated that under the old FARS system, they received between 2,000 and 3,000 timesheets each month and this timesheet must have been missing or misplaced.

Effect: Based on the one CC O/H sample item that could be recalculated, the recalculation problem appears to impact AS&T costs and not impact CC O/H. However, neither LECS nor IES could generate reports to break down the total allocated costs between AS&T and Cost Center Overhead. Since they could not provide a break down of costs between AS&T and Cost Center Overhead, we were unable to determine the exact amount of questioned costs. Therefore, an undetermined amount of costs up to $4,484,546 are questioned as unallowable. With respect to the one missing timesheet, an additional $205 in direct personnel service costs (salaries and benefits) are questioned as unsupported.

Without written procedures for the recalculation of AS&T and Cost Center Overhead and the lack of retention of key data, the Commonwealth is unable to demonstrate that costs were allocated correctly.

In addition, without a documented verification that all allocated costs have been distributed, there is minimal assurance that all costs were allocated properly or in a timely manner each month.

Recommendation: L&I should pursue appropriate settlement with USDOL for the unknown questioned costs up to $4,484,751 identified above. Also, LECS personnel should work with IES to develop a process that retains the information necessary to recalculate and verify all allocated costs. The processes used to recalculate the costs should be clearly documented and understood. Further, system manuals, procedures and other documentation should be developed to aid in the operation and control of the system.

Further, LECS should work with IES to develop a documented process to verify that all costs have been properly allocated each month. This process should be reviewed by the appropriate supervisory personnel and evidence of that review should be retained.

Agency Response: The auditors have elected to disapprove all AS&T allocations between February 2004 and June 30, 2004. This approach is misleading for two main reasons. First, the auditors had originally selected about eight different cost collector "buckets" to verify that these cost collector buckets were empty after the allocations were performed. In every case, the cost collection buckets were empty at the end of the allocation, indicating that the allocation did in fact take place. Second, incomplete verification of the other six samples was due to the auditors' time constraints. It was noted at the meeting with the auditors that more time was needed to extract the data they requested. Attached to this response is a disk with a file containing an additional five of the six sample items. The attached should be adequate proof. The remaining sample will be pursued but again time has become a factor. It will be provided at a later date. It is not necessary to issue a monetary finding on all costs when individual system steps and tables require adequate time to access.

With regard to the missing time sheet, we agree that it could not be located. The office where the individual had been assigned was moved. Unfortunately, the time sheet copy files could not be located.

The auditors recommended that a process should be established to recalculate and verify that all costs have been allocated. Although the allocation buckets were sampled monthly to insure that the process was working correctly, it was not completed on all allocation cost collector buckets. We will request that a report be established with written procedures and will work with the auditors to get a clear understanding of what they might want to avoid future issues.

Auditors Conclusion: The sample items selected were not cost collector "buckets," but rather costs charged to the ES Program Cluster through the SAP FARS Replacement system. Neither the personnel from the LECS Comptroller Office nor the Integrated Enterprise System could recalculate our sample items back to the primary cost objects after several failed attempts during our fieldwork. These recalculations are needed as audit trails to test the allowability of the items in accordance with OMB Circular A-87.

Finding 04 – 8: (continued)

The Excel spreadsheets provided with the response to the finding support only one step in our required test of allowability. What the response fails to mention is that during our testing, IES personnel represented to us that key fields needed for the recalculation and to provide an audit trail were overwritten and not stored in the database. Further, the attempt to demonstrate the recalculation appeared to be a trial-and-error process because no procedural documentation was available to guide staff in their attempts at recalculation.

As a result, the agency response did not provide adequate information, documentation, and explanation to properly support the allocated changes to the ES program. The Excel spreadsheets and the recalculation methodology they contain may aid in the federal audit resolution process and will be considered in planning during the next audit.

Our finding and recommendation, with the above clarifications, 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 04 – 9:

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 #03-7)

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 June 30, 2004, which reported on TAA participants who had exited TAA during the quarter January 1, 2003 through March 31, 2003. We selected 40 participants from the TAPR out of a total of 475 participants and compared the key data (ten separate data fields) for each participant to supporting documentation. Our testing revealed the following:

- Two of the 40 participants in our sample were improperly included on the report. One of the individuals was still in training after the reported quarter of exit. The other individual had terminated training prior to the reported quarter of exit.

- The most recent qualifying separation date was incorrect for three 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 second participant, the incorrect date was not in the same quarter as the correct separation date. This error did not affect the wage information in fields 44 & 45, which L&I reported as zero, since this individual only had non-PA wages and L&I would not have had access to these wage records for the quarters prior to the correct separation date. For the last participant, the incorrect date was not in the same quarter as the correct separation date which caused the wages in fields 44 & 45 to be reported incorrectly.

- 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.

During our prior year audit, we noted the following weaknesses in L&I's controls over preparation and submission of the TAPR, as follows:

- In the prior year, the data for the TAPR was accumulated from various sources and entered onto a data sheet for each participant who had been identified as exiting the program for the quarter. The information from the data sheet, including wage information, was 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 first two quarters of the prior year. Starting with the third quarter, L&I personnel performed a limited supervisory review of the data input, which we found to be inadequate based on the errors noted in our prior year testwork.

  For the current year, we noted that in-state (PA) wage information for the TAPR is being provided electronically through a data feed from the UC Wage Record System. This system holds wage data for a period of time and then the information gets purged and placed into the UC archived files. For each individual on the TAPR, either the wages are entered or a code (99999.99, 88888.88, or no hit) is entered into the applicable data field. Each code identifies a potential error in the wages being reported. For example, a "99999.99" means that there is no wage information available in the UC database. This could occur if an individual's separation date was prior to the date parameters within the UC system. When the wages are imported into the TAPR database, a zero will appear in all

Finding 04 – 9: (continued)

wage data fields containing a 99999.99 or no hit code. For the 88888.88 code, the code is changed to a monetary value of $99,998. We noted that L&I does not have any procedures in place to follow up on the codes generated from this data feed prior to the import of UC data into the TAPR database. Further, they do not perform any review of the wage data fields on the TAPR prior to submission to USDOL to ensure the accuracy of the wages reported on the TAPR.

- In the prior year, we noted that the exit date in the database used to generate the TAPR was 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 have been based on the last date on which the participant received 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.

  Our current year procedures revealed that L&I used the same procedures noted above to identify exiters for the first three quarters of the current year. Effective for the June 30, 2004 report, L&I implemented new procedures to properly identify exiters for the reporting quarter. However, based on the results of our testing above, these procedures were not adequate.

- Participants who receive a waiver from training were not being included on the TAPR when they exited the program. Based on our current year testing, we noted that effective for the 6/30/04 report, L&I implemented procedures to include individuals who receive waivers on the report in the quarter they exit the program. However, these procedures were not in place for the first three quarters of our audit period.

In addition to the weaknesses described above, our current year procedures revealed the following additional weaknesses:

- PA has a data sharing agreement with various states to obtain out of state wage information from the WRIS wage database. This agreement enables L&I to request and report out of state wage information for individuals included on the TAPR. The information obtained from WRIS is electronically fed into the TAPR database. However, we noted that this data feed does not appear to consider individuals with more than one wage entry for the reporting quarter. Further, L&I is not performing any comparison of the WRIS wage data file to the wage data on the TAPR to ensure the wages reported are accurate and complete.

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.

Finding 04 – 9: (continued)

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: L&I did not have any procedures in place during the year to verify the accuracy of the wage information reported on the TAPR, which is electronically fed into the TAPR. Additionally, most of the non-wage data for the TAPR is compiled from a variety of databases and manually input into the TAPR system. Although L&I has review procedures in place to verify the accuracy of the non-wage data, these procedures were not adequate based on the inaccuracies cited in the condition.

Further, the exit date in the TAPR system is based on the completion date provided on the participant's application for training. For the first three quarters of the year under audit, L&I did not have adequate procedures in place to ensure that this date was the actual exit date, as defined in the reporting instructions. Also, L&I had no procedures in place to ensure that participants who receive waivers from training were included on the report for the first three quarters of the year under audit, since L&I was unaware that these individuals were to be included on the TAPR. Although, L&I implemented new procedures for the fourth quarter of the year to properly identify exiters to include on the TAPR, these procedures still need improvement since errors were 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: L&I should strengthen existing procedures to verify the completeness and accuracy of the TAPR information that is accumulated and transmitted to USDOL. These procedures should include a review of all codes generated from the UC data feed prior to the import of the wage data into the TAPR database, or a cursory review of the wage data fields once its in the TAPR database. These procedures should also include a comparison of the WRIS wage data to the wage data reported on the TAPR. Further, L&I should ensure that performance of these review procedures is formally documented.

Agency Response: While the Commonwealth agrees that there were some minor inaccuracies, we do not agree with the overall finding as cited in the *Caus*e, *Effect*, and *Recommendation*; in particular we object to the statements that the Commonwealth's TAPR review procedure is not accurate and does not comply with Federal regulations.

The first bullet concerns two students being reported in the wrong quarters: one is still attending and will be reported on in the correct TAPR but the other had completed training in the prior quarter and was reported incorrectly. Since only one was an error, that is only a 2.5% error rate and certainly not to be considered not complying with Federal regulations nor does it invalidate the entire report.

The next issue is only a 5% error rate involving the qualifying separation date in how it relates to prior wage information. Two individuals' separation dates were reported in the wrong quarter; the other one where the date was off slightly was not an error as the correct quarter was indicated. Once again, we know that is a now extinct paper application system and human error of minor significance that will not occur when the data is collected completely electronically. Exit dates are currently being assigned based on the last date of a TAA funded service, whatever it might be. There continues to be improvement in the process and accuracy of reporting as we transfer from the old system to the new CareerLink system. With the introduction of Common Measures, these processes will continue to be improved and streamlined.

Finding 04 – 9: (continued)

The finding concerning wage information that was reported in the review of 4 participants where 0 wages were reported in the review of wage record fields indicating now existing records is indicative of a system that is not static. Since the wage records are automatically extracted from the mainframe, all-existing wages that were available at that time were brought over. These wages had to have been added after the information was imported and therefore not an error.

The information that is received on the wage feed from the UC system contains several codes, including wages. These codes are not errors, simply identifiers regarding the information available or not available at the time of request. The '99999.99' code indicates that there is a record for the SSN but no wage for that time period being requested. The '88888.88' code indicates that there is a wage present that exceeds $99,998.00 for the quarter being requested. The 'No Hit' code indicates there is no record for that person in the UC database at the time of the request. The results of the wage feed are fed into a holding table where the '99999.99', and no hit codes are all set to a 0 wage since they all indicate that no wage exists at the time of request for the quarter being requested. The '88888.88' code is changed to a monetary value of $99,998.00 to report the maximum amount possible to the feed. So the '88888.88' code has not been returned from a TAPR feed. The wages are all then inserted into the TAPR database. The verification of data sent from UC and their procedures are to be done by the UC programmers before sending the data to the TAPR. This is a process that has been previously tested for its accuracy plus a review of the information is conducted to check for inconsistencies or potential errors after the wages are imported.

The quarter of the audit was one of the first quarters in which we had received the WRIS data and processes have since been established to ensure accuracy and data integrity. The WRIS information is imported, summarized, reviewed, and then inserted into the TAPR database with checks before and after to ensure the correct amounts are reported. The IT staff member that does the import and the TAA Supervisor both complete a review of all wage information; potential problems are investigated if necessary. The TAA Supervisor reviews the entire report including the wages before report submission.

As stated many times, this report and the systems supporting it is a continuous improvement process. We have changed our procedures since the time of the audit and will continue to do so with the migration from an old system to a new system and the introduction of Common Measures.

Auditors' Conclusion: Regarding the first bullet in the condition, both individuals cited in this bullet were improperly included on the report since they did not exit the program during the reporting quarter of January 1, 2003 through March 31, 2003. Therefore, we consider both to be errors.

With respect the second bullet, the most recent qualifying separation date was incorrect for all three individuals. Although the incorrect date was in the same quarter as the correct date for one of the three individuals, we still consider this an error since the most recent qualifying separation date, which is a key data field, was not accurately reported.

For the third bullet under the condition, the most recent qualifying separation dates for these four individuals ranged from the third quarter of 1991 to the first quarter of 1999. As a result, it appears unlikely that historical wage information for these four individuals would have been added to the UC database for quarters prior to these dates. Since our testing revealed that all four individuals had wages for the quarters reported in these data fields, we consider the reporting of zero wages to be errors.

It should be noted that our overall error rate was approximately 22 percent based on errors noted for nine of the 40 participants in our sample. This error rate would be significant when applied over the population of data reported.

Regarding the codes from the UC wage feed, we agree these codes are not necessarily errors. However, as stated in our finding, these codes identify potential errors that should be followed up by L&I. Although L&I has indicated in their response that a review of wage information is performed after the wages are imported, including WRIS data, we were initially informed that no review of this wage data was being performed. Further, L&I did not provide any documentation to evidence the performance of these review procedures.

Finding 04 – 9: (continued)

While we agree with management that there is continuous improvement in its TAPR reporting process, any corrective action cited by L&I will be evaluated in our subsequent audit. Our finding and recommendation, with the above clarifications, remain as stated above.

Finding 04 – 10:

CFDA #17.245 – Trade Adjustment Assistance - Workers

Lack of Supporting Documentation and Inaccurate Reporting on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #03-9)

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 employer 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. Each separate report contains 37 data fields used to report both financial and statistical information by petition number; seven data fields include financial and 30 data fields include statistical information.

In order to test the accuracy of the information submitted to USDOL, we obtained the ETA 563 submitted for the quarter ended June 30, 2004 for the TAA petitions. This report contained 965 petitions, many of which only had one or a minimal number of data fields completed. We judgmentally selected a sample of six of the larger petitions with the most data submitted, and requested documentation to support the financial and statistical information reported by L&I in the 37 data fields for each petition. The petitions selected were #40180, #40354, #42024, #51143, #52130 and #50366. For data fields where the source of the information was the UCAP system (Fields 1 through 9 and 12 through 15), L&I's supporting documentation consisted of a list of individuals for each related UCAP data field. We selected a sample of 40 individuals out of a population of 357 individuals from all of the UCAP data fields on the 6 petitions in order to determine if the individual was properly included as support for the field. For data fields where the source of the information was the Careerlink system (Fields 16-26), L&I again provided a list of individuals as support for each of the related data fields. We selected a sample of 74 individuals out of a population of 548 individuals and haphazardly selected Careerlink data fields from all of the six petitions in order to determine if the individual was properly included as support for the field.

Our testing for the 6 petitions disclosed differences between amounts reported and the supporting documentation for 20 of the 37 data fields as follows:

- For 3 of the 37 data fields tested (field 5a, field 5b and field 13), no support was provided by L&I for the amount reported on any of the 6 petitions. The unsupported dollar totals were $806,150 for field 5a, $427,077 for field 5b, and $6,162 for field 13.

- For 4 of the 37 data fields tested, there were differences between the statistical information reported and the supporting documentation provided by L&I as follows:

Field	Total Number Reported for all Six Petitions	Total Number Supported for all Six Petitions	Difference
2a-Number Determined Entitled	73	34	39
12-Overpayment Total Number	4	3	1
18-Job Order Referrals	1493	1492	1
20-Title III Participants	9	8	1

Finding 04 – 10: (continued)

- For 9 of the 37 data fields, there were differences between the statistical information reported and the supporting documentation provided by L&I as follows:

Field	Total Number Reported for Six Petitions	Total Number Supported for Six Petitions	Difference
1a-Request for Determination of Entitlement	33	6	27
3a-First Basic Payment	72	49	23
4a-Weeks of Basic paid	3606	306	3300
6a-Final Basic Payment Exhaustion	113	57	56
7a-Final Basic Payment, eligibility expired	108	12	96
2b-Number (Additional TRA) Determined Entitled	69	52	17
4b-Additional TRA Weeks Paid	1806	137	1669
24-In Training	248	243	5
25-Completed Training	99	100	(1)

Further, based on our review of the supporting documentation, we noted additional discrepancies in the above data fields:

For field 1a, we noted that 3 of the 6 individuals included in L&I's support were improperly included as support for the field. Specifically, one individual filed an "Application Under the Trade Act of 1974" after the reporting quarter, another individual never filed an application and one individual had completed an application in a previous reporting quarter.

For field 3a, we noted that 1 of the 49 claimants included in L&I's support tested, did not receive any basic TRA payments during the reporting quarter and therefore was improperly included in this field.

For fields 4a and 4b, L&I was able to identify 306 and 137 individuals as support for these fields, respectively. However, L&I did not provide any detail to show the number of weeks paid for each of the individuals. Further, we noted that 8 of the 306 individuals in the support tested for field 4a did not receive any basic TRA payments during the reporting quarter and therefore were improperly included as support for this field. Also, we noted that 3 individuals, who received additional TRA for the reporting quarter, were not included in the 137 total in the support for field 4b.

For field 6a, we noted that 3 of the 57 individuals in L&I's support tested for this field were incorrectly included. We also identified 3 other individuals that should have been included in the support for the field, but were not.

For field 7a, we identified 1 other individual who should have been included in the support total of 12 for the field.

Finding 04 – 10: (continued)

For field 2b, we noted that 1 of the 52 individuals included in the support tested was determined eligible after the reporting quarter and therefore should not have been included in this field. Further, we identified 2 other individuals that should have been included in the support for this field.

For fields 24 and 25, we noted that 1 individual included in the support total of 243 for field 24 had completed training during the quarter and should have been excluded from field 24 and included as support for field 25. Additionally, we noted that 2 individuals included in the support total of 100 for field 25 had completed training after the reporting quarter and should have been excluded from field 25 and included in the support for field 24. Further, for 1 other individual included in the support tested for field 24, there was no evidence that this individual had ever attended training and therefore the individual should not have been included in this field.

- For 2 of the 37 data fields (3b-First Additional TRA Payment and 6b-Final Additional TRA Payment Exhaustion), we noted that zeros were reported in both data fields for 4 of the 6 petitions tested. However, based on our review of the claim records and Jak-Paks provided for our sample of 40 individuals for UCAP related data fields, we identified 11 individuals that received their first additional TRA payment during the reporting quarter and therefore should have been included in the support for data field 3b. We also identified 8 individuals that should have been included in the support for data field 6b since they received their final additional TRA payment in the reporting quarter.

- For 1 of the 37 data fields (21-Entered Occupational Training) on Petition #50366, we noted that the statistical information reported by L&I agreed to the supporting documentation. However, based on our testing of the supporting documentation, we noted that 1 of the 11 individuals included in this field should not have been reported since there was no evidence that the individual ever attended training.

- For 1 of the 37 data fields (17-Applicants Active) on 4 of the 6 petitions tested, we noted that numerous individuals were included in data field 16, "Applicants New" but were not included in data field 17, which appeared to be an error. Based on our review of the report instructions, it appears that all individuals reported as "Applicants New" should also be reported in the "Applicants Active" data field.

In addition to the data discrepancies noted above, we also noted the following weaknesses in reporting procedures:

- For the data field 16, "Applicants New" we noted that the definition used by L&I to accumulate data for this field could result in an individual being included in this field on more than one quarterly report which does not appear to be in compliance with the reporting instructions.

- For data field 17, "Applicants Active", we noted that the definition used by L&I to accumulate data for this field will only include an individual who has an active ES registration and is TAA eligible. However, if an individual is in TAA training and does not have an open ES registration, the individual is not included in this field which appears to contradict the reporting instructions.

In addition to our detail testing of the 563 report for the quarter ending June 30, 2004, we also performed a reconciliation of the total benefit payments on the four quarterly ETA 563 reports for the year ended June 30, 2004 to the total reported on the SEFA. Our testing revealed that the total benefit payments on the four quarterly 563 reports were $1,507,134 less than the total benefit payments reported on the SEFA, which properly agreed to L&I's accounting records, and L&I was unable to provide an explanation of the difference.

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.

Finding 04 – 10: (continued)

Part D, Chapter III of the ETA Handbook 315 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.*

4. *Preparation of the Report. "Overview. The ETA 563 report has three basic types of data items-counts of people, counts of actions (TRA payments, job referrals, etc.), and dollar amounts. With few exceptions, the data items which report numbers of people are meant to be accurate counts of claimants under the petition number. Please be careful not to double-count people in these categories, i.e., do not include the same person more than once in any quarterly report or in reports for more than one quarter. Exceptions will be noted below where the item is discussed…."*

   "d. Section C, Reemployment Services (line 300). (1) Column 16 Applicants, New. Enter on line 300 the number of newly-registered applicants for reemployment services. Include previously registered applicants newly identified as TAA adversely affected workers."

   "d. Section C, Reemployment Services (line 300). (2) Column 17, Applicants, Active. Enter on line 300 the number of applicants in active status as of the end of the reporting period. Include applicants currently enrolled or participating in TAA approved training. Within one reporting period, there must be no double-counting of applicants. However, the same applicant(s) may remain active, and be reported as such, in more than one reporting period."

Training and Guidance Letter (TEGL) No. 6-03 regarding the revisions to the USDOL allocation process for disbursing TAA training and administration funds states:

Overview of Funding Process-ETA is adopting an annual process for disbursing TAA funds for training and associated administrative costs. The annual allocation process will utilize a set formula for distributing 75% of available TAA training funds. …. The factors that will be used in determining each state's share of the formula funds include prior year allocations of trade training funds and participant levels.

Program Reporting-The new funding process emphasizes the importance of accurate and timely reporting of program participant and expenditure data on the ETA 563 and SF 269. Reported data on these forms will take on increasing importance in determining the level of funds states may receive each year for serving trade affected workers. ….

Cause: L&I indicated that the errors noted in the condition are primarily due to the use of so many different systems to accumulate information for this report. L&I could not explain the differences cited in the condition between the supporting documentation provided and the numbers or amounts reported. Also, the programming for certain data fields on the report is based on definitions that do no appear to capture all individuals that should be included in the respective field. Further, L&I does not have adequate procedures in place to prevent the above errors and ensure the accuracy and completeness of amounts on the ETA 563 report submitted to USDOL. With respect to the difference between the total benefit payments reported on the 563 reports and the amount reported on the SEFA, L&I could not provide an explanation.

Effect: Based on the number of errors cited in the condition and the lack of supporting documentation for information on the ETA-563 for the quarter ended June 30, 2004, and based on the unreconciled difference between the total benefit payments reported on the 563 reports for the year and the SEFA, L&I did not comply with federal reporting requirements. L&I's procedures also provide limited assurance that the information submitted to USDOL on the ETA 563 is accurate and complete. Further, inaccuracies in the amounts reported on the ETA-563 could directly affect the future funding levels for TAA since the factors used in determining each state's share of formula funds include information reported on the ETA 563.

Recommendation: L&I should modify their existing systems to ensure that information being provided is accurately accumulated and reported to USDOL. Further, we recommend that L&I review all data fields that categorize individuals

Finding 04 – 10: (continued)

based on definitions to ensure the criteria used is in accordance with the reporting instructions and federal program regulations. Further, 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 fully support the information being reported to the federal government. Also, L&I should ensure that amounts reported on the 563 reports agree to the accounting records supporting the SEFA.

Agency Response: The Department of Labor and Industry was not afforded the opportunity to ascertain the accuracy of all the fields by field data documented in the finding prior to responding. It should be noted that the files used to compare the UC data in line 100 and line 200 of the ETA-563 report were not available at the time of the audit and were hastily reconstructed for the audit review. Further, only rolled up data, that is raw data that is enhanced with supplementary information from various units, is provided to the bureau that subsequently produces the ETA 563 Report. Without an extensive comparison of the information, it is difficult to ensure, field by field, accuracy or discrepancies.

The Department is not in agreement that it has not complied with federal reporting requirements nor that it can only provide limited assurance that data submitted on the ETA 563 is accurate or complete. As stated in the finding, because "of the use of so many different systems" in addition to the information being retrieved from various sources resulting in a compilation of data that does not remain static, it is difficult to provide documentation to support the testing of information reported. It is with that understanding that the Department is undertaking steps to improve this testing process as well as developing the concept of comprehensively reviewing the reported data.

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 04 – 11:

CFDA #17.245 – Trade Adjustment Assistance-Workers

Unallowable Training and Benefit Payments Result in Questioned Costs of $4,318 (A Similar Condition Was Noted in Prior Year Finding #03-8)

Condition: As part of our testing of TAA program expenditures, we randomly selected 15 Trade Readjustment Assistance (TRA) training payments charged to the program during SFYE June 30, 2004 and determined whether the payments to training facilities were allowable. Additionally, we selected a sample of 35 TRA weekly benefit payments made to claimants during SFYE June 30, 2004 and determined whether claimants were eligible for TRA and whether they received the correct benefit amount. Our testing disclosed the following:

- One of the 15 training payments in the amount of $2,793 related to services provided by a training facility on behalf of a TRA claimant during the period from October 1, 2001 through December 2, 2001. The amount was paid in September 2003 via document number 1900348471 and was charged to TAA grant #TA-12714-03-55. However, since this grant did not start until October 1, 2002, the costs charged were outside the period of availability and are therefore unallowable.

- Claimants receiving basic TRA benefit payments are required to be actively participating in training, to have completed training or received a waiver from training. For 2 of the 35 claimants in our sample (Claimants A and B), we noted that the claimants received a basic TRA payment and, according to L&I, had received a waiver from the training requirement for the benefit week covered by the payment. However, L&I could not provide a formal written notice of waiver for the benefit week covered by the sample payment. Further, for Claimant B, we also noted that two basic TRA payments in addition to our sample payment were paid to the claimant even though there was no formal written notice of waiver for the benefit weeks covered by the payments.

Claimant	Weekly Benefit Amount	Weeks in Question	Amount of Overpayment	Total Questioned Costs
A	$334	1	$ 334	$ 334
B	397	3	1,191	1,191
Total			$1,525	$1,525

For Claimant A, the benefit week in our sample was check week ending date of October 4, 2003. For Claimant B, the benefit week in our sample was check week ending date of January 24, 2004 and the additional two payments included in the questioned costs above were for the check week ending dates of January 10, 2004 and January 17, 2004.

- In conjunction with our testing of TRA benefit payments, we also noted that for 1 of the 35 claimants in our sample, the claimant was underpaid one week of basic TRA and one week of additional TRA for a total underpayment of $800. Although this error did not result in any questioned costs, we believe this error is a result of a control weakness relative to L&I's calculation of the number of eligible weeks.

The total amount of the 15 training payments tested was $38,701. During the period under audit, there were TRA training payments made totaling $20,021,957. The total amount of the 35 benefit payments tested was $11,144, which consisted of 23 payments for basic TRA totaling $6,676 and 12 payments for additional TRA benefits totaling $4,468. Based on the ETA 563 reports submitted for the year under audit, the total TRA benefit payments made during the year were $33,664,352. The TRA benefit total consisted of $25,408,454 for basic TRA and $8,255,898 for additional TRA benefits.

Finding 04 – 11: (continued)

Criteria: The TAA Grant award for Grant Number TA-12714-03-55 states:

Funds allocated pursuant to this agreement will be available for grantee for obligation and expenditure beginning October 1, 2002 through the period ending September 30, 2005.

OMB Compliance Supplement, Part 4 for TAA, Section H. states:

Funds allotted to a State for any fiscal year are available for expenditure by the State during the year of award and the two succeeding fiscal years.

20 CFR 617.11 (a) (2) (vii) states that a claimant must:

(1) Be enrolled in or participating in a training program approved pursuant to 617.22(a), or
(2) Have completed a training program approved under 617.22(a), after a total or partial separation from adversely affected employment within the certification period of a certification issued under the Act, or
(3) Have received from the State agency a written statement under 617.19 waiving the participation in training requirement for the individual.

20 CFR 617.19 (a) (2) states in part that:

When it is determined…that it is not feasible or is not appropriate…to approve a training program for an individual otherwise entitled to basic TRA, the individual shall be furnished a formal written notice of waiver, with an explanation of the reason(s) for the waiver and a statement of why training is not feasible or not appropriate in the case of such individual.

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 . . . 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. . . .

Cause: With respect to the training payment, L&I indicated that the invoice was originally assigned to a prior grant. However, the training facility submitted the invoice for this claimant late and so it was paid from available grant funds. Regarding the TRA benefit payments, for Claimant A, L&I provided a waiver that they indicated covered the benefit week in our sample; however, we could not determine the period covered by the waiver since the waiver was dated April 21, 2003 but the "effective through claim week ending" date was not determinable. For Claimant B, L&I provided waivers that covered the periods from July 1, 2003 through January 3, 2004 and January 30, 2004 through June 21, 2004. However, the waivers did not cover the weeks paid for the three benefit payments cited in the condition. With respect to the underpayment, L&I did not properly calculate the number of eligible weeks for this claimant and did not identify the error in the calculation.

Effect: Training costs of $2,793 claimed under TAA grant #TA-12714-03-55 for services provided prior to October 1, 2002 are unallowable since they were not incurred during the period of availability for this grant which runs from October 1, 2002 to September 30, 2005.

Additionally, since TRA benefits were overpaid to the two claimants listed above, there are additional questioned costs of $1,525. Also, based on the questioned costs and the underpayments cited in the condition, 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.

Finding 04 – 11: (continued)

<u>Recommendation</u>: We recommend that L&I repay the $4,318 in questioned costs or pursue appropriate settlement with the U.S. Department of Labor. Additionally, we recommend that L&I strengthen existing procedures at the CareerLink 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>: In regard to the first item cited in the finding relating to a claimant payment made in a different fiscal period than when it occurred, we offer the following information:

The issue described in the finding arose from two practices that existed at the time but have either been amended or discontinued. There is no dispute that the invoice was for a legitimate training expense of a TAA eligible participant. The finding centers on the date the service was delivered and the Federal Fiscal Year from which the payment was made.

There was a significant lag between the date the service was provided and when the training facility submitted an invoice to the Commonwealth. When the training facility submitted the invoice, the Comptroller's Office had closed the grant for FFY 2002. At that time, the Comptroller's practice was to close the end of one year even though the funds had a three-year term. The encumbrances were "rolled forward" to the next fiscal year. This practice ended with Federal Fiscal Year 2003.

On October 1, 2003, the Trade Adjustment Assistance Master Agreement language was amended to ensure that late billing would no longer occur. The exact language follows:

"The Contractor shall **not** be paid if invoices are not received within 60 days of the completion of the training, completion of the semester, term or quarter or the end of the month for training provided on a clock hour basis, whichever is applicable. The last invoice for each student shall be marked Final."

In conclusion, since the training payment was an allowable cost and the costs were still within the Federal three-year life of the funds, the Department does not agree with the finding. In addition, the Department has amended its practices to ensure that a similar instance will not occur in the future.

The Single Audit Report indicated there were training enrollment waiver issues for two individuals. The report found that the Department needed to strengthen existing procedures at the CareerLink and agency levels to ensure proper payment of Trade Readjustment Allowance (TRA) payments. Claimants A and B had a gap between the initial training enrollment waiver and the renewed training enrollment waiver which resulted in incorrect Basic TRA payments to these workers. In addition, another Claimant was paid for training outside of a defined period for allowed training funds. A final Claimant was underpaid for a week of Basic TRA and a week of Additional TRA due to an error in transitioning the worker from Basic TRA to Additional TRA.

We do not dispute the findings for Claimants A & B. We dispute the finding on the underpaid Claimant that we did not identify the error prior to the Audit.

We agree that the Department should repay the total amount of $1,525 indicated in the findings for Claimants A & B.

We also note that the current TRA claim and benefit payment system is still primarily a manual system, with limited automated system checks. However, our current instructions and procedures are in accordance with the current Trade Act law, regulations and other federal guidelines. The errors noted are due to human errors, not due to failure to have the proper instructions and procedures in place. We do not agree that these few errors are tantamount to material noncompliance as indicated by the auditors.

<u>Corrective Action Plan Synopsis Relating to Claimants A and B</u>

At the beginning of the audit period, BWDP updated the CareerLink electronic system, which includes information that is submitted to the Unemployment Compensation (UC) Service Centers to confirm eligibility requirements for TRA

Finding 04 – 11: (continued)

benefits. BWDP added new controls to ensure correct and timely information is submitted to the UC Service Center staff so proper TRA decisions and payments are made.

Since July 1, 2003, the new electronic system to automatically record dates of training enrollment waivers (among other records) was available for use by Pennsylvania CareerLink offices. The electronic system automatically records the date of training enrollment waiver, which cannot be changed once submitted. The training enrollment waiver date recorded by the electronic system is automatically transferred to an electronic waiver form. UC Service Center staff use the online dates to determine the eligibility for further TRA benefits, based on the Form ES-1940A, Training Waiver Approval/Revocation – Trade Act of 2002, that is forwarded from the CareerLink electronic system. An example of correctly processed initial and subsequent waivers using the electronic system is enclosed.

When used, the electronic system does not allow gaps between the initial and any subsequent training enrollment waivers. Both errors in this situation were due to paper waivers being issued, so the online system was not used to check for the gap in dates between each waiver. Since the waiver periods in question occurred after implementation of the electronic system, it appears that some CareerLink staff were not knowledgeable in its use.

Consequently, TCS provided three-day training sessions to Pennsylvania CareerLink staff that included instruction regarding correct and timely processing of training enrollment waivers using the electronic system. TCS has completed 14 training sessions since July 2004. Additional sessions will be scheduled for any remaining staff and as new staff are hired.

In addition, the Federal Programs Unit of the Bureau of UC Benefits and Allowances provided three-day training sessions to the TRA staff in each of the eight UC Service Centers. These training sessions began in July 2004, with the last training session being held in February 2005 that included a full review of both initial and continued requirements for proper payment of TRA benefits, including continuous review of the claimant's training enrollment or training enrollment waiver status. Further sessions will be scheduled for UC Service Center staff in the future as required due to significant changes in staff.

Further, Form UC-604, Quick Reference Guide for TRA Claims, Revised March 2005 (enclosed), provides guidance and annotations for waiver and enrollment status. The claimant handbook UCP-11A, Trade Act of 2002, was revised to include information that it is the claimant's responsibility to obtain a written renewal of the initial or subsequent waiver before any current waiver expires or is otherwise revoked (see page 12 enclosed).

Corrective Action Plan for Underpaid Claimant

We dispute the finding that the error was not identified prior to the Audit. The Claimant was paid the week ending November 15, 2003, out of order on Basic TRA. The UC Service Center correctly identified that week ending November 8, 2003, should have been paid prior to this week, which would have exhausted the Claimant's Basic TRA entitlement. The UC Service Center established a nonfraud TRA overpayment in the amount of $405 on Additional TRA, and had this amount recouped through partial offsets over the next three weeks of Additional TRA. While this was not the correct procedure and resulted in the Claimant being underpaid two weeks of TRA benefits, the payment "out-of-order" error was in fact identified prior to the Audit. The Claimant has since been paid his full amount of Basic and Additional TRA benefits (see enclosed TRA checkwriting printout).

We do not agree there is an overall fault in the calculation of the total amount of Basic TRA and Additional TRA benefits. Again, this was human error and controls for such errors are not available under the current UC/TRA electronic systems. Again, the Federal Programs Unit has provided comprehensive TRA claims processing training to all UC Service Center TRA staff since the end of this audit period. No further corrective action plan is necessary.

However, the Department has embarked on a major UC electronic system modernization, which will update the existing TRA electronic filing and benefit payment systems. This will include automatic calculation and adjustment of TRA benefits, and will preclude manual errors of this nature.

Finding 04 – 11: (continued)

<u>Auditors' Conclusion</u>: Regarding the training payment, we acknowledge as stated in the finding, that the training facility was late in submitting the invoice to L&I and that the invoice was previously assigned to a prior grant. However, we noted that all grants prior to TAA grant #TA-12714-03-55 (FFY 03) were fully expended as of June 30, 2003. Therefore, the invoice in question, which had a service period of October 1, 2001 through December 2, 2001, was charged to and paid from the grant for federal fiscal year 2003 which began after the service period on the invoice.

With respect to the underpayment of benefits, we agree that L&I did identify the "out-of-order error" with respect to the Basic TRA payment for the week of November 8, 2003 and did establish an overpayment by reducing Additional TRA payments. However, the claimant was entitled to a basic payment for the week of November 8, 2003 and 5 weeks of additional TRA starting November 15, 2003. Because of an error in L&I's calculation of the maximum benefit amount and the improper establishment of an overpayment, the individual was underpaid a total of two weeks of TRA benefits, which at the time of the audit, had not been identified by L&I.

With respect to L&I's comment regarding material noncompliance, the results from our sampling of benefit payments and training payments resulted in error rates, that when projected over the respective population of benefit payments and training payments, result in unallowable costs that are potentially material to the TAA Program. Therefore, in accordance with guidance in federal OMB Circular A-133, we consider the noncompliance to be material.

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, with the above clarifications, 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 04 – 12:

CFDA #20.205 – Highway Planning and Construction
CFDA #23.003 – Appalachian Development Highway System

Internal Control Weakness Over Expenditure Information Reported on the SEFA

Condition: The PADOT Comptroller Office generated a series of computer reports (CFDA Reports) from the FMIS accounting system primarily used in preparation of the June 30, 2004 SEFA. In our testing of program expenditures of the HPC Cluster we found that $96.2 million of new federal appropriations were recorded in error as Highway Planning and Construction (CFDA #20.205) when they should have been recorded in Appalachian Development Highway System (CFDA #23.003), Appalachian Local Access Roads (CFDA #23.008) and Motor Carrier Safety (CFDA #20.217). The SEFA was corrected as a result of our audit.

Criteria: 49 CFR 18.20 provides the following standards for financial management:

(b)(1) Financial reporting. Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.

(b)(3) Internal control. Effective control and accountability must be maintained for all grant and subgrant cash, real property and personal property, and other assets.

Additionally, OMB Circular A-133, Section 310 (b) regarding the Schedule of Expenditures of Federal Awards states in part that:

(b) The auditee shall also prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum the schedule shall: (3) provide total federal awards expended for each individual federal program.

Cause: The program criteria used to create the CFDA Reports was not updated by PADOT Comptroller personnel for the new federal appropriations and therefore, the federal expenditures defaulted to CFDA #20.205. The CFDA reports are created by PADOT at fiscal year end using query software for which the criteria is updated manually each year prior to the preparation of the SEFA. Also, the PADOT Comptroller's SEFA review process lacked adequate quality control to detect the errors. According to PADOT Comptroller management, the error was an oversight and in the future, certain manual procedures of preparing reports will be eliminated due to the implementation of the SAP accounting system.

Effect: The amounts reported on the SEFA for CFDA #20.205, 23.003, 20.217 and 23.008 were reported incorrectly due to PADOTs oversight. The errors resulted in an overstatement to HPC #20.205 of $96.2 million and understatements in HPC #23.003, 23.008 and 20.217 by $92.6 million, $3 million and $517 thousand respectively, necessitating auditor adjustments. Without adequate internal controls in place, the SEFA for these programs may continue to be misstated in the future.

Recommendation: We recommend that PADOT Comptroller's Office improve its preparation, review, and quality control of the various reports used to prepare the SEFA for the HPC cluster and other PADOT federal programs.

Agency Response: This error occurred as a result of an oversight in updating the CFDA codes table used in the computer programs that generate the reports used to prepare the SEFA. These computer programs and reports were retired with the implementation of SAP. Future SEFAs will be generated via SAP. Therefore, no additional corrective action is necessary.

Auditors' Conclusion: Based on the agency response, 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 04 – 13:

CFDA #66.458 – Capitalization Grants For Clean Water State Revolving Funds
CFDA #66.468 – Capitalization Grants For Drinking Water State Revolving Funds

Internal Control Improvements Needed in Subrecipient Loan Monitoring System

Condition: PENNVEST requires CWSRF and DWSRF loan recipients to submit annual financial statements which are used to evaluate each recipient's fiscal position and its ability to repay the loans to PENNVEST (PV). PV sends the statements to a CPA firm who reviews them in detail for any adverse conditions. PENNVEST maintains a tracking system to control the review process, which includes the date financial statements are received, date sent to the CPA firm, and date CPA returns their written analysis.

Our audit sampled 20 CWSRF and 10 DWSRF loans out of 471 and 136 active loans, respectively, during the current year. Our test results disclosed 5 instances out of 30 in which PV received the CPA analysis, but did not record the receipt on the tracking system. We also identified one instance in which the CPA notified PV that the subrecipient did not submit complete documentation, but PV did not properly follow-up to obtain required information.

In addition to the 30 loans tested, we reviewed the entire tracking system and found that for many loans, missing information made it impossible to determine whether financial statements were received, sent to the CPA, or had a completed analysis. Additionally, we identified instances in which the tracking system erroneously noted financial statements were received by PV prior to the loan recipients' fiscal year end. As a result, internal controls at PV over its tracking system for monitoring the financial status of DWSRF and CWSRF subrecipients need improvement.

Criteria: Section 3(m) of the loan agreement requires loan recipients to submit financial statements within 150 days after the end of each fiscal year. PENNVEST is required to use these financial statements to monitor the subrecipient's ability to repay the loan.

The A-133 Compliance Supplement Part 3 M. Subrecipient monitoring references the requirements of the USC 7502(f)(2)(B) which states:

Each pass-through entity shall monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means.

Cause: It appears that PV is not maintaining the monitoring system up to date to determine the status of financial statement submissions and analysis because their procedures do not include a requirement stating how frequently the tracking system should be updated.

Effect: The untimely updating of the tracking system could delay the identification and follow up on adverse conditions which would disclose the entity's inability to repay the loan.

Recommendation: We recommend that PV accurately maintain the tracking system up to date to identify the entities failing to submit financial statements. Also, PV should contact the entities that fail to submit financial statements requesting they be submitted.

Agency Response: We are in partial agreement that PENNVEST is not maintaining the monitoring system up to date to determine the status of financial statement submissions. The tracking system has gone under several revisions that included the transfer of data from one information system to another. As it has been with other data transfer, information is sometimes misread and misaligned into the new system. It is management's position that the data reviewed had not had an integrity quality control test. The monitoring system is updated in a timely manner. However, a formal policy is not in place as to the timing of said updates.

It is management's belief that reviews conducted on the PENNVEST monitoring system revealed the knowledgeable shortcomings of the information transfer that occurred. Corrections to management information system are underway for aged information.

Finding 04 – 13: (continued)

As of July 2005, PENNVEST has deployed an interactive financial statement collection system. Financial information is faxed to the PENNVEST automatic scanner. The borrower has to complete a cover sheet with the subject federal identification number as the entity may have more than one PENNVEST loan to report. The scanner reads the federal identification number and sweeps the financial information into a management information system. Information that cannot be read by the scanner is reported for manual updates. Emails are transmitted to the PENNVEST financial consultant that the referenced information is available to review and analysis performed. Planning is underway to have the financial consultant report findings electronically. Information will be tracked electronically including dates of receipt.

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 04 – 14:

CFDA #83.544 – Public Assistance Grants

Weaknesses in PPR Comptroller Office Internal Controls Over Federal Reporting

Condition: The PPR Comptroller Office is required to submit a Financial Status Report (FSR), FEMA Form 20-10, to FEMA on a quarterly basis for each open disaster grant under the Public Assistance Grants Program (PAG). We tested two FSRs for the quarter ended June 30, 2004 and although our testing revealed no errors in reported amounts, we noted PPR has no procedures in place for the supervisory review and, approval of amounts on the FEMA 20-10 reports that are submitted to FEMA.

Further, we noted that another auditor, acting on behalf of the federal OIG, performed testing of the FEMA Form 20-10 reports for the quarter ended September 30, 2003. Based on our review of the other auditor's report, we noted that the other auditor identified three instances where the amounts reported on Line f. "Federal share of unliquidated obligations" did not agree to the accounting records as follows:

Disaster Grant	Reported Federal Share of Unliquidated Obligations	Accounting System Federal Share of Unliquidated Obligations	Difference
1383	$1,212,989	$ 0	$1,212,989
1294	2,042,414	1,343,930	698,484
1130	15,254	0	15,254

In addition to the above, we noted that PPR uses the Payment Management System (PMS) operated by the Division of Payment Management (DPM) to draw federal funds. On a quarterly basis, PPR receives PSC 272 reports from DPM. These reports include a PSC 272-E, Major Program Statement, which lists individual payments during the quarter by major program (Part I) and provides a cash accountability for all advances received through PMS by major program (Part II). As part of our testing of the PSC 272 reports, and review of related internal controls, we noted that PPR does not have adequate procedures in place to verify and document its review of the amounts reported by DPM on PSC 272-E for the grants under PAG.

Criteria: 44 CFR 13.20 regarding standards for financial management systems states:

(b) The financial management systems of other grantees and subgrantees must meet the following standards:

(1) Financial reporting. Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.

In addition, adequate internal controls over federal reporting would include the supervisory review and approval of financial data reported prior to submission to the federal agency.

The OMB A-133 Compliance Supplement Part 3, L. Reporting, states:

Once a quarter, using the authorized amounts provided by the Federal agency, payments requested by recipients, cash collection activity, and disbursement information provided by recipients, DPM generates PSC-272 reports. …The reports are either mailed to the recipient or electronically downloaded by the recipient using DPM's Electronic 272 System. Recipients should verify the reported amounts.

Finding 04 – 14: (continued)

Cause: PPR personnel stated that an individual separate from the preparer is signing the 20-10 reports but no formal review is done to ensure that the information on the reports is complete and accurate. Regarding the errors in the amounts reported on the FEMA Form 20-10s, PPR indicated that the encumbrances at June 30, 2003 were erroneously canceled on the accounting system and not rolled into the fiscal year 2004 during the year end close process. PPR did not retain the necessary support and could not retrieve the needed records to support amounts reported.

With respect to the PSC 272-E Report, PPR indicated that they do perform a spot check of the cumulative draws on a periodic basis but this review is not performed for each quarter and there is no documentation of this review.

Effect: Since PPR submitted unsupported or inaccurate financial information on line f. of the FEMA Form 20-10, PPR was not in compliance with federal reporting requirements. Additionally, PPR does not have any procedures in place for the supervisory review and approval of the FEMA Form 20-10 to ensure accurate and complete financial reporting. Further, PPR does not have adequate procedures in place to verify and document its review of the accuracy of the data reported by DPM on the PSC 272-E Report for the grants applicable to the PAG Program.

Recommendation: We recommend that PPR establish formal procedures for the supervisory review and approval of the FEMA Form 20-10 prior to submission to FEMA to ensure that amounts reported are accurate and complete. Regarding line f. of Form 20-10, unliquidated obligations, PPR should ensure amounts reported are accurately supported by program accounting records. Further, PPR should establish formal procedures to compare amounts reported by DPM in Parts 1 and II of the PSC 272-E to their accounting records and report any discrepancies to DPM. PPR should also ensure that the performance of these control procedures is adequately documented.

Agency Response: We concur with Part I of the finding stating that obligations reported on the September 30, 2003, Financial Status Reports did not agree with the accounting system for several disaster assistance programs.

As noted in the previous audit report, these differences were the result of prior year encumbrances as of June 30, 2003, being erroneously cancelled on the accounting system instead of rolled to the current fiscal year during the year end closing process. The encumbrance balances had not been properly reestablished on the accounting system; however, they were reported on the September 30, 2003, Financial Status Reports. In some cases, additional spending authority had to be established on the accounting system to provide sufficient funding to repost the encumbrances for the disaster. As indicated in the finding, the problem was corrected and the encumbrances were properly posted and reported on the June 30, 2004 FSR's. Therefore, the finding has been resolved and no additional action is needed.

Part II of the finding concerns the preparation of the 272 Report. There are no other procedures in place to document the review of the amounts reported on the PSC 272-E. However, as indicated in the finding, we do periodically review the cumulative draws and available balances on the SMARTLINK system for accuracy and this review is always done during the closeout process.

It is our opinion that additional procedures for supervisory review are not required for the FEMA Form 20-10. All of the individuals preparing the reports are accountants requiring little supervision. A cursory review is all that is necessary.

Auditors' Conclusion: Based on PPR's response, no additional information was provided to mitigate the condition in the finding. Therefore, the finding and recommendation remain as stated above. 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 04 – 15:

CFDA #84.010 – Title I – Grants to Local Educational Agencies
CFDA #84.027 – Special Education – Grants to States
CFDA #84.048 – Vocational Education – Basic Grants to States
CFDA #84.367 – Improving Teacher Quality State Grants

Internal Control Weakness Over the Reconciliation of the U. S. Department of Education's Grant Administration and Payment System (EDGAPS) to Revenue on the SAP System

Condition: The LECS Comptroller Office is responsible for performing periodic reconciliations of federal drawdowns on USDE's EDGAPS tracking system to the Commonwealth's SAP and CDS systems for PDE's federal programs. Our testing of the EDGAPS reconciliation at June 30, 2004 for the four major programs listed above disclosed that it was not performed and differences were not corrected until October 2004. In addition, reconciliations were performed monthly until September 2003. It was decided by the LECS Comptroller Office to perform them quarterly after this date for greater efficiency. However, only the year-end reconciliations were completed and, as indicated above, they were not performed until October 2004. Therefore, the errors noted above were not detected timely.

Criteria: Strong internal controls should ensure the EDGAPS reconciliations are being performed timely to ensure the accuracy of PDE's internal accounting records.

Cause: According to LECS management, reconciliations were not performed timely due to the loss of two critical staff members.

Effect: Since the reconciliations were not performed timely, errors were undetected leading to misstated accounting records.

Recommendation: We recommend that LECS Comptroller Office ensure its EDGAPS reconciliations are performed and followed up on timely to ensure accurate accounting records.

Agency Response: As noted in the *Condition,* subsequent to September 2003, reconciliations were performed quarterly for greater efficiency. The change from monthly to quarterly reconciliations was due to the loss of two critical staff members.

The *Effect* section states that errors were undetected, when in fact, errors were detected, unfortunately not in a timely manner.

For the 2004 state fiscal year, the EDGAPS reconciliation is being performed on a monthly basis. Therefore, the reconciliation and any corrections are being performed in a timely manner.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 16:

CFDA #84.010 – Title I – Grants to Local Educational Agencies
CFDA #84.367 – Improving Teacher Quality State Grants

Internal Control Weakness in Monitoring Subrecipient Compliance With Maintenance of Effort Requirements

Condition: PDE requires each of its subrecipients to submit an Annual Financial Report (AFR) with expenditure information to calculate and measure subrecipient compliance with federal Maintenance of Effort (MOE) requirements each fiscal year. PDE's Bureau of Information Systems extracted the necessary AFR information, determined net expenditures, and generated the current-year MOE report that compares net expenditures year to year. Net increases or decreases are calculated on the MOE report, and decreases in net expenditures greater than 10 percent should be identified as potentially not meeting the MOE requirement and require investigation by PDE.

Our testwork disclosed several subrecipients where expenditure levels decreased by more than 10 percent in the current year, but PDE conducted no follow up to ascertain subrecipient compliance with MOE. Although the subrecipients in question were subsequently found to be in compliance with MOE requirements due to their original submission of incorrect AFR expenditure totals, further auditor inquiry disclosed an internal control weakness in that PDE officials did not review the current-year MOE report and investigate potential subrecipient noncompliance with MOE.

Criteria: Section 9521 of the Elementary and Secondary Education Act (ESEA) states:

(a) *IN GENERAL.—A local educational agency may receive funds under a covered program for any fiscal year only if the State educational agency finds that either the combined fiscal effort per student or the aggregate expenditures of the agency and the State with respect to the provision of free public education by the agency for the preceding fiscal year was not less than 90 percent of the combined fiscal effort or aggregate expenditures for the second preceding fiscal year.*

(b) *REDUCTION IN CASE OF FAILURE TO MEET.—*

   (1) *IN GENERAL.—The State educational agency shall reduce the amount of the allocation of funds under a covered program in any fiscal year in the exact proportion by which a local educational agency fails to meet the requirement of subsection (a) of this section by falling below 90 percent of both the combined fiscal effort per student and aggregate expenditures (using the measure most favorable to the local agency).*

Cause: This deficiency is the result of a lack of management oversight of the MOE process. Although the subrecipient MOE report was produced by PDE, no one at PDE reviewed the report to actually verify LEA compliance with the MOE requirement.

Effect: Without a proper review process, PDE is not properly monitoring its LEAs for MOE compliance. MOE regulations are in place to ensure that local and state spending in education does not decrease on account of the federal grant moneys. According to regulations, for LEAs with expenditure decreases of more than 10 percent, PDE shall reduce the amount of allocation of funds in the proportion by which the LEA fails to meet MOE.

Recommendation: PDE should take the necessary actions to ensure that the MOE report is reviewed each year and LEAs not meeting MOE requirements are timely identified and contacted. MOE review and any subsequent action taken by PDE should be documented and maintained on file.

Agency Response: The Division of Federal Programs received formal notification of this finding and agrees that the deficiency was due to a lack of management oversight of the MOE process. The subrecipient MOE report was produced by the Pennsylvania Department of Education and reviewed by the Division of Federal Programs, but the appropriate actions to resolve the deficiency were not documented according to Subpart 2, Sec. 9521, of the Federal Regulations.

The Division of Federal Programs has complied with the recommendation made by the auditors' report and taken the necessary steps to ensure that the MOE report is reviewed each year and appropriate actions taken.

Finding 04 – 16: (continued)

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 17:

CFDA #84.010 – Title I – Grants to Local Educational Agencies
CFDA #84.367 – Improving Teacher Quality State Grants

Inadequate Controls in PDEs On-Site Monitoring of Subrecipients

Condition: Our review of PDE's on-site monitoring of Title I and Title II subrecipients (LEAs and Charter Schools) disclosed significant internal control weaknesses in management's oversight of the monitoring process.

In our current year, we performed tests to determine if LEAs and Charter Schools were monitored at least once during the current three-year monitoring cycle of July 1, 2001 to June 30, 2004. During our prior year audits, PDE provided schedules of LEAs and Charter Schools that were monitored during SFYE June 30, 2002 and June 30, 2003. In the course of the current year audit we obtained a schedule of monitoring reviews completed during SFYE June 30, 2004. LEAs and Charter Schools are to be monitored on-site at least once every three years; therefore, SFYE June 30, 2004 was the third and final year of the three-year review cycle of 2001 to 2004.

As a result of reviewing 3 years of monitoring schedules, we identified 26 out of approximately 450 LEAs and 61 out of approximately 74 Charter Schools receiving federal funds that were not listed on PDE's schedules as being monitored during the current review cycle of 2001 to 2004. We informed management of our test results and asked for an explanation. Management responded that these LEAs and Charter Schools were actually monitored on-site and that the monitoring schedules provided to us were not correct. As a result, we expanded our audit procedures and asked to review the monitoring reports for all 26 LEAs and a sample of 20 of the 61 Charter Schools, or a total of 46 items. As a result of testing these 46 items, we noted the following:

- For 6 of the 26 LEAs and for 17 of the 20 Charter Schools, either no report was provided or the report provided was for a period outside the three-year review cycle. We consider these 23 items as audit exceptions due to monitoring procedures not being completed within the established three-year review cycle.

- Of the 26 LEA monitoring reports reviewed, 3 LEAs monitoring reports were faxed from the LEA to PDE, so PDE did not properly maintain these reports on file.

- There were 3 instances out of 26 in which the monitoring reports provided were dated within the three-year review cycle but for a year other than the year indicated on PDE's updated monitoring completion schedules.

As a result of this testwork, we determined that PDE's oversight of its on-site monitoring system for Title I and Title II needs improvement. Monitoring schedules are not accurately tracking the LEAs and Charter Schools being monitored. In addition, not all LEAs and Charter Schools are being visited on-site within the 3-year monitoring cycle.

Criteria: PDE monitors each LEA and Charter School participating in education grants associated with the No Child Left Behind (NCLB) Federal Act, including Title I – Grants to Local Education Agencies and Title II – Improving Teacher Quality. As a matter of good internal control, PDE monitors each participating LEA at least once every three years.

Cause: Lack of oversight by PDE management created the lack of accountability over the tracking and actual monitoring of the LEAs and Charter Schools. Also, PDE did not have adequate procedures in place during the monitoring cycle to verify the accuracy of the information reported in the monitoring schedules.

Effect: Title I grants are the largest dollar education grants as part of the NCLB Act. The monitoring report is a detailed review of school activities that ensures the LEA is operating within the guidelines of NCLB. Without proper tracking of periodic on-site reviews, PDE cannot ensure that schools are providing allowable and necessary services in accordance with federal regulations.

Finding 04 – 17: (continued)

Recommendation: We recommend that PDE management take the necessary actions to design and implement a system that schedules and accurately tracks the monitoring of LEAs and Charter Schools. PDE should ensure that LEAs and Charter Schools are monitored in accordance with the three-year review cycle. Finally, PDE should ensure that completed monitoring reports are properly maintained in their files.

Agency Response: The Division of Federal Programs is in agreement with the finding that there needs to be better accountability of tracking monitoring of LEAs. The Division of Federal Programs intends to design and implement a system that schedules and accurately tracks the monitoring of LEAs and Charter Schools. Due to a turnover in staff within the Division of Federal Programs, the process of documenting on-site LEA monitoring has not been consistent.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 18:

CFDA #84.010 – Title I – Grants to Local Educational Agencies

Inadequate Controls Over PDE's Consolidated State Performance Report and the Annual State Report Card

Condition: Title I federal education grant moneys are enacted under the Elementary and Secondary Education Act (ESEA) as amended and by the No Child Left Behind (NCLB) federal legislation of 2002 as amended. Under ESEA and NCLB, Title I services are to be linked to state-determined performance standards that are expected of all children. To that end, assessment exams are given to students in an effort to identify and assist schools that do not make adequate yearly progress towards meeting the standards.

PDE insures that Local Education Agencies (LEAs) annually review the progress of each Title I school to determine whether the schools are making adequate yearly progress (AYP). Under NCLB, the general rule is that LEAs and schools that do not make AYP for two consecutive years are identified for improvement, are classified under a status called Needs Improvement I. A school that has not made AYP for three consecutive years is classified as Needs Improvement II. A school that has failed to meet AYP for four consecutive years is classified as Corrective Action I and a school that has not made AYP for five consecutive years is classified as Corrective Action II. Schools under the above classifications are all considered under an improvement status. For schools in the above classifications, the LEAs must create school plans and work with PDE to implement the plans to ensure that students can make AYP.

According to NCLB, PDE must annually review the progress of each LEA that receives Title I funds to determine whether the LEA made AYP. PDE must identify for improvement any LEA that fails to make AYP for two consecutive years or was in an improvement status. PDE must identify the LEA for corrective action if it continues to fail to make AYP.

PDE must report annually to USDE and make certain information widely available within the state including the number and names of each school identified for improvement, the reason why the school was identified, and measures taken to address the achievement problems in the school. Based on data received from an outside vendor, PDE generates reports to USDE on the Consolidated State Performance Report (CSPR). Further, PDE must prepare and disseminate an annual State Report Card (SRC) including the number and name of each school and LEA identified for improvement.

As part of the reporting and AYP process, PDE contracted with an outside vendor to provide numerous services which include:

- Design state assessment materials at PDE specifications
- Provide assessment testing materials to students in grades 5, 8 and 11 in the subjects of reading and mathematics
- Train the exam administrators
- Score and evaluate each assessment booklet
- Compile assessment results by school and LEA
- Provide assessment results via data files to LEAs and PDE

In short, PDE is required to collect, compile, and determine the accuracy of information about the number and names of schools in need of improvement and report this information on the CSPR and SRC.

In December 2003, PDE filed the CSPR, Part 1 with USDE. Also, during FYE June 30, 2004, PDE posted on the PDE web site, the 2003 SRC. PDE provided the auditors with copies of each report.

Although our testwork detected no significant errors in the actual data compiled and reported during our current year, our audit found that PDE has inadequate documentation procedures regarding the collection, compiling and verifying the accuracy of the data reported in the CSPR and SRC. PDE indicated that it performs various automated data validation checks (i.e., record counts and control totals) and comparisons of year to year on test score data received from its outside

Finding 04 – 18: (continued)

contractor but has no formal documented procedures supporting these steps. Further, for any supervisory review of the data that PDE performs, there is no documented evidence on what type of review procedure was done and no evidence of PDE's supervisory review and approval.

Criteria: Title I, Sections 1111(h)(1) and (4) of ESEA state:

(h) Reports.

(1) Annual State Report Card.

(A) In General. Not later than the beginning of the 2002-2003 school year, unless the State has received a 1-year extension pursuant to subsection (c)(1), a State that receives assistance under this part shall prepare and disseminate an annual State report card.

(C) Required Information. The State shall include in its annual State report card—

(i) information, in the aggregate, on student achievement at each proficiency level on the State academic assessments described in subsection (b)(3) (disaggregated by race, ethnicity, gender, disability status, migrant status, English proficiency, and status as economically disadvantaged, . . .

(v) aggregate information on any other indicators used by the State to determine the adequate yearly progress of students in achieving State academic achievement standards;

(vii) information on the performance of local educational agencies in the State regarding making adequate yearly progress, including the number and names of each school identified for school improvement under section 1116; and

(4) Annual State Report to the Secretary. Each State educational agency receiving assistance under this part shall report annually to the Secretary, and make widely available within the State—

(A) beginning with school year 2002-2003, information on the State's progress in developing and implementing the academic assessments described in subsection (b)(3);

(E) the number and names of each school identified for school improvement under section 1116(c), the reason why each school was so identified, and the measures taken to address the achievement problems of such schools;

Cause: According to PDE management, the 2003 CSPR was created by employees no longer associated with the CSPR reporting function at PDE during our audit. Therefore, the PDE personnel responsible for providing information to us were not familiar with the 2003 report information.

PDE depends heavily upon an outside vendor for the determination of making AYP and identifying schools in the improvement classification. Further, it appears that PDE has an inadequate number of staff devoted to the State Report Card and CSPR efforts. Since timeliness of the reports is viewed as most critical, accuracy of the information is left to the vendor to ensure.

Effect: USDE and the public cannot be reasonably assured that CSPR and SRC information as reported is complete and accurate. A situation may exist whereby the vendor has control of the assessment process, from creating the tests to scoring and reporting the results without adequate oversight by PDE. With the vendor's control over the assessment process and lack of documented PDE verification, inaccurate data could be reported to USDE and the public. LEAs and schools in need of improvement may not be properly identified, tracked, and reported resulting in noncompliance with NCLB.

Finding 04 – 18: (continued)

Recommendation: PDE management should institute reasonable documented measures to insure that AYP data is complete and accurate as reported on the CSPR and SRC. Assessment data should be documented in detail, tested, and reviewed by PDE to ensure it's accuracy before it is compiled for the reports.

PDE should strengthen and better document internal controls over the collecting, compiling, verifying accuracy, and reporting of AYP data. PDE should develop comprehensive written procedures to document the process. Procedures should include supervisory review and documented sign-offs. Audit trails should be documented that show individual and school data rolling-up into the summary data presented on the CSPR and SRC. Procedures, audit trails, data summaries, and reviews and approvals should be retained in a file by PDE.

Agency Response: The Pennsylvania Department of Education understands the importance of complete and accurate data for determination of Adequate Yearly Progress (AYP). PDE also understands that reasonable documented measures must be taken to insure that the data is correct and accurate. While the measures may not be well documented, PDE does maintain that reasonable measures are taken. To that end, PDE will develop written procedures to document:

- Measures taken to insure accuracy of data
- Internal controls over collecting, compiling, verifying accuracy and reporting of AYP data.

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 04 – 19:

CFDA #84.048 – Vocational Education – Basic Grants to States

Errors and Internal Control Weaknesses in PDE's VOC ED Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE (A Similar Condition was Noted in Prior Year Finding #03-15)

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. Fourteen are reported under the four Core indicators of performance and the remaining ten 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 2001-2002 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 5 subindicators (1S2, 2S2, 1S1, 1P2 and 3P2) out of the 24 subindicators in the 2002-2003 CAR, and we found material data errors and noted that prior-year weaknesses had not been corrected as follows:

- For two of the five sampled subindicators (1S2 – Skill Attainment, Secondary Level; and 2S2 – Diploma, Secondary Level), 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 review for these two subindicators. Our prior audit noted that although PDE performed its own limited assessment of the data, it was not documented. For the current audit, PDE prepared a timeline document to summarize and record various control activities to ensure data accuracy in the CAR, but many of these control activities were not documented, had no documented supervisory review and approval, or did not occur at all. For example, PDE claimed to have held internal review committee meetings to ensure propriety of CAR data, but nothing was documented to support these meetings or their impact. In addition, PDE intended to randomly select 60 percent of test sites for verification of needed data elements, but this activity was never performed. PDE also failed to include all students and their PDE-approved test results on the CAR for 1S2 and 2S2 as required by USDE/PDE agreed-upon measurement definitions. According to PDE, this was due to schools not submitting needed data in a timely manner. As a result, the CAR report was understated by over 6 percent (approximately 450 students out of 7,324 reported) in the numerator and by about 5 percent (approximately 800 students out of 15,571 reported) in the denominator for these subindicators. Finally, in addition to the third party contractor's verification of data, PDE also compares the number of students to be tested (program completers) to the number of students actually tested. However, this activity is not signed-off either by the individual performing the review or a supervisor reviewing the work. There is also no documentation to show how this analysis is used to confirm the third party contractor's data or the testing of contractor data contained in the contractor's annual summary report, which is used for subindicator 1S2 and 2S2 reporting.

- For another subindicator (1S1 – Academic Achievement, Secondary Level), 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. In the prior audit, PDE did not perform or document procedures to confirm that the data control totals used for this subindicator agreed to the control totals submitted by the test contractor to ensure data on the CAR was complete. For the current engagement, we again noted that PDE did not obtain total record counts from the test contractor to ensure data was complete.

- For subindicator 1P2 (Postsecondary Occupational Attainment), PDE inadvertently double-counted a large group of students on the CAR resulting in erroneous reporting of totals. PDE added "special populations" students to the total of all students and reported the net sum, but the "special populations" students were already included in the all students total. We noted that this error also inflated the data in subindicator 1P1 (Postsecondary Academic Attainment). Further, PDE inappropriately skipped a year of data (2000-2001) when it reported subindicators 1P1 and 1P2, which is inconsistent with other subindicators in the CAR and could invalidate current- to prior-year comparisons of the data. PDE contended that USDE encourages states to report the most current data available, and

Finding 04 – 19: (continued)

since 2001-2002 data was available, it was used. Although we could not ascertain the total error in 1P1 and 1P2 data elements that resulted from the above discrepancies, we noted material increases in the 2002-2003 CAR data vs. the 2001-2002 CAR ranging from 80 percent to 99 percent for these two subindicators. These increases could only be explained by the discrepancies noted above, which indicates incorrect reporting of the data.

- For subindicator 3P2 (Postsecondary Retention), PDE completed the CAR using incorrect employment data. The USDE/PDE agreed-upon measurement definition for this subindicator includes only students who were employed in a related field, but PDE incorrectly mixed and reported students employed in both related and unrelated fields. The total number of students reported who had originally been employed in an unrelated field was 984, which represented a 23 percent overstatement of the CAR denominator amount of 4,292. We could not determine the impact of this overstatement on the numerator, which represented updated data on students who retained their employment status. We also noted that the CAR submitted to USDE documented a data measurement definition for 3P2 that did not match the actual data submitted or the USDE/PDE agreed-upon version. The CAR definition included not only program completers who were employed but also included those who were pursuing additional education or advanced training and/or serving in the military. As a result, it appears the reported definition for 3P2 in the CAR was incorrect and needs to change to match the actual data reported and the USDE/PDE agreed-upon version for this subindicator. Finally, PDE does not document verification of the accuracy of data received from the Pennsylvania Department of Labor and Industry as part of a data sharing agreement for the requirements of subindicator 3P2. PDE's Division of Data Services indicated they perform a visual reasonableness check of the data prior to forwarding it to the Bureau of Career and Technical Education (BCTE). However, the substance of this review, the related conclusions, and approval of the data are not documented.

In addition to the discrepancies noted in our sampled subindicators above, we also noted continuing overall control weaknesses in preparation of the CAR as follows:

- Once the three bureaus gather their CAR data, it is submitted to one individual in BCTE. This individual, along with other members of the internal review committee, are supposed to review all data for accuracy and proper support prior to forwarding the CAR to the Bureau Director for final approval and submission to USDE. Although there is Bureau Director approval (electronic) of the report, we found no supervisory sign-offs or other evidence of meetings by the internal review committee to indicate that supporting compilations were reviewed to ensure CAR data is accurately supported and complete, and the data has been properly analyzed for reasonableness. In addition, PDE could not provide a "data changes document" noted in PDE's corrective action plan, which is to evidence review and changes made by the Bureau Director to CAR data prior to submission to USDE. Therefore, the overall weaknesses reported in the prior year were not corrected in the current year.

- Overall, the file provided by PDE to support the timeline document did not contain any supervisory signatures attesting to the accuracy of any of the data compilations. Evidence of meetings and problem discussions was limited to some e-mails among PDE staff and one meeting to review test data from a contractor, which was inadequate and failed to document results and conclusions. While the timeline document represents a good internal control to monitor and track the progress of data compilation, and internal review and approval for the CAR, there is little or no documented evidence for many of PDE's control activities. For example, the meeting of the internal review committee for final assessment of CAR data was not documented at all. Also, since the person who prepared the 2002-2003 timeline document is no longer a PDE employee, we understand that this document was not being prepared for next year's 2003-2004 CAR to document PDE's controls.

- According to PDE, there is no established timetable for CAR data to be received from any sources outside of BCTE. Data may be received at a time when an independent review or sampling by BCTE is not possible due to federal CAR submission deadlines. According to BCTE, if data is late in arriving from outside sources, BCTE assumes the necessary checks on data validity and accuracy had been performed at the source and no further review by BCTE is done on any of the data. Also, a "CAR Data Checklist" was prepared by BCTE to document the various sources and receipt of data for the CAR subindicators. However, the form is not signed-off by the person completing it. Nor does the form contain fields or areas to note the date of the data request, date received, and the signature and date of the person that reviewed and approved the data.

Finding 04 – 19: (continued)

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 . . .

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.

Finding 04 – 19: (continued)

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 subchapter 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.

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, while PDE's corrective action plan for our prior year finding was intended to be implemented for the 2002-2003 CAR, which was tested during the current audit, certain aspects of the plan have not been fully implemented or are lacking in evidence.

PDE indicated that it would notify USDE at the time corrected numbers are submitted for 1P1 and 1P2 that data for the 2000-2001 year had never been reported. PDE was unaware if this omission was in violation of federal regulations.

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. Also, the CAR contains 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. Furthermore, PDE should ensure that errors noted above are corrected as necessary for all subindicators in the CAR.

Agency Response: Based on the USDE Program Determination Letter for the audit period July 1, 2002 through June 30, 2003, Finding No. 84048A was resolved and closed. The determination of the U.S. Deputy Assistant Secretary for Vocational and Adult Education sustain the auditor's findings that the PDE needs to continuously review and improve its internal control procedures over the CAR and establish a system to ensure that all CAR data are accurate, complete, adequately supported and are analyzed and properly reviewed prior to submission.

The Department continues to address the issues with data collection and data verification. As the Department continues to update the definitions of the CAR subindicators, the data collection methods change subsequently changing the review process. USDE will address the concerns with the PDE pertaining to complete and accurate data at the scheduled September 2005 on-site monitoring visit.

Auditors' Conclusion: Since corrective action to the prior-year finding was not properly implemented by PDE in the current year, USDE's prior-year Determination Letter does not impact our current-year conclusions. Therefore, the finding and recommendation remain as stated above. 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 04 – 20:

CFDA #84.048 – Vocational Education – Basic Grants to States

PDE Allocated VOC ED Funds to Subrecipients Based on Outdated Statistical Data

Condition: During our current audit, we found that PDE allocated FFY 2003-04 Postsecondary and Adult VOC ED funding based on outdated Pell Grant data in noncompliance with VOC ED federal regulations. The current year allocation was based on the number of 1999-2000 Pell grant recipients rather than on the preceding year Pell Grant recipients as required by 20 USC 2352. In addition, PDE was unable to provide the auditors with updated Pell grant recipient information (i.e., on the preceding year) to determine if its current-year allocations to Postsecondary and Adult Subrecipients were reasonable per the VOC ED regulation.

In addition, we found that PDE allocated FFY 2003-04 secondary VOC ED funding based on outdated census data in noncompliance with VOC ED federal regulations. The current year allocation was based on 1995 census data rather than current available census data.

Criteria: 20 USC 2352 (a) (2) related to Postsecondary and Adult allocations, states:

Each eligible institution or consortium of eligible institutions shall be allocated an amount that bears the same relationship to the portion of funds made available under section 2322(a)(1) of this title to carry out this section for any fiscal year as the sum of the number of individuals who are Federal Pell Grant recipients... enrolled in programs meeting the requirements of section 2355 of this title offered by such institution or consortium in the preceding fiscal year bears to the sum of the number of such recipients enrolled in such programs within the State for such year.

20 USC 2351(b) related to Secondary allocations, states:

(b) Special distribution rules for succeeding fiscal years

Except as provided in Section 2353 of this title and as otherwise provided in this section, each eligible agency shall distribute the portion of funds made available under Section 2322(a)(1) of this title to carry out this section for fiscal year 2000 and succeeding fiscal years to local educational agencies within the State as follows:

(1) 30 percent

30 percent shall be allocated to such local educational agencies in proportion to the number of individuals aged 15 through 19, inclusive, who reside in the school district served by such local educational agency for the preceding fiscal year compared to the total number of such individuals who reside in the school districts served by all local educational agencies in the State for such preceding fiscal year.

(2) 70 percent

70 percent shall be allocated to such local educational agencies in proportion to the number of individuals aged 15 through 19, inclusive, who reside in the school district served by such local educational agency from families with incomes below the poverty line (as defined by the Office of Management and Budget and revised annually in accordance with section 9902(2) of title 42) applicable to a family of the size involved for the fiscal year for which the determination is made compared to the number of such individuals who reside in the school districts served by all the local educational agencies in the State for such preceding fiscal year.

Cause: According to PDE management, they were unaware of the requirement to use preceding year Pell Grant information in its postsecondary allocation formula. Also, management stated that due to staff turnover, they are unable to explain why updated census data was not used. Additionally, management stated that due to a high amount of turnover, PDE found it most efficient to use the same Pell Grant and census information for each year's allocations.

Finding 04 – 20: (continued)

Effect: PDE allocated its 2003-04 postsecondary and secondary funding using incorrect data which may have caused each subrecipient to receive an incorrect share. Because PDE did not have current data available for the auditors, we were unable to determine the amount of incorrect allocations awarded to each subrecipient.

Recommendation: We recommend that PDE obtain the correct Pell Grant and census data and, in cooperation with USDE, evaluate a course of corrective action to pursue. Also, we recommend in the future that PDE keep current with federal regulations and allocate Postsecondary and Adult and Secondary VOC ED funding appropriately.

Agency Response: The Department agrees that correct Pell and census data was not used to determine the allocations distributed to the Local Education Agencies (LEAs). Due to staff turnover in the Division of Contract Administration, the current regulations were not reviewed and an effort to collect the correct data did not occur. The existing data was used in the allocation distribution formulas. By the time vacancies were filled in the Division of Contract Administration, time was not available to develop a survey, distribute the survey to the LEAs, collect the data from the LEAs and analyze the data in order to use in the allocation formula. Therefore, the decision was to use Pell data that was currently available as it takes months to develop a survey, collect data, analyze the data and enter into the formula. This fall, the Department will develop a survey to collect the correct Pell data, 2002-2003. The allocations will be determined based on the correct Pell data and the allocation figures comparing both correct and incorrect Pell data. Also, PDE will obtain and use current census data to allocate future allocations of VOC ED Secondary funding. The USDE will be consulted on the findings of the comparison and the development of a Corrective Action Plan.

Auditors' Conclusion: Based on the agency response, we further recommend that PDE consult with and obtain documented verification from USDE that PDE is using the proper year's Pell Grant and census data when allocating VOC ED funds in the future. The finding and recommendation, with this additional clarification, remains 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 04 – 21:

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 #03-17)

Condition: As a result of federal resolution of multiple prior audit findings on debarment and suspension requirements, OVR was required to manually check the List of Parties Excluded from Federal Procurement and Nonprocurement Programs for new vendors enrolled in RSBS after August 1, 2000. OVR was also required 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 prior audit period on June 19, 2003, OVR enhanced its system by adding a new data field named "Date Record Added" to indicate the date each new vendor is initially added to the vendor file.

We tested a sample of 18 vendors receiving RSBS payments in SFYE June 30, 2004, to verify whether OVR was documenting its review of the Federal List after August 1, 2000. We noted that for 9 of these 18 vendors, the respective vendor file indicated a "Date Record Added" between August 1, 2000 and June 19, 2003, indicating a review for debarment/suspension appeared necessary. However, for all 9 vendors, there was no indication in the "Debar Review" field that the vendor was reviewed for debarment or suspension in accordance with federal resolution of the prior audit finding.

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 04 – 21: (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 the "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 new 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: OVR reviewed the nine vendors cited as not having debarment reviews documented and found they had been added to the OVR vendor file between September 2000 and August 2001. The Debarment Review field, which documents a debarment review has been done, was added to our vendor file in March 2002. The Date Record Added field, which documents the date a vendor was added to the OVR vendor file, was added to our vendor file on June 19, 2003. We have concluded that you would be unable to document that any of these vendors needed a debarment review since they were added to the vendor file prior to both of these dates. Our conclusion is based on the fact that an accurate determination on whether or not a vendor needed a debarment review could not be made until after both the Date Record Added and Debarment Review fields were in place. Since all of the nine vendors have dates added prior to March 2002 we feel they should be eliminated from the review and that only vendors added to the OVR vendor file after June 19, 2003 should be considered. Since the effective dates for both of these date checks were in effect prior to the beginning of this audit period we are asking that the auditors consider dropping this finding.

Auditors' Conclusion: Since the nine vendors in question all received RSBS funding during the current audit period, the nine vendors were part of our audit scope and should have been checked by OVR for debarment or suspension. However, OVR could not provide documentation to indicate that the nine vendors were checked for debarment or suspension. Federal resolution of the prior-year finding was based on corrective action to be taken by OVR in August of 2000, not in June of 2003. Therefore, this finding and recommendation remain as previously stated. OVR should pursue resolution of this finding with the federal government. 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 04 – 22:

CFDA #84.126 – Rehabilitation Services – Vocational Rehabilitation Grants to States

Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding # 03-18)

Condition: During the two prior audits, 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 solely on Vocational Rehabilitation-related activities, and their salaries and benefits are charged 100 percent to RSBS and, therefore, do not maintain timesheets as supporting documentation. Certain central service employees (i.e. Information Technology, Bureau of Financial Management, etc.) also charge time to the RSBS program, but these employees maintain certified timesheets to support their time since they do not work solely on this program.

Based on our current year audit inquiries, sampling of transactions, and review of job descriptions supporting the OVR employees charged 100 percent, we found the documented grant activities of OVR personnel to be allowable under RSBS. However, although we determined OVR's activities to be allowable, we noted that OVR was still not maintaining updated documentation required by a provision in 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 re-certify that the respective employees worked solely on the RSBS program during the audit period. During the state fiscal year ended June 30, 2004, OVR incurred personnel expenditures of $32,174,452 in salaries and $11,613,092 in fringe benefits, or $43,787,544 in total (federal portion) for the RSBS program.

Criteria: OMB Circular A-87, Attachment B, Section 8(h), pertaining to the support for salaries and wages states, in part:

(5) 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 annually rather than semi-annually, detailing the respective employees' job duties for the employees charging 100 percent of their personnel costs to the RSBS program. OVR personnel also stated that in response to the prior year finding, they are in the process of implementing a semi-annual certification process for OVR employees whose personnel costs are charged 100 percent to the RSBS program. However, no changes were made during the fiscal year ended June 30, 2004.

Effect: Although our audit determined OVR personnel costs to be allowable, OVR's signed job descriptions or other certification documents are not timely updated on a semi-annual basis for 100 percent-charged employees. Therefore, OVR is not in compliance with a significant documentation requirement in OMB Circular A-87.

Recommendation: OVR management should strengthen internal controls to ensure that all personnel costs charged to RSBS for employees doing RSBS-related work are more timely documented in accordance with the semi-annual certification provision in OMB Circular A-87.

Agency Response: OVR had initiated the necessary procedures in accordance with A-87 but did not get them implemented within the time period of this audit review. OVR has since begun the semi-annual certification process for employees working solely on the Vocational Rehabilitation Program. Certifications have been obtained for the period July 1, 2004 through December 31, 2004. Certification lists for the period January 1, 2005 through June 30, 2005 will be mailed out in the next two weeks for signature. These signed forms should be completed by mid September 2005. It is hoped that this action will eliminate this finding for OVR for the next audit period, July 1, 2004 through June 30, 2005.

Finding 04 – 22: (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 04 – 23:

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 #03-20)

Condition: During our current audit period, we reviewed 40 active TANF case files to ensure that DPW is making an assessment of the TANF participants skills, prior work experience, and employability. Our review disclosed that 11 of the 40 cases were exempt from this requirement due to the participant being disabled, or the case being child only assistance. For the remaining 29 cases, our review disclosed that only 7 case file records 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. During a prior audit period, the DPW, Office of Income Maintenance, issued Operations Memorandums 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 not provide a copy of the completed RESET Guide (PA 1680) for applicable 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 concurs with the audit finding and recommendation. 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 Memo dated February 13, 2002 giving direction to carry this out and use the guide was distributed to Area Managers and this audit sample could only find seven PA 1680s of the 29 cases reviewed.

In response to this audit, three points of action are in the process of 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. In addition, an assessment is also in progress and may impact policy regarding use of 1680s.

Finding 04 – 23: (continued)

DPW agrees that documentation to support compliance with federal welfare reform regulations is critical in confirming that recipients received the necessary information, in addition to appropriate training and employment placement guidance, as required by TANF regulations and the federal Welfare Reform Act of 1996. It is a functional responsibility of the County Assistance Office to have the RESET participant Guide to Success (PA 1680) as part of the individual records.

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 04 – 24:

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 #03 - 21)

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. During prior audit periods, this file consisted of three individual monthly files (one for each month of the quarter) of all TANF participants contained on DPW's Client Information System (CIS). Effective October 1, 2003, as allowed by program regulations, DPW began to select a stratified random monthly sample of 250-300 cases for submission to HHS, as opposed to the monthly files of all participants.

In order to test the data on the file submitted to HHS, we obtained the file for the sample month of June 2004. We randomly selected 40 out of the 250 - 300 cases from the data file, and attempted to trace the key line items as required by the OMB A–133 Compliance Supplement, to documentation in the participant's case file. Our testing disclosed errors for 5 of the 40 cases, or 12.5 percent, as follows:

- Out of the 40 cases reviewed on the data report, 24 cases had no work activity for the period and 16 cases included work activity. However, for 4 of the 16 cases with work activity, or 25 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
410122210	35	30	5
512034695	45	*	45
580024978	0	18	18
650300794	20	2	18

  * The hours worked could not be determined since check stubs or other valid verification from the employer supporting the number of hours the participant worked were not included within the case file.

- One of the 40 case files, Case #250281424, included 33 hours of job skills training – employment related (item #57) activity on the ACF-199 Report. However, pay stubs provided to support the hours for job skills training – employment related activities calculated to only 19 hours.

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:

(xi) If the adults participated in, and the number of hours per week of participation in, the following activities:

(III) Unsubsidized employment.
(VI) Job skills training or on-the-job training.

Finding 04 – 24: (continued)

(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.

(1) Disaggregated Data on Families Receiving TANF Assistance – Section one. Each State must file disaggregated 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.

Cause: DPW officials cannot explain why supporting documents related to work activity and job skills training activity were not obtained or did not agree to the amounts reported on the ACF-199 Report.

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 2003 may be materially incorrect.

Recommendation: DPW should evaluate the feasibility of submitting revised ACF-199 reports for the FFY 2003. 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: The Office of Income Maintenance concurs in part with the audit finding and recommendation as follows:

Case Record 41/0122210 – DPW provided the auditors with documentation that supports 30 hours of work per week compared to the 35 hours as indicated on the ACF-199 report. Although there is a discrepancy in the number of hours that could be documented, the client was appropriately categorized for participation purposes as meeting the 30 hour requirement (code 19).

Case Record 51/2034695 – DPW provided the auditors documentation that the participant was performing home health care services for 9 hours a day for 5 days a week which is adequate to prove compliance with requirements. The ACF-199 report was properly coded as meeting the 30 hour requirement for this participant (code 19).

Case Record 58/0024978 – DPW agrees with the finding on this case and is researching why the case was improperly coded. If it is determined finally that the coding is improper, a revised report will be send to correct the previously submitted data on the ACF-199.

Case Record 65/0300794 – DPW identified a coding error when this case was extracted and submitted a correction to ACF to record the hours appropriately. Two hours were reported in the corrected data instead of 20. DPW is waiting for confirmation from ACF that the revised data was received and corrected. Although the hours were originally reported incorrectly, the change in the number of hours does not change the category – the participant was properly categorized as not meeting participation requirements (code 18).

Case Record 25/0281424 – DPW provided the auditors with documentation that supports 22 hours of work per week compared to the 33 hours as indicated on the ACF-199 report. Although there is a discrepancy in the number of hours that could be documented, the client has a child under age 6 and was appropriately categorized for participation purposes as meeting the 20 hour participation requirement (code 19).

Finding 04 – 24: (continued)

DPW feels that one case that was reported in the incorrect category does not substantiate the auditor's finding that "DPW also provides little assurance that the information submitted to HHS on the ACF-199 Report is accurate." Nor does the finding on one case provide a basis to state that "Pennsylvania's participation rate for FFY 2003 may be materially incorrect."

The report also states that "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" and "the accuracy of CIS data for other TANF reports submitted to HHS is also questionable." The one case that remains in error is in error because documentation does not support the hours entered on the ACF-199 report. These hours are not reported from CIS, they are reported from information that the caseworker gathers from the employer or contractor when completing the ACF-199 report. There were no errors cited in the audit report related to the data in CIS. There had been errors for FFY 2002 that would support this statement, but there are no findings for FFY 2003 of errors in data incorrectly transferred from CIS to the ACF-199.

The findings in this audit indicate significant improvement over the results of the FFY 2002 audit. This improvement is a result of DPW's implementing policy and procedures to provide more accurate data and to monitor and control the information collected and reported on the ACF-199 report prior to submission to ACF. DPW asserts that the audit report should reflect this improvement.

Auditors' Conclusion: Based on our review of the agency response, our comments are as follows:

- Case Record 410122210 – We concur that DPW provided documentation to support that the participant worked 30 hours as opposed to the 35 hours reported. We changed the finding to reflect this change.

- Case Record 512034695 – The documentation provided by DPW consists of a handwritten letter signed by a person indicating that the participant performed home health care services for nine hours a day for five days a week. However, the letter did not indicate what days, month and year the participant actually worked these hours. Further, the letter did not contain an address indicating where the participant worked. Therefore, the finding for this case remains as stated.

- Case Record 580024978 – DPW agrees with this case and, therefore, the finding for this case remains as stated.

- Case Record 650300794 – DPW could not provide a confirmation from ACF that the hours reported were 2 instead of 20 hours as contained in the file provided to us for audit. Therefore, the finding for this case remains as stated.

- Case Record 250281424 – The hours supported by pay stubs using the week in the calculation for whichever week the Friday falls (i.e., the JOBS approach), which is the approach DPW used in all other cases, are 19 hours, not the 22 noted by DPW.

We agree that DPW has made significant improvements by implementing new policies and procedures to ensure the accuracy of data reported on the ACF-199 Report. However, as disclosed in the finding, the number of hours worked could not be supported or were inaccurate for 5 of 40 cases tested, not the 1 case that DPW claims in its response. When our sample error rate of 12.5 percent is projected over the population of TANF cases at DPW at any given point in time, the errors in the population are potentially significant to the TANF Block Grant as a whole. Further, for CIS to be verified as accurate, all data entered into CIS must be supported by adequate documentation.

Based on the agency response, our finding and recommendation, with the above clarifications, remains as stated above. 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 04 – 25:

CFDA #93.563 – Child Support Enforcement

Noncompliance and Internal Control Weakness Over the Processing and Reporting of Interstate Cases (A Similar Condition Was Noted in Prior Year Finding #03-22)

Condition: Federal regulations require that DPW and its DRS's establish and utilize an interstate central registry for CSE which is responsible for receiving, distributing, and responding to inquiries on all interstate IV-D cases within federally-established timeframes. Our review of DPW's interstate case processing system disclosed noncompliance with federal regulations and internal control weaknesses in the processing and reporting of timeframes for required action on interstate cases. Therefore, proper corrective action on our prior-year finding was not implemented by DPW in the current year.

Per CSE regulations, responding interstate cases must be reviewed, distributed, and responded to by DPW within 10 working days of receipt from other states. However, the list of responding interstate cases for our test month of June 2004 extracted by DPW from the Department's PACSES system showed that 79 of the 431 cases (or 18.3 percent) received during June took between 20 and 274 calendar days to process, which is beyond the 10 working-day requirement. Initiating interstate cases must be referred by the Commonwealth's DRS's to other states within 20 calendar days after determining that the non-custodial parent is in another state. However, the listing of initiating interstate cases for the test month of June 2004 extracted from PACSES showed that 67 of 296 cases (or 22.6 percent) referred during June took between 21 and 246 calendar days to process. As a result, we noted that the PACSES extractions provided to us by DPW demonstrated significant noncompliance with federally-established timeframes for responding and initiating interstate cases.

In addition to examining DPW's PACSES extractions to evaluate compliance, we also selected a sample of 20 initiating and 20 responding cases, or 40 cases in total, to ascertain the propriety of individual dates extracted from PACSES by DPW to demonstrate compliance. For 30 out of the 40 cases sampled, we found minor dating errors in DPW's PACSES extraction which had no impact on demonstrating compliance with federally-established timeframes. For 10 of the 40 cases sampled (5 initiating and 5 responding cases) DPW's PACSES extractions showed PACSES processing beyond the applicable federally-required timeframe. For all 10 cases, our follow-up showed that DPW extracted incorrect dates from the PACSES system which caused PACSES to incorrectly measure compliance. Therefore, as in the prior year, the PACSES system weakness continued to exist in our current year since DPW's extraction of dates from PACSES is inaccurate. Because of these inaccuracies, the PACSES system is not being properly used by DPW and the actual level of compliance vs. noncompliance with established timeframes cannot be reasonably determined during our audit.

In accordance with federal reporting requirements, DPW's CSE Self-Assessment Report sent to HHS for the Federal Fiscal Year 2004 indicated that PACSES data extractions derived an average statewide efficiency (i.e., compliance) ratio of 79 percent for interstate services. As a result, PACSES data extractions for FFY 2004, as reported to HHS, were showing that 21 percent of interstate cases were not processed within the required federal timeframes, which approximates our audit results for our test month of June disclosed above. However, within the interstate services section of this report, DPW explained to HHS that timeframe measurements of interstate activities in the report are not accurately extracted from PACSES, which is consistent with the results of our testing of PACSES dates disclosed above.

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;*

Finding 04 – 25: (continued)

(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.

(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 individual cases are actually being processed within the required timeframes, but DPW has not yet been able to accurately extract the necessary data from PACSES to accurately demonstrate this and properly report the data to HHS. Regarding DPW's use of PACSES extractions, we noted that there is an inadequate system to demonstrate compliance with CSE timeframes, and there is ineffective review and oversight by DPW to ensure the dates extracted from PACSES to demonstrate compliance 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. Specifically, BCSE personnel noted 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.

Effect: As a result of the late processing of CSE cases recorded on the PACSES system, DPW cannot demonstrate compliance with federal regulations, and internal controls need to be strengthened. In addition, DPW cannot demonstrate its enforcement of 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 the accuracy of PACSES extractions are not strengthened, dates utilized from the system will continue to be inaccurate in the future, thus causing the system to be unreliable to measure compliance and inaccurate reporting to HHS.

Recommendation: DPW should strengthen its existing controls to ensure that responding and initiating interstate registry cases are processed within federally-established timeframes and are accurately extracted and reported from PACSES to properly and reliably measure compliance.

Agency Response: The Single Audit Finding specifically focuses on the Pennsylvania Child Support Enforcement System's (PACSES) interstate extract record provided to the auditors. The auditors contend that PACSES' extractions provided to the auditors demonstrated significant noncompliance with federally established timeframes for responding and initiating interstate cases.

The Bureau of Child Support Enforcement's (BCSE), Division of Program Development and Evaluation, review disclosed that the Single Audit Finding is inconsistent with Federal and State case processing standards. BCSE's review disclosed that the auditors used the elapsed time difference between the PACSES' case application date and the PACSES' case status date to determine the time needed to process an interstate case. However, application dates and status dates are not data elements that are used to measure interstate activity.

Finding 04 – 25: (continued)

The auditors did not request PACSES' data elements that actually identify and report the dates when cases were determined to require interstate services. They also did not request the PACSES' data elements that would identify and report the dates the cases were referred to the other states for action. BCSE's review of the PACSES' interstate extract disclosed that the records identified all data elements requested by the auditors for the 137,536 cases that required interstate services at some point in the life of the case. The auditors requested data elements were as follows:

Data Elements	BCSE Comments
County Code	The County Code assigned to the County that retains jurisdiction of the case.
County Name	The name of the County that retains jurisdiction of the case.
Case ID	PACSES Case Identification Number.
CT	Case Type. Case type is A – TANF, C – Transitional Child Care, F - Foster-Care, G - General Assistance, J - Non-Federal Foster Care, M - Medically Needy Only, N - Non-TANF, and S - Supplemental Security Income.
IS	Interstate. Interstate cases are designated I – Initiating and R – Responding.
App Date	Application Date is the date the Application for Title IV-D Services was received by the State IV-D Agency. Once the case is created, the application date is permanently stored in PACSES. The application date remains unchanged even when a case is closed and subsequently re-opens. All PACSES cases have application dates. **BCSE notes that the auditors used the application date as the date the case was determined to require interstate services. Although the application date is sometimes the same date as the date the case was determined to require interstate services, the application date is not an element that can be used to identify the need for interstate activity. Interstate activity is predicated on either the Plaintiff or the Defendant being in another state. Plaintiff or Defendant relocation to other states can take place years after the application was processed by PACSES.**
Status Date	Date of last status change in PACSES. A case can have one of the following statuses: O – Open, C – Closed, V – Archived. **BCSE notes that the auditors used the status date as the date the case was processed for interstate services. Although the status date is sometimes the same date as the date the case received interstate services, i.e. a case was opened and forwarded to another state; the status date has nothing to do with identifying when a case received interstate processing.**
Arrears	Child Support arrearages due as of the date the extract was created.
Defendant	Name of the Defendant in the PACSES case.
Plaintiff	Name of the Plaintiff in the PACSES case.

BCSE will make appropriate PACSES Interstate Registry universe extracts available upon Single Auditors' request. In reference to the auditor's finding regarding the Child Support Enforcement Self-Assessment Report, BCSE initiated redesigns of the Self Assessment Report to give the Domestic Relations Sections (DRSs) credit for the period of time

Finding 04 – 25: (continued)

needed to initially pursue service of process through a local, long-arm complaint - a process that is encouraged by the Federal agency. This redesign was done as the original Self Assessment Report penalized the DRSs and allowed the 20-day timeframe to expire while the DRS was pursuing local action. The report did not give the DRS credit when the DRS subsequently proceeded with the UIFSA course of action.

In August 2005, work was completed on the redesign of the Interstate Initiating and Interstate Responding Self-Assessment Reports. Through extensive logic and case sample testing, the redesign ensures that the program's logic accurately and fairly presents county DRS case activity using the appropriate data fields in PACSES. Cases where the correct PACSES processes/coding have not been completed will fall into "actionable case lists" for follow-up county DRS review. The redesign will ensure that the reports are effective and reliable internal auditing tools to evaluate performance and compliance with Federal standards as well as diagnostic tools to assist DRS staff to monitor program operations and develop quality business practices.

Auditors' Conclusion: BCSE states that its application and status dates recorded on PACSES are not the correct dates to measure compliance with federal interstate case processing requirements. However, these are the dates DPW provided to us in its data extract for our current-year testwork, and these are the dates used by DPW in its CSE Self-Assessment Report submitted to HHS. Furthermore, as stated in the finding, the PACSES data extract provided to us by DPW during our audit disclosed noncompliance error rates consistent with those noted in DPW's own Self-Assessment Report for FFY 2004. Since management is now stating that it is using incorrect PACSES dates to measure and report compliance, this corroborates our conclusions about DPW's inaccurate data extractions and the lack of support for compliance in the finding. It is DPW's responsibility to ensure that data is accurate, is properly maintained and extracted, and properly demonstrates and documents compliance with applicable federal regulations. Since DPW could not provide accurate data for our audit of compliance with regulations on interstate cases, 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 04 – 26:

CFDA #93.569 – Community Services Block Grant

LECS Comptroller Office Did Not Submit Required Federal Reports Within the CSBG Program

Condition: Our review of controls over federal financial reporting in CSBG disclosed that the LECS Comptroller Office did not submit any SF-269A expenditure reports to HHS for our audit period ended June 30, 2004 as they were not aware that they were required to do so. LECS Comptroller personnel also stated that they did not know when the last time expenditure reports were prepared and submitted to HHS for CSBG. As a result of our inquiry, on May 19, 2005, LECS Comptroller personnel prepared and submitted the required SF-269A expenditure reports for the five FFY grants in which expenditures were incurred during SFYE June 30, 2004. The expenditures included on these reports were as of the FFY ended September 30, 2004, which was subsequent to our audit period.

Criteria: 45 CFR 96.30(b) (4) which provides the fiscal and administrative requirements states:

Grantees shall submit . . . OMB Standard Form 269A Financial Status Report (short form). Grantees are to provide the requested information within 90 days of the close of the applicable statutory grant periods.

Further, the Terms and Conditions of the Community Services Block Grant Award for FY 2002 states:

Grantees are required to submit annual financial status reports, SF-269A's (short form), for this program. The first report is due 90 days after the end of first year, i.e., December 30, 2002. Final reports are due December 30, 2003.

Further, the Terms and Conditions of the Community Services Block Grant Award for FY 2003 states:

Grantees are required to submit annual financial status reports, SF-269A's (short form), for this program. The first report is due 90 days after the end of first year, i.e., December 30, 2003. Final reports are due December 30, 2004.

Cause: Staff at LECS were not aware of CSBG financial reporting requirements prior to auditor inquiry.

Effect: LECS Comptroller Office control environment is not adequate to ensure compliance with CSBG regulations and grant requirements regarding federal reporting. The LECS Comptroller Office did not comply with federal regulations since they did not submit SF-269A expenditure reports for CSBG during our current audit period; therefore, HHS could not monitor grant financial activity. In addition, it cannot be assured that nonmajor federal program grants the LECS Comptroller Office is responsible for are properly reported upon.

Recommendation: LECS Comptroller Office should implement procedures to ensure that the SF-269A expenditure reports are properly submitted to HHS for CSBG each year as required by federal regulations. Also, LECS Comptroller personnel should strengthen its control environment to ensure it complies with all federal financial reporting requirements in all federal grants for which the LECS Comptroller Office has responsibility.

Agency Response: ECS was aware of the 269 reporting requirements for the CSBG program. In the course of staffing changes, however, we were not aware that there were outstanding 269As to be submitted. The presentation of the *Condition* suggests that we were not familiar with our job requirements; this was not the case. We have reviewed our grant listing to ensure that the ones for which reports were missed are included and have filed the applicable 269As. The lack of submission did not result in HHS notifying DCED or LECS or in the suspension of available funding.

Auditors' Conclusion: Beginning with federal fiscal years (FFY) ending on or after September 30, 2002, HHS required all recipients of HHS Block Grants to file SF-269A Financial Status Reports (FSR). The first reports for CSBG were due on December 30, 2002; however, LECS Comptroller Office did not file any FSRs since the initiation of the requirement. As a result, FFYs September 30, 2002, 2003 and 2004 FSRs were not submitted as required. It was not until after we made several different requests for FSRs for the CSBG program that LECS Comptroller Office personnel

Finding 04 – 26: (continued)

provided us with copies of FSRs filled on May 19, 2005 for FFY September 30, 2004 and an explanation that they were not aware of the requirement to file FSRs for CSBG. Whether the cause of the non-submission of the FSRs was lack of awareness of the requirements or the lack of awareness of which FSRs were not filed, it is still an indication of a weak control environment.

Based on the agency response, our 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 04 – 27:

CFDA #93.569 – Community Services Block Grant

Weaknesses in Internal Controls Over Subgrantees Result in $47,722 in Questioned Costs

Condition: Federal regulations require DCED to perform on-site monitoring of each CSBG subgrantee once every three years. To ensure compliance with this requirement, DCED prepares a monitoring schedule to identify the 45 subgrantees they plan to monitor during the three years. Our review of DCED's monitoring schedule for SFYE June 30, 2004, the second year within the current three-year cycle, disclosed that 16 subrecipients were scheduled for current-year on-site monitoring visits. However, based on our audit inquiry, DCED personnel in the Office of Community Services (OCS) indicated that only 10 of 16 subrecipients, or 63 percent, of the monitoring visits were actually performed. Since actual visits fell 37 percent short, DCED's current-year monitoring of its subrecipients was not adequate to provide reasonable assurance of the subrecipients' compliance with federal regulations. Based on further discussions with OCS officials, we also noted that in the subsequent fiscal year (04-05), the last year in the current monitoring cycle, DCED failed to monitor 2 of its 45 subgrantees listed on the monitoring schedule within the federally-required three-year timeframe. These two subrecipients were awarded over $1 million in our current year.

In addition to testing on-site monitoring, we reviewed payments to subrecipients for compliance with CSBG period of availability requirements. We noted that one subrecipient payment for $47,722 was charged to the SAP system after the September 30, 2003 period of availability, and we tested it as follows:

Document Number	Document Date	Grant Number Charged	Grant Period
KR1900444092	11-17-03	G02B1PACOSR	10-1-01 to 9-30-03

We determined that this payment represented the entire amount paid out under the current-year contract award to this subrecipient. We could not determine when the subgrantee invoice was prepared since the subgrantee personnel who signed the invoice did not date it. Furthermore, DCED could not provide an expenditure report from the subgrantee showing the expenditures were incurred by September 30, 2003. Since DCED could not provide documentation to support that the $47,722 of expenditures were incurred within the period of availability, the entire amount is questioned as unallowable. Also, since this was a one-time subgrantee only receiving funds in the current-year, DCED excluded this entity from its on-site monitoring schedules, so the $47,722 was not subject to on-site monitoring by DCED.

Criteria: Regarding subgrantee monitoring, 42 USC 9914(a)(1) states:

(a) In general

In order to determine whether eligible entities meet the performance goals, administrative standards, financial management requirements, and other requirements of a State, the State shall conduct the following reviews of eligible entities:

(1) A full on-site review of each such entity at least once during each three-year period.

Regarding the expenditure of funds, in addition, 45 CFR, Part 96.14(b) states:

(b) Expenditure. No limitations exist on the time for expenditure of block grant funds, except those imposed by statute with respect to the community services, maternal and child health services, and social services block grants.

Finding 04 – 27: (continued)

The Terms and Conditions of the Community Services Block Grant Awards state:

Payments to grantees from their allotment for any fiscal year shall be expended by the grantee in such fiscal year or in the succeeding fiscal year, Section 678(b) (42 U.S.C. 9907).

Grantees shall adhere to the provisions of 678D which addresses the grantees responsibilities for fiscal control, fund accounting and audit procedures.

Cause: DCED personnel indicated that staffing shortages prevented them from completing all of the on-site monitoring visits scheduled for the 2003-2004 monitoring year. DCED personnel also indicated that the subrecipients that were scheduled to be monitored during the 2003-2004 year, but were not monitored during that year, were added to the 2004-2005 monitoring year schedule. However, DCED indicated a full on-site review of each subgrantee could not be completed during the three-year period ended 2004-2005.

With regard to DCED not being able to provide documentation to support that the $47,722 was expended within the period of availability, DCED personnel stated that they normally require subgrantees to submit monthly expenditure reports which document when the expenditures were incurred. However, they could not explain why an expenditure report was not available for this subgrantee. In addition, the entity was excluded from the on-site monitoring schedules due to only receiving CSBG funds in one year.

Effect: DCED did not adequately perform on-site monitoring of the CSBG subrecipients to ensure compliance with federal regulations. In addition, since DCED could not provide documentation to support that the $47,722 of subgrantee expenditures were incurred within the period of availability, the $47,722 is questioned as unallowable.

Recommendation: We recommend that DCED establish a system to ensure that all on-site visits are completed within the scheduled monitoring cycle to provide reasonable assurance that subrecipients are complying with federal regulations. In addition, we recommend that DCED pursue appropriate settlement with HHS regarding the $47,722 of questioned costs.

Agency Response: A shortage of personnel and increasing responsibilities has prevented the CSBG Unit and regional staff (who perform most of the monitoring functions) from achieving our monitoring goals.

The Office of Community Services, working in conjunction with the executive director of the Community Action Team (responsible for the regional offices and the monitoring function) will develop a monitoring schedule for CSBG 90 percent grants, as well as a portion of the discretionary grants. The schedule will include quarterly goals for each of the regions. Those goals will be monitored by the Office of Community Services, and tracked on a quarterly basis. When quarterly goals are not met, monitors and regional directors will be informed, and will be requested to submit a revised plan to meet the goal of 100 percent monitoring of Community Action Agencies' 90 percent grants, and approximately 25 percent of the discretionary grants. Emphasis will be placed on monitoring those agencies that have not been monitored in the last three-year cycle, followed by those that were monitored during the first year of the cycle. Emphasis on the discretionary grants will be those that receive multi-year funding.

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 04 – 28:

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 Inadequate Support for Federal Earmarking Requirements Result in Questioned Costs of $3,220,142 (A Similar Condition Was Noted in Prior Year Finding #03-23)

Condition: Federal regulations applicable to the discretionary fund portion of the CCDF program established an earmark within each federal award requiring a minimum funding level to increase the supply of quality child care for infants and toddlers. The FFY 2002 infant and toddler earmark applicable to Pennsylvania in our current audit period was $3,220,142. In our prior-year audits, our test of expenditures charged and obligated to CCDF disclosed that DPW did not adequately track and could not provide adequate documentation to properly support the expenditures claimed for the infant and toddler earmark. Our current-year follow-up to these prior year findings disclosed that DPW did not implement corrective action and again did not adequately support this earmark for the current FFY 2002 CCDF grant.

Prior to the September 30, 2003 federal deadline for obligating all discretionary FFY 2002 CCDF grant funds, on August 26, 2003, DPW posted a $1,760,336 expenditure adjustment within its FFY 2002 infant and toddler earmark account on the statewide SAP accounting system (via SAP adjustment document #SU101546156), and claimed this same amount under the earmark on its FFY 2002 ACF-696 Report submitted to HHS as of September 30, 2003. In July of 2004, over nine months after the September 30, 2003 obligation deadline for the FFY 2002 grant, DPW discovered that this $1,760,336 amount was not enough to comply with the minimum earmark of $3,220,142. DPW, therefore, posted an additional expenditure adjustment of $1,701,008 to SAP (SAP adjustment document #SU104012489), bringing the total expenditures posted to the infant and toddler earmark account to $3,461,344. These additional expenditures were later reported on the final FFY 2002 ACF-696 Report submitted to HHS.

Both of these expenditure adjustments represented costs transferred into the infant and toddler earmark account on SAP from non-earmarking SAP accounts in which the costs were originally recorded. In response to our inquires to obtain support for these adjustment postings, DPW provided only a one-page memo for each adjustment which listed individual subrecipient contracts and expenditure amounts that totaled to the adjustments posted to SAP. These memos were prepared by one individual in DPW and there was no supervisory review, monitoring, or verification of the propriety of the costs claimed by this individual for the earmark on these memos.

DPW officials further indicated to us that documentation supporting these two SAP adjustments was not available and they needed to go back and perform a retrospective review of the support since the individual responsible for preparing the postings was no longer employed at DPW. After further research and review of additional supporting documentation, DPW's total costs claimed for the infant and toddler earmark changed from the above-mentioned $3,461,344 originally posted to SAP and reported to HHS. The adjusted earmark amount provided to us during our audit was $3,242,588, but this adjusted amount was not posted to the earmark account on the SAP accounting system, nor was it reported to HHS on the ACF-696 Report. In reviewing the support DPW provided for this adjusted earmarking amount, we noted the following audit exceptions:

- The specific subrecipient contracts and expenditure amounts supporting the adjusted earmarking amount of $3,242,588 significantly differed from the mix of contracts and expenditure amounts listed on the one-page memos supporting the two original postings to SAP and the ACF-696 amount reported to HHS. By way of example, the $1,760,336 original posting all came from one subrecipient contract #SP01670001, but DPW's adjusted earmark total included only $560,947 in expenditures from this contract, with a $1,199,389 difference. In addition, numerous subrecipient contracts were included in the adjusted earmark total, but were not included in the original earmark postings on SAP, and vice-versa. Therefore, DPW's retrospective review did not corroborate the $1,760,336 and the $1,701,008 above-mentioned postings to the earmark account on SAP or the earmark total of $3,461,344 submitted to HHS on its ACF report.

Finding 04 – 28: (continued)

- For certain subrecipient awards, DPW only used a portion of the total paid out under the award to count towards the infant and toddler earmark, but provided no support for the appropriateness of its calculation of this infant and toddler portion. We noted that many subrecipient award documents included a mix of qualifying infant and toddler earmark activities and other child care activities that would not qualify for the earmark, so more support is needed for these subrecipient amounts claimed. This exception applied to both the adjusted earmark total of $3,242,588, and to the original adjustment postings to the SAP earmark account and ACF-696 reporting to HHS.

- As reported in another finding, DPW does not properly monitor the activities of its CCDF subgrantees and this significant weakness exists over DPW's claims for the infant and toddler earmark. In addition to not verifying subrecipient earmarking versus non-earmarking activities and costs on-site, DPW does not have an adequate system in place to obtain certifications, confirmations, detailed expenditure reports, or any other support from its subrecipients to support amounts claimed by DPW for the earmark, and relies on each subrecipient's budget obtained at the beginning of the contract. We also noted that many subrecipient awards under CCDF have significant refunds after year-end, but DPW obtains no information or detail on these refunds to consider the impact of these unexpended funds on, and adjust, its earmarking calculations. Since the population of subrecipients claimed by DPW for the infant and toddler earmark enter into multiple additional subcontracts at the subrecipient level to expend these funds, this lack of an earmark monitoring/reporting mechanism up the line from subcontractors to subrecipients to DPW provides little assurance that appropriate audit trails are maintained on a regular basis to track earmark versus non-earmark amounts, that support is adequately reviewed and verified to prevent misreporting of non-earmark expenditures, and actual subrecipient costs claimed by DPW are subject to a proper post-audit of the earmark at the subrecipient level. Because of these significant system deficiencies and the major inconsistencies in DPW's retrospective recalculation of subrecipient costs versus the original earmark expenditures posted to SAP, there is also a significant risk that the same subrecipient or subcontracted expenditures may be unknowingly claimed by DPW for the earmark in more than one federal grant year.

Based on our review of the $3,461,344 in expenditure adjustments posted to SAP, DPW's accounting for the infant and toddler earmark on the SAP accounting system and reporting the earmark to HHS on the ACF-696 Report is deficient. DPW is not properly recording expenditures or obligations into the SAP earmark account when incurred, and subsequent expenditure adjustments are required to correct SAP. In addition, as stated above, the expenditure adjustments posted to SAP were not reviewed for propriety by a supervisor and were not properly supported by DPW. Also, due to untimely DPW monitoring of this CCDF earmark on SAP, one of the adjustments supporting approximately 50 percent of the required earmark was not posted until over 9 months after the deadline for obligating all grant funds. Furthermore, no obligated amounts for the earmark were posted to SAP as of the September 30, 2003 obligation deadline for the FFY 2002 discretionary grant to properly support that the earmark expenditures posted over 9 months later were appropriately obligated by the federal deadline.

In addition, based on our review of DPW's adjusted earmark total of $3,242,588, DPW is not reasonably verifying or documenting its subrecipient expenditures claimed. Although the subrecipient awards and subcontracts included by DPW in the earmark total clearly include infant and toddler activities and costs, DPW provides little assurance on the accuracy and propriety of the amounts included. As a result, DPW cannot support that the $3,220,142 minimum earmark was properly met for the FFY 2002 grant.

Finally, during our current audit period, we learned that HHS performed follow up at the subrecipient level on one of our prior audit findings in this area and found inappropriate subrecipient costs claimed for the infant and toddler earmark in a prior year. As disclosed above, DPW has not implemented corrective action by establishing a suitable internal control system to properly track and verify subrecipient spending to prevent these inappropriate costs from continuing to be claimed.

Finding 04 – 28: (continued)

Criteria*:* The terms and conditions issued with the FFY 2002 Child Care and Development Fund grant award state:

Discretionary Fund

Discretionary Funds must be obligated by September 30, 2003. States must liquidate obligations by September 30, 2004.

Earmarks associated with the Discretionary Fund

The Department of Labor, HHS, and Education Appropriations Act, 2002 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-02-01 regarding the FFY 2002 Final Allotments and Earmarked Funds established Pennsylvania's infant and toddler earmark as $3,220,142.

Also, 45 CFR Part 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.

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: Since corrective action was not implemented by DPW to resolve our prior year finding, compliance with the infant and toddler earmark was not properly documented, tracked, and monitored at the state or subrecipient levels by DPW. According to personnel, the earmark was taken into consideration during the budgetary phase of the grant, but actual costs were never obligated or properly tracked on SAP by DPW program personnel to calculate and measure compliance. Only one individual in DPW was responsible for tracking and recording the earmark on SAP with inadequate supervisory oversight of this process. When the individual left the agency, nobody at DPW could provide adequate documentation to support the expenditures posted to SAP.

DPW personnel agree that there were no obligations posted to the infant and toddler earmark account (i.e., order number) in the SAP Accounting System as of September 30, 2003, but they disagree that the funds were not obligated as required. DPW personnel indicated that the expenditures charged to the infant and toddler order number in SAP represent subrecipient expenditures that were obligated under other order numbers within the grant prior to October 1, 2003. However, since DPW did not post any obligations to the infant and toddler earmark order number in SAP to document which obligations occurred within the required timeframe, controls to track and ensure the earmark was obligated are weak.

Finding 04 – 28: (continued)

Effect: DPW did not retain adequate documentation to support its compliance with federal earmarking regulations. Since the necessary documentation to support compliance with the earmark is not available, DPW cannot reasonably demonstrate that any FFY 2002 CCDF funds were spent on federally-mandated infant and toddler activities versus other CCDF activities. Because costs spent or obligated on other CCDF activities in lieu of the minimum required earmark would not be allowable, the entire amount of the $3,220,142 minimum earmark is questioned.

Recommendation: We recommend that DPW pursue appropriate settlement with HHS regarding the $3,220,142 of questioned costs. In addition, DPW should establish a system to adequately document, track, verify with subrecipients, and ensure that infant and toddler earmarks are properly obligated, accurately recorded, and met within future CCDF grants.

Agency Response: The DPW is committed to the infant and toddler quality improvement efforts, and expends more dollars on quality than the federal minimum amounts. Pennsylvania demonstrated that strong commitment when the Department of Health and Human Services (HHS) conducted an on-site review of a prior year's infant toddler earmark. With a similar audit finding by the auditors, the DPW was able to substantiate during the HHS review that Pennsylvania expended 99 percent of the required infant toddler earmark requirement.

The remaining one percent was expended on infant and toddler quality efforts, but the funds were expended on renovations that were not allowable under the CCDFBG regulations. Therefore, the DPW stepped up its efforts to provide additional documentation to the child care providers on what constitutes renovations versus repairs. The HHS approved the DPW's technical assistance language on October 6, 2004. The language is now incorporated into the provider's standard grant packet.

While the DPW guarantees at least $3,220,142 in the fiscal year (FY) 2003-04 infant and toddler quality improvement spending, it has pursued and implemented a documenting system to identify the obligations and expenditures of this earmark. The DPW obligated funds for the FY 2005-06 in an internal order in the SAP established for the infant and toddler earmark. The DPW hopes that this effort will eliminate any future audit findings in this area.

The DPW accepts responsibility for the reporting issue mentioned in the audit finding. The DPW is currently working with the HHS and the HHS' contractor to strengthen federal reporting in child care. The DPW looks forward to this joint national effort to review reporting parameters and any additional guidance from the HHS on federal child care reporting.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as stated above. 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 04 – 29:

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 $4.8 Million in Excess Subgrantee Federal Cash at June 30, 2004 (A Similar Condition Was Noted in Prior Year Finding #03-24)

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 81 percent and 75 percent of total CCDBG/CCDF Cluster and SSBG program expenditures, respectively. However, we noted that program monitoring of subgrantee activities during the awards was not adequate to ensure subgrantee compliance with applicable 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, after June 30, 2004, subgrantees returned approximately $4.8 million in year-end excess cash to DPW from advance payments made monthly but not adequately monitored by DPW during SFYE June 30, 2004. DPW did not perform adequate monitoring (on-site or other) of CCDBG/CCDF subgrantee activities 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 04 – 29: (continued)

Cause: DPW personnel indicated that for child care payments under CCDBG/CCDF and SSBG, DPW began implementing the Child Care Management Information System (CCMIS) in 19 CCIS agencies statewide during SFY 2003-04. 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. DPW personnel stated that they will implement CCMIS statewide in the remaining CCIS agencies during FY 2004 – 05 which should greatly reduce the amount of returned funds. However, given the fact that excessive refunds are returned to DPW every year and refunds for the current year were about $4.8 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 applicable federal regulations. Furthermore, day care subgrantees refunded $4.8 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 all applicable federal regulations.

Agency Response: Regarding the Child Care Cluster:

The DPW strongly disagrees with your finding that a weakness in its monitoring of subgrantees resulted in $4.8 million in excess subgrantee federal cash. In fact, the DPW's monitoring under this Administration is the reason why subgrantees returned only $4.8 million, or 1.5 percent, of the total allocated dollars. The DPW's fiscal year goal was a return of less than two percent of the $326 million allocated across 59 subgrantees. In order to assure a return of less than two percent, the DPW monitored the subgrantees on a monthly basis. Towards the end of the fiscal year, the monitoring became more frequent and the data was viewed daily to meet our fiscal monitoring goal.

The child care market is a very fluent market where the statewide costs change on a daily basis. There are many factors that are outside the DPW's control. Parents can change providers, which impact the child's annual cost of care; children terminate from the child care system; families who come off the waiting list enroll at any time within a 30 day window;

Finding 04 – 29: (continued)

and some families suspend their child care services for 90 days. Since the subgrantees cannot control the child care costs, and since they are responsible for any over-spending at the end of a fiscal year, a small percent returned at the end of each fiscal year will be an ongoing practice. Many of the Commonwealth's child care providers are nonprofit agencies that do not have funds available to cover their program's overspending. Therefore, any reasonable manager would end the fiscal year a little under budget rather than over budget. These facts when properly understood and realized, make the 1.5 percent return a fiscal year achievement, not a reportable condition.

The DPW questions the apparent lack of balance in this finding. There is no mention of the total amount allocated or the fact that the return is less than two percent of the total allocated amount. In addition, your finding recommends that the DPW limit cash on hand to "immediate needs, but no longer than one month." The DPW's new payment system reconciles the subgrantees cash on-hand monthly. In addition, our child care system's monthly payout amount is around $25 million dollars. The $4.8 million returned is substantially lower than one month's cash payout amount in the child care system. Lastly, the DPW provided information to your office that it redirected over $11 million dollars throughout the fiscal year for cash management purposes and to serve more eligible families. Again, this important information was not included in your cash management finding. The DPW's return of $4.8 million, when considered against past returns in excess of $15 million, should have necessitated, at the very least, new language in the finding as opposed to the same language of the past few years.

The DPW believes it has implemented a monitoring system that resolves the cash management issues and exceeds the HHS recommendation of "at least quarterly monitoring of cash balances throughout the fiscal year." In addition, the DPW feels it has achieved an optimal balance between providing timely payments to fiscally dependent child care providers and the amount of cash on hand at the subgrantees.

In regard to the remaining Social Service Block Grant (SSBG) subgrantee funding, the DPW has included the Annual Report of Services Funded by the SSBG that indicates that the amount allocated is also the total expenditures. This report is submitted to the federal Department of Health and Human Services.

The DPW also receives Single Audits of all the counties that receive SSBG funding. These include Agreed Upon Procedures and Schedules that show the actual expenditures which are reconciled through the DPW's settlement process.

Auditors' Conclusion: The information provided by DPW on the redirection of $11 million demonstrates that these funds were adjustments mainly based on encumbrances recorded on the state's accounting system, not revenue and expense reports from subgrantees, so this redirection of funds was not based on subrecipient cash balances, nor was it the result of DPW's monitoring of these cash balances. Further, DPW did not begin redirecting funds until December of 2003.

Also, since DPW was not monitoring the revenues, expenses, and cash balances of most subgrantees during the year, the total cash balance on hand with subgrantees may have been significantly higher during the year than the $4.8 million noted at year end, without being detected by DPW. As we acknowledge in our finding, during SFYE June 30, 2004, DPW was in the process of implementing CCMIS, which is being designed to receive monthly revenue, expense, and cash balance information from subgrantees; however, only a few of the smaller subgrantees were operational on CCMIS as of June 30, 2004. Therefore, while we acknowledge DPW's assertion that the year-end cash at the subrecipient level has been reduced from prior years, the prior-year internal control weakness of DPW not properly monitoring subrecipients during the year is not resolved and our finding and conclusions do not change in this regard.

Regarding SSBG, while all SSBG funds were ultimately expended by year end, since DPW does not receive revenue, expense, or cash balance reports from subgrantees during the year, DPW is not properly monitoring cash-on-hand for its SSBG subgrantees on a monthly or quarterly basis during the year.

Finding 04 – 29: (continued)

Finally, it should be noted that the agency response only addressed cash management monitoring, but our finding also disclosed a lack of on-site monitoring of CCDF and SSBG subrecipients for other program compliance requirements as well.

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 04 – 30:

CFDA #93.658 – Foster Care – Title IV-E

Internal Control Weaknesses Over Reviewing and Approving Supplemental Payments to Subrecipients

Condition: Within the Foster Care Program, each of the 67 County Children and Youth Agencies, to whom DPW subgrants funds to perform Foster Care Services, are required to submit quarterly invoices for reimbursement of program expenditures incurred. The invoices consist of a Summary Invoice (Form CY64) and a Summary of Placement Maintenance (Form CY63) that identifies the children for whom Foster Care Services were provided, service dates, costs of care, etc. In addition, for any quarter in which a county needs to change an invoice due to not billing for all expenses incurred or to return funds that were previously received from DPW that were subsequently deemed to be ineligible due to an audit, overbilling, etc., the counties are required to submit a supplemental invoice for the quarter. All invoices are reviewed and approved by the PHHS Comptroller Office for propriety prior to payment. However, our inquiries disclosed an internal control weakness in that when a county submits a supplemental invoice to DPW, nobody within OCYF or the PHHS Comptroller Office compared the supplemental invoice to the original quarterly invoice to ensure that services were not billed twice. Furthermore, although routine during-the-award (i.e., on-site and other) monitoring of Philadelphia's Foster Care program was performed by DPW during our current audit period, no specific monitoring or review of subrecipient records was performed by state officials to ascertain the propriety of the supplemental payments. During SFYE June 30, 2004, our audit procedures identified four large supplemental payments totaling $23,241,761 that were made to Philadelphia County as follows:

Document Number	Document Date	Maintenance Assistance	Admin Costs	Training Costs	Total Payment	Service Period
1900543190	1/27/04	$ 3,497,735	$ -0-	$ -0-	$ 3,497,735	4/1/02-6/30/02
1900543634	1/27/04	5,031,076	46,114	121,631	5,198,821	7/1/02-9/30/02
1900543620	1/27/04	6,617,677	158,394	115,669	6,891,740	10/1/02-12/31/02
1900543571	1/27/04	7,380,424	162,040	111,001	7,653,465	1/1/03-3/31/03
Totals		$22,526,912	$366,548	$348,301	$23,241,761	

As a result of the aforementioned weakness, DPW cannot demonstrate adequate monitoring of these higher-risk supplemental charges to the program. While this weakness would apply to all supplemental invoices submitted to DPW for reimbursement, the potential for significant double billings or unsupported/unallowable billings on supplemental invoices is especially high in large counties like Philadelphia where the supporting summary documents are often in excess of 1,000 pages.

We noted that Philadelphia County is subject to the audit provisions of OMB Circular A-133, and submits a Single Audit to the Commonwealth every year. DPW officials informed us that they intended to rely solely on Philadelphia's Single Audit for testing the propriety of the $23.2 million in supplemental payments mentioned above. However, we found that because of the risk-based provisions for auditor selection of major programs in OMB A-133, the Foster Care Program was not always audited as a major program in prior years and may not receive auditing coverage in Philadelphia's A-133 audit. While DPW has attempted to ensure audit coverage of Foster Care in prior A-133 audits of Philadelphia, no additional program monitoring or oversight of Philadelphia was performed by DPW when audit coverage was not attained as part of the A-133 audit. In addition, because audits of subrecipients occur after the fiscal-year end, post-audit testing and verification of the propriety of costs is typically not a timely oversight control without proper program monitoring and oversight during the year. DPW's current practice of solely relying on subrecipient A-133 audits without enhanced during-the-award program monitoring of the above supplemental costs is an internal control weakness in Foster Care.

Finding 04 – 30: (continued)

We received confirmation from the auditors performing Philadelphia's A-133 audit for the fiscal year ended June 30, 2004, that Foster Care is being audited as a major program and that the propriety of the above supplemental payments is being tested in the subrecipient audit. This subrecipient audit has not yet been completed as of the end of our state-level audit. We also learned that HHS OIG is currently in the process of conducting an audit of the Foster Care Program in Philadelphia, and that audit also has not yet been completed.

Since DPW conducted during-the-award monitoring of Philadelphia's Foster Care program operations in our current audit period, and because the propriety of these supplemental costs is being audited and reported on, as required, at the subrecipient level, the reporting on the appropriateness of these costs incurred at the subrecipient level is not within the scope of our state-level audit. Because of these mitigating factors, we do not question these costs as part of our state-level audit. Per the audit and program monitoring provisions of OMB A-133, DPW, in cooperation with its federal awarding agency (HHS), is responsible for obtaining the future reports from these other audit engagements at the subrecipient level and ascertaining any additional monitoring necessary to verify the propriety of these supplemental costs.

Criteria: 45 CFR 92.40 (a) states:

Monitoring by grantees. Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with application Federal requirements. . .

In addition, good internal controls should include procedures to ensure that supplemental subgrantee invoices are properly reviewed and costs monitored to ensure that expenditures are not being claimed inappropriately for reimbursement.

Cause: OCYF and PHHS Comptroller Office personnel indicated that they do not compare supplemental invoices with the original invoices due to large number of children being served. This comparison would require the use of a computer program, especially for those counties like Philadelphia in which the supporting Summary of Maintenance Forms are over 1,000 pages. In addition, PHHS Comptroller personnel stated that they rely solely on subrecipient audits to verify that the subrecipient supplemental billings and related procedures are appropriate. Management believes that its reliance on the OMB A-133 subrecipient audit in the case of Philadelphia is proper. As stated above, however, we do not agree that sole reliance on the subrecipient audit is appropriate for these large-dollar supplemental costs.

Effect: OCYF and PHHS Comptroller Office officials did not adequately monitor or review $23.2 million in Foster Care expenditures submitted on supplemental invoices by Philadelphia County. As a result of this internal control deficiency, additional DPW review and/or follow-up on the propriety of Philadelphia's supplemental costs is necessary.

DPW's sole reliance on OMB A-133 audits of subrecipients in these situations is an internal control weakness since DPW's only on-site monitoring and assurance on these costs is not achieved in a timely manner. In addition, without adequate program monitoring of these costs during the year, potentially material subrecipient noncompliance would not be detected and corrected by DPW, including the prevention and/or collection of any potential questioned costs, in a reasonably timely manner.

Recommendation: OCYF and the PHHS Comptroller Office should implement procedures to review and follow up on the $23.2 million in Foster Care expenditures reported on Philadelphia's supplemental invoices, and strengthen monitoring procedures for these supplemental costs to ensure that these costs are allowable, reasonable, and necessary in accordance with federal regulations. These enhanced review and monitoring procedures should also be implemented for future supplemental Foster Care claims by subrecipients, as deemed appropriate by program management. In addition, when the OMB A-133 Single Audit and the HHS OIG program audit of Philadelphia's Foster Care Program are completed, DPW should review results to ensure proper follow up is performed on any audit findings or questioned costs identified at the subrecipient level, and consider whether additional monitoring coverage of these costs is necessary.

Finding 04 – 30: (continued)

Agency Response: The Office of Children, Youth and Families (OCYF) relies on three approaches to ensure that subrecipient's expenditures in the Foster Care Program are allowable, reasonable, and necessary in accordance with federal regulations. First, through the Department's normal audit resolution protocol, OCYF will review and follow up on the $23.2 million in Foster Care expenditures reported in Philadelphia's supplemental invoices when the OMB A-133 Single Audit of Philadelphia's child welfare program is completed. OCYF will review results to ensure proper follow up is performed on any audit findings or questioned costs identified and consider whether additional monitoring coverage of these costs is necessary.

Second, OCYF receives and reviews annual programmatic audits conducted by the Department of Auditor General (AG) of all county child welfare programs. These audits review allowability, reasonableness and necessity of costs and are acted on by OCYF in order to recover funds provided to subrecipient counties in violation of federal regulations, including duplicate billing.

Third, OCYF implements an extensive Quality Assurance Management program whereby on-site Title IV-E quality assurance reviews are conducted in all counties. These reviews verify that the eligibility file contains appropriate documentation to substantiate that the child meets eligibility for age, income, etc. These reviews include checking the child's age, income, resources, ongoing agency custody/responsibility, permanency planning, court order language, and whether the child was placed in a fully approved/licensed home. In addition, the review includes ensuring that the client remained eligible and reimbursable during the period invoiced by the county. Additionally, the Quality Assurance process requires that staff pull Title IV-E ineligible cases to ensure that ineligibility was correctly determined, and that these cases were not invoiced. Staff also pulls actual invoices to determine if claiming is correct, i.e., claims were eligible, allowable, and necessary.

Auditors' Conclusion: Based on the agency response, since DPW does not perform any additional monitoring, on-site or otherwise, of higher-risk supplemental invoices, 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 04 – 31:

CFDA #93.778 – Medical Assistance
CFDA #93.917 – HIV Formula Care Grants

Internal Control Weakness and Known Fraud Affecting Federal Awards at DPW

Condition: While conducting audit inquiries and reviewing other audit and investigative reports on fraud affecting federal awards at DPW, we learned about the following case reported in our current year that impacted drug procurements in the Medical Assistance and HIV Formula Care Grants programs at DPW:

- A Director of Pharmacy employee at DPW in the Office of Mental Health, Substance Abuse Services was found to be in violation of the Commonwealth's Ethics Act and Commonwealth procurement regulations for participating in the actions of a drug procurement committee in DPW on behalf of a pharmaceutical company on the state formulary while the individual had received inappropriate financial benefits from that pharmaceutical company. Placing drugs on the state formulary allowed the drugs to be procured on behalf of recipients of the MA and HIV programs. The final report on this case indicated that this inappropriate behavior occurred during a period of over three years from 1998 to 2002.

Our follow up inquiries on this case disclosed that DPW took reasonable corrective action after detecting this activity when they referred the case to the state Office of Inspector General, who in turn referred it to the state Attorney General for prosecution. In addition, after the official's inappropriate behavior was discovered, the individual was terminated from employment at DPW.

Because of the audit finding requirements in OMB Circular A-133, Section ___.510, we inquired with DPW officials about notifying HHS, the federal awarding agency for MA and HIV, about this case. We made this inquiry based on our conclusion that when federal funds are involved in known fraud, it is a prudent and reasonable practice to at least make the federal awarding agency aware of the case (unless clearly inconsequential) under the direct reporting requirements of GAGAS, even though state officials believed they conducted appropriate follow up on their own. DPW management stated that HHS was not made aware of this case since they believed DPW satisfied all their responsibilities by notifying the proper state authorities. When we requested that DPW submit a copy of the final report on this case to HHS (or the HHS OIG), DPW management refused, stating there was no requirement to do so. Therefore, in accordance with A-133, Section __.510, since no direct reporting occurred to the federal awarding agency outside of our audit, a Single Audit finding is required to be issued for known fraud reported in our current year which affected the MA and HIV programs.

Based on our review of the final report on this case, it appears there was an internal control weakness at DPW which allowed the inappropriate activity of this employee to go undetected for a significant length of time. However, in current-year Basic Financial Statement (BFS) Comment #04-10, we reported that it is Commonwealth management's policy to not provide auditors in the Department of the Auditor General with information and documentation to allow the auditors to properly test for compliance with state and federal procurement regulations. Management considers certain procurement information, such as the makeup and activities of agency procurement committees, along with their scoring sheets and evaluations of contract proposals, to be confidential in nature and not subject to Auditor General review. Because of this overall policy, we could not reasonably determine what, if any, remedial action was needed or implemented by DPW related to internal controls within its drug procurement committee(s) as a result of this case.

Criteria: OMB Circular A-133 Subpart E states, in part:

Section ___.510 Audit Findings.

(a) Audit findings reported. The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

Finding 04 – 31: (continued)

(6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.

The direct reporting requirements of GAGAS Chapter 5 Reporting Standards for Financial Audits state, in part:

5.21 GAGAS require auditors to report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties outside the audited entity in two circumstances, as discussed below.

5.22 The audited entity may be required by law or regulation to report certain fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to specified external parties, such as a federal inspector general or a state attorney general…

Cause: Our follow up review of the final report on this case disclosed that DPW officials were not aware of this high-level employee's inappropriate behavior for a significant length of time while the official was involved in the drug procurement process. DPW normally places reliance on employee ethics statements filed annually with the Department, which must disclose financial interests. Reliance on ethics statements filed by state officials on drug procurement committees without additional management oversight would be an internal control weakness within the procurement function for the MA and HIV programs. However, as explained above, because of management's policy of refusing to provide procurement information for us to properly conduct our audit, we could not determine why the inappropriate activity went undetected by DPW or whether a control weakness was present in this case.

In response to our inquiries about reporting this case to HHS, DPW officials indicated that they are not aware that instances of fraud, illegal acts, or abuse affecting federal programs are required to be reported to the federal OIG because there is no specific law or regulation clearly requiring grantees to report such matters to any federal agency. DPW officials further indicated they have no separate state policy in place for directly reporting known fraud involving federal funds to federal awarding agencies.

Effect: This case indicates a potential weakness in internal controls in DPW's drug procurement process which may result in future noncompliance with state and federal procurement regulations if not corrected. We could not definitively verify whether a weakness exists or if any remedial action was taken by DPW because of management's refusal to provide adequate procurement documents for our audit. DPW is not adhering to a practice of disclosing known fraud, illegal acts, or abuse in federal programs to the federal government and may not be reasonably adhering to the direct reporting requirements for known fraud in its federal programs.

Recommendation: DPW should ensure proper and timely management oversight of members of its procurement committee(s) to reasonably prevent conflicts of interest in the procurement of drugs for MA and HIV, and of other goods and services for all its federal programs. DPW should also review fraud reporting requirements for its federal programs and consider establishing and implementing a prudent practice of reporting instances of known fraud, illegal acts, or abuse in federal programs to the federal government (unless clearly inconsequential).

Agency Response: The DPW currently does take all prudent steps reasonably available to us to ensure proper and timely management oversight of members of its procurement committee(s) to prevent conflicts of interest in all of the programs we administer. In this case, the employee sidestepped normally effective monitoring safeguards by failing to disclose supplementary employment as required, and by failing to report outside income in two separate required reporting processes. We are not aware of any alternative approach that would have enabled us to more effectively provide oversight in this situation. There is no computer bank or other repository of information that would allow us, in advance of employee compliance with reporting requirements, to detect undisclosed supplementary employment, or undisclosed outside income. The Supplementary Employment Request policy and the Financial Disclosure policies can only be enforced through the administration of appropriate discipline when we find out ex post facto that an employee has violated one of these policies.

Finding 04 – 31: (continued)

We agree with the second part of the recommendation to the extent that we believe that we do need to carefully review fraud reporting requirements for federal programs to determine precisely what our obligations entail in this area. We have several open issues related to this that will require further analysis and review. To the best of our knowledge, we have never reported state employee misconduct to the federal government, nor have we ever previously been apprised that the U.S Department of Health and Human Services Office of Inspector General was interested in having us do so. Additionally, since almost all of our Pennsylvania DPW programs involve federal funding, we will have to determine what types of employee misconduct represent reportable fraud.

Regarding the description provided in the "**Condition**" section, we have a few points of clarification that we would like to offer. The paragraph below is not entirely accurate, and to that extent, it is unintentionally misleading regarding the final disposition of this matter:

- A Director of Pharmacy employee at DPW in the Office of Mental Health, Substance Abuse Services was found to be in violation of the Commonwealth's Ethics Act and Commonwealth procurement regulations for participating in the actions of a drug procurement committee in DPW on behalf of a pharmaceutical company on the state formulary while the individual had received inappropriate financial benefits from that pharmaceutical company. Placing drugs on the state formulary allowed the drugs to be procured on behalf of recipients of the MA and HIV programs. The final report on this case indicated that this inappropriate behavior occurred during a period of over three years from 1998 to 2002.

There was no final actionable finding issued by either the DPW or the State Ethics Commission that found the employee to be in violation of applicable procurement regulations. The employee was, in fact, only found guilty of specific violations of the Pennsylvania Public Official and Employee Ethics Act. As a result, he paid a fine in the amount of $27,268.50; his case was "referred to the Office of Attorney General with the Commission's recommendation for the review as to a criminal prosecution against the individual as to violations of the Ethics Act." (point 29. of Ethics Commission Order Number 1363); referred to the Pennsylvania Department of State, Bureau of Professional Occupational Affairs, State Board of Pharmacy for possible disciplinary action pursuant to applicable licensing regulations; and he was separated from employment via retirement "in lieu of discharge."

<u>Auditors' Conclusion</u>: Regarding management's comments on its oversight of procurement committee members, we acknowledge that monitoring safeguards may not always prevent inappropriate employee behavior and may, at times, be side stepped regardless of their effectiveness. However, as stated above, because of management's policy of withholding relevant information and documentation from us on the activities of its procurement committees, we cannot properly audit DPW's internal controls over these committee members and ascertain their effectiveness. So our finding does not change on this issue.

Regarding fraud reporting requirements, we concur with management's acknowledgement of its need to perform further analysis and review to ascertain the types of employee misconduct which should be reported to the federal government. However, regardless of management's responsibilities or actions taken on this issue, it should be noted that our Single Audit must follow OMB Circular A-133, Section ___.510(a)(6) and report known fraud effecting federal awards as a finding if not reported to a federal agency through other channels.

With regard to management's statement that there was no violation of procurement regulations, we concluded that the employee's conflict of interest violated the Commonwealth Procurement Code (Title 62 PA C.S.), Chapter 23, Subchapter A, Sections 2301 and 2302(a), which prohibit conflicts of interest by Commonwealth employees in the procurement of goods and services.

Therefore, our finding and recommendations, 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 04 – 32:

CFDA #93.778 – Medical Assistance

Internal Control Weaknesses in the Administration of the MA Program

Condition: Several weaknesses in internal controls were noted in our audit of the new PROMISe system implemented in the current year by DPW to process medical claims in the MA program. These weaknesses were reported by another auditor during an independent SAS #70 review of DPW's outside contractor who operates the new PROMISe system. These SAS #70 report weaknesses include the following:

- Controls have not been developed to validate that a periodic review of user access to the PROMISe environment is performed, researched and documented.
- Controls have not been implemented to ensure that firewall and other security logs are periodically reviewed and investigated.
- There is no formal documentation or written approval of application changes made outside of regularly scheduled biweekly releases.
- While the contractor performs a periodic review of individuals with card access to the PROMISe areas of its Camp Hill building, there is no evidence or documentation to support this review.
- The detailed logs of the job failures and actions taken to resolve each job failure were not consistently and completely maintained from April 13, 2004 to June 30, 2004.
- Off-site rotation of file backup tapes to a third-party offsite storage vendor for the adjudicated claim data were not taking place.
- Extracts of claims data and medical services questionnaires are to be sent to DPW on a weekly basis. However, during the period of March 1, 2004 to June 30, 2004, both reports were only sent one time rather than weekly.

In addition to the control weaknesses identified in the contractor SAS 70 report, it was noted that DPW did not perform testing of the User Control Considerations (UCC's) identified as DPW's responsibility in the SAS #70 report since the controls were not covered in the SAS #70 review during the audit period of July 1, 2003 – June 30, 2004. The SAS #70 Report UCC's included, for example, the Commonwealth's responsibility for proper controls over logical access, application changes, physical access, claims administration, managed care, and other MA program areas.

Criteria: The ITIL (IT Infrastructure Library) provides a framework of 'best practice' guidance for IT Service Management and is the most widely used and accepted approach to IT Service Management in the world. According to this framework, there are several best practice processes which should be in place to manage Service Delivery, Application Management, Security Management and Infrastructure Management.

The COBIT (Control Objective for Information Technology) published by the IT Governance Institute serves as a framework for IT governance, control and assurance. COBIT provides a set of 34 high-level control objectives, one for each of the IT processes, grouped into these four domains: planning and organization; acquisition and implementation; delivery and support; and monitoring.

Both of these framework documents provide specific criteria which, if followed, would resolve the above-mentioned conditions.

The OMB Circular A-133 Compliance Supplement, Part 4 for CFDA #93.778, Section II, related to ADP control systems, states:

The Medicaid program is highly dependent on extensive and complex computer systems that include controls for ensuring the proper payment of Medicaid benefits. States are required to establish a security plan for ADP systems that include policies and procedures to address: (1) physical security of ADP resources; (2) equipment security to protect equipment from theft and unauthorized use; (3) software and data security; (4) telecommunications security; (5) personnel security; (6) contingency plans to meet critical processing needs in the event of short- or long-term interruption of service; (7) emergency preparedness; and (8) designation of an agency ADP security manager.

Finding 04 – 32: (continued)

Commonwealth agencies must establish and maintain a program for conducting periodic risk analyses to ensure appropriate, cost effective safeguards are incorporated into new and existing systems. Commonwealth agencies must perform risk analyses whenever significant system changes occur. On a biennial basis Commonwealth agencies shall review the ADP system security of installations involved in the administration of HHS programs. At a minimum, the reviews shall include an evaluation of physical and data security operating procedures, and personnel practices.

Cause: On March 1, 2004, DPW's outside contractor implemented the new PROMISe system which replaced DPW's in-house MAMIS system. During this implementation, the contractor was focused on delivering the new system and ensuring that all claims processing now provided by the new PROMISe system was being completed. Therefore, while the contractor strives to ensure they meet all necessary control objectives in a SAS #70 review, the challenge of implementing the new PROMISe system was of primary concern. In regards to the testing of the UCC's by DPW, it was noted that there were insufficient resources allocated to address these items, and therefore, no testing of the UCC's was performed.

Effect: While the above-mentioned conditions, taken individually, may not pose serious risks, together they demonstrate a weakness in the documentation and monitoring processes in the MA environment. These weaknesses may allow a security breach to go unchecked, application updates to be performed without approval, or claims activity to not be reported in a timely manner. In addition, ineffective controls on the Commonwealth's deliverables to the contractor may allow for the processing of inaccurate data, and allows for the potential risk of improper transactions to occur without being noticed.

Recommendations:

We recommend that DPW ensure the contractor performs the following corrective actions related to the new PROMISe system:

- Implement a review of user access which would take place on at least a quarterly basis. The review process should require all users' access to be reviewed and validated by the users' immediate manager or supervisor. Further, this review should also be well documented to ensure that the control can be validated in the future.
- Conduct a daily review of all firewall and other security logs. All potential issues should be documented, investigated and resolved on a timely basis to ensure the security of the systems.
- Implement a formal process to ensure that there is written approval of all application changes. No changes should be released into production without formal approval from DPW.
- Implement a formal process to review all user access to the PROMISe area within the Camp Hill facility. This review process should be performed at least quarterly and documented for future review.
- Implement a formal process to ensure all job failures and the corresponding corrective action to correct the failures is noted and documented appropriately.
- Implement a formal process to ensure that backup media used to backup the stored adjudicated claim data are sent off-site daily to the Iron Mountain Data Protection facility.
- Implement a formal process to ensure extracts of claims data and medical services questionnaires are consistently sent on a weekly basis.

Also, DPW should perform an audit of the SAS #70 Report UCC's to validate that the controls are in place from the Commonwealth's perspective to ensure the accurate processing of data by the contractor within Pennsylvania's PROMISe application. Further, DPW should perform risk assessments and update them for PROMISe consistent with the ADP requirements for HHS programs.

Agency Response: The DPW, OMAP agrees with the finding and the recommendations to ensure that the contractor performs the corrective action related to the new PROMISe. See the below response:

- The contractor has implemented a quarterly review of user access to the PROMISe system. The contractor continues to perform daily reviews of firewalls and other security logs. The corrective action plan for the periodic review of user accounts began in September 2004 and will be done on-going on a quarterly basis.

Finding 04 – 32: (continued)

- In August 2004, the contractor implemented a formal process that ensures written DPW approval is obtained for all application changes.

- On September 14, 2004, the contractor began the formal process to review individual access to the PROMISe area in the Camp Hill facility. On-going reviews will be conducted on a quarterly basis.

- An automated system of job failures has been in place since PROMISe was implemented in March 2004, but documenting the corrective action was not done routinely. Corrective action was implemented in October 2004 to ensure job failures and related corrective actions are being timely documented.

- The contractor has implemented a formal process to backup stored adjudicated claim data and the backup files are sent daily to an off-site facility with Iron Mountain Data Protection. This process was implemented on July 7, 2004.

- Claims data extracts were sent to HMS beginning in November 2004. The backlog of medical services questionnaires was completed in October 2004.

Auditors' Conclusion: Based on our review of the agency response, DPW did not address the disclosures related to UCC's in the SAS #70 Report. Our finding and recommendation remain as stated above. 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 04 – 33:

CFDA #93.917 – HIV Formula Care Grants

Weaknesses in Internal Controls Over Eligibility Determinations Result in an Undetermined Amount of Questioned Costs Up To $20,792,266

Condition: Within the HIV Care Formula Grants program, federal regulations established an AIDS Drug Assistance Program (ADAP) earmark, in which funds are to be used to provide therapeutics to treat HIV disease or prevent the deterioration of health arising from HIV disease in eligible individuals. The amount of the ADAP earmark is provided within the annual grant award. Each year the DOH, as lead agency for the program, enters into an interagency agreement with DPW to administer the ADAP portion of the grant. This administration is the responsibility of DPW's Special Pharmaceutical Benefits Program (SPBP).

Whenever a person applies for ADAP assistance, they are required to submit to the SPBP a completed application and supporting documentation which includes proof of PA residence, a copy of their social security card, verification of income and copies of their HIV-related and other prescriptions for SPBP reimbursable drugs. The SPBP reviews all of the documents to determine if the applicant is eligible to receive benefits. It should be noted that, although not required by SPBP, certain applicants also submit a doctor's certification showing documented proof of diagnosis with HIV. Our inquiries of SPBP personnel and testing of a sample of 40 case files supporting $35,396 out of $20,792,266 charged to HIV ADAP in our current year disclosed the following results:

As detailed in the chart below, case files tested did not contain documents needed to verify proof of income, health insurance coverage noting prescription co-pays or percentage of coverage, or a signed statement from a medical doctor indicating a medical diagnosis of HIV disease.

Case Number	Date of Application	Proof of Income	Insurance Coverage and Co-Pay Documentation	Documentation Indicating a Diagnosis of HIV	Amount Of Drug Claims Paid	Dates of Service
SP1001247	8/7/90	Yes	No	No	$ 637	5/10/2004
SP1001456	10/6/01	Yes	Yes	No	$ 1,566	5/6/2004
SP1002257	*	*	*	*	$ 234	4/19/2004
SP1002611	5/20/92	Yes	Yes	No	$ 1,259	5/11/2004
SP1003003	2/8/93	Yes	Yes	No	$ 1,761	4/16/2004
SP1003107	3/9/93	Yes	Yes	No	$ 192	4/29/2004
SP1003419	10/15/98	Yes	No	No	$ 46	4/28/2004
SP1003477	11/5/93	Yes	Yes	No	$ 1,243	4/20&21/04
SP1003714	4/20/94	Yes	No	No	$ 1,315	5/3/2004
SP1003974	7/1/93	No	Yes	Yes	$ 1,011	4/27&29/04
SP1004326	5/22/95	Yes	Yes	No	$ 184	5/10/2004
SP1004559	10/20/95	Yes	Yes	No	$ 1,752	4/21/2004
SP1004792	3/15/96	Yes	Yes	No	$ 1,652	4/19/2004
SP1004878	4/17/96	Yes	No	No	$ 769	4/18&20/04
SP1004969	6/10/96	Yes	No	No	$ 1,566	5/11/2004
SP1005947	7/1/97	Yes	Yes	No	$ 1,409	5/11/2004
SP1006391	12/13/99	No	No	No	$ 4,073	5/3,4&5/04
SP1006721	3/2/98	Yes	No	No	$ 26	4/20,26 &28/04
SP1006815	4/10/98	Yes	No	No	$ 253	5/12/2004

Finding 04 – 33: (continued)

Case Number	Date of Application	Proof of Income	Insurance Coverage and Co-Pay Documentation	Documentation Indicating a Diagnosis of HIV	Amount Of Drug Claims Paid	Dates of Service
SP1006928	7/1/98	Yes	Yes	No	$ 1,055	5/7/2004
SP1007163	9/11/98	Yes	No	No	$ 727	5/3&4/04
SP1007212	10/1/98	Yes	No	No	$ 1,317	4/21/2004
SP1007502	1/6/00	Yes	Yes	No	$ 1,289	4/20/2004
SP1007737	5/22/99	Yes	No	No	$ 6	4/16/2004
SP1008928	11/21/00	Yes	Yes	No	$ 44	5/10/2004
SP1009577	9/28/01	Yes	Yes	No	$ 1,055	4/22/2004
SP1009680	11/16/01	Yes	No	No	$ 1,048	4/23/2004
SP1009828	1/23/02	Yes	Yes	No	$ 14	5/1/2004
SP1009893	2/20/02	Yes	No	No	$ 1,382	4/28/2004
SP1009935	3/14/02	Yes	No	No	$ 10	5/8/2004
SP1010379	10/8/02	Yes	Yes	No	$ 10	4/23/2004
SP1010427	10/30/02	No	No	No	$ 69	4/23/2004
SP1010428	10/30/02	Yes	No	No	$ 604	5/10/2004
SP1010607	2/5/03	Yes	No	No	$ 1,676	5/6/2004
SP1010690	3/6/03	Yes	No	No	$ 601	5/12/2004
SP1010845	3/12/03	Yes	No	No	$ 1,390	5/4/2004
SP1011087	8/14/03	Yes	No	Yes	$ 1,860	4/30/04&5/3/04
SP1011302	11/21/03	Yes	Yes	No	$ 163	4/29/2004
SP1011316	11/25/03	Yes	No	No	$ 107	4/30/2004
SP1011534	2/17/04	Yes	No	No	$ 18	5/5/2004
				Total Amount Tested	$ 35,396	

* No case file could be provided for this participant.

The SPBP does not have an annual re-certification process to support continued participant eligibility. Specifically, during our review of the 40 case files, although we noted "yes" in the above table for proof of income, we found that most of the participants had originally applied for and began to receive benefits many years ago, going back as far as 1990 without ever being re-certified as still eligible. We also noted that several participants' income was close to the $30,000 maximum allowable level for original eligibility, and that their application was several years old. As a result, DPW provided no assurance that these program participants remained eligible to receive benefits in the current year.

We also noted a major lack of documentation to support the HIV diagnosis for program participants. DPW stated that it relies on a self-certification within the SPBP application that the individual applicant is currently being treated for HIV/AIDS and on the types of prescription drugs being claimed to verify at least one of the prescriptions specifically relates to HIV treatment. However, we noted no documentation in the participant case files demonstrating DPW's review of specific HIV-related prescription drugs at the time of application. This lack of diagnosis documentation is even more significant considering the recent expansion in the number of HIV and non-HIV related drugs in this program. With all the different types of drugs allowed for this program, both HIV and non-HIV-related, DPW provided little documented assurance that program participants were properly diagnosed with HIV.

Finding 04 – 33: (continued)

We also noted a major weakness in documenting other insurance coverage in participant case files. Where we note "yes" in our table above, we verified that the application documented no other insurance coverage existed. However, where we indicated "no" in the table, we found that other insurance coverage was documented on the application, but no documentation was placed in the case file about what coverage existed, amounts of co-pays, or the amount that should be paid for through other insurance coverage and not the HIV program. As a result, we could not audit whether DPW was properly reducing HIV program costs for drugs where other insurance coverage was available.

Further, DPW uses a third party contractor to administer all pharmacy benefit claims for the HIV Formula Care grant. The primary oversight of the third party contractor is performed by the PA Department of Aging (PDA) since the same contractor administers the Pharmaceutical Assistance Contract for the Elderly (PACE) program, a state funded program at PDA. As part of our inquiry of the controls in place at DPW and PDA over this third party contractor, we found the following additional weaknesses.

While PDA obtained a GAGAS audit of the third party contractor, the audit was not an OMB Circular A-133 audit and the opinion is rendered on the receipts and disbursements taken as a whole. Since the HIV Formula Care grant funds less than 10 percent of the receipts and disbursements processed by the third party contractor, DPW cannot rely on the audit for proper coverage of HIV program pharmacy benefit claims administration.

While the PHHS Comptroller Office performs audits of pharmacies' claims reimbursed with PACE funds, no audits are performed on pharmacy claims reimbursed with HIV Formula Care grant funds.

As a result of the above noted lack of audit coverage of HIV Formula Care grant pharmacy benefit claims, the propriety of reimbursements to the third party contractor, and in turn to the pharmacies, cannot be assured.

Because of the lack of documentation in the HIV participant case files supporting eligibility, and the lack of audit coverage of the third party contractor and the participating pharmacies in the HIV program, DPW is not adequately documenting the eligibility and allowability of the drug portion of the HIV program as a whole in accordance with OMB Circular A-87, and there is an undetermined amount of questioned costs up to the $20,792,266 charged to HIV for the current year.

Criteria: Section 2616(a) and (b) of the Ryan White Comprehensive AIDS Resource Emergency Act of 1990 states:

SEC. 2616. Provision of Treatments.

(a) In General. – A State may use amounts provided under a grant awarded under this part to establish a program under section 2612(a)(4) to provide treatments that have been determined to prolong life or prevent the serious deterioration of health arising from HIV disease in eligible individuals.

(b) Eligible Individual. – To be eligible to receive assistance from a State under this section an individual shall—

(1) Have a medical diagnosis of HIV disease; and
(2) Be a low-income individual, as defined by the State.

The Special Pharmaceutical Benefits application establishes the income limits for low-income limits for low-income individuals as follows:

Eligibility for the SPBP is determined by the following criteria:

Income Limits: Individuals - $30,000 gross income per year
Families - $30,000 gross income per year, plus an allowance of $2,480 for each additional family member. (Example: family of two $32,480 combined gross; family of three $34,960 combined gross; etc.)

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In addition, good internal controls dictate that all documentation supporting the participant's eligibility such as a physicians certification and insurance information, be maintained within the participant's case file.

In addition, Section 6.2 of DDS Program Policy Guidance No. 6, issued by HHS, regarding eligibility for the ADAP portion of the HIV Care Formula Grants program states:

6.2 Eligibility

(a) The CARE Act indicates that ADAPs are to serve "low-income individuals," as defined by the States. The State's poverty criterion for ADAP eligibility should be based on Federal poverty guidelines.

(b) All States should devise, implement, and rigorously monitor the use of consistent eligibility standards across all entities involved in certifying and re-certifying ADAP eligibility. Such certification is expected to include review and documentation of an applicant's income from all sources and any pharmaceutical benefits derived from private health insurance or other sources.

(c) Every State should establish and implement procedures for ADAP client re-certification on a periodic basis, and for de-certifying individuals who qualify but have not utilized the program for a specific period of time (e.g., one year or longer). Re-certification procedures should include mechanisms to assure that individuals who have become eligible for Medicaid are transferred to the Medicaid program at the earliest possible date.

Cause: SPBP personnel indicated that they do a monthly comparison of Medical Assistance participants with DPW's CIS system to identify program participants who may have become eligible for drug coverage through MA. If any matches are found, the participants are removed from the SPBP roles so that they don't duplicate services. SPBP personnel indicated that they consider this process a re-certification to ensure participant eligibility. However, we concluded that this re-certification process is not reasonable to ensure that all of the participants receiving HIV benefits are eligible. Specifically, this approach would only be applied to MA participants within the program and would exclude non-MA participants receiving benefits. In addition, this approach is not consistent with other programs administered by DPW such as MA, TANF and LIHEAP in which annual re-certifications are performed to ensure that the program participants remain eligible to receive benefits.

With regard to not having documentation verifying that the participant was diagnosed with an HIV disease, and not having documentation identifying the participants' insurance coverage within the case file, SPBP personnel indicated that their procedures don't require the participants to submit this information with their applications. SPBP personnel indicated they determine if a person has HIV based on the participant prescriptions for drugs which are only used to treat HIV. SPBP agreed that it would be a good control to have this documentation maintained within the participant's files.

SPBP personnel indicated that insurance and co-pays are part of the third party pharmacy benefits manager's responsibility; therefore, copies of the insurance information was not maintained within the participant's case files or routinely monitored by DPW.

Regarding the audit of the pharmacy benefits manager and the lack of pharmacy audits, SPBP personnel indicated that they believed that either PDA or the PHHS Comptroller Office was addressing the audits and any questionable charges by pharmacies would be forwarded to them by PDA or the PHHS Comptroller Office.

Effect: Since SPBP does not perform annual re-certifications of the program participants, they are not in compliance with DSS Program Policy Guidance No 6. In addition, without performing a re-certification, DPW has little assurance that program participants receiving ADAP benefits remain eligible. Based on the number of participants receiving ADAP benefits (over 5,000) and the fact that there has never been a re-certification, we consider this to be a material weakness. In addition, since SPBP could not provide the case file for one participant, could not provide documentation supporting the participants income at the time of application for three participants, and did not require and/or maintain documentation evidencing a medical diagnosis of HIV for 37 of the 40 participants in our sample, SPBP has limited

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assurance that the participants are eligible to receive ADAP benefits. Also, since SPBP did not require and maintain documentation regarding the participants insurance coverage and/or co-pay for 22 of 40 sampled participants that indicated health insurance coverage, SPBP provides limited assurance that insurance information is correct on the applications and HIV costs are being properly reduced for other insurance coverage available.

Also, based on the lack of audit or monitoring coverage of HIV Formula Care grant pharmacy benefit claims of the third party contractor, and the lack of audits or monitoring of pharmacies, DPW cannot provide assurance on the propriety of pharmacy claims being paid.

As a result of not adequately documenting the allowability and eligibility of the drug portion of the HIV program as a whole, there is an undetermined amount of questioned costs for the current year under audit, up to $20,792,266.

Recommendation: SPBP should pursue appropriate settlement with HHS on the undetermined amount of current-year questioned costs, up to $20,792,266. Also, we recommend that DPW's SPBP implement an updated re-certification process to ensure that all program participants remain eligible to receive ADAP benefits. In addition, SPBP should implement procedures to ensure that adequate documentation supporting the participants' eligibility (i.e., proof of income, HIV diagnosis, etc.) and insurance coverage is maintained within the participant's case file. DPW should also ensure that proper auditing or monitoring is performed on the pharmacy benefits manager, and that an appropriate sample of HIV program claims are audited or tested at the benefits manager and at the pharmacies.

Agency Response: Response to the fourth paragraph:

The finding is correct in that there is currently no annual recertification process as it is perceived or implemented by other DPW/OMAP program offices. The Ryan White Emergency Care Act II (Health & Human Services (HHS)) recommends but does not mandate that Title II AIDS Drug Assistance Program (ADAP) implement an annual recertification process. However, to protect the fund from paying for duplicate services, a monthly match of SPBP clients against the Office of Income Maintenance's file and the Client Information System (CIS) identifies any Special Pharmaceutical Benefits Program (SPBP) client who might have transitioned to the regular Medical Assistance Program with a benefit package that includes drug coverage. The HHS views the process as recertification. The clients are requested to report a change of income and some clients do. The finding is correct; currently, there is no annual recertification process regarding the SPBP's eligibly criteria components of income and residence. The program office has had internal discussions regarding annual recertification, but has not implemented the initiative.

Response to the fifth paragraph:

This component of the draft finding is completely inaccurate and we disagree with this finding. We are attaching an SPBP HIV application. The application includes an attestation field to verify a diagnosis of HIV and must be signed by the applicant. We recognize that applicants may falsify the diagnosis in an attempt to access free medications. Every SPBP application includes a copy or copies of prescriptions for HIV specific medications or other acceptable documentation to verify a diagnosis of HIV/AIDS. These medications are not prescribed for other diseases or illnesses. The medications are approved by the Food and Drug Administration for the treatment of HIV/AIDS. Requesting this disease specific documentation is a quality assurance measure implemented by the program office staff. Therefore, we disagree with the finding that implies there is a major lack of documentation. Additionally, if a client's physician has not recommended the immediate use of an HIV pharmaceutical treatment regimen, and there are no HIV prescriptions with the application, the applicant must provide a statement from their physician, that the physician is treating the patient for a diagnosis of HIV/AIDS. The statement must be on the physician's letterhead or their prescription form. This process is recognized by the **HHS** as a quality management tool to ensure that the funding is being used appropriately. The **HHS** does not mandate the format, design or text of each state's AIDS Drug Program application, but does recognize that Pennsylvania's medical criteria is appropriate to identify clients with a diagnosis of HIV/AIDS. The **HHS** concurs that copies of prescriptions for HIV specific medications are legitimate and appropriate justification to show medical need for drugs covered under the SPBP's HIV/AIDS Baseline and Tiers formularies.

Finding 04 – 33: (continued)

The physical document(s), the prescription, and the name(s) of the drugs written on the prescription or a letter from the prescribing physician attesting that the physician has diagnosed the applicant with HIV/AIDS, or a print out from the pharmacy showing the patient is using HIV specific medications, are acceptable documentation that the client has a medical need for SPBP and meets that medical component of the criteria (i.e., the name of the drug clearly proves the client has a diagnosis of HIV/AIDS).

Every SPBP application **must** provide supporting documentation that shows the client meets the established eligibility criteria. Sometimes a client or caseworker will shrink the documents and photocopy everything on one or two sheets. It may appear to an auditor that not all of the documentation is included in the client's file if they are looking for individual documents for each element.

The below criteria is reviewed to determine eligibility for the SPBP:

Place of residence
Social Security number
Proof of income
Prescriptions or Dr.'s letterhead with diagnosis or pharmacy list of prescriptions dispensed to that client.

If any of these four supporting documents are missing, the application is put into a pending status until the missing documents are received.

Applicants who do not submit the missing documentation are not granted eligibility.

Response to paragraph six:

The program office disagrees with the way it is described. If an SPBP client has third party coverage, they are asked to indicate the name of the carrier on the application and indicate if the policy includes drug coverage and the percentage that is covered. Some clients do have third party insurance that does **not** cover medications. Some clients have third party coverage that **does** cover medications. This information is entered on the clients online file. Providers sign legal contracts to acknowledge that the SPBP is the payer of last resort and where third party insurance exists, it must be billed first. Additionally, clients are forewarned that if they do have third party insurance and do not disclose the information to the program and provider, they are in potential jeopardy of losing benefits. Please note that carrying a third party insurance policy is not eligibility criteria. The hard copy files would not show that the appropriate third party coverage was being reduced in the claims process. That data appears in the claims processing reports provided by our claims processing contractor, First Health Services Corporation.

Response to the weaknesses pertaining to paragraph seven:

The third party contractor is a for-profit entity.

Under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations Subpart B--Audits §___.210, Subrecipient and vendor determinations. (e) For-profit subrecipient.* "Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipients compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits."

Response to the eighth paragraph:

In addition to the Generally Accepted Government Auditing Standards audit of the third party contractor, the DPW relies on the proper coverage for claims administration through weekly reports submitted to DPW office of the Budget from First Health Services.

Finding 04 – 33: (continued)

Response to the ninth paragraph:

We disagree with the statement that no audits are performed on pharmacy claims reimbursed with HIV Formula Care grant funds. It is our understanding that Pharmaceutical Assistance Contract for the Elderly (PACE) pharmacy audits includes PACE, SPBP, and the Department of Health Chronic Renal Drug Program claims.

Response to the tenth paragraph:

The DPW Office of the Budget receives a weekly claims report to ensure the appropriateness of reimbursement to the pharmacies.

Response to the eleventh paragraph:

We completely disagree with the finding regarding eligibility documentation. The SPBP does not approve any application unless the application and supporting documentation meet the eligibility requirements. The clients who fail to provide appropriate documentation are denied eligibility. We can provide reports indicating clients who have been denied because they do not meet or have not provided eligibility documentation. The finding that the program does not adequately document eligibility is erroneous and false. The auditors should have kept in mind that the Mental Health component of the program, which is State-funded only, has different application requirements and should not have held the State-funded program against the federally-funded HIV component.

Lastly, based upon our disagreement with this finding, we urge at least the elimination of the $20.8 million of the questioned cost, in its entirety.

Auditors' Conclusion: Regarding re-certification, we believe that key components of eligibility such as income and residence, along with pharmaceutical benefits derived from private health insurance or other sources, should be updated on a regular basis to ensure all program participants remain eligible and all costs allowable. Our finding and recommendation do not change in this regard.

Based on the agency response to the fifth paragraph, we acknowledge DPW's statement about self-certification and we added to our condition that individuals self certify within the SPBP application that the applicant is currently being treated for HIV/AIDS. It should be noted, of course, that participant self-certification alone, without other appropriate documentation in the case file, is not adequate to support eligibility.

Regarding DPW's procedure of verifying at least one prescription for HIV-specific medications to support the diagnosis of HIV/AIDS, we found there was no listing or indication of what drugs are considered by DPW to be HIV/AIDS-specific drugs on DPW's application reviewer checklist to verify the diagnosis of HIV/AIDS, nor was there any notation in any of the case files we reviewed to demonstrate this eligibility verification was performed by DPW. Furthermore, we noted that many participants receive multiple prescriptions with HIV funds, which are clearly not to specifically treat HIV/AIDS. Also, certain drugs that are HIV-related may also be used to treat diseases other than HIV/AIDS. As a result, we noted an overall lack of documentation maintained by DPW to properly support eligibility and DPW's review of eligibility. DPW needs to improve its standard eligibility documentation procedures, including either physician certifications and/or other clear documentation (e.g., outside desk references, notations, etc. in case files) supporting the diagnosis of HIV/AIDS for each client.

Regarding the documentation of third party insurance coverage, either DPW must maintain such insurance documentation to support its review and appropriate follow-up on third party liability coverage, or DPW must ensure proper audit coverage of this within the audit of the third party pharmacy benefits claims processor. DPW provided no evidence to demonstrate that either of these activities was occurring.

Regarding the audit requirements applicable to the third party pharmacy claims processor, while an audit of a for-profit subrecipient is not specifically required as noted in section 210 (e) of OMB Circular A-133, methods to ensure compliance should include pre-award audits, monitoring during the contract, and post-award audits. Since DPW

Finding 04 – 33: (continued)

indicated an audit of the third party pharmacy benefits claims processor was relied upon to ensure contractor compliance with federal award requirements, we reviewed this audit to ensure appropriate coverage of the HIV program and noted that the audit is performed on the receipts and disbursements taken as a whole. Since the HIV Formula Care grant funds less than 10 percent of the total receipts and disbursements processed by the third party contractor, we do not agree that DPW can rely on the audit for proper coverage of HIV program pharmacy benefit claims administration without additional oversight. The weekly reports received by the DPW Office of the Budget do not support the pharmacy claims processor's compliance with federal award requirements since the DPW Office of the Budget does not obtain any supporting documentation from pharmacies to support their billing and does not perform any testing or recalculation of the accuracy of third party insurance reimbursements. Further, our inquiries and testwork disclosed that no HIV Formula Care SPBP pharmacy claims are included in PHHS Comptroller audits of pharmacies. Finally, we noted during our audit that DPW HIV program personnel were not aware of this lack of HIV program audit coverage at the claims processor and at participating pharmacies since they did not perform adequate review, inquiry, and follow up procedures to ensure the HIV program was properly covered in these audits.

Given the lack of income-eligibility re-certification, the weaknesses in documenting the diagnosis of HIV/AIDS, and the lack of proper audit or monitoring coverage of the third party pharmacy claims processor and the dispensing pharmacies, we believe material weaknesses are present which result in an undetermined amount of questioned costs up to the $20.8 million charged to the ADAP portion of the HIV program.

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 04 – 34

CFDA #93.959 – Block Grants for Prevention and Treatment of Substance Abuse

DOH Did Not Meet Maintenance Of Effort Requirements For State Expenditures Resulting in Questioned Costs of $230,000

Condition: Our audit of maintenance of effort requirements for the SAPT Program for FYE June 30, 2004 disclosed that DOH did not maintain state expenditures for substance abuse at the required level. The Commonwealth is required to maintain state expenditures at a level not less than the average level of such expenditures for the two state fiscal years preceding the current fiscal year. State expenditures for FYE June 30, 2002 and June 30, 2003 were $42,336,000 and $42,076,000, respectively. Therefore, the Commonwealth is required to maintain state expenditures for substance abuse at a level not less than $42,206,000 for FYE June 30, 2004. However, DOH had state expenditures amounting to only $41,976,000 for FYE June 30, 2004, or $230,000 less than the required level.

Criteria: In regard to maintenance of effort of state expenditures 45 CFR Section 96.134 states, in part:

(a) With respect to the principal agency of a State for carrying out authorized activities, the agency shall for each fiscal year maintain aggregate State expenditures by the principal agency for authorized activities at a level that is not less than the average level of such expenditures maintained by the State for the two year period preceding the fiscal year for which the State is applying for the grant.

(c) In making a Block Grant to a State for a fiscal year, the Secretary shall make a determination of whether, for the previous fiscal year or years, the State maintained material compliance with any agreement made under paragraph (a) of this section. If the Secretary determines that a State has failed to maintain such compliance, the Secretary shall reduce the amount of the allotment for the State for the fiscal year for which the grant is being made by an amount equal to the amount constituting such failure for the previous fiscal year.

Cause: DOH prepares a spreadsheet to monitor state expenditure levels for substance abuse and did show on their spreadsheet that expenditures for FYE June 30, 2004 were lower than the average expenditures of the two preceding years. DOH management stated that the reasons the required maintenance of effort level was not achieved for FYE June 30, 2004 was that: (1) during FYE June 30, 2002, DOH received $350,000 in non-recurring allocations from a one-time legislative initiative, increasing the required maintenance of effort level for FYE June 30, 2004, and (2) expenditures in the state stores fund decreased by $238,000 from FYE June 30, 2003 to FYE June 30, 2004.

Effect: DOH was not in compliance with federal maintenance of effort requirements for the SAPT Program for FYE June 30, 2004. Costs of $230,000 are questioned.

Recommendation: We recommend that DOH ensure that the required level of state expenditures for substance abuse be maintained in order to be in compliance with federal maintenance of effort requirements for the SAPT Program. In addition, DOH should resolve questioned costs with HHS.

Agency Response: DOH concurs with the finding as issued by the Auditor General's Office. This finding cites DOH failure to meet the Maintenance of Effort (MOE) requirement as defined in 45 CFR Section 96.134 for state fiscal year ending June 30, 2004. The condition states that in order for the MOE to be met, an expenditure of $42,206,000 was required and that only $41,976,000 of expenditures were realized. This resulted in a $230,000 shortfall in expenditures to maintain the MOE, thereby, resulting in the same amount in questioned costs under this finding.

DOH agrees with the recommendation forwarded by the Auditor General's office to the extent that the agency has the ability to control the level of appropriations and the resulting level of expenditures. The current MOE for receipt of SAPT Block Grant funding is comprised of two appropriations. The first is general tax revenues appropriated under Appropriation 10-653 as part of the Governor's Budget. The second appropriation included in the MOE is captured under Appropriation 20-105 and is equal to two per centum of the annual profits realized from the sale of liquor and

Finding 04 – 34: (continued)

alcohol in the Commonwealth and transferred to DOH from the State Stores Fund. Although these funds are part of the budget process and appropriated under the Appropriation Legislation, the final amount for this appropriation in a given year is dependent on the level of sales for liquor and alcohol through the State Stores. It is therefore more difficult to control the final expenditure level for the MOE as a result of this.

It should be noted that funding budgeted by DOH was sufficient to cover the MOE. If the revenue received from the annual profits of liquor and alcohol sales were equal to the amount budgeted and anticipated based on prior year sales, the MOE requirement would have been met.

DOH, through BDAP, will contact the Substance Abuse and Mental Health Services Administration to resolve issues related to the MOE. Specifically, BDAP will seek to remove the $350,000 in non-recurring allocations from the formula used to calculate the MOE. BDAP will also address the remaining deficiency in funding related to State Fiscal Year 2003/04 for meeting this requirement.

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 04 – 35:

CFDA #96.001 – Social Security – Disability Insurance

Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs

Condition: During the state fiscal year ended June 30, 2004, the Bureau of Disability Determination (BDD) incurred personnel expenditures of $28,142,000 in salaries and $10,311,000 in fringe benefits, or $38,453,000 in total for the SS-DI program. BDD employees charging personnel costs to SS-DI work solely on SS-DI-related activities, and their salaries and benefits are charged 100 percent to SS-DI and, therefore, do not maintain timesheets as supporting documentation. Certain central service employees (i.e. Information Technology, Bureau of Financial Management, etc.) also charge time to the SS-DI program, but these employees maintain certified timesheets to support their time since they do not work solely on this program.

Based on our audit inquiries, sampling of transactions, and review of job descriptions supporting the BDD employees charged 100 percent, we found the documented grant activities of BDD personnel to be allowable under SS-DI. However, although we determined BDD's activities to be allowable, we noted that BDD was not maintaining updated documentation required by a provision in OMB Circular A-87 for personnel costs. Specifically, BDD was not obtaining signed semi-annual updates to its job descriptions (or any other semi-annual certification documents) on file to re-certify, that the respective employees worked solely on the SS-DI program during the audit period.

Criteria: OMB Circular A-87, Attachment B, Section 8(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: BDD personnel indicated that they maintain job descriptions, updated yearly rather than semi-annually, detailing the respective employees' job duties for the employees charging 100 percent of their personnel costs to the SS-DI program. BDD personnel noted there are typically no major changes to its employees' SS-DI responsibilities from year to year, so an annual re-certification is a reasonable timeframe. In addition, BDD personnel noted that they submit the SSA-4514 Report, *Time Report of Personnel Services*, to SSA on a quarterly basis to account for and report employee time. BDD personnel believed these procedures were sufficient and they were not aware of the OMB Circular A-87 requirement to obtain updated certifications on a semi-annual basis. However, since the job descriptions are not updated on a semi-annual basis and the SSA-4514 Report does not provide a certification of the work performed by each employee, these procedures are not timely or sufficient to satisfy the requirement in OMB Circular A-87.

Effect: Although our audit determined SS-DI personnel costs to be allowable for the program, BDD's signed job descriptions or other certification documents are not timely updated on a semi-annual basis for 100 percent-charged employees. Therefore, BDD is not in compliance with a significant documentation requirement in OMB Circular A-87.

Recommendation: BDD management should strengthen internal controls to ensure that all personnel costs charged to the SS-DI program for employees doing SS-DI-related work are more timely documented in accordance with the semi-annual certification provision in OMB Circular A-87.

Agency Response: BDD disagrees with this finding and maintains that current procedures, including quarterly time reporting, are sufficient to satisfy all requirements under OMB Circular A-87.

Finding 04 – 35: (continued)

OMB Circular A-87, Attachment B, Section 8(h) 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."*

Circular A-87 does not describe what form the periodic certifications must take to meet this requirement. BDD maintains that the preparation and submission of the SSA-4514 meets and exceeds the requirement set forth in Circular A-87, Attachment B, Section 8(h).

The SSA-4514 is the quarterly Time Report of Personnel Services for Disability Determination Services. This report is used to reflect the total hours worked by all personnel engaged in the SSA-DI program by quarter. Supporting documentation for this report includes a breakdown by employee of On Duty Time, Overtime, Time Not on Payroll, Paid Leave and Unpaid Leave. Paper leave slips are also maintained to support the leave requests, and these leave slips are approved by appropriate supervisory personnel. All time reported on the SSA-4514 is reviewed by the appropriate Branch administration and final SSA-4514's are signed by the Director of BDD.

The auditors assert that the SSA-4514 Report "does not provide a certification of the work performed by each employee." This is not required by Circular A-87. Circular A-87 requires only that the charges for the employees' salaries and wages be supported by a certification that the employees worked solely on the SSA-DI program for the period covered by the certification. The instructions for the SSA-4514 quarterly report state that On Duty Hours "…should reflect hours worked during the report period by all personnel engaged in the SSA disability program." The SSA-4514 instructions further state that "…The entries should represent only personnel who worked full-time on SSA disability program work." Therefore, preparation and submission of the SSA-4514 certifies that the employees whose time is represented on the SSA-4514, in this case all BDD personnel, worked solely for the SSA-DI program during that quarter.

Additionally, SSA OIG conducted an audit of BDD including evaluating internal controls over the accounting and reporting of the administrative costs claimed for the period October 1, 2001 through September 30, 2003. Extensive evaluation was conducted relative to support of salaries and wages as set forth in Circular A-87. The draft findings of May 20, 2005 note no deficiencies relative to the certification required in Circular A-87. BDD maintains that no deficiency was noted because all requirements of Circular A-87 are satisfied under the procedures currently in place. For the auditors to add additional documentation not required by SSA would be duplicative and burdensome to the Bureau, and ultimately is not necessary to meet the provisions of Circular A-87.

Auditors' Conclusion: While we acknowledge management's contention that its submission of the 4514 Report to SSA meets the requirement in OMB A-87 quoted above, we do not agree that it clearly resolves the finding. Semi-annual certifications signed by the employee or a supervisor with first-hand knowledge of the employee's work are required, and the 4514 signature process does not clearly demonstrate the applicable supervisory officials' first-hand knowledge of all employee work performed, as required by A-87. The fact that the SSA OIG did not report this specific issue in its recent program audit of BDD does not, by itself, resolve the potential noncompliance with A-87, which we are required to report in our Single Audit. Furthermore, since the OIG audit report is only in draft form and has not been issued yet, BDD did not allow us to review the report, so we could not confirm its contents as part of our Single Audit.

We believe the federal awarding agency needs to conclude on BDD's compliance with the above A-87 provision during the audit finding resolution process. 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 04 – 36:

CFDA #66.468 – Capitalization Grants for Drinking Water State Revolving Funds
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 #93.658 – Foster Care
CFDA #93.778 – Medical Assistance Program
CFDA Various – Various Major Programs

OB Did Not Have Adequate Procedures in Place to Ensure the Accuracy of the Subrecipient Audit Universe

Condition: The Commonwealth's OB and IES are responsible for the compilation of a centralized subrecipient universe listing which is used to track and ensure that subrecipients receiving over $300,000 in federal awards from the Commonwealth have audits performed in accordance with OMB Circular A-133 and submit those audits to the Commonwealth.

Our testing of the SFYE June 30, 2003 subrecipient universe which was used by OB-BOA to identify subrecipients who were required to submit audit reports to the Commonwealth during SFYE June 30, 2004 disclosed that material amounts of subgranted expenditures were erroneously excluded from the subrecipient universe for the following major Federal programs:

Major Program/ CFDA Number	Subgranted Expenditures per SFYE 6-30-03 Subrecipient Universe	Subgranted Expenditures per SFYE 6-30-03 SEFA	Subrecipient Universe Understatement
TANF #93.558	$ 395,826,951	$ 434,769,781	$ (38,942,830)
CCDF Cluster #93.575 and #93.596	210,533,693	229,644,799	(19,111,106)
Foster Care #93.658	322,331,222	331,239,761	(8,908,539)
MA Program #93.778	186,572,930	603,040,246	(416,467,316)
DWSRF #66.468	9,249,081	14,527,951	(5,278,870)
Total	$1,124,513,877	$1,613,222,538	$(488,708,661)

Although OB had procedures in place to collect and accumulate subrecipient payment data from the various Commonwealth agencies for their numerous federal programs, the procedures were not adequate to ensure that the SFYE June 30, 2003 subrecipient universe was complete and accurate.

Criteria: OMB Circular A-133, Subpart D, Section 400, states:

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.

Finding 04 – 36: (continued)

In order to fulfill the responsibilities of OMB Circular A-133 above, OB and IES should have adequate procedures in place to generate a reliable and accurate subrecipient universe. An adequate internal control structure is necessary to achieve this objective.

Cause: DPW expenditures were posted on the Commonwealth's ICS accounting system from July 1, 2002 until December 31, 2002, after which time DPW expenditures were posted on the Commonwealth's newly-implemented SAP accounting system. OB personnel stated that MA expenditures in the amount of $409,076,303 were erroneously posted to CFDA #0.001 as part of the conversion process from ICS to SAP. Since the subrecipient universe query only included CFDA numbers from #1.000 through #99.999, these MA expenditures were not included in the subrecipient universe.

Additional DPW expenditures posted on ICS between July 1, 2002 and December 31, 2002 for the MA, TANF, CCDF Cluster, Foster Care, and other DPW non-major programs in the amount of $81,308,913 were processed by IES through OB's separate Progress database in order to interface the database with SAP and generate the subrecipient universe query in SAP. IES posted the expenditures to an incorrect SAP document type (ZN) and the wrong posting period. In order to correct the posting period, IES reversed the data which was initially loaded and reloaded the entire data file. The data was reversed with a different SAP document type (KA). The ZN document type was excluded from, and the KA document type was included in the SAP query which produced the subrecipient universe. Since the KA document type posted negative amounts to the subrecipient payment general ledger accounts, these negative postings caused the subrecipient universe amounts to be understated by $81,308,913. This understatement of the subrecipient universe remained undetected until identified by the auditor.

OB personnel stated that the DWSRF understatement (and other smaller dollar misstatements) in the subrecipient universe were due to Comptroller Office personnel not following the established process for posting subrecipient refunds and adjustment documents. Subrecipient refunds and adjustment documents which are not posted to specific subrecipient codes in SAP are erroneously excluded from the subrecipient universe, since the subrecipient universe query parameters do not include refunds and adjustment items which are not associated with a subrecipient number. In addition, OB stated that differences also occur due to subgranted expenditures not always being posted to the correct general ledger account or SAP fund, which may have resulted in subgranted expenditures being erroneously excluded from the subrecipient universe.

OB did not have adequate review, reconciliation, and follow-up procedures in place for the SFYE June 30, 2003 subrecipient universe which should have detected and corrected the above errors in order to ensure the completeness and accuracy of the subrecipient universe. In addition, OB did not have adequate procedures in place to generate subrecipient universe exception reports and to investigate and follow up on exceptions in order to ensure the completeness and accuracy of the subrecipient universe.

Effect: Our testing of the accuracy of the June 30, 2003 subrecipient universe by major program disclosed that the universe excluded material amounts of subgranted funds for five major programs. Although the universe was not materially correct and did not include all the subgranted funds for the federal programs noted above, procedures performed by BFM and BOA subsequent to the auditor's inquiry disclosed that all subgrantees which were required to submit A-133 audit reports to the Commonwealth for those major programs did in fact submit audit reports to the Commonwealth. Therefore, for the current audit period, Commonwealth compliance with OMB Circular A-133 was not affected by these weaknesses in subrecipient universe development. However, the lack of adequate reconciliation and follow-up procedures could result in significant unaudited dollars not being detected and followed up by OB in future periods if not corrected.

Recommendation: OB and IES need to implement procedures to review and reconcile the subrecipient universe to the Commonwealth's SAP accounting system and the SEFA, and investigate and follow-up on differences to ensure that the subrecipient universe is reliable and accurate. OB and IES need to develop subrecipient universe exception reports and implement procedures to investigate exception transactions including accounting adjustments and refunds which were not posted to the accounting system with a subrecipient number in order to identify whether they should be included in the subrecipient universe.

Finding 04 – 36: (continued)

Agency Response: The Office of the Budget (OB) was aware of the discrepancies caused by the erroneous postings to CFDA #0.001 for the $409,076,303 in MA expenditures. OB elected not to adjust the universe for these expenditures because the payments were made to counties and county-related entities that were over the threshold for requiring an A-133 audit and already included in the universe follow-up procedures.

The discrepancies of $81,308,913 were caused by the ICS to SAP conversion performed by IES. This was a one-time process and therefore will not impact future subrecipient universes.

OB took the following actions to ensure discrepancies would be identified and corrected for future subrecipient universes:

OB has reinforced the established process for posting subrecipient refund and adjustment documents to ensure that such items are not excluded from the subrecipient universe. In addition, OB has provided additional instructions to Comptroller Offices on using the proper procedures.

OB began development of reconciliation procedures between the BW subrecipient universe and the R3 general ledger balances during fiscal year 2003. Beginning fiscal year 2004, the Comptroller Offices are following up on all discrepancies prior to BOA initiating the universe process. OB is also developing reconciliation procedures between the BW Subrecipient Universe and the SEFA. OB issued a remedy ticket to IES to develop exception reports. Until then, exceptions must be identified manually through the reconciliation process.

We feel that these actions will serve to prevent these discrepancies in future subrecipient universes.

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 04 – 37:

CFDA #Various – All Major Programs Covered by CMIA

Weaknesses in Cash Management System Cause Noncompliance With CMIA and at Least a $624,042 Understatement of the CMIA Interest Liability (A Similar Condition Was Noted in Prior Year Finding #03-29 and #03-30)

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 at the time) 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, 2004:

- The Commonwealth did not reconcile expenditure totals from the check clearance study (BFM Report 833) to the ICS general ledger in 1999 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, 2004 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 decommissioning ICS with a 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 July 1, 2003, Federal grants comprising most of 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 did not occur until after January 2004.

Also, the interest liability on the CMIA Annual Report for SFYE June 30, 2003 which was submitted to the U.S. Treasury during our audit period SFYE June 30, 2004, was misstated by a minimum of $624,042 as follows:

Finding 04 – 37: (continued)

- Within the Medical Assistance program, DPW's MAMIS and PROMISe systems processed 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 $53,931,461 at June 30, 2003, with a carry-forward balance from the prior fiscal year of $40,620,331. 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 of amounts paid to school districts. As a result, assuming the average balance in the account was $47,275,896 during the June 30, 2003 fiscal year, the state's interest liability was understated by an estimated $624,042. We also found that the excess cash in this account had grown to $55.9 million as of June 30, 2004, so additional CMIA interest is owed for SFYE June 30, 2004 to be remitted during SFYE June 30, 2005.

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:

- Excess cash on hand can result due to the rejection of payment invoices by the PA Department of Treasury if timely adjustments are not made and 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 adjustments immediately and not subject them to a draw delay, not posting adjustments to the Commonwealth accounting system on a timely basis will result in unrecognized interest liabilities.

- 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 on SAP as interest generating transactions. Therefore, an interest liability is not assessed by CDS, and the Commonwealth interest liability appears to be understated as a result. Although our review of revenues drawn and posted to major program accounts on SAP did not disclose any current year revenue collected in advance, our review of federal revenue collected in advance accounts at year-end in the Department of Corrections, Department of Health, State Police, Department of Conservation and Natural Resources and the Executive Offices disclosed unexplained excess federal funds collected in advance for non-covered programs. While interest is not due for federal cash on hand in non-covered programs, this appears to be a violation of federal cash management regulations. In addition, with regard to revenue collected in advance at DPW, the year-end balance of this account (which is net of Medicare Services not considered federal financial assistance) has rapidly grown over the past three years as follows:

As of	Balance
June 30, 2002	$ 48,377,192
June 30, 2003	$153,274,939
June 30, 2004	$183,644,890

A further breakout of total balances by DPW federal program at June 30, 2004 and at June 30, 2003 is as follows:

Program	June 30, 2004	June 30, 2003	Change
SSBG	$ 1,838,764	$ 2,139,057	$ (300,293)
MA	107,026,071	93,800,000	13,226,071
Food Stamps	57,305,861	47,107,205	10,198,656
LIHEAP	2,842,994	0	2,842,994
CSE	4,577,968	2,900,000	1,677,968
Cash Grants (MA, TANF, Food Stamps)	9,953,463	6,522,000	3,431,463
Other	99,769	806,677	(706,908)
Total	$183,644,890	$153,274,939	$30,369,951

Finding 04 – 37: (continued)

All the above programs, except the "other" category, are covered programs under the Treasury-State Agreement and, thereby, appear to owe interest to the U.S. Treasury. Based on the average year-end balances listed above at the current CMIA interest rate, the estimated amount of interest owed to the U.S. Treasury could potentially range from over $1.3 million for SFYE June 30, 2003 to over $2 million for SFYE June 30, 2004. However, since DPW does not perform any analysis of the transactions posted into and out of its collected-in-advance account for CMIA interest impact, DPW cannot adequately explain or support the source of this excess revenue on the SAP system and the interest owed on this excess revenue at year-end cannot be determined in our audit.

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:

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.

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 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.

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.

Finding 04 – 37: (continued)

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 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 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 in 1999, 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 had 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.

Regarding the posting of adjustments causing unrecognized interest liabilities, BFM personnel have indicated that this issue is not significant. Also, the issue of Treasury rejecting payments is outside the control of BFM and is an inherent limitation within the CDS system because the draw delay is based on general ledger postings and not check issuance. Therefore, when Treasury rejects paying an invoice, excess cash can result under the current system.

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 noted, the Commonwealth is not in compliance with the CMIA regulations and procedures for clearance pattern requirements and for the interest calculation in the CMIA Annual Report as stated in 31 CFR 205.

The state and federal interest liability amounts reported on the CMIA Annual Report for SFYE June 30, 2003 are not accurate. Our testing disclosed a minimum of $624,042 in understatements in the state interest liability to the federal government. Further testing of DPW's federal revenue collected in advance accounts at year-end disclosed additional potential interest owed the federal government that could not be determined in our audit, but could range from over $1.3 million for SFYE June 30, 2003 to over $2 million for SFYE June 30, 2004.

Finding 04 – 37: (continued)

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.

Also, various transactions that create interest liabilities, such as adjustment transactions, cancelled payments, 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 further understated by an undetermined amount.

Recommendation: For future audit periods, we recommend BFM personnel implement a system to ensure that 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 CMIA-covered programs and report and remit this additional interest liability to the U.S. Treasury.

Also, 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, 2003 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:

Check Clearance Study:

- At the time the check clearance study was performed, the CFDA numbers were not on VTs or checks, therefore we identified the VTs paid from appropriations that were linked to a CFDA number. The Treasury Department could link only one appropriation to one VT because the checks cleared were not identified to an appropriation.

  Treasury must assign the entire VT to the first appropriation that matched 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 perform 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.

  A new check clearance study is underway and will identify all VTs and SAP payments for a specific CFDA. This should alleviate the concerns identified in this portion of the finding.

- We have noted the differences between the clearance study posting dates and the actual ICS posting dates. This will not occur under the new check clearance study.

- For payroll in CFDA No. 20.205, the Commonwealth historically selected appropriations that contained payments to CFDA No. 20.205. The new check clearance study is underway and will identify all VTs and payments for CFDA No. 20.205. A separate check clearance pattern is not required for payroll; the check clearance study is based on all expenditures for a program. For this reason, it is appropriate that we continue to include payroll costs in our study.

Finding 04 – 37: (continued)

Medical Access Program:

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.

Based on the claims submitted for valid MA eligible expenditures incurred by the LEAs, DPW pays PDE on behalf of the LEAs and draws down the funds in accordance with the Treasury State Agreement and MA program guidelines. 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 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.

Various Weaknesses:

- 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 Correction Vouchers (CVs) and Expenditure Adjustments (EAs) immediately, thus alleviating this problem.

- The final section of the finding is related to “Federal Revenue Collected in Advance” (RCIA). In response to the RCIA related to DPW’s major programs, the Commonwealth does not transfer any “Federal drawdown” to RCIA. Any revenue which 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.

  For example, DPW is mandated to make payments but does not have sufficient spending authorization in the federal appropriation. The department processes payments against the grant and funds are drawn based on the CDS files. Since there is not sufficient appropriation balance in the federal appropriation, an expenditure adjustment is done outside of the grant accounting system to move the expenditure from the federal appropriation to a ledger 5 appropriation, with approval from the budget office. This corrects the negative available balance in the federal appropriation, however the revenue remains in the appropriation that was drawn based on the original expenditure posted to the grant’s federal fund. Fiscal year end closing policy does not allow for more cash in the appropriation than the total commitments and expenditures, therefore cash must be transferred out and placed in RCIA until a supplemental appropriation is granted by the state legislature in the next fiscal year. At that time the expenditure is moved back to the federal fund and the RCIA balance is reclassified to the grant appropriation as operating revenue. The Comptroller and BFM are available to meet to further discuss the budgetary accounting process.

Finding 04 – 37: (continued)

- As for non-major program RCIA, the finding states "…our review of federal revenue collected in advance accounts at year-end…disclosed unexplained excess federal funds collected in advance for non-covered programs." No inquiry was made to either the appropriate comptroller offices or BFM in regard to these "unexplained excess federal funds." Consequently, we disagree with this presumption that a violation of federal cash management regulations occurred and offer the following explanation:

  The RCIA funds for the Department of Corrections result from annual payments from the US Department of Justice for housing alien inmates. The money is requested electronically on a per diem basis. These funds are available for any activities related to the correctional institutions. Since not all of the funds have been utilized in recent years, they have been deposited in RCIA.

  The funds for the Department of Health have three sources resulting from contracts with the federal government:

  - The Adult Blood Lead Epidemiology and Surveillance (ABLES) program consists of fee for service contracts with the federal government. Payments are received quarterly, so consequently there is lag time between the posting of expenditures and the receipt of funds. This is not excess cash.

  - The Drug and Alcohol Services Information System (DASIS) funds are received from the Substance Abuse and Mental Health Services Administration (SAMHSA) to maintain the system. Payments are received quarterly, and unexpended funds remain available for expenditures associated with the program after the termination of the contract (currently December 15, 2007) until fully expended. Since the funds are for the purchase of data and not for reimbursement of operating expenses, there is no one-to-one relationship between the funds received and expenditures posted to SAP. This is not excess cash.

  - The Vital Statistics funds are for fixed price contracts with the federal government to provide vital statistical data. Since the funds are for the purchase of data and not for reimbursement of operating expenses, there is no one-to-one relationship between the funds received and expenditures posted to SAP. This is not excess cash.

  The RCIA funds for the State Police are a result of programs with insufficient spending authority. Funds were obtained as reimbursements from PENNDOT based on state expenditures.

  The funds for the Department of Conservation and Natural Resources (DCNR) are disaster assistance funds that had no spending authority. Information is given to PEMA, which reimburses DCNR for state expenditures. DCNR is currently submitting requests for executive authorizations to the Office of the Budget.

  The funds in RCIA for the Executive Offices consist mainly of Jobs and Growth Tax Relief revenue (approximately $378 million), which is advance funding for use in general government operations. The remaining funds are a result of federal requirements to draw down all of the funds for a Local Law Enforcement Block Grant within 90 days of the award, a posting error that has since been corrected, and federal requirements regarding the PA Human Relations Commission.

  We feel that had an inquiry about these funds been made during the audit, it would have been unnecessary to address this issue in the body of this finding.

The finding indicates that adjustment transactions and revenue collected in advance are not recognized by CDS as interest–generating transactions. This statement is not accurate. All adjustment transactions are passed to CDS and may result in interest generating transactions. In addition, if refund transactions and adjustments cause a balance in federal revenue collected in advance, those same transactions are passed to CDS and result in interest calculations.

Overall, we believe that our current check clearance study has accurately represented the flow of federal funds and exceeded the standards set forth by 31 CFR 205.20. However, with the Commonwealth-wide implementation of the Enterprise Resource Planning software, a new check clearance study is now underway. This new study will again

Finding 04 – 37: (continued)

exceed the three-month requirement of CMIA regulations, as it will involve the four consecutive months of February 1, 2005 through May 31, 2005. The results of the new study are expected to be amended to our Treasury-State Agreement beginning in January of 2006.

Auditors' Conclusion: Based on our review of the Office of the Budget's response, we believe OB should place a priority on performing a new check clearance study since the last one was performed in 1999.

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 federal funds were drawn in advance of the payments made to LEAs; therefore, we believe CMIA interest should be paid until the federal funds are disbursed to the LEA. The Commonwealth should resolve this issue with U.S. Treasury.

Regarding rejected VTs, since BFM did not track and provided no support on 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 the Federal Revenue Collected in Advance (RCIA) balances recorded on the state's accounting system. Although the agency response may be correct in that federal drawdowns are not directly posted to RCIA, 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. Although the agency response provides detailed reasons for the adjustments and/or excess federal funds recorded on the SAP accounting system (i.e., inadequate spending authority, budgetary or FY closing considerations, quarterly federal payments), they do not adequately explain why noncompliance with CMIA does not exist or why CMIA interest is not due the fed for these RCIA balances.

Further, the Commonwealth's Manual of Accounting M310.3, Part Twelve, Accounting for Revenues and Receipts, Section III, 6. d. states: "Federal Revenue Collected in Advance is credited with the amount of federal revenue received in the current fiscal year that is applicable to the succeeding fiscal year (deferred revenue)." Since this is the only written guidance related to federal RCIA, there is little assurance that postings in this account are not federal revenue collected in advance of payments, and management has not taken any corrective action on its use of the RCIA account to resolve our prior year findings or to provide that assurance. If budgetary or other postings are occurring each year on the accounting system, but are not being properly reversed out, management should either correct its accounting system or follow our recommendations to comply with CMIA.

BFM has not developed any written procedures regarding RCIA, nor has BFM updated the Commonwealth's Manual of Accounting since 1996 even as the Commonwealth implemented its new enterprise-wide accounting system, SAP. As recommended in our prior Single Audits we recommend that BFM develop and implement policies and procedures to properly address the CMIA interest impact of federal RCIA on the state's 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.

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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 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	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the finding was issued, FEMA is not currently following up on this finding, and a management decision was never issued.

FINDINGS FOR THE YEAR ENDED JUNE 30, 1995:

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	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the finding was issued, FEMA is not currently following up on this finding, and a management decision was never issued.

FINDINGS FOR THE YEAR ENDED JUNE 30, 1996:

DEPARTMENT OF TRANSPORTATION (PADOT)

Finding 16	Inadequate Property Management Procedures (A Similar Condition Was Noted in Prior Year Finding #32)	DOT	Unresolved – Federal regulations were revised to reduce federal regulatory requirements regarding property management procedures. 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 2005.
Finding 19	PADOT District Offices Need Improved Procedures to Ensure Subcontracted Work is Approved in Writing Prior to Commencement of Work	DOT	Resolved – Corrective action has been taken. Resolved per FHWA letter of August 17, 2005.
Finding 23	PADOT Did Not Properly Report Federal Expenditures on the SEFA for the Flood of 1996 (FEMA 1093-DR-PA)	FEMA	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the finding was issued, FEMA is not currently following up on this finding, and a management decision was never issued.
Finding 25	FEMA Audit Disclosed Material Weaknesses in PADOT's System Used to Accumulate and Report Expenditures Eligible for Reimbursement for the 1996 Blizzard (A Similar Condition Was Noted in Prior Year Finding #40)	FEMA	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the finding was issued, FEMA is not currently following up on this finding and a management decision was never issued.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
FINDINGS FOR THE YEAR ENDED JUNE 30, 1997:			
DEPARTMENT OF TRANSPORTATION (PADOT)			
Finding 12	Weakness in PADOT Controls Over Davis-Bacon Monitoring	DOT	Resolved – Corrective action has been taken. Resolved per FHWA letter of August 10, 2005.
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	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the finding was issued, FEMA is not currently following up on this finding, and a management decision was never issued.
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	Closed – Finding closed per OMB Circular A-133, section 315(b)(4). More than two years have passed since the finding was issued, FEMA is not currently following up on this finding, and a management decision was never issued.
FINDINGS FOR THE YEAR ENDED JUNE 30, 1998:			
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	Resolved – Corrective action has been taken. Resolved per FHWA letter of August 10, 2005.
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	Resolved – PADOT and OB implemented a corrective action plan established in March 2001. FEMA was provided information concerning the corrective action on November 3, 2003. Closed per FEMA correspondence of October 1, 2004.
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.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
DEPARTMENT OF PUBLIC WELFARE (DPW)			
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.

FINDINGS FOR THE YEAR ENDED JUNE 30, 2001:

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
OFFICE OF BUDGET (OB)			
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	Closed – Corrective action has been taken. Additional information provided to HHS in a letter dated June 14, 2002. 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.
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	Closed – Corrective action has been taken. Additional information provided to HHS in a letter dated June 14, 2002. 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.

Summary Schedule of Prior Audit Findings - June 30, 2004

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
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 – 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 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.
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 01-12	Weaknesses in L&I's Monitoring of RSBS Subgrantees (A Similar Condition Was Noted in Prior Year Finding #00-9)	USDE	Unresolved – OVR discussed this finding with USDE during resolution of a similar prior year finding. L&I 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.

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
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.
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.

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 action 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. LECS is awaiting action from DOL & HHS.

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. LECS is awaiting action from USDE.
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 02-36	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 and HHS/DPM in letters 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 and HHS/DPM in letters dated December 26, 2003. OB/BFM is awaiting action from HHS/DPM.
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.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
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 – 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 HEALTH (DOH)			
Finding 02-16	Noncompliance and Internal Control Weaknesses at DOH Result in $551,764 in Questioned Costs	HHS & USDE	Unresolved – All questioned costs associated with this finding have been waived by the respective federal funding agencies. HHS resolved the portion of the finding relative to the MCH Block Grant and waived the questioned costs of $302,370 associated with it. USDE issued a program determination letter to PDE on March 31, 2005 regarding the portion of the finding pertaining to the Special Education and Even Start programs. USDE does not require repayment of the IDEA-B and Even Start questioned costs. DOH and PDE are still working with USDE to achieve final resolution of this finding.
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 on the data elements drawing information directly from the Career Link System and by matching “work arounds files” from Career Links to files from the UC mainframe. As a result, reports for the second and third quarters of 2004 were submitted. Further, the Commonwealth resubmitted the report for the third and fourth quarters of 2003 reflecting the updated data. DOL has not yet contacted L&I concerning this finding.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
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 action is not warranted since the staff is aware of the 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.
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.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
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 02-23	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.
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. In correspondence dated November 17, 2003, the 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.

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
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.

FINDINGS FOR THE YEAR ENDED JUNE 30, 2003:

OFFICE OF BUDGET (OB)

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
Finding 03-6	Noncompliance and Internal Control Weaknesses in the LECS Comptroller Office System of Cash Management	DOL	Unresolved – Drawdown review procedures continue to be utilized. TAA Draws - Subsequent to the audit, the FARS Accounting System was discontinued and the SAP system is now used. Reports containing up-to-date information can be accessed, and a current report is produced each week showing actual expenditures and cash drawn to date. This report is used to draw funds and should eliminate drawing excess TAA funds. UI Benefit Payment Draws - Where bank balances were not known, the system draw amount is typed over with the actual amount that was drawn. This in effect overrides the system formula calculation. The actual amount that was drawn and typed in will not change in the program and will adjust any future calculations appropriately.
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)	USDE	Unresolved - An additional interest calculation was completed and submitted to BFM on October 4, 2004.
Finding 03-25	Internal Control Weaknesses in Federal Reporting and State Matching Procedures (A Similar Condition Was Noted in Prior Year Finding # 02-29)	HHS	Unresolved – OB/CS 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. OB/CS and INS will continue to work together to verify that the posting, monitoring and processing of CHIP funds is correct. In addition, OB/CS manually calculated interest on the $402,802 erroneously posted as Federal Funds and drawn, and the interest owed was included in the June 30, 2003 CMIA interest report for CFDA 93.767.

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
Finding 03-29	The Commonwealth's Statewide Cash Management System Needs Improvement (A Similar Condition Was Noted in Prior Year Finding # 02-36)	HHS/DPM	Unresolved – Additional information provided to HHS in a letter dated March 1, 2005. OB/BFM is awaiting action from HHS.
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)	HHS/DPM	Unresolved – Additional information provided to HHS in a letter dated March 1, 2005. OB/BFM is awaiting action from HHS.
DEPARTMENT OF AGRICULTURE (AGRI)			
Finding 03-1	Internal Control Weaknesses and Noncompliance with Processor Record-keeping and Reporting Requirements Result in Questioned Costs of $8,278,102 (A Similar Condition Was Noted in Prior Year Finding #02-1)	USDA	Resolved – Closed per USDA letter of determination dated April 8, 2005.
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)	USDE	Resolved – Finding closed per USDE Program Determination Letter of April 19, 2005.
DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT (DCED)			
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)	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.
Finding 03-26	An Internal Control Weakness Exists in DCED's Subrecipient Audit Resolution Process	HUD	Unresolved – DCED implemented new procedures to ensure that all single audit reports with audit findings are reviewed within six months after receipt of the audit report. DCED is awaiting final resolution from HUD.
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)	EPA	Resolved – Closed per EPA correspondence of June 6, 2005.
Finding 03-13	DEP Failed to Provide Documentation to Support Administrative Expenditures Resulting in Questioned Costs of $159,622	EPA	Resolved – Questioned costs of $25,453 were adjusted against a subsequent billing to PENNVEST. The remaining questioned costs were waived. Closed per EPA correspondence of June 6, 2005.

Summary Schedule of Prior Audit Findings - June 30, 2004

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
DEPARTMENT OF HEALTH (DOH)			
Finding 03-3	Noncompliance and Internal Control Weaknesses in DOH Systems Result in Questioned Costs of $36,015 (A Similar Condition Was Noted in Prior Finding 02-3)	USDA	Resolved – Finding resolved per USDA letter of June 3, 2005. The questioned costs of $36,015 were waived.
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	USDA	Unresolved – DOH is working with USDA to resolve the questioned costs associated with this finding. Adjustments will be made to SAP and the closeout 798 Report to make them equal. The revised 798 Report will be completed the week ending January 21, 2005.
Finding 03-14	Noncompliance and Internal Control Weaknesses at DOH Result in $100,606 in Questioned Costs (A Similar Condition Was Noted in Prior Finding 02-16)	USDE	Unresolved – USDE issued a program determination letter to PDE on June 1, 2005. The letter does not require repayment of the IDEA-B questioned costs. DOH and PDE are working with USDE to achieve final resolution of this finding.
DEPARTMENT OF LABOR & INDUSTRY (L&I)			
Finding 03-7	Inaccurate Data and Weakneses 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)	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 03-8	Overpayment of TRA Benefits Resulted in Questioned Costs of $8,392 (A Similar Condition Was Noted in Prior Year Finding #02-11)	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, which is subject to the provisions of Section 243 (a) of the Trade Act, for the questioned costs of $3,989 reported in the 2002 Single Audit. Further corrective action is not warranted since the staff is aware of the unintentional error.
Finding 03-9	Incomplete Reporting on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #02-9)	DOL	Unresolved – Updates and improvements have been made on the data elements drawing information directly from the Career Link System and by matching "work around files" from Career Links to files from the UC mainframe. As a result, reports for the second and third quarters of 2004 were submitted. Further, the Commonwealth resubmitted the reports for the third and fourth quarters of 2003 reflecting the updated data. DOL has not yet contacted L&I concerning this finding.

STATE AGENCY / FINDING		FEDERAL AGENCY	COMMENTS
Finding 03-10	Errors and Inadequate Controls in the WIA Annual Performance Report (A Similar Condition Was Noted in Prior Year Finding #02-13)	DOL	Unresolved – DOL has not yet contacted L&I concerning this finding.
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)	USDE	Unresolved – L&I provided additional information to USDE on February 19, 2004 in response to USDE program determination letter of December 18, 2003. Awaiting USDE's final determination on resolution.
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)	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 upon receipt, USDE will make a final determination on resolution. USDE's letter indicated that the questioned costs cited in the 2002 Single Audit have been resolved by receiving full reimbursement from L&I.
Finding 03-19	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)	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 upon receipt, USDE will make a final determination on resolution.
Finding 03-28	Noncompliance With OMB Circular A-133 Subrecipient Audit Requirements (A Similar Condition Was Noted in Prior Year Finding #02-34)	HHS/ACF	Unresolved – HHS/ACF has not yet contacted L&I concerning this finding.
PENNSYLVANIA INFRASTRUCTURE INVESTMENT AUTHORITY (PENNVEST)			
Finding 03-12	PENNVEST Did Not Comply with Federal Loan Repayment Provision	EPA	Resolved – Closed per EPA correspondence of June 6, 2005.
DEPARTMENT OF PUBLIC WELFARE (DPW)			
Finding 03-2	Internal Control Weaknesses at DPW Result in Noncompliance with Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #02-3)	HHS/ OARCP	Resolved – Resolved per HHS/OARCP letter of March 23, 2005.
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)	HHS/ACF	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 the June 30, 2004 Single Audit.

Summary Schedule of Prior Audit Findings - June 30, 2004

	STATE AGENCY / FINDING	FEDERAL AGENCY	COMMENTS
Finding 03-21	Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #02-24)	HHS/ACF	Unresolved – Corrective compliance plan submitted to HHS/ACF October 28, 2003 in response to ACF letter of August 28, 2003 regarding potential sanction action. ACF approved the plan on December 18, 2003 with DPW having until March 31, 2004 to achieve compliance. Compliance will be tested as part of the June 30, 2004 Single Audit.
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)	HHS/ACF	Unresolved – DPW provided additional documentation to HHS on May 31, 2002 in response to HHS letter of May 10, 2002. Awaiting federal audit resolution action.
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)	HHS/ACF	Unresolved – ACF will conduct its own on-site review of the noncompliance and questioned costs of Federal Earmarking Requirements and will issue a corresponding draft report. Awaiting scheduling of on-site review action.
Finding 03-24	Weakness in DPW Monitoring Procedures 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)	HHS/DPM	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. In correspondence dated November 17, 2003, the HHS/DPM requested agreement or disagreement with the finding and copies of supporting documentation. DPW sent a letter dated November 18, 2003 to HHS encouraging resolution of this long-standing issue. Awaiting federal resolution action.
DEPARTMENT OF TRANSPORTATION (PADOT)			
Finding 03-27	An Internal Control Weakness Exists in PADOT's Subrecipient Audit Resolution Process	DOT	Resolved – Corrective action has been taken. PADOT currently has proper controls in place to meet federal requirements concerning the subrecipient audit resolution process. Resolved per DOT/ FHWA letter of March 24, 2005.

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Corrective Action Plans

Commonwealth of Pennsylvania

COMMONWEALTH OF PENNSYLVANIA

Index to Corrective Action Plans
Basic Financial Statement Comments - June 30, 2004

Comment No.	Comment	Impacted State Agency	Comment Page	CAP Page
04-1**	Internal Control Weakness Over Financial Reporting for Lottery Fund's Property Tax Rent Rebate Accrual (A Similar Condition Was Noted in Prior Year Comment #03-4)	OB/CS	136	**329**
04-2*	DOH Did Not Comply with Annual Contractor and Service Provider Audit and Annual Reporting Requirements for the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-8)	DOH	137	**335**
04-3**	Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed by DCED (A Similar Condition Was Noted in Prior Year Comment #03-10)	DCED	140	**331**
04-4**	Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance (A Similar Condition Was Noted in Prior Year Comment #03-9)	DOH	142	**336**
04-5**	Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-11)	OB/BFM	144	**329**
04-6**	Internal Control Weaknesses Result in Improper Payments in the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Comment #03-1)	DPW	146	**338**
04-7**	Internal Control Weakness Over Financial Reporting in the Department of Education GAAP Template (A Similar Condition Was Noted in Prior Year Comment #03-7)	OB/LECS	149	**329**
04-8**	Inadequate Review and Testing of Data Conversion Programs From the FMIS Legacy System to SAP Resulted in Undetected Material Errors in the Motor License Fund Basic Financial Statements	PADOT	150	**340**
04-9**	Weaknesses in Internal Controls and Inadequate SAP Financial Reporting Led to Undetected Material Errors in the Motor License Fund Financial Statements	OB/TRANS	153	**340**
04-10**	Lack of Documentation and Internal Control Weaknesses Over Contracting and Procurement (A Similar Condition Was Noted in Prior Year Comment #03-16)	OB/OA	156	**329**
04-11*	Noncompliance With Statutory Limits for Equity Investments	L&I	161	**336**

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Index to Corrective Action Plans
Basic Financial Statement Comments - June 30, 2004

Comment No.	Comment	Impacted State Agency	Comment Page	CAP Page
04-12**	Internal Control Weaknesses Over Reporting Inter- and Intrafund Activity in the Basic Financial Statements (A Similar Condition Was Noted in Prior Year Comment #03-5)	OB/BFM	163	**329**
04-13**	Errors and Internal Control Weaknesses in Accruing and Reporting Intergovernmental Revenues and Receivables in the Basic Financial Statements	OB/BFM	165	**329**
04-14**	The Bank Shares Tax Liability and Related Expense was Understated in the Department of Revenue GAAP Template	OA	167	**329**
04-15**	Cash and Investment Balances in the Statutory Liquidator Fund Were Misstated in the Preparation of the GAAP Template (A Similar Condition Was Noted in Prior Year Comment #03-2)	INS OB/CS	168	**329**
04-16**	Internal Control Weaknesses Over Agency Accounting for Capital Assets (A Similar Condition Was Noted in Prior Year Comment #03-14)	OB/BFM	169	**330**
04-17*	Internal Control Weaknesses in PLCB's Financial Reporting from the New SAP Accounting System	LCB	171	**337**
04-18**	Statewide Weaknesses in Segregation of Duties and System Security Within the SAP Accounting System (A Similar Condition Was Noted in Prior Year Comment #03-13)	OB/BFM	174	**330**
04-19*	Internal Control Weakness in the Financial Accounting Records	OB/BFM	177	**330**

* - Reportable Condition
** - Material Weakness
CAP - Corrective Action Plan

Index to Corrective Action Plans
Federal Award Findings and Questioned Costs - June 30, 2004

Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	State Agency	Finding Page	CAP Page
04-1**	10.550	Food Donation Program	Internal Control Weakness and Noncompliance in BFD's Subrecipient Monitoring		AGRI	183	**331**
04-2**	10.550	Food Donation Program	Internal Control Weaknesses and Noncompliance With Processor Record0keeping and Reporting Requirements Result in Inaccurate SEFA Reporting and Questioned Costs of $52,917 (A Similar Condition Was Noted in Prior Year Finding #03-1)	$52,917	AGRI	185	**331**
04-3**	10.551 93.558 93.575 93.596 93.778	Food Stamps Program Temporary Assistance for Needy Families Child Care and Development Block Grant Child Care Mandatory and Matching Funds Medical Assistance	Internal Control Weaknesses at DPW County Assistance Offices Result in Noncompliance With Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #03-2)		DPW	193	**338**
04-4*	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance and Internal Control Weaknesses in DOH Systems Result in $26,719 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-3)	$26,719	DOH	198	**336**
04-5**	10.557	Special Supplemental Nutrition Program for Women, Infants and Children	Noncompliance in DOH Submission of WIC Financial Management and Participation FNS-798 Report Results in $774,331 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-4)	$774,331	DOH	201	**336**
04-6**	14.228 14.239	Community Development Block Grant Program HOME Investment Partnerships Program	DCED Did Not Perform Adequate During-the-Award Monitoring of Subrecipients (A Similar Condition Was Noted in Prior Year Finding #03-5)		DCED	204	**331**
04-7**	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 (A Similar Condition Was Noted in Prior Year Finding #03-6)		OB/LECS	207	**330**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	State Agency	Finding Page	CAP Page
04-8**	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	Weaknesses Exist in the FARS and SAP FARS Replacement Systems Resulting in an Undetermined Amount of Questioned Costs up to $4,484,751	$4,484,751	L&I OB/LECS	209	**336**
04-9**	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 #03-7)		L&I	213	**336**
04-10**	17.245	Trade Adjustment Assistance – Workers	Lack of Supporting Documentation and Inaccurate Reporting on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #03-9)		L&I	218	**337**
04-11**	17.245	Trade Adjustment Assistance – Workers	Unallowable Training and Benefit Payments Result in Questioned Costs of $4,318 (A Similar Condition Was Noted in Prior Year Finding #03-8)	$4,318	L&I	223	**337**
04-12**	20.205 23.003	Highway Planning and Construction Appalachian Development Highway System	Internal Control Weakness Over Expenditure Information Reported on the SEFA		TRANS	228	**330**
04-13*	66.458 66.468	Capitalization Grants for Clean Water State Revolving Funds Capitalization Grants for Drinking Water State Revolving Funds	Internal Control Improvements Needed in Subrecipient Loan Monitoring System		PENN-VEST	229	**336**
04-14**	83.544	Public Assistance Grants	Weaknesses in PPR Comptroller Office Internal Controls Over Federal Reporting		OB/PPR	231	**330**
04-15*	84.010 84.027 84.048 84.367	Title I–Grants to Local Educ. Agencies Special Education – Grants to States Voc. Education – Basic Grants to States Improving Teacher Quality State Grants	Internal Control Weakness Over the Reconciliation of the U. S. Department of Education's Grant Administration and Payment System (EDGAPS) to Revenue on the SAP System		OB/LECS	233	**330**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	State Agency	Finding Page	CAP Page
04-16**	84.010 84.367	Title I – Grants to Local Educational Agencies Improving Teacher Quality State Grants	Internal Control Weakness in Monitoring Subrecipient Compliance With Maintenance of Effort Requirements		PDE	234	**331**
04-17*	84.010 84.367	Title I – Grants to Local Educational Agencies Improving Teacher Quality State Grants	Inadequate Controls in PDE's On-Site Monitoring of Subrecipients		PDE	236	**332**
04-18*	84.010	Title I – Grants to Local Educational Agencies	Inadequate Controls Over PDE's Consolidated State Performance Report and the Annual State Report Card		PDE	238	**333**
04-19**	84.048	Vocational Education – Basic Grants to States	Errors and Internal Control Weaknesses in PDE's VOC-ED Consolidated Annual Performance, Accountability, and Financial Status Report Submitted to USDE (A Similar Condition Was Noted in Prior Year Finding #03-15)		PDE	241	**334**
04-20**	84.048	Vocational Education – Basic Grants to States	PDE Allocated VOC-ED Funds to Subrecipients Based on Outdated Statistical Data		PDE	245	**335**
04-21*	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 #03-17)		L&I	247	**337**
04-22**	84.126	Rehabilitation Services – Vocational Rehabilitation Grants to States	Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding #03-18)		L&I	249	**337**
04-23**	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 #03-20)		DPW	251	**338**
04-24**	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 #03-21)		DPW	253	**339**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

COMMONWEALTH OF PENNSYLVANIA

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	State Agency	Finding Page	CAP Page
04-25**	93.563	Child Support Enforcement	Noncompliance and Internal Control Weakness Over the Processing and Reporting of Interstate Cases (A Similar Condition Was Noted in Prior Year Finding #03-22)		DPW	256	**339**
04-26**	93.569	Community Services Block Grant	LECS Comptroller Office Did Not Submit Required Federal Reports Within the CSBG Program		OB/LECS	260	**330**
04-27**	93.569	Community Services Block Grant	Weaknesses in Internal Controls Over Subgrantees Result in $47,722 in Questioned Costs	$47,722	DCED	262	**331**
04-28*	93.575 93.596	Child Care and Development Block Grant Child Care Mandatory and Matching Funds	Internal Control Weaknesses and Inadequate Support for Federal Earmarking Requirements Result in Questioned Costs of $3,220,142 (A Similar Condition Was Noted in Prior Year Finding #03-23)	$3,220,142	DPW	264	**339**
04-29**	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 $4.8 Million in Excess Subgrantee Federal Cash at June 30, 2004 (A Similar Condition Was Noted in Prior Year Finding #03-24)		DPW	268	**339**
04-30**	93.658	Foster Care – Title IV-E	Internal Control Weaknesses Over Reviewing and Approving Supplemental Payments to Subrecipients		DPW	272	**339**
04-31**	93.778 93.917	Medical Assistance HIV Formula Care Grants	Internal Control Weakness and Known Fraud Affecting Federal Awards at DPW		DPW	275	**340**
04-32*	93.778	Medical Assistance	Internal Control Weaknesses in the Administration of the MA Program		DPW	278	**340**
04-33**	93.917	HIV Formula Care Grants	Weaknesses in Internal Controls Over Eligibility Determinations Result in an Undetermined Amount of Questioned Costs Up To $20,792,266	$20,792,266	DPW	281	**340**

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

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Finding No.	CFDA No.	CFDA Name	Finding Title	Questioned Costs	State Agency	Finding Page	CAP Page
04-34	93.959	Block Grants for Prevention and Treatment of Substance Abuse	DOH Did Not Meet Maintenance of Effort Requirements for State Expenditures Resulting in Questioned Costs of $230,000	$230,000	DOH	289	**336**
04-35**	96.001	Social Security – Disability Insurance	Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs		L&I	291	**337**
04-36**	Various	Various Major Programs	OB Did Not Have Adequate Procedures in Place to Ensure the Accuracy of the Subrecipient Audit Universe		OB/BFM OB/BOA	293	**331**
04-37**	Various	All Major Programs Covered by CMIA	Weaknesses in Cash Management System Cause Noncompliance with CMIA and at Least $624,042 Understatement of the CMIA Interest Liability (A Similar Condition Was Noted in Prior Year Findings #03-29 and #03-30)		OB/BFM	296	**331**
			Total Questioned Costs	$29,633,166			

CAP - Corrective Action Plan
* - Reportable Condition
** - Material Weakness

OFFICE OF ADMINISTRATION (OA)

Comment 04-14: The Bank Shares Tax Liability and Related Expense Was Understated in the Department of Revenue GAAP Template

No additional information provided. See Agency Response in the body of the finding.

OFFICE OF THE BUDGET (OB)

Comment 04-1: Internal Control Weaknesses 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 04-5: Internal Control Weaknesses Over Financial Reporting in the Tobacco Settlement Fund

Through June 30, 2005 and subsequent thereto, Central Services and BFM have provided specific training sessions to ensure proper amounts are reported in June 30, 2005 CAFR templates. Through August 23, such training has concluded, the CAFR template has been prepared and is currently being reviewed. One of our several goals is to avoid the need for proposed auditor adjusting entries related to June 30, 2005 CAFR templates.

Comment 04-7: Internal Control Weakness Over Financial Reporting in the Department of Education GAAP Template (A Similar Condition Was Noted in Prior Year Comment #03-7)

No additional information provided. See Agency Response in the body of the finding.

Comment 04-10: Lack of Documentation and Internal Control Weaknesses Over Contracting and Procurement (A Similar Condition Was Noted in Prior Year Comment #03-16)

No additional information provided. See Agency Response in the body of the finding.

Comment 04-12: Internal Control Weakness Over Reporting Inter- and Intra-fund Activity in the Basic Financial Statements (A Similar Condition Was Noted in Prior Year Comment #03-5)

Management will continue to provide training to the General Accounting Division personnel and GAAP Team Leaders on Internal Activity. Management has asked Integrated Enterprise Systems (IES) to assist with developing a systems approach to identifying and managing Internal Activity that requires elimination.

Comment 04-13: Errors and Internal Control Weaknesses in Accruing and Reporting Intergovernmental Revenues and Receivables in the Basic Financial Statements

No additional information provided. See Agency Response in the body of the finding.

Comment 04-15: Cash and Investment Balances in the Statutory Liquidator Fund Were Misstated in the Preparation of the GAAP Template (A Similar Condition Was Noted in Prior Year Comment #03-02)

No additional information provided. See Agency Response in the body of the finding.

Comment 04-16: Internal Control Weaknesses Over Agency Accounting for Capital Assets (A Similar Condition Was Noted in Prior Year Comment #03-14)

A new Management Directive will be developed to establish Agency and Comptroller Responsibilities for Project Settlements. FY2005 fixed asset confirmation letters will be revised. The revision will require project settlement rules and AUC/Fixed asset balances be confirmed on a quarterly basis beginning with the third quarterly confirmation for FY2005.

BFM will also provide Project systems training for staff at PADOT, DCNR, DPW, DGS, and each agency's respective Comptroller fixed asset coordinator. Assistant Comptrollers for Accounting will also be invited to raise their awareness of the Project System requirements. Agency specific training sessions will be considered if the agency is uniquely applying SAP functionality. Training materials will be used to start forming a chapter for Fixed Assets and Project Settlements in a Commonwealth Accounting Manual.

Comment 04-18: Statewide Weaknesses in Segregation of Duties and System Security Within the SAP Accounting System (A Similar Condition Was Noted in Prior Year Comment #03-13)

No additional information provided. See Agency Response in the body of the finding.

Comment 04-19: Internal Control Weaknesses in the Financial Records

BFM has included "open item managed" accounts as a task on the current IES action plan and is working with IES to identify which accounts are or should be open item managed and, if an account is open item managed, determining whether the account can be set up to automatically clear the settled items in the account. BFM is in the first phase of this effort and is working to identify those accounts to be open item managed and then communicating this information to IES so that IES can devise an auto-clearing process for the account. As part of this effort, BFM will also develop reconciliation and account-monitoring procedures that will ensure that the proper accounts are open-account managed on an ongoing basis, as a normal part of the comptroller office's monthly activities, and are properly reviewed by employee supervisors. This task is considered a high priority for BFM, following the issuance of the CAFR, and significant results are expected by the end of the 05-06 fiscal year.

Finding 04-7: Noncompliance and Internal control Weaknesses in the LECS Comptroller Office System of Cash Management (A Similar Condition Was Noted in Prior Year Finding #03-6)

No additional information provided. See Agency Response in the body of the finding.

Finding 04-12: Internal Control Weakness Over Expenditure Information Reported on the SEFA

No corrective action required. See Agency Response in the body of the finding.

Finding 04-14: Weaknesses in PPR Comptroller Office Internal Controls Over Federal Reporting

No additional information provided. See Agency Response in the body of the finding.

Finding 04-15: Internal Control Weaknesses Over the Reconciliation of the U.S. Department of Education's Grant Administration and Payment System (EDGAPS) to Revenue on the SAP System

No additional information provided. See Agency Response in the body of the finding.

Finding 04-26: LECS Comptroller Office Did Not Submit Required Federal Reports Within the CSBG Program

No additional information provided. See Agency Response in the body of the finding.

Finding 04-36: **OB Did Not Have Adequate Procedures in Place to Ensure the Accuracy of the Subrecipient Audit Universe**

No additional information provided. See Agency Response in the body of the finding.

Finding 04-37: **Weaknesses in Cash Management System Cause Noncompliance with CMIA and at least $624,048 Understatement of the CMIA Interest Liability (A Similar Condition Was Noted in Prior Year Findings #03-29 and #03-30)**

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF AGRICULTURE (AGRI)

Finding 04-1: **Internal Control Weaknesses in BFD's Subrecipient Reporting**

No additional information provided. See Agency Response in the body of the finding.

Finding 04-2: **Internal Control Weaknesses and Noncompliance with Processor Recordkeeping and Reporting Requirements Result in Inaccurate SEFA Reporting and Questioned Costs of $52,917 (A Similar Condition Was Noted in Prior Year Finding #03-1)**

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT (DCED)

Comment 04-3: **Annual Reviews of Regional Biotechnology Research Centers for Tobacco Settlement Fund Were Not Performed**

DCED staff has been working with the three Regional Biotechnology Centers to enhance the guidelines. The guidelines are in their final draft stage and will be implemented for the state fiscal year ended June 30, 2005. DCED staff has reviewed the Annual Reports submitted by the Regional Biotechnology Centers. In the future, DCED staff will document and perform the procedures to verify whether each Center was meeting and achieving their goals and functions on a timely basis. DCED started to administer the program July 1, 2003. Prior to July 1, 2003 the Office of Administration oversaw the program.

Finding 04-6: **DCED Did Not Perform Adequate During-the-Award Monitoring of Subrecipients (A Similar Condition Was Noted in Prior Year Finding #03-4)**

No additional information provided. See Agency Response in the body of the finding.

Finding 04-27: **Weaknesses in Internal Controls Over Subgrantees Result in $47,722 in Questioned Costs**

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF EDUCATION (PDE)

Finding 04-16: **Internal Control Weaknesses in Monitoring Subrecipient Compliance With Maintenance of Effort Requirements**

I. Period of Audit: July 1, 2003 through June 30, 2004

II. Audit Reference: CFDA No. 84.010 – Title I Grants to Local Education Agencies
CFDA No. 84.367 – Improving Teacher Quality State Grants

III. Description of Noncompliance or Weakness: Internal control weaknesses in monitoring subrecipient compliance with Maintenance of Effort (MOE) requirements.

IV. Specific Steps to be Taken and Timetable:

- A preliminary MOE report will be requested on April 15 every year.
- The figures will be reviewed and any district that shows a drop of more than 10% in fiscal effort will be highlighted.
- The Regional Coordinator of that district will be given a copy of the report and asked to contact the district to have the Annual Financial Report (AFR) reviewed for accuracy.
- If mistakes have been made in reporting, such as entering figures in an incorrect column, the district contact will file a corrected AFR with the Division of School Finance (DSF).
- If the AFR is correct, it will be necessary for Division of Federal Programs (DFP) to reduce the amount of the allocation of funds in the exact proportion by which a local education agency fails to meet the requirement of subsection (a) of this section (by falling below 90% of both the combined fiscal effort per student and aggregate expenditures).
- When corrections have been made and all AFRs have been received, a final report will be run by the DSF.

V. Description of Monitoring: The MOE Report will be compiled based on the AFR of each district. The DFP will review the data and follow the corrective action plan developed to correct the deficiency in management oversight of the MOE process.

VI. Title of Official Responsible for Corrective Action: Regional Coordinator for Federal Programs

VII. Anticipated Completion Date for Corrective Action: Corrective actions have already been implemented and will be maintained in an ongoing process.

Finding 04-17: Inadequate Controls in PDE's On-Site Monitoring of Subrecipients

I. Period of Audit: July 1, 2003 through June 30, 2004

III. Audit Reference: CFDA No. 84.010 – Title I Grants to Local Education Agencies
CFDA No. 84.367 – Improving Teacher Quality State Grants

III. Description of Noncompliance or Weakness: Inadequate Controls in PDEs On-Site Monitoring of Subrecipients

IV. Specific Steps to be Taken and Timetable: We agree with the recommendations and have taken the following necessary actions:

The Division of Federal Programs (DFP) has developed a spreadsheet containing a snapshot of the district's federal funding allocations. Information on the date the district was last monitored appears in bold print next to the district name. Information on this spreadsheet will be updated annually to ensure compliance.

Completed monitoring reports are now kept in a separate, locked filing cabinet located in the Monitoring Program Manager's cubicle. The DFP employees will be required to sign-out reports when they are removed from the monitoring files.

V. Description of Monitoring: At the end of each monitoring year, the DFP will do an inventory of the LEAs monitored and ensure that there is a corresponding report in the locked files. To be sure that each LEA is monitored within the three-year cycle, the spreadsheet will be updated at the beginning of each monitoring year to determine which LEAs must be monitored.

VI. Title of Official Responsible for Corrective Action: Consolidated Review Program Manager

VII. Anticipated Completion Date for Corrective Action: Corrective actions have already been implemented and will be maintained in an ongoing process.

Finding 04-18: Inadequate Controls over PDE's Consolidated State Performance Report and the Annual State Report Card

I. Period of Audit: July 1, 2003 through June 30, 2004

II. Audit Reference: CFDA No. 84.010 – Title I Grants to Local Education Agencies

III. Description of Noncompliance or Weakness: Weakness in documenting accuracy of adequate yearly progress (AYP) data.

IV. Specific Steps to be Taken and Timetable:

The PDE will develop written procedures to document the measures taken by both the contractor and PDE to insure the accuracy of the assessment data by November 1, 2005. These procedures will be applied to the data from the 2006 assessments. Data from the 2005 assessments has been released.

The PDE will develop written procedures to document the internal controls over collecting, compiling, verifying accuracy and reporting of AYP data by November 1, 2005. These procedures will be applied to the data from the 2006 assessments. Data from the 2005 assessments has been released.

V. Description of Monitoring: Before the data is released, PDE will monitor to see that all steps in the written procedures have been completed with approvals in writing for each step. Copies of these approvals will be filed for reference.

VI. Title of Official Responsible for Corrective Action: Director, Bureau of Assessment and Accountability

VII. Anticipated Completion Date for Corrective Action: The written procedures will be completed by November 1, 2005. These procedures will be applied to the data from the 2006 assessments. Specific dates when the data is available varied from the usual timeframe with the 2005 assessments because of the need to validate the performance level cut-scores and will vary with the 2006 assessments because of the need to conduct performance level setting for the new grades in the assessment system, Grades 4, 6, and 7. The anticipated completion date for corrective action for the assessment data is August 15, 2006. The anticipated completion date for corrective action for the AYP data is September 15, 2006.

Finding 04-19: Errors and Internal Control Weaknesses in PDE's VOC-ED Consolidated Annual Performance, Accountability and Financial Status Report Submitted to USDE (A Similar Condition Was Noted in Prior Year Finding #03-15)

I. Period of Audit: July 1, 2003 through June 30, 2004

II. Audit Reference: CFDA 84.048 – Vocational Education – Basic Grant to States

III. Description of Noncompliance or Weakness: The auditors' review disclosed errors and weaknesses in PDE's internal controls over the Vocational Education Consolidated Annual Performance, Accountability, and Financial Status Report (CAR) submitted to USDE.

IV. Specific Steps to be Taken and Timeline:

The Department continues to address the issues with data collection and data verification. As the Department continues to update the definitions of the CAR subindicators, the data collection methods change and the review process changes. The PDE consistently reviews its internal control procedures especially as staff turnover continues. The PDE agrees that the documentation of the efforts to improve the system is limited, and PDE will develop a means of meaningfully documenting improvements to the system. To address this the Bureau management team will discuss the specific audit findings and develop a new Corrective Action Plan. The Corrective Action Plan will address the specific findings by:

- Identifying meaningful documentation. Completed by August 2005
- Adjusting timelines of systems related to CAR data collection and submission. Completed May 2005
- Adjusting current data submission timelines for the schools. Completed May 2005
- Developing a process to confirm third party contractor's data and testing of the contractor's data. This will include obtaining total record counts from the test contractor to ensure complete data. Complete by August 2005
- Developing a process to verify the data to insure correct reporting of data that prevents an entire year of data from being submitted or double counting of students in the submitted data. Complete by September 2005
- Developing a manual that identifies the process used to verify the data. Complete by September 2005
- Developing a routing process that prohibits the movement of data without supervisory sign-off. Complete by August 2005
- Contacting USDOE about the errors in the 2001-2002 CAR data. Completed by June 2005

V. Description of Monitoring: Management staff will review each of the specific steps along with the timeline identified to ensure completion. Management staff will review the implementation of the verification process to ensure that all CAR sub-indicators are verified.

VI. Title of Official Responsible for Corrective Action: Bureau Director

VII. Anticipated Completion Date of Corrective Action: June 2006

Finding 04-20: PDE Allocated Postsecondary and Adult VOC-ED Funds to Subrecipients Based on Outdated Pell Grant Data

I. Period of Audit: July 1, 2003 through June 30, 2004

II. Audit Reference: CFDA 84.048 – Vocational Education – Basic Grants to States

III. Description of Noncompliance or Weakness: PDE Allocated Postsecondary and Adult VOC-ED funds to Subrecipients Based on Outdated Pell Grant Data

IV. Specific Steps to be Taken and Timetable:

The Department will develop a survey to collect the correct Pell data, administer the survey, analyze the survey responses and rerun the allocation. The review of both allocation runs will be examined to determine the variance. This will be completed by December 2005. PDE will consult with USDE on the use of Pell Grant data when allocating Voc Ed funds and the manner in which USDE would like verification, if any, of the use of Pell Grant data prior to determining allocations.

V. Description of Monitoring: Division of Data Services will develop the survey, collect the data and provide the new data to the Bureau of Information Systems (BIS). BIS will rerun the allocation formula. Manager of Contract Administration in the Bureau of Career and Technical Education will oversee and review the allocation runs and data provided.

VI. Title of Official Responsible for Corrective Action: Manager, Contract Administration, Bureau of Career and Technical Education

VII. Anticipated Completion Date for Corrective Action: Corrective action will be implemented now and the issue will be discussed with USDE when they conduct the on-site monitoring review September 12-16, 2005. Date of completion is December 2005.

DEPARTMENT OF HEALTH (DOH)

Comment 04-2: DOH Did Not Comply with Annual Contractor and Service Provider Audit and Annual Reporting Requirement for the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Year Finding #03-8)

DOH reviewed the audit of Montgomery County for the period July 1, 2002 to June 30, 2003 for compliance with the provisions of the contract's Audit Requirements Appendix and other applicable contract provisions. DOH found the report met the professional and technical audit reporting standards required by these contract provisions and notified the auditee of this in a letter dated June 1, 2005. DOH's program office is currently reviewing the findings in the audit report. This review is to be completed by July 1, 2005. Upon completion of this review, DOH will contact the auditee either to request additional information or to notify them that DOH accepts their report.

As of June 10, 2005, DOH has not received a program audit report from the City of York for the period of May 1, 2002 through June 30, 2004. The DOH program office will contact the City of York for an explanation as to why the report was not submitted by the end of May 2005 as they originally agreed to do, and to obtain a revised time frame for the report's submission to DOH.

See DOH's response in the body of the finding for additional details.

Comment 04-4: Recipients of Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants Were Paid Excessive Funds in Advance (A Similar Condition Was Noted in Prior Year Finding #03-9)

No additional information provided. See Agency Response in the body of the finding.

Finding 04-4: Noncompliance and Internal Control Weaknesses in DOH Systems Result in at Least $26,719 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-2)

DOH will pursue resolution of this finding with USDA. No further information provided. See Agency Response in the body of the finding.

Finding 04-5: Noncompliance in DOH Submission of WIC Financial Management and Participation FNS-798 Report Results in $774,331 in Questioned Costs (A Similar Condition Was Noted in Prior Year Finding #03-4)

DOH will pursue resolution of this finding with USDA. No further information provided. See Agency Response in the body of the finding.

Finding 04-34: DOH Did Not Meet Maintenance of Effort Requirements for State Expenditure Resulting in Questioned Costs of $230,000

DOH will pursue resolution of this finding with U. S. Department of Health and Human Services' Substance Abuse and Mental Health Services Administration. No further information provided. See Agency Response in the body of the finding.

PENNSYLVANIA INFRASTRUCTURE INVESTMENT AUTHORITY (PENNVEST)

Finding 04-13: Internal Control Weaknesses in PENNVEST Subrecipient Loan Monitoring System

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF LABOR AND INDUSTRY (L&I)

Comment 04-11: Noncompliance With Statutory Limits for Equity Investments

No additional information provided. See Agency Response in the body of the finding.

Finding 04-8: Weaknesses Exist in the FARS and SAP FARS Replacement Systems Resulting in an Undetermined Amount of Questioned Costs up to $4,484,751

No additional information provided. See Agency Response in the body of the finding.

Finding 04-9: 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 #03-7)

Most corrective action information is provided within the body of the Agency Response in the finding. However, L&I continues to review and comply with any and all recommendations from past data errors to the point possible. We have 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. These improvements attempt to address the related deficiencies cited within the finding to the best of our ability. However, it is important to note that 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. Finally, PA is designing a pilot project, subject to USDOL approval, for a report designed to incorporate various program areas called Common Measures. The TAA information will be rolled into the process beginning October 1, 2005. As such, only one more TAPR report will be issued. It will encompass reporting information for the second quarter 2004. Following that, the TAPR report will no longer exist; the Common Measures Report will replace it as the reporting document.

Finding 04-10: Lack of Supporting Documentation and Inaccurate Reporting on the ETA 563 Report (A Similar Condition Was Noted in Prior Year Finding #03-9)

Most information is provided within the body of the Agency Response within the finding. However, in response to the Audit Finding, an L&I workgroup has been formed to review current procedures and requirements for the counting of TRA activity reported on the quarterly electronic ETA-563, Quarterly Determinations, Allowance Activities, and Employability Services Under the Trade Act, to determine the need for any enhancements.

Finding 04-11: Unallowable Training and Benefit Payments Result in Questioned Costs of $4,318 (A Similar Condition Was Noted in Prior Year Finding #03-8)

Most information is provided within the body of the Agency Response within the finding. However, in an effort to further strengthen procedures, the responsible unit will be sending information reaffirming the importance of reviewing the current status of a claimant's enrollment in training or waiver status, especially if the CareerLink has issued paper waivers instead of using the CareerLink on-line system, to the UC Service Centers via "Weekly Updates." A notice will also be sent reminding offices to ensure that all eligible Basic TRA weeks have been issued and issued in the proper sequence prior to establishing entitlement to Additional TRA benefits. These additional steps are expected to be implemented within the next couple of months.

Finding 04-21: A Weakness Exists in L&I's Procurement System Related to Debarment and Suspension (A Similar Condition Was Noted in Prior Year Finding #03-17)

No additional information provided. See Agency Response in the body of the finding.

Finding 04-22: Noncompliance and Weaknesses in Internal Controls Over Charging of Personnel Costs (A Similar Condition Was Noted in Prior Year Finding #03-18)

No additional information provided. See Agency Response in the body of the finding.

Finding 04-35: Noncompliance and Weakness in Internal Controls Over Charging of Personnel Costs

No additional information provided. See Agency Response in the body of the finding.

LIQUOR CONTROL BOARD (LCB)

Comment 04-17: Internal Control Weakness in PLCB's Financial Reporting From The New SAP Accounting System

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF PUBLIC WELFARE (DPW)

Comment 04-6: Internal Control Weaknesses Result in Improper Payments in the Tobacco Settlement Fund

The DPW, Office of Medical Assistance Programs (OMAP), is currently collecting the Extraordinary Expense (EE) overpayments for fiscal year ended (FYE) 2003, and will make the underpayments when the first step is completed. The Pennsylvania Health Care Cost Containment Counsel implemented a new audit process for claims related to the FYE 2005 tobacco EE payments. The OMAP used consistent data (FYE 2001, 2002, and 2003) in both the numerator and the denominator in FYE 2005 tobacco calculations. Lastly, OMAP and AG staff met and discussed the continuation of the AG audits of the EE payments. Based on these discussions, it appears the audits will continue for the foreseeable future.

Finding 04-3: Internal Control Weaknesses at DPW County Assistance Offices Result in Noncompliance with Federal Regulations (A Similar Condition Was Noted in Prior Year Finding #03-2)

In reference to the first recommendation for county assistance office (CAO) caseworker training and supervision, the DPW, Office of Income Maintenance (OIM), has ensured that the caseworkers receive additional training by utilizing the e-learning modules offered through the Staff Development Program. Management will reinforce to staff the importance of following established DPW policies and procedures regarding eligibility determination and redeterminations. These periodic reviews will be done on an ongoing basis.

In reference to the second recommendation that the DPW and its CAOs strengthen system access controls for welfare-to-work participants employed at the CAOs, an Operations Memorandum 050705, dated July 7, 2005, to Executive Directors provides a process for each CAO to review internal procedures. The Security Process Overview is a self-assessment tool to be used by CAO management staff. Statewide security standards for the CAOs will be issued by year's end.

In the related recommendation to strengthen procedures that will ensure compliance with Act 1996-35 and ensure recipient compliance with the court-ordered payment plans, the OIM uses the Income Eligibility Verification System (IEVS) Exchange 10, which allows for communication with local courts and other authorities and the exchange of information. IEVS Exchange 10 screens have recently been revised, which has made it easier for the workers to interpret the information on the screens. Policy clarifications and a desk guide have also been issued to staff to strengthen compliance in this area.

In reference to the Susquehanna CAO and Allegheny CAO issues, a CAP has been developed to ensure completed CSR forms are retained for two years per OPS Memorandum #980303, and a CAP has been developed to ensure that future CSRs are completed.

Finding 04-23: Lack of Documentation to Support Compliance with Federal Welfare Reform Regulations (A Similar Condition Was Noted in Prior Year Finding #03-20)

The DPW'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. Since this finding is recognized as a repeat finding from the previous year's single audit, three points of action are in the process of 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. Lastly, an assessment is in progress, the results of which may impact on policy regarding the use of 1680s.

Finding 04-24: Inaccurate Reporting on the TANF ACF-199 Data Report (A Similar Condition Was Noted in Prior Year Finding #03-21)

This finding indicates significant improvement over the results of the previous year's (SFY 2002) audit finding. This improvement is a result of the DPW implementing policy and procedures to provide more accurate data, and to monitor and control the information collected and reported on the ACF-199 report prior to submission to the Administration for Children and Families (ACF). As previously reported, a TANF penalty was imposed on Pennsylvania as explained in an ACF letter dated August 28, 2003. The penalty is a result of ACF's concurrence with the auditors' recommendations for the audit year ended June 30, 2001.

Pennsylvania submitted a Corrective Action Compliance Plan dated October 28, 2003, to correct the noncompliance, which was accepted by the ACF on December 18, 2003. The DPW had until March 31, 2004, to achieve compliance. By the ACF's correspondence dated April 6, 2005, the ACF will use the results of the audit for the years ended June 30, 2004, and June 30, 2005, to determine if the DPW corrects the deficiencies in accordance with its CAP. Otherwise, the ACF will enforce the penalty for 2001 and impose penalties for subsequent years if the DPW has not achieved compliance.

Finding 04-25: Noncompliance and Internal Control Weakness Over the Processing of Interstate Registry Cases (A Similar Condition Was Noted in Prior Year Finding #03-22)

No additional information provided. See Agency Response in the body of the finding.

Finding 04-28: Internal Control Weaknesses and Inadequate Support For Federal Earmarking Requirements Result in Questioned Costs of $3,220,142 (A Similar Condition Was Noted in Prior Year Finding #03-23)

Funds were expended on renovations that were not allowable under the Child Care Development Fund Block Grant regulations. Accordingly, the DPW stepped up its efforts to provide additional documentation to the childcare providers on what constitutes renovations versus repairs. The U. S. Department of Health and Human Services (HHS) approved the DPW's technical assistance language on October 6, 2004. The language is now incorporated into the provider's standard grant packet.

The DPW has pursued and implemented a documenting system to identify the obligations and expenditures of this earmark. The DPW obligated funds for SFY 2005-06 in an internal order in the SAP established for the infant and toddler earmark. The DPW hopes that this effort will eliminate any future audit findings in this area.

The DPW is currently working with the HHS, and the HHS' contractor to strengthen federal reporting in childcare. The DPW looks forward to this joint national effort to review reporting parameters and any additional guidance from the HHS on federal childcare reporting.

Finding 04-29: Weaknesses in DPW Monitoring of Subgrantees Results in Over $4.8 Million in Excess Subgrantee Federal Cash at June 30, 2004 (A Similar Condition Was Noted in Prior Year Finding #03-24)

No additional information provided. See Agency Response in the body of the finding.

Finding 04-30: Internal Control Weaknesses Over Reviewing and Approving Supplemental Payments to Subrecipients

The DPW, Office of Children, Youth and Families (OCYF), relies on three approaches to ensure that the subrecipient's expenditures in the Foster Care Program are allowable, reasonable, and necessary in accordance with federal regulations. First, through the DPW's normal audit resolution protocol, the OCYF will follow up on the $23.2 million in Foster Care expenditures reported in Philadelphia's supplemental invoices when the OMB Circular A-133 Single Audit of Philadelphia's child welfare program is completed. The OCYF will review results to ensure that proper follow up is preformed on any audit findings or questioned costs identified, and consider whether additional monitoring coverage of these costs is necessary.

Second, the OCYF receives and reviews annual programmatic audits conducted by the Department of the Auditor General (AG) of all county child welfare programs. These audits review allowability, reasonableness, and the necessity of costs and are acted on by the OCYF in order to recover funds provided to subrecipient counties in violation of federal regulations, including duplicate billings.

Lastly, the OCYF implements an extensive Quality Assurance Management Program whereby on-site Title IV-E quality assurance reviews are conducted in all counties. These reviews verify that the eligibility file contains appropriate documentation to substantiate that the child met the eligibility requirements. In addition, the review includes ensuring that the client remained eligible and reimbursable during the period invoiced by the county. In addition, the quality assurance process requires that staff pull the Title IV-E ineligible cases to ensure that ineligibility was correctly determined, and that these cases were not invoiced. Staff also pulls actual invoices to determine if claiming is correct (i.e., claims were eligible, allowable, and necessary).

Finding 04-31: Internal Control Weaknesses and Known Fraud Affecting Federal awards at DPW

No additional information provided. See Agency Response in the body of the finding.

Finding 04-32: Internal Control Weaknesses in the Administration of the MA Program

No additional information provided. See Agency Response in the body of the finding.

Finding 04-33: Weaknesses in Internal Control Over Eligibility Determined Result in an Undetermined Amount of Questioned Costs up to $20,792,266

No additional information provided. See Agency Response in the body of the finding.

DEPARTMENT OF TRANSPORTATION (PADOT)

Comment 04-8: Inadequate Review and Testing of Data Conversion Programs From the FMIS Legacy System to SAP Resulted in Undetected Material Errors in the Motor License Fund Basic Financial Statements

No additional information provided. See Agency Response in the body of the finding.

Comment 04-9: Weaknesses in Internal Controls and Inadequate SAP Financial Reporting Led to Undetected Material Errors in the Motor License Fund Financial Statements

No additional information provided. See Agency Response in the body of the finding.