



General Assembly of Pennsylvania

Financial statement audit results
and communications for Fiscal Year
Ended June 30, 2011

Report to the Legislative Audit
Advisory Commission of the
Commonwealth of Pennsylvania

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March XX, 2012

Members of the Legislative Audit Advisory Commission
Commonwealth of Pennsylvania

Dear Members of the Legislative Audit Advisory Commission:

We are pleased to present the results of our audit of the statement of financial affairs (financial statement) for the fiscal year ended June 30, 2011 of the General Assembly of the Commonwealth of Pennsylvania (General Assembly).

This report to the Legislative Audit Advisory Commission summarizes our audit, the scope of our engagement, and key observations and findings from our audit procedures. The document also contains the communications required by our professional standards to the Legislative Audit Advisory Commission.

The audit was designed to express an opinion on the financial statement for the fiscal year ended June 30, 2011. In accordance with professional standards, we obtained a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. However, we were not engaged to and we did not perform an audit of internal control over financial reporting.

As required by Statement on Auditing Standards No. 114, we are bound to restrict the use of this report to those familiar with the financial operations and systems used to produce the financial statement. This report is, accordingly, intended solely for the information and use of the Legislative Audit Advisory Commission and management, and is not intended to be and should not be used by anyone other than these specified parties.

We appreciate this opportunity to meet with you to discuss the contents of this report and answer any questions you may have about these or any other audit-related matters.

Very truly yours,

Ernst + Young LLP

Statement on Auditing Standards (SAS) No. 114 communications

Planned audit scope, considerations and responsibilities

Planned Scope

Ernst & Young ("EY" or "we") planned to audit and report on the statement of financial affairs of the General Assembly of the Commonwealth of Pennsylvania for the year ended June 30, 2011. The objective of our audit of the financial statement was to express an opinion on whether the financial statement is presented fairly, in all material respects, in conformity with the basis of accounting as described in the notes of the financial statement.

Auditor's Responsibilities Under Generally Accepted Auditing Standards (GAAS)

We are responsible for forming and expressing an opinion about whether the financial statement that has been prepared by management with the oversight of those charged with governance is presented fairly, in all material respects, in conformity with the basis of accounting as described in the notes of the financial statement.

The audit of the financial statement does not relieve management or those charged with governance of their following responsibilities:

- a. The financial statement is the responsibility of the General Assembly's management, which is also responsible for establishing and maintaining effective internal control, for properly recording transactions in the accounting records, for safeguarding assets, and for the overall fair presentation of the financial statement. Management also is responsible for the identification of, and for the General Assembly's compliance with, laws and regulations and provisions of contracts and grant agreements (if any) applicable to its activities.
- b. Management is responsible for adjusting the financial statement to correct material misstatements and for affirming to us in its representation letters that the effects of any unrecorded audit misstatements accumulated by us during the current audit and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statement taken as a whole.
- c. Management is responsible for apprising us of all allegations involving financial improprieties received by management (regardless of the source or form and including, without limitation, allegations by "whistle-blowers"), and providing us full access to these allegations and any internal investigations of them, on a timely basis. Allegations of financial improprieties include allegations of manipulation of financial results by management or employees, misappropriation of assets by management or employees, intentional circumvention of internal controls, inappropriate influence on related party transactions by related parties, intentionally misleading EY, or other allegations of illegal acts or fraud that could result in a misstatement of the financial statement or otherwise affect the financial reporting of the

General Assembly. If the General Assembly limits the information otherwise available to us under this paragraph (based on the General Assembly's claims of attorney/client privilege, work product doctrine, or otherwise), the General Assembly will immediately inform us of the fact that certain information is being withheld from us. Any such withholding of information could be considered a restriction on the scope of the audit and may prevent us from opining on the General Assembly's financial statement; alter the form of report we may issue on such financial statement; or otherwise affect our ability to continue as the General Assembly's independent auditors. We are not aware of any such withholding of information.

- d. As required by AICPA auditing standards, we make specific inquiries of management about the representations contained in the financial statement. AICPA auditing standards also require that, at the conclusion of the audit, we obtain representation letters from certain members of management about these matters. The responses to those inquiries, the written representations, and the results of our procedures comprise the evidence on which we will rely in forming our opinion on the financial statement. Management is responsible for providing us with all financial records and related information on a timely basis, and its failure to do so may cause us to delay our report, modify our procedures, or even terminate our engagement.
- e. Management shall make appropriate inquiries to determine whether the General Assembly has a capital lease, material cooperative arrangement, or other business relationship with EY or any other member firm of the global Ernst & Young organization (any of which, an "Ernst & Young Entity").
- f. Management shall discuss any independence matters with EY that, in its judgment, could bear upon EY's independence.

We are responsible for performing the audit in accordance with auditing standards generally accepted in the United States (GAAS), which is designed to obtain reasonable, rather than absolute, assurance about whether the financial statement is free of material misstatement.

An audit of the financial statement includes our consideration of internal control over financial reporting as a basis for designing our audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the General Assembly's internal control over financial reporting.

We are responsible for communicating significant matters related to the financial statement audit that are, in our professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. GAAS do not require us to design procedures for the purpose of identifying other matters to communicate with those charged with governance.

We concluded that the financial statement that was audited fairly presents, in all material respects, the appropriations, disbursements, commitments, and available balances of the General Assembly for the fiscal year ended June 30, 2011, on the basis of accounting as described in Note 1 to the financial statement.

Qualitative aspects of significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures

The General Assembly's accounting policies are summarized in the notes to the financial statement. We believe the General Assembly's accounting policies are appropriate for the General Assembly's circumstances.

There were no significant disclosures relating to accounting estimates.

Existing policies, as summarized in the financial statement notes, remained consistent with those of the prior year.

Significant difficulties encountered during the audit

None.

Uncorrected and corrected misstatements

We are required to inform the Legislative Audit Advisory Commission about adjustments arising from the audit (whether recorded or not) that could in our judgment either individually or in the aggregate have a significant effect on the financial statement.

There were no audit adjustments, recorded or unrecorded, for the fiscal year ended June 30, 2011, that were considered material to the financial statement.

Disagreements with management significant to the financial statement or auditor's report

None.

Consultation with other accountants

None.

Other information in documents containing audited financial statements

The schedule of disbursements by category contained in the financial statement is presented for purposes of additional analysis and is not a required part of the statement of financial affairs. Such information has been subjected to the auditing procedures applied in our audit of the statement of financial affairs and, in our opinion, is fairly stated in all material respects in relation to the statement of financial affairs taken as whole.

Significant findings or issues discussed, or subject to correspondence with management

None.

Independence

We are not aware of any relationships between Ernst & Young and the General Assembly that, in our professional judgment, may reasonably be thought to bear on our independence.

Fraud and illegal acts

In prior years, this section contained disclosures relative to the Attorney General's Office investigation into the propriety of disbursements made by certain employees. We have been informed by management that this matter is not expected to have a material impact on the financial statements for the fiscal year ended June 30, 2011.

Material weaknesses in internal control

We noted no material weaknesses in internal control; however, as described in the attached management letter, we noted significant deficiencies in internal control relating to the General Assembly's financial statement close process and the processing of expenditures through committee and leadership checking accounts for the House of Representatives.

March XX, 2012

The Legislative Audit Advisory Commission of the
Commonwealth of Pennsylvania

In planning and performing our audit of the financial statement of the General Assembly of the Commonwealth of Pennsylvania (General Assembly) as of and for the year ended June 30, 2011, in accordance with auditing standards generally accepted in the United States, we considered its internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statement, but not for the purpose of expressing an opinion on the effectiveness of the General Assembly's internal control. Accordingly, we do not express an opinion on the effectiveness of the General Assembly's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

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

Significant deficiencies

During our audit, we noted the following matters involving internal control over financial reporting and its operation that we consider to be significant deficiencies, as defined above.

Financial statement close process (FSCP)

Observation:

The General Assembly of Pennsylvania is statutorily organized by the Senate, House of Representatives (House), and various legislative service agencies. The Senate and House are further statutorily organized by Republican and Democratic caucuses. Each of these separate entities and caucuses has independent and differing financial rules and policies, which creates a decentralized environment. Some legislative agencies may also have limited staff available for processing financial transactions and; therefore, could inherently produce segregation of duties issues.

Appropriation activity is tracked internally through financial information systems by each respective entity on the budgetary basis of accounting, and by utilizing the "Status of Appropriations," a report produced by the Pennsylvania Treasury Department, which tracks appropriation activity monthly. As a result, the financial information systems and supporting staff utilized by the General Assembly are designed and trained to track appropriation activity on a budgetary basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States (GAAP).

The General Assembly is required to produce entity-wide financial statements annually. Revenue (appropriations) and expenditure activity is included in the financial systems of the Pennsylvania Office of the Budget on a budgetary basis via an interface from the Pennsylvania Treasury Department; however, the General Assembly is also required to provide the Pennsylvania Office of the Budget with the activity and balances consistent with accounting principles generally accepted in the United States (GAAP) for inclusion in the Commonwealth-wide Comprehensive Annual Financial Report.

The decentralized environment and financial systems of the General Assembly are not designed to produce entity-wide financial statements or reflect activity or balances consistent with accounting principles generally accepted in the United States (GAAP).

Recommendation:

We recommend that the General Assembly consider developing/enhancing the financial statement close process, including centralizing financial information systems and controls necessary to record, process and report financial data consistent with the above-mentioned reporting requirements - entity-wide financial statements, accumulation of commitments related to appropriations and GAAP balances for inclusion in the Commonwealth-wide Comprehensive Annual Financial Report. Listed below are examples, including, but not limited to, financial statement close process and/or financial reporting and related systems enhancements that should be considered:

- System-Related Enhancements – implementation of a general ledger system that enhances the General Assembly’s ability to initiate, authorize, record, process, and report financial data, by agency, utilizing a double-entry accounting system;

Financial Reporting Presentation – presenting expenditures by category (e.g., salaries and wages, benefits, rent, furniture, equipment, etc.), by appropriation, in the financial statement may provide users of the financial statement with more detailed information as to natural expenditure classifications; and

- Universal/Centralized Leave Policy – the House of Representatives should consider adopting a universal and centralized leave policy that allows for a consistent and all-inclusive leave tracking system to measure and control accrued leave liability commitments. Such a universal and centralized leave policy would be consistent with that which is currently employed by the Senate of Pennsylvania.

Processing of committee and leadership expenditures through conventional checking accounts for the House of Representatives

Observation:

Reimbursement for varying expenses incurred by certain committee chairmen and leadership of the House of Representatives is made from separate advancement accounts specific to each committee chairman or member of leadership. For banking purposes, such advancement accounts have been established as conventional checking accounts, and are maintained by the respective committee chairmen and leadership.

As a result of a prior year recommendation, the House Comptroller’s Office took control over the reimbursement of committee expenses for many smaller House committees (e.g. Labor Relations Committee, Education Committee, Health and Human Services Committee, etc.) during the 2008-2009 legislative session. These committees’ chairmen no longer maintain advancement accounts for committee expenses, and now request reimbursement of associated expenses through the House of Representatives Comptroller’s Office. However, advancement accounts for larger committees (e.g. Appropriation Committees, Administration for Staff Committee, etc.) and leadership (e.g. Speaker’s Office, Caucus Secretary, etc.) remain open. Additionally, two of the larger committees process payroll through these types of advancement accounts, rather than through the Pennsylvania Treasury Department.

The Rules of the House of Representatives require committee chairmen and leadership responsible for advancement accounts to prepare “Statements of Monthly Expenditures” reports (i.e., Rule 14 reports). Although the Rule 14 report documents certain expenditure information, it does not appear to adequately document the specific business or legislative purpose related to each expense item on a consistent basis. Failure to document legislative purpose for expenses incurred could subject members

or employees to IRS regulations associated with deeming such expenses as income instead of expense reimbursements, which would require the House to include such expenses in the respective members' or employees' annual IRS Forms W-2.

The recording of expenditures from the advancement accounts does not consistently follow the same expense coding or classifications as expenditures made from the Legislative Financial System (LFS). As a result, this impacts the General Assembly's ability to report expenditures on an entity-wide basis by expense category. Additionally, the current advancement method for expense reimbursement, including payroll, contains a lack of segregation of duties relating to the cash disbursements, cash receipts (advancements) and reconciliation processes because those initiating transactions may also be the ones approving them.

Recommendation:

Consistent with our prior-year recommendation, consideration should be given to consolidating the committee and leadership advancement accounts into one account controlled by the House Comptroller's Office, similar to the practice currently being utilized by the Senate Chief Clerk's Office. Alternatively, consideration could be given to processing such expense reimbursements by the House Comptroller through the Pennsylvania Treasury Department. Either reimbursement method would improve the design of internal controls over such funds by subjecting such expenditures to a review by the Comptroller's Office - providing for a review of documentation of the legislative or business purpose and an enhancement to the segregation of duties.

Absent any changes to the current House advancement method of expense payment and reimbursement, consideration should be given to alternative internal control enhancements, including, but not limited to, a reduction of available advancement balance amounts, enhanced descriptions of legislative purpose included on Rule 14 reports, the processing of all payroll transactions through the Pennsylvania Treasury Department, the acceleration of checkbook audit procedures and/or the introduction of an internal audit function for more timely and frequent audits, and the coding of expenditures consistent with that of LFS.

Legislative financial reserve policies

Observation:

As a matter of good fiscal policy, the General Assembly may consider current measurable commitments (e.g., accounts payable, accrued payroll, lease commitments, etc.) as well as other types of commitments (e.g., post-employment retirement benefits for retired employees, future payments of unused employee compensated leave, etc.) in its monitoring and establishment of financial reserves and continuing appropriation balances. Accordingly, the General Assembly could consider maintaining a reasonable, budgetary reserve for continued operations to adequately fund both measurable and estimated costs incurred in the current or prior fiscal years, but payable in subsequent fiscal years. The

General Assembly currently does not have a formally adopted policy to determine the appropriate amount of legislative financial reserves.

Recommendation:

As a leading practice, various organizations utilize benchmarking or other measures or formulas to determine the appropriate amount of budgetary reserves necessary for continuing operations.

The General Assembly could consider adopting a policy that establishes and monitors the appropriate amount of budgetary reserves to be carried over, or lapsed, between budget cycles.

For example, a possible approach, among others, may be designating a set number of months' average or a specific percentage of current fiscal year appropriations on an appropriation-by-appropriation basis in establishing a budgetary "reserve." Appropriation surpluses in excess of this reserve for a particular appropriation symbol, including prior-year appropriations, after commitments (e.g., accounts payable, accrued payroll commitments, etc.), would be lapsed to the Commonwealth's General Fund by the close of the subsequent fiscal year - available for appropriation in the subsequent budget cycle. Such an analysis would be performed after each fiscal year.

It is noted that in fiscal year ended June 30, 2011, the Senate and House of Representatives approved the lapse of \$26,726,000 and \$36,000,000, respectively, of appropriations back to the Commonwealth's general fund; however, the actual lapse of funds occurred during fiscal year ending June 30, 2012.

As required by auditing standards generally accepted in the United States, this communication is intended solely for the information and use of management, the Legislative Audit Advisory Commission, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

We would be pleased to discuss the above matters or to respond to any questions, at your convenience.

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