COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND
AUDIT REPORT
HARRISBURG, PENNSYLVANIA

FOR THE FISCAL YEARS ENDED JUNE 30, 2011 AND 2010

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JACK WAGNER

AUDITOR GENERAL

BACKGROUND

Act 77 of 2001 created the Tobacco Settlement Fund to receive the revenues from the Master Settlement Agreement (MSA) that was reached with the five major tobacco companies on December 17, 1999. The Tobacco Settlement Fund currently provides funding for health care insurance for the uninsured, home and community-based services for seniors, tobacco use prevention and cessation, broad-based health research, medical care for workers with disabilities and hospital uncompensated care in accordance with the resource allocation plan set forth in Act 77 of 2001. Although not currently funded, the Tobacco Settlement Fund also maintains an Endowment Account to preserve a portion of the receipts to ensure funds for future generations, sustain critical programs if tobacco allocations decrease and provide ongoing revenue if tobacco allocations cease. Also, a Health Venture Account was established to provide additional capital for investment in private venture firms that extend financial resources to early stage start-ups and emerging life sciences companies.

In 2005, the Commonwealth entered into the Annual Community Health Reinvestment Agreement with Pennsylvania's four Blue Cross/Blue Shield plans. The Blue Cross/Blue Shield plans have agreed to an annual commitment of funds to provide affordable basic health care coverage for thousands of low-income and uninsured Pennsylvanians. The Commonwealth decided not to extend the Community Health Reinvestment Agreement past December 31, 2010. As a result, the Adult Basic Program funded by the agreement to provide affordable basic health care coverage was discontinued on February 28, 2011.

JACK WAGNER

AUDITOR GENERAL

Independent Auditor's Report

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

We have audited the financial statements of the Commonwealth of Pennsylvania Tobacco Settlement Fund (TSF), a Special Revenue Fund, as of and for the fiscal years ended June 30, 2011 and 2010, including the Balance Sheet, and the Statement of Revenues, Expenditures, and Changes in Fund Balance. These financial statements are the responsibility of TSF's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Pennsylvania Tobacco Settlement Fund and do not purport to, and do not, present fairly the financial position of the Commonwealth of Pennsylvania as of June 30, 2011 and 2010, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tobacco Settlement Fund as of June 30, 2011 and 2010, and the results of the Tobacco Settlement Fund's operations for the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

TSF Management's Discussion and Analysis is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 29, 2011 on our consideration of the TSF's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying supplemental information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is presented fairly, in all material respects, in relation to the basic financial statements taken as a whole.

November 29, 2011

JACK WAGNER
Auditor General

TSF Management's Discussion and Analysis

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

Description	2011	2010	2009	2011 Inc/-Dec Amount	2011 Inc/-Dec %	2010 Inc/-Dec %
Cash and investments	$ 572	$ 1,041	$ 1,269	$ (469)	-45%	-18%
Other assets	213	273	315	(60)	-22%	-13%
Total assets	**$ 785**	**$ 1,314**	**$ 1,584**	**$ (529)**	**-40%**	**-17%**
Accounts payable	$ 165	$ 239	$ 179	$ (74)	-31%	34%
Securities lending obligations	12	30	106	(18)	-60%	-72%
Other liabilities	169	218	272	(49)	-22%	-20%
Total liabilities	**$ 346**	**$ 487**	**$ 557**	**$ (141)**	**-29%**	**-13%**
Total fund balance	**$ 439**	**$ 827**	**$ 1,027**	**$ (388)**	**-47%**	**-19%**
Total liabilities and fund balance	**$ 785**	**$ 1,314**	**$ 1,584**	**$ (529)**	**-40%**	**-17%**
Intergovernmental	$ 170	$ 192	$ 159	$ (22)	-11%	21%
Investment income	29	82	(110)	(53)	-65%	-175%
Other revenues	418	434	522	(16)	-4%	-17%
Total revenues	**$ 617**	**$ 708**	**$ 571**	**$ (91)**	**-13%**	**24%**
Protection of persons and property	$ 116	$ 157	$ 165	$ (41)	-26%	-5%
Health and human services	474	548	511	(74)	-14%	7%
Economic development	3	4	9	(1)	-25%	-56%
Total expenditures	**$ 593**	**$ 709**	**$ 685**	**$ (116)**	**-16%**	**4%**
Net transfers in (out)	$ (412)	$ (199)	$ (16)	$ (213)	107%	-1144%
Net change in fund balances	**$ (388)**	**$ (200)**	**$ (130)**	**$ (188)**	**94%**	**54%**

The year-over-year decrease in cash and investments of $469 million is due primarily to a statutory transfer of $121 million from the Health Endowment Account for Long-Term Hope to the General Fund, statutory transfers totaling $265 million from the Tobacco Settlement Account to the General Fund, and a $18 million year-over-year decrease in the size of the Treasury Department's securities lending program. Other assets decreased by $60 million due to the discontinuation of the Adult Basic program supported by the Community Health Reinvestment receivable (and related unearned revenues) resulting in a $37 million decrease, disputed payments from the tobacco product manufacturers participating in the Master Settlement Agreement (MSA) resulting in a decrease of $7 million for the MSA receivable (and related unearned revenues), and investment sales proceeds held by BNY Mellon Bank decreased by $12 million. The accounts payable year-over-year decrease of $74 million is largely due to a decrease in the accrual of program expenditures that have received a reduction in appropriation. Securities lending obligations decreased by $18 million due to the decrease in the Treasury Department's

TSF Management's Discussion and Analysis (Continued)

securities lending program. Other liabilities decreased by $49 million due primarily to a decrease of $37 million in unearned revenues related to the discontinuation of the Adult Basic program supported by the Community Health Reinvestment Account (and related receivable), and unearned revenues related to disputed payments from the tobacco product manufacturers participating in the MSA resulting in a decrease of $7 million (and related receivable).

During the fiscal year, intergovernmental revenue decreased $22 million due to a reduction in accrued federal revenues for the Medical Assistance Uncompensated Care program. Investment income decreased by $53 million due largely to a lower investment valuation and earnings of the Health Endowment Account for Long-Term Hope and the Tobacco Settlement Account as of and during the fiscal year ended June 30, 2011. Other revenues decreased by $16 million largely due to the reduction in revenues received from the MSA payment. Total expenditures year-over-year decrease of $116 million is primarily due to the decrease in accrual of program expenditures that have received a reduction in appropriation. Net transfers out increased by $213 million due primarily to current year statutory transfers (Act 46) requiring the Tobacco Settlement Fund to transfer $387 million to the General Fund in comparison to $167 million transferred for the prior year statutory transfers (Act 50).

COMPARATIVE BALANCE SHEETS
JUNE 30, 2011 AND 2010

ASSETS

	June 30, 2011	June 30, 2010 (restated)
Assets:		
Temporary Investments – Note 2	$ 339,796,468	$ 498,117,712
Long-Term Investments – Note 2	220,375,054	497,266,629
Securities Lending Collateral – Note 2	11,782,807	30,414,289
Accounts Receivable – Note 1	162,923,447	207,256,209
Accrued Investment Income Receivable	1,090,134	3,010,582
Investment Sales Receivable – Temporary Investments – Note 1	629,998	5,727,333
Investment Sales Receivable – Long-Term Investments – Note 1	-	6,853,127
Due From Federal Government – Note 1	47,926,253	65,548,132
TOTAL ASSETS	$ 784,524,161	$ 1,314,194,013

LIABILITIES AND FUND BALANCE

	June 30, 2011	June 30, 2010 (restated)
Liabilities:		
Accounts Payable and Accrued Liabilities	$ 162,076,171	$ 213,114,611
Investment Purchases Payable – Temporary Investments – Note 1	2,603,286	19,849,441
Investment Purchases Payable – Long-Term Investments – Note 1	-	5,805,593
Securities Lending Obligations – Note 2	11,773,683	30,397,897
Due to Other Funds	332,631	3,762,500
Due to Political Subdivisions	5,549,066	6,820,566
Due to Other Governments	546	1,866
Unearned Revenue	162,923,447	207,256,209
Due to Fiduciary Funds	506	1,039
TOTAL LIABILITIES	$ 345,259,336	$ 487,009,722
Fund Balance:		
Restricted for Health Related Purposes – Note 1	$ 44,261,256	$ 45,580,611
Committed for Health Related Purposes – Note 1	395,003,569	781,603,680
TOTAL FUND BALANCE	$ 439,264,825	$ 827,184,291
TOTAL LIABILITIES AND FUND BALANCE	$ 784,524,161	$ 1,314,194,013

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

COMPARATIVE STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES JUNE 30, 2011 AND 2010

	July 1, 2010 to June 30, 2011	July 1, 2009 to June 30, 2010
REVENUES:		
Master Settlement Agreement Payments – Note 1	$ 309,880,586	$ 326,849,929
Master Settlement Agreement Strategic Contribution Payment – Note 4	20,954,872	22,993,282
Community Health Reinvestment – Note 4	87,750,479	84,068,471
Intergovernmental Revenues – Federal	169,617,890	191,892,566
Redeposit of Checks	150	405
Investment Income:		
Interest on Deposits	687,288	954,928
Interest and Dividend Income	9,694,905	16,359,521
Increase/(Decrease) in Fair Value of Investments	18,280,253	64,822,920
Total Investment Income	$ 28,662,446	$ 82,137,369
TOTAL REVENUES	**$ 616,866,423**	**$ 707,942,022**
EXPENDITURES:		
Program Expenditures:		
State Funded Programs		
Home and Community Based Services	$ 47,433,442	$ 50,480,042
Tobacco Use Prevention and Cessation	14,053,657	17,266,009
Health and Related Research	60,900,140	72,091,509
Uncompensated Care	26,588,583	39,275,001
Health Investment Insurance	165,221,172	199,166,276
Medical Assistance Long-Term Care	103,599,000	130,923,000
Life Science Greenhouses	2,995,078	2,901,585
Total State Funded Programs	$ 420,791,072	$ 512,103,422
Federally Funded Programs		
Home and Community Based Services	$ 50,720,747	$ 70,930,637
Uncompensated Care	34,200,989	47,497,000
Health Investment Insurance	86,015,509	73,548,953
Total Federally Funded Programs	$ 170,937,245	$ 191,976,590
Total Program Expenditures	$ 591,728,317	$ 704,080,012
Administrative Expenditures:		
Salaries and Benefits	$ 275,967	$ 381,601
Board Expenditures	110,922	(172,820)
Private Equity Activity	-	1,389,857
Investment Management Fees	704,982	3,102,264
ADR Fees	-	1,319
Consulting Fees	60,000	195,000
Commissions on Futures	6,674	13,981
Taxes and Insurance	36,257	35,053
Legal Fees	4,969	-
Miscellaneous	1,801	3,183
Total Administrative Expenditures	$ 1,201,572	$ 4,949,438
TOTAL EXPENDITURES	**$ 592,929,889**	**$ 709,029,450**
EXCESS/(DEFICIENCY) OF REVENUES OVER/(UNDER) EXPENDITURES	**$ 23,936,534**	**$ (1,087,428)**

COMPARATIVE STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES JUNE 30, 2011 AND 2010 (CONTINUED)

	July 1, 2010 to June 30, 2011	July 1, 2009 to June 30, 2010
OTHER FINANCING SOURCES (USES):		
Transfer to Public School Employees' Retirement System per Act 46 of 2010 – Note 4	$ (121,000,000)	$ -
Transfer to General Fund per Act 50 of 2009 – Note 4	(14,708,000)	(167,673,000)
Transfer to General Fund per Act 46 of 2010 – Note 4	(250,000,000)	-
Transfer to Pacenet	(26,148,000)	(31,420,000)
NET OTHER FINANCING SOURCES (USES)	**$ (411,856,000)**	**$ (199,093,000)**
NET CHANGE IN FUND BALANCE	**$ (387,919,466)**	**$ (200,180,428)**
Fund Balance, June 30, 2010 and 2009	827,184,291	1,027,364,719
Fund Balance, June 30, 2011 and 2010	**$ 439,264,825**	**$ 827,184,291**

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

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Commonwealth of Pennsylvania Tobacco Settlement Fund ("COPA TSF") was established in 2001 as a special revenue fund of the Commonwealth of Pennsylvania ("Commonwealth") pursuant to Act 77 of 2001, Section 303(a), also known as the Tobacco Settlement Act (Act). All payments pursuant to the Master Settlement Agreement ("MSA") between the settling states and participating tobacco manufacturers are deposited by the Commonwealth Treasury Department ("Treasury") into the COPA TSF.

The Tobacco Settlement Investment Board ("TSIB") was created to manage, invest and reinvest money in the COPA TSF in accordance with the Act. The TSIB consists of eleven members, including the Secretary of the Department of Community and Economic Development, the Secretary of the Budget, three members appointed by the Governor, two appointees by the President pro tempore of the Senate, two appointees by the House Speaker, an appointee by the Minority Leader of the House and an appointee by the Minority Leader of the Senate.

The Department of Community and Economic Development, the Office of the Budget's Office of Comptroller Operations, and certain other Commonwealth agencies provide staff personnel and other services to the COPA TSF. Certain salaries, benefits and other costs are charged to the COPA TSF.

The COPA TSF has an administrative budget, which is approved by the TSIB each fiscal year but does not have a formal adopted budget for the other activities of the COPA TSF.

Basis of Accounting

The TSIB follows Generally Accepted Accounting Principles ("GAAP"). GAAP allows specialized accounting for government entities, which is governed by pronouncements set by the Governmental Accounting Standards Board ("GASB"). The COPA TSF's statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the COPA TSF considers revenues to be available if collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred.

Master Settlement Agreement Revenues

The TSIB implemented GASB Technical Bulletin No. 2004-1: Tobacco Settlement Recognition and Financial Reporting Issues (the "Bulletin"), effective July 1, 2003. The Bulletin requires the COPA TSF to recognize MSA asset and revenues when the event giving rise to recognition occurs (the domestic shipment of cigarettes by the tobacco product manufacturers).

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Future collections are contingent upon future tobacco product sales subject to various adjustments as outlined in the MSA. The COPA TSF recognizes revenue from tobacco settlement collections as the collections are received by the COPA TSF. In addition, an estimated receivable is accrued for estimated product sales from January 1 through June 30 of each year.

Accounts Receivable

Accounts receivable represents one-half of the estimated MSA payment to be received in April of the following fiscal year. The total in this asset classification is unavailable at fiscal year-end.

Investments

Investments are reported at fair value as of the financial statement date based upon values provided by the custodian bank. Investment receivables and payables are recorded separately from investment balances. Receivables and payables are caused by a difference between trade date and settlement date on investment transactions. Securities lending asset and liability amounts are equal to 1) the value of cash and securities purchased with cash received and 2) amounts owed to the counterparty that are part of the Commonwealth's Treasury Security Lending Program. Private equity investments are valued primarily based on amounts estimated by the general partners which are consistent with the guidelines established by the Private Equity Industry Guidelines Group and accepted by the TSIB.

Due from Federal Government

Within the Commonwealth, each fund supports its own federal appropriations. COPA TSF must pay expenditures charged to federal appropriations and await reimbursement from the federal government. Both the Department of Aging and the Department of Public Welfare have federal appropriations for medical assistance programs. There is a maximum thirteen day lag between the expenditure and the reimbursement from the federal government.

Fund Balance Categories

Fund balance consists of the following:

Restricted for Health Related Purposes

Amounts which may only be spent for expenditures in accordance with Federal grants are reported as restricted fund balance.

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Committed for Health Related Purposes

Commonwealth law, enacted by the General Assembly (legislature) and approved by the Governor, is the Commonwealth's highest level of decision-making authority. Both legislative enactment and gubernatorial approval on or prior to fiscal year end are necessary, formal actions to establish, modify and/or rescind amounts committed. The enabling legislation (as amended from time to time) for the TSF provides committed purposes; related amounts are reported as committed fund balance.

Commitments

As of June 30, 2011, private equity investment purchase commitments were as follows:

Tobacco Settlement Account	$ 73,957,170
Health Venture Account	$ 8,228,901

New Accounting Pronouncements – Adopted

In February 2009, the GASB issued Statement No. 54, "Fund Balance Reporting and Governmental Fund Type Definitions." GASB Statement No. 54 changes the existing fund balance components within governmental funds from the former Reserved and Unreserved (within Unreserved: Designated and Undesignated) fund balances, to the newer Nonspendable and Spendable (within Spendable: Restricted, Committed, Assigned and Unassigned). The COPA TSF previously reported categories and amounts within total fund balance, as reported at June 30, 2010, were Reserved for Encumbrances totaling $450,430, Reserved for Other totaling $514,274,843, and Unreserved/Undesignated totaling $312,459,018. Effective July 1, 2010, the COPA TSF adopted the newer fund balance categories and amounts Restricted for Health Related Purposes totaling $45,580,611 and Committed for Health Related Purposes totaling $781,603,680, and restated the former, previously reported fund balance categories at June 30, 2010.

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

Risk Management Policies

In May of 2010, the COPA TSF established new contractual arrangements with investment managers, identifying investment objectives while also providing strict limitations on 'allowable' investment purchases which are limited to U.S. Treasury and Agency securities, including agency mortgage-backed securities such as those issued by Government National Mortgage Association

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

("GNMA"), Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Association ("FHLMC"). Cash Equivalent securities may be invested in short-term investment funds that consist entirely of U.S. Treasury or Agency securities. At June 30, 2011, approximately 4% of COPA TSF holdings remain in Corporate Obligations. The establishment of the new policies in May 2010 restricted the purchase of new investments, but did not require the COPA TSF to liquidate existing holdings in other investment classes. At this time the COPA TSF continues to hold corporate obligations, equities, and derivatives.

Portfolios are prohibited from investing in any type of securities or investment vehicles other than U.S. Treasury or Agency securities and from entering into short sales or margin purchases.

The COPA TSF also consists of pooled assets within the Treasury Global Investment Fund (Pool 124) and is subject to its own investment policy. Pool 124 is a short-term investment vehicle that seeks to maintain a stable net asset value per share (NAV) of $1 by investing exclusively in fixed income securities, primarily of short duration. The only approved investments are cash and cash equivalents and fixed income. Given the purpose of the Pool, these funds should assume significant liquidity needs and minimum risk tolerance.

Investments by Type: At June 30, 2011, the investment types and related amounts of the COPA TSF are as follows:

Investment Type	Amount
Cash Equivalents	$ 251,538
Corporate Obligations	25,268,097
Derivatives (futures contracts)	(10,212)
Equities	27,081
Mortgage Backed Securities	14,474,858
Private Equity	190,574,943
Treasury Investment Program	142,629,318
U.S. Government Sponsored Enterprises	65,702,919
U.S. Treasury Obligations	121,252,980
Total	$560,171,522

Custodial Credit Risk: Custodial credit risk for investments is the risk that, in the event a counterparty fails to uphold its agreement to a transaction, the COPA TSF would not be able to recover the value of investment or collateral securities in the possession of an outside party. In accordance with a contractual relationship between the Treasury Department and its custodial agents, substantially all investments, where securities are used as evidence of the investment, are held by the custodians in book entry form in the name of the Commonwealth or the custodian.

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Similarly, investments of the COPA TSF are registered in the name of the Commonwealth, as the Treasury Department is the statutory custodian for such investments. At June 30, 2011, no investment securities were subject to custodial credit risk.

Concentration Risk: Concentration risk is the risk of loss attributed to the magnitude of the government's investment in a single issuer. As of May 2010, portfolios are prohibited from investing in any type of securities or investment vehicles other than U.S. Treasury or Agency securities. The following concentrations existed as of June 30, 2011:

Issuer Name	Amount	Percentage Concentration
Treasury Investment Program	$142,629,318	25.46%
United States Treasury	121,252,980	21.65%
Federal National Mortgage Association	48,535,096	8.66%
Chrysalis Capital Partners	39,929,350	7.13%

Credit Quality Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by Nationally Recognized Statistical Rating Agencies ("NRSRA") such as Moody's Investors Service ("Moody's").

The TSIB established investment policy statements, effective May 2010, with each individual fixed income manager limiting portfolios to be constructed of only U.S. Treasury or Agency securities with no stated restrictions to investment grade requirements. Certain investments of the COPA TSF are not rated by Moody's, S&P or Fitch as detailed below.

At June 30, 2011, approximately 66 percent of the total investments held by the COPA TSF are fixed income investments in Corporate Obligations and U.S. Government Sponsored Enterprises, susceptible to credit quality rating; the remainder is primarily private equity. The following table discloses aggregate fair value, by the lowest credit quality rating category, at June 30, 2011 for the COPA TSF fixed income investments:

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Moody's Investor Services	Amount
Aaa	$ 20,952,208
Moody's Investor Services subtotal	**$ 20,952,208**
Standard and Poor's	
AA+	$ 4,315,889
A	978,341
Standard and Poor's subtotal	**$ 5,294,230**
Rated subtotal	**$ 26,246,438**
Unrated	
Cash Equivalents	$ 251,538
Derivatives	(10,212)
Mortgage Backed Securities	14,474,858
Treasury Investment Program	142,629,318
U.S. Government Sponsored Enterprises	64,724,578
U.S. Treasury Obligations	121,252,980
Unrated subtotal	**$ 343,323,060**
Total Fixed Income Investments	**$ 369,569,498**

Interest Rate Risk: Interest rate risk is the risk that an investment's value will change, advantageously or adversely, due to a change in the absolute value of interest rates. The COPA TSF measures interest rate risk using duration. Duration is a measure of an investment's sensitivity to changes in interest rates. The higher the duration, the greater the changes in fair value when interest rates change. The COPA TSF measures interest rate risk using option-adjusted duration, which takes into account embedded options affecting cash flows. The TSF portfolios are not expected to be exposed to high levels of interest rate risk, as the effective duration is expected to have a targeted duration within a band of +/- 20% around the effective duration of the benchmark index. At June 30, 2011, the COPA TSF had the following option adjusted durations (in years) by investment type:

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Investment Type	Amount of Securities with Duration	Amount of Securities with no Duration	Option-Adjusted Duration
Cash Equivalents	$ -	$ 251,538	-
Corporate Obligations	25,268,097	-	1.11
Derivatives	(10,212)	-	5.58
Mortgage Backed Securities	13,120,025	1,354,833	2.33
Treasury Investment Program	142,629,318	-	0.08
U.S. Government Sponsored Enterprises	65,702,919	-	1.77
U.S. Treasury Obligations	121,252,980	-	1.83
Total	$ 367,963,127	$ 1,606,371	

Foreign Currency Risk: Foreign currency risk is the risk of an investment's value changing, advantageously or adversely, due to changes in currency exchange rates. At June 30, 2011, the COPA TSF reported the following foreign currency-denominated holdings:

Currency Name	Equities	Private Equity	Cash Equivalents	Total
Euro Currency Unit	$ -	$4,104,493	$ 40	$4,104,533
Swiss Franc	-	-	35,691	35,691
Canadian Dollar	27,081	-	-	27,081
Total	$27,081	$4,104,493	$ 35,731	$4,167,305

Securities Lending Program

In accordance with a contract between the Treasury Department and its custodial agent, the COPA TSF participates in a securities lending program. 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 U.S. dollars or whose primary trading market is located outside the U.S., the fair value of the collateral received must be at least 105 percent of the fair value of the securities lent.

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

For all other securities lent, the fair value of the collateral received must be at least 102 percent. Securities lent consists of both domestic and foreign equity securities and U.S. Treasury and foreign debt obligations. Almost all collateral received consists of cash; a very small portion of collateral received consists of letters of credit, U.S. 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 do 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, 2011, there were no failures by any borrower to return securities lent or pay distributions thereon that would impact the COPA TSF. 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 that would impact the COPA TSF.

At June 30, 2011, there was no Treasury Department or participant credit risk to the borrowers that would adversely affect the COPA TSF because the fair value of collateral received was greater than the fair value of the securities lent, consistent with the lending agreements outstanding.

The fair value of the securities lent, along with type of investments lent, are:

Securities Lent Amount	U.S. Treasury Obligations	U.S. Government Sponsored Enterprises
$11,494,631	$9,752,500	$1,742,131

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Financial Instruments With Off-Balance Sheet Risk

The COPA TSF enters into derivatives and structures instruments primarily to enhance the performance and reduce volatility of its investment portfolio. It enters into futures contracts to gain or hedge exposure to certain investment markets and to manage interest rate risk.

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

The COPA TSF has entered into certain futures contracts maturing through September 2011. The notional value of these contracts at June 30, 2011 is as follows:

Futures Contracts	Buy Contracts	Sell Contracts
U.S. Treasury Futures	$12,721,938	$(5,482,984)

NOTE 3 – RELATED PARTIES

The COPA TSF employs one full-time salaried staff member and owns no capital assets; the remaining employees performing services for the COPA TSF are employees from the Office of the Budget's Office of Comptroller Operations (OCO). The COPA TSF reimburses the OCO for services rendered by Comptroller employees to the COPA TSF. Applicable to the fiscal year ended June 30, 2011, the services provided by the OCO to the COPA TSF and recorded as administrative expenses totaled $32,481.

NOTE 4 – COMMITMENTS AND CONTINGENCIES

Litigation has been filed alleging, among other claims, that the MSA violates provisions of the U.S. Constitution, state constitutions, federal antitrust and civil rights laws, and state consumer protections laws; these actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable. The lawsuits seek to prevent the states from collecting any monies under the MSA and/or a determination that prevents the tobacco product manufacturers from collecting MSA payments through price increases to cigarette consumers. In addition, class action lawsuits have been filed in jurisdictions alleging violations of state Medicaid agreements. No such lawsuits have been successful.

NOTE 4 – COMMITMENTS AND CONTINGENCIES (CONTINUED)

The enforcement of the terms of the MSA may continue to be challenged in the future. In the event of an adverse court ruling, the COPA TSF may not have adequate financial resources to continue its programs and services.

In April 2011, 2010, 2009, 2008, 2007 and 2006 many of the tobacco product manufacturers participating in the MSA either withheld all or portions of their payments due, or remitted their payments to an escrow account, largely disputing the calculations of amounts due under the Agreement. These manufacturers assert that the calculations of the amounts due failed to recognize a prescribed adjustment for non-participating manufacturers. The Commonwealth of Pennsylvania's anticipated portion of these disputed payments by fiscal year is approximately:

Fiscal Year	Amount
2006	$ 46,759,401
2007	43,670,479
2008	33,201,419
2009	30,147,888
2010	38,306,575
2011	50,873,568
	$242,959,330

Due to uncertainties regarding the ultimate collection of the remaining amount of these disputed payments, they have not been recognized as revenue in the accompanying financial statements. The COPA TSF and other affected parties are taking actions prescribed in the MSA to arrive at a resolution of these matters.

The COPA TSF is currently involved in certain legal proceedings related to potential disallowances of Federal Medicaid reimbursements received for payments made by the COPA's Home and Community Based Services program during the year ended June 30, 2009 for which the likelihood of an unfavorable outcome is reasonably possible, for which liabilities have not been reported as of June 30, 2011. Unfavorable outcomes to the COPA's TSF, which the COPA is vigorously contesting, could range from approximately $0 to $54 million.

NOTE 4 – COMMITMENTS AND CONTINGENCIES (CONTINUED)

As of June 30, 2011, the COPA TSF had the following commitments related to private equity investments:

	Capital Committed	**Capital Called**	**Recallable Capital**	**Reserved Capital**
Tobacco Settlement Account	$224,906,000	$159,431,856	$8,483,026	$73,957,170
Health Venture Account	66,000,000	59,264,433	1,493,334	8,228,901

The Community Health Reinvestment Account balance at June 30, 2011 was $29,418,032. In the current year the agreement providing for revenues ended December 31, 2010. The Adult Basic Program funded by this account was discontinued on February 28, 2011.

During the fiscal year ended June 30, 2011, the TSIB transferred the strategic payment received in fiscal year 2009-2010 totaling $22,993,282 from the Endowment Account to the Tobacco Settlement Account, the Endowment Account portion of the MSA payment received in fiscal year 2009-2010 totaling $26,147,994 from the Endowment Account to the Tobacco Settlement Account and $121,000,000 from the Endowment Account to the General Fund to augment payment of required contributions for Public School Employees' Retirement. The TSIB also transferred $14,708,000 from the COPA TSF to the General Fund in accordance with Act 50 of 2009, and $15,487,619 in lapsed TSF appropriations, as well as TSIB salaries, benefits and operating expenditures from the Tobacco Settlement Account to the Endowment Account in accordance with Act 77 of 2001. Act 46 of 2010 also required that $15,000,000 of TSF earnings be retained in the Tobacco Settlement Account and not be transferred to the Endowment Account.

The balance of the Endowment Account at June 1, 2011 in the amount of $317,532,943 to the Tobacco Settlement Account and $250,000,000 from the COPA TSF to the General Fund in accordance with Act 46 of 2010. Through fiscal year ending June 30, 2012, the fiscal year 2010-2011 strategic payment and fiscal year 2011-2012 Endowment Account monies are to remain in the Tobacco Settlement Account. Also, funds deposited into the TSF from MSA payments received in April 2011 and April 2012 are to be used to make appropriations for the 2011-2012 fiscal year.

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND

STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES BY ACCOUNT
JULY 1, 2010 THROUGH JUNE 30, 2011

	Health Venture	Tobacco Settlement	Community Health	Commercialization	Total
REVENUES:					
Master Settlement Agreement Payments - Note 1	$ -	$ 309,880,586	$ -	$ -	$ 309,880,586
Master Settlement Agreement Strategic Contribution Payment - Note 4	-	20,954,872	-	-	20,954,872
Community Health Reinvestment - Note 4	-	-	87,750,479	-	87,750,479
Intergovernmental Revenues - Federal	-	169,617,890	-	-	169,617,890
Redeposit of Checks	-	150	-	-	150
Investment Income:					
Interest on Deposits	-	687,288	-	-	687,288
Interest and Dividend Income	107,577	9,393,804	193,514	10	9,694,905
Increase/(Decrease) in Fair Value of Investments	(2,404,528)	20,748,259	(63,478)	-	18,280,253
Total Investment Income	$ (2,296,951)	$ 30,829,351	$ 130,036	$ 10	$ 28,662,446
TOTAL REVENUES	**$ (2,296,951)**	**$ 531,282,849**	**$ 87,880,515**	**$ 10**	**$ 616,866,423**
EXPENDITURES:					
Program Expenditures:					
State Funded Programs					
Home and Community Based Services	$ -	$ 47,433,442	$ -	$ -	$ 47,433,442
Tobacco Use Prevention and Cessation	-	14,053,657	-	-	14,053,657
Health and Related Research	-	60,900,140	-	-	60,900,140
Uncompensated Care	-	26,588,583	-	-	26,588,583
Health Investment Insurance	-	65,004,279	100,216,893	-	165,221,172
Medical Assistance Long-Term Care	-	103,599,000	-	-	103,599,000
Life Science Greenhouses	-	2,995,078	-	-	2,995,078
Total State Funded Programs	$ -	$ 320,574,179	$ 100,216,893	$ -	$ 420,791,072
Federally Funded Programs					
Home and Community Based Services	$ -	$ 50,720,747	$ -	$ -	$ 50,720,747
Uncompensated Care	-	34,200,989	-	-	34,200,989
Health Investment Insurance	-	86,015,509	-	-	86,015,509
Total Federally Funded Programs	$ -	$ 170,937,245	$ -	$ -	$ 170,937,245
Total Program Expenditures	$ -	$ 491,511,424	$ 100,216,893	$ -	$ 591,728,317
Administrative Expenditures:					
Salaries and Benefits	$ -	$ 275,967	$ -	$ -	$ 275,967
Board Expenditures	-	110,922	-	-	110,922
Investment Management Fees	-	694,745	10,237	-	704,982
Consulting Fees	-	60,000	-	-	60,000
Commissions on Futures	-	6,674	-	-	6,674
Taxes and Insurance	-	36,257	-	-	36,257
Legal Fees	-	4,969	-	-	4,969
Miscellaneous	-	1,801	-	-	1,801
Total Administrative Expenditures	$ -	$ 1,191,335	$ 10,237	$ -	$ 1,201,572
TOTAL EXPENDITURES	**$ -**	**$ 492,702,759**	**$ 100,227,130**	**$ -**	**$ 592,929,889**
EXCESS/(DEFICIENCY) OF REVENUES OVER/(UNDER) EXPENDITURES	**$ (2,296,951)**	**$ 38,580,090**	**$ (12,346,615)**	**$ 10**	**$ 23,936,534**
OTHER FINANCING SOURCES (USES):					
Transfer to Public School Employees' Retirement System per Act 46 of 2010 - Note 4	$ -	$ (121,000,000)	$ -	$ -	$ (121,000,000)
Transfer to General Fund per Act 50 of 2009 - Note 4	-	(14,708,000)	-	-	(14,708,000)
Transfer to General Fund per Act 46 of 2010 - Note 4	-	(250,000,000)	-	-	(250,000,000)
Transfer to Pacenet	-	(26,148,000)	-	-	(26,148,000)
NET OTHER FINANCING SOURCES (USES)	**$ -**	**$ (411,856,000)**	**$ -**	**$ -**	**$ (411,856,000)**
NET CHANGE IN FUND BALANCE	**$ (2,296,951)**	**$ (373,275,910)**	**$ (12,346,615)**	**$ 10**	**$ (387,919,466)**
Fund Balance, June 30, 2010					**$ 827,184,291**
Fund Balance, June 30, 2011					**$ 439,264,825**

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND

SCHEDULE OF CASH RECEIPTS AND DISBURSEMENTS BY ACCOUNT
JULY 1, 2010 THROUGH JUNE 30, 2011

	Health Venture	Tobacco Settlement	Community Health	Commercialization	Total
Investment Fair Market Value - July 1, 2010	$ 58,992,045	$ 903,858,262	$ 22,385,753	$ 4,063	$ 985,240,123
RECEIPTS					
Master Settlement Agreement Payments	$ -	$ 309,880,586	$ -	$ -	$ 309,880,586
Master Settlement Agreement Strategic Contribution Payment	-	20,954,872	-	-	20,954,872
Community Health Reinvestment	-	-	87,750,479	-	87,750,479
Intergovernmental Revenues - Federal	-	214,737,769	-	-	214,737,769
Redeposit of Checks	-	150	-	-	150
Investment Income:					
Interest on Deposits	-	687,288	-	-	687,288
Interest and Dividend Income	107,577	9,318,026	193,513	10	9,619,126
Increase/(Decrease) in Fair Value of Investments	(2,404,528)	20,844,875	(63,478)	-	18,376,869
Total Investment Income	$ (2,296,951)	$ 30,850,189	$ 130,035	$ 10	$ 28,683,283
TOTAL RECEIPTS	**$ (2,296,951)**	**$ 576,423,566**	**$ 87,880,514**	**$ 10**	**$ 662,007,139**
DISBURSEMENTS					
Total Program Expenditures Paid	$ -	$ 594,228,485	$ 80,837,998	$ -	$ 675,066,483
Administrative Expenditures:					
Salaries and Benefits	$ -	$ 302,801	$ -	$ -	$ 302,801
Board Expenditures	-	(14,417)	-	-	(14,417)
Investment Management Fees	-	694,745	10,237	-	704,982
Consulting	-	60,000	-	-	60,000
Commisions on Futures	-	6,674	-	-	6,674
Taxes and Insurance	-	36,257	-	-	36,257
Legal Fees	-	4,969	-	-	4,969
Miscellaneous	-	1,801	-	-	1,801
Total Administrative Expenditures Paid	$ -	$ 1,092,830	$ 10,237	$ -	$ 1,103,067
TOTAL DISBURSEMENTS	**$ -**	**$ 595,321,315**	**$ 80,848,235**	**$ -**	**$ 676,169,550**
TRANSFERS					
Transfer to Public School Employees' Retirement System per Act 46 of 2010 - Note 4	$ -	$ (121,000,000)	$ -	$ -	$ (121,000,000)
Transfer to General Fund per Act 50 of 2009 - Note 4	-	(14,708,000)	-	-	(14,708,000)
Transfer to General Fund per Act 46 of 2010 - Note 4	-	(250,000,000)	-	-	(250,000,000)
Transfer to Pacenet	-	(26,148,000)	-	-	(26,148,000)
TOTAL TRANSFERS	**$ -**	**$ (411,856,000)**	**$ -**	**$ -**	**$ (411,856,000)**
Investment Fair Market Value - June 30, 2011	**$ 56,695,094**	**$ 473,104,513**	**$ 29,418,032**	**$ 4,073**	**$ 559,221,712**

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND

SCHEDULE OF INVESTMENT DETAIL BY ACCOUNT
AS OF JUNE 30, 2011

	Health Venture	Tobacco Settlement	Community Health	Commercialization	Total
Cash & Cash Equivalents	$ -	$ 113,005,363	$ 912,567	$ 4,073	$ 113,922,003
Fixed Income Securities	-	196,397,277	28,505,465	-	224,902,742
Equity	-	27,081	-	-	27,081
Futures Contracts	-	(10,212)	-	-	(10,212)
Total Temporary Investments	**$ -**	**$ 309,419,509**	**$ 29,418,032**	**$ 4,073**	**$ 338,841,614**
Cash & Cash Equivalents	$ 29,805,155	$ -	$ -	$ -	$ 29,805,155
Private Equity	26,889,939	163,685,004	-	-	190,574,943
Total Long Term Investments	**$ 56,695,094**	**$ 163,685,004**	**$ -**	**$ -**	**$ 220,380,098**
Total Investments	**$ 56,695,094**	**$ 473,104,513**	**$ 29,418,032**	**$ 4,073**	**$ 559,221,712**

Total Investments includes interest receivable, investments sold receivable, and investment purchases payable. Cash and cash equivalents includes cash plus investments from the Treasury Investment Program and certain U.S. Treasury Obligations.

JACK WAGNER
AUDITOR GENERAL

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 Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

We have audited the financial statements of the Pennsylvania Tobacco Settlement Fund (TSF) as of and for the fiscal years ended June 30, 2011 and 2010, including the Balance Sheet, and the Statement of Revenues, Expenditures, and Changes in Fund Balances, and have issued our report thereon dated November 29, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered TSF's internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of TSF's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of TSF's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting 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 over financial reporting that we consider to be material weaknesses.

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. We consider the deficiencies described in Findings 11-1 through 11-4 to be material weaknesses.

Compliance and Other Matters

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

TSF's agency responses to the findings identified in our audit are described in Findings 11-1 through 11-4. We did not audit TSF's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the TSF management and is not intended to be and should not be used by anyone other than this specified party.

November 29, 2011

JACK WAGNER
Auditor General

Finding 11 – 1:

Office of the Budget
Office of Administration

Lack of Documentation to Support Contracting and Procurement (A Similar Condition Was Noted in Prior Finding 10-1)

Condition: During our current audit of the Tobacco Settlement Fund (TSF), the Commonwealth expended TSF monies in accordance with numerous contracts and grants to provide tobacco use prevention and cessation services, health related research, health insurance and other services. For the past 11 audits of the Commonwealth's Statewide Basic Financial Statements (BFS) for the fiscal years ended June 30, 2000 to June 30, 2010, we have 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. This same situation also applies to our audit of the TSF.

During the fiscal year ended June 30, 2011, Commonwealth management refused to provide proposal evaluation committee members' names by redacting them from procurement documentation provided to the auditors, such as detailed proposed scoring sheets. This precluded the auditors from determining proper controls are in place to prevent potential conflicts of interest, fraud, abuse or other inappropriate activity from occurring during the contract procurement process.

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 II, 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 are reasonably followed to prevent conflicts of interest, etc., and contracts are properly awarded. Regarding procurement duties, Section C of Chapter 7 states:

12. Evaluation Committee.

- *a. Performs final technical submittal evaluations after discussions/best and final offers have been completed/received* (i.e. score sheets).

Cause: Management maintains that the identity of evaluation committee members is considered confidential information that auditors are not entitled to review. Management also maintains that these documents are not within the scope of a financial statement audit.

Effect: By refusing to provide the requested documentation, management has prevented the Department of the Auditor General from performing duties required of it by Pennsylvania's Constitution and by Pennsylvania law. The Constitution provides that "all departments, boards, commissions, agencies, instrumentalities, authorities and institutions of the Commonwealth shall be subject to audits made in accordance with generally accepted auditing standards." (Article VIII, Section 10) The Fiscal Code directs the Department of the Auditor General "to make all audits of transactions after their occurrence, which may be necessary, in connection with the administration of the financial affairs of the government of this Commonwealth…" (72 P.S. § 402) Management has taken the position that the invocation of confidentiality supersedes these constitutional and statutory directives.

Without the necessary documentation, we could not verify that management adhered to Commonwealth procurement standards and laws, or exercised due diligence in awarding the contracts mentioned above. More specifically, we could not verify that management had proper controls in place to prevent conflicts of interest, 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)*

Recommendation: We recommend that management alter 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: We disagree with this finding. In response to this finding as issued in prior years, the Commonwealth has reviewed its policies and significantly expanded the procurement-related documentation available to the auditors. Effective for the June 30, 2010 Basic Financial Statement audit the auditors were provided, upon request, the following additional procurement documentation beyond the executed contracts:

- Copies of losing vendor proposals.
- Detailed scoring sheets showing the scores of each committee member by category with committee member names redacted.
- Summary information regarding the procurement as contained in the "Recommendation for Contractor Selection" memorandum required to be completed by each committee. Among other detailed information, this memorandum includes: information regarding the reasonableness of cost and minority participation; the list of agencies that had representatives on the evaluation committee; the indication of Department of General Services & Comptroller participation; the results of the evaluation conducted by the committee; the overall scoring results; the evaluation committee recommendations; and the signed agency head approval/disapproval of recommendation.

In addition to the aforementioned documentation, the auditors were informed in writing that they could initiate requests to interview individual evaluation committee members if they identified compelling reasons to do so within the scope of specific audits and Commonwealth representatives concurred with the compelling reasons put forth by the auditors. We believe this is a reasonable approach specific to evaluation committee members given the balance necessary to ensure willing participation of evaluation committee members in the Commonwealth's procurement process while also ensuring the auditors have access to necessary documentation. The importance of evaluation committee member confidentiality is demonstrated in the Commonwealth's Right to Know Law. In accordance with Act 3 of 2008, §708 – Exceptions for public records, (b)(26), the "identity of members, notes and other records of agency proposal evaluation committees established under 62 Pa. §513 (relating to competitive sealed proposals)." are exempt from requestors access. The Commonwealth also recognizes the importance of internal controls related to conflicts of interest within the procurement process and has a longstanding policy of requiring evaluation committee members to review/acknowledge and sign an RFP Evaluation Committee Certification of Confidentiality and No Conflict of Interest Form (Procurement Handbook 11/10, Pt. II, Chpt.7). These forms are reviewed by the agency coordinators and referred to the Department of General Services' Office of Chief Counsel Legal Purchasing Unit if there are any questions or disclosures by the evaluation committee members.

In an effort to alleviate the auditors' remaining issues with the Commonwealth's procurement audit disclosure policy, the Commonwealth continues to pursue conversations with audit staff that were initiated during the prior year audit to discuss potential alternate compromises to releasing evaluation committee member names. We recognize the importance of audit staff's ability to properly test our internal controls and want to work cooperatively to ensure audit staff understands our desire to provide each Commonwealth employee who agrees to serve as a committee member the opportunity to evaluate procurements candidly.

Auditors' Conclusions: We acknowledge that over the years, Office of the Budget (OB) has improved its transparency and provided auditors documents that it previously would not have.

Nevertheless, as noted in the finding, we believe that it is necessary for OB to disclose the identities of the respective committee members involved with the evaluation of contracts in order for auditors to conclude their procurement audit procedures.

Looking ahead, we are encouraged by OB's statements that it is willing to work with our auditors to discuss potential resolutions with regard to these matters.

Finding 11 – 2:

Department of Health

DOH Did Not Comply With Annual Contractor and Service Provider Audit Requirements for the Tobacco Settlement Fund (A Similar Condition Was Noted in Prior Finding 10-2)

Condition: In lieu of performing its own audits of contractors, DOH relies on its contractors to have audits completed. Our testing of the receipt of contractor audits during the SFYE June 30, 2011 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, 2010 by 8 of 14 contractors required to have audits. These 8 contractors received $8.1 million out of the $20.4 million paid to the 14 contractors during the SFYE June 30, 2010. Of the 8, one contractor received more than $2.5 million (12.3%), the second most of any contractor that received funding under the DOH Prevention and Cessation program during the SFYE June 30, 2010.

Similar internal control weaknesses over contractor audit reports have been reported in our prior-year audits since SFYE June 30, 2003. Although DOH tracks audits submitted by the contractors, it failed to proactively monitor which entities did not submit an audit. DOH did not notify the contractors when their audits were past due, nor did DOH verify that these audits were in process.

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

Section 709. Accountability.

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

Cause: DOH management stated that it lacked sufficient staff and resources to implement an effective system to proactively monitor the audit requirements for the contracts related to the Prevention and Cessation program. As noted above, management only tracked audit submissions during SFYE June 30, 2011.

Effect: Since DOH personnel did not receive an audit for 8 of the 14 contractors for the SFYE June 30, 2010, 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. Furthermore, this inadequate monitoring to ensure all required audits are received and reviewed permits potential weaknesses to continue for extended periods.

Recommendation: DOH should ensure that all contractors have audits completed as required by Section 709(a) of the Tobacco Settlement Act by proactively monitoring contractor audits and following up when audit reports are not timely received.

Agency Response: The eight contracts identified as not submitting audits for the SFY 2010 (July 1, 2010 – June 30, 2011) include both Primary Contractors and Statewide contractors.

Primary Contractors:

1. Family Health Council of Central Pennsylvania: On August 24, 2011, the Family Health Council of Central Pennsylvania, Inc. submitted a single audit report for the period July 1, 2010 through June 30, 2011; however, this report is not program-specific and is not acceptable per DOH's Audit Resolution Section (Audit Section). The DOH Project Officer will provide written notice to the vendor requiring a program-specific audit, which will also include the extension period. The Family Health Council of Central Pennsylvania must submit a 15-month program–specific audit report to DOH no later than 90 days from the date of the letter that will be forwarded by the DOH Project Officer by December 31, 2011.

Statewide Contractors:

2. American Lung Association of Pennsylvania for the Pennsylvania Alliance to Control Tobacco (PACT): On October 26, 2011, the DOH Project Officer forwarded an electronic copy of the June 30, 2011 audit report for the American Lung Association of Pennsylvania for the Pennsylvania Alliance to Control Tobacco (PACT) to the DOH Audit Section.

3. American Cancer Society (ACS): This contract is a unit cost Purchase Order for quitline operations. A contract with ACS for quitline operations went into effect in 2002 through 2005; audits were conducted as required by the contract's audit requirements appendix. In 2005, in order to improve efficiency of DOH management of the quitline, DOH moved to a unit cost purchase order. This change allowed DOH to more closely monitor costs and data to match the billings. Since ACS exceeded the audit requirement threshold of $100,000 of expenditures for the year ended June 30, 2010 DOH will require ACS to submit a program-specific audit report to DOH no later than 90 days from the date of the letter that will be forwarded by the DOH Project Officer by December 31, 2011.

4. Free & Clear, Inc.: Effective November 23, 2009 quitline operations were assigned to Alere Wellbeing (formally known as Free & Clear, Inc) because ACS discontinued providing quitline services to states, and by letter of assignment transferred operations to Free & Clear, Inc. Since Free & Clear, Inc. exceeded the audit requirement threshold of $100,000 of expenditures for the year ended June 30, 2010 DOH will require Free & Clear, Inc. to submit a program-specific audit report to DOH no later than 90 days from the date of the letter that will be forwarded by the DOH Project Officer by December 31, 2011.

5. Clarion University: Clarion University is part of the State System of Higher Education and as such is not required to conduct an audit.

6. Pennsylvania State University/Area Health Education Center: The grant was executed as an inter-governmental agreement and no audit was required by the Department.

7. The Harmelin Group: The Harmelin Group contract was held by the Governor's office. Since the vendor exceeded the audit requirement threshold of $100,000 of expenditures under their contract for the year ended June 30, 2010 they must therefore submit to DOH an audit report no later than 90 days from the date of the letter that will be forwarded by the DOH Project Officer by December 31, 2011.

8. The Neiman Group: The Neiman Group contract for SFY 2009-2010 was held by the Governor's office. Since the vendor exceeded the audit requirement threshold of $100,000 of expenditures under their contract for the year ended June 30, 2010 DOH will request the Office of the Budget's Bureau of Audits to perform the necessary audit of the tobacco settlement fund monies in the Neiman Group contract held by the Governor's Office.

As reported in the 2010 response, DOH initiated several steps to improve the auditing of tobacco primary contractors and statewide contractors:

- As applicable, all contractors continue to be required to include budgetary provisions in their yearly budgets to ensure that required audits will be conducted. Appendix F – Audit Requirements to tobacco Primary Contractor contract requires a program audit within 120 days of the end of each year for contracts that have expended over $100,000 within the year.

- Primary and Statewide Contractors receive broadcast emails reminding them of their audit responsibilities, and individual reminders are sent during September and October, as all audits are due October 31. As an additional reminder, DOH Project Officers make direct inquires by calling contractors if audit reports are not received by the due date. A two-week extension is granted to vendors. However, an extension up to 90 days can be granted to provide additional time to meet the requirement.

- An audit spreadsheet is maintained and shared with the DOH Audit Section providing the names of all of the entities including total expenditure amounts by contractor with the audit due date of October 31, 2011 and extension dates if appropriate. This audit spreadsheet is shared with the DOH Audit Section weekly until all audits are received.

- The DOH Audit Section provides receipt dates to the DOH Program staff. Contractors not submitting their audit reports by the defined due dates are contacted by the DOH project officer.

Auditors' Conclusions: We welcome DOH's enumeration of the primary and statewide contractors whose audits were outstanding and the status of each. Moreover, we are pleased with the corrective action steps initiated by DOH to date in order to improve the auditing of primary and statewide contractors. However, for purposes of clarification, the audit reports requested by our auditors were from SFYE June 30, 2010. Consequently, the audits denoted in the agency's response are more than a year late according to DOH Audit Requirement Policy, which requires that audit reports be completed and submitted within 120 days of the end of the state fiscal year. Therefore, contractors should have submitted audit reports no later than October 31, 2010. We encourage DOH to ensure that future audits are submitted timely. Furthermore, because DOH was unable to provide our auditors with the aforementioned audit reports, our finding and recommendation remain as stated above.

Additionally, we do not believe that a contract pertaining to Tobacco Settlement Fund is outside the purview of DOH simply because the vendor is under the governance of another agency (e.g., Clarion University). Section 709(a) of the Tobacco Settlement Act of 2001 specifically states, "*Contracts with Statewide contractors and primary contractors and grants to service providers shall be subject to an annual audit by the [Department of Health]*." Therefore, we reiterate that DOH should ensure that all contractors have audits completed as required by Section 709(a) of the Tobacco Settlement Act by proactively monitoring contractor audits and following up when audit reports are not timely received.

Finding 11 – 3:

Department of Health

Internal Control Weaknesses Over Tobacco Settlement Fund Commonwealth Universal Research Enhancement Grants (A Similar Condition Was Noted in Prior Finding 10-3)

Condition: Our testing of DOH Tobacco Settlement Fund expenditures revealed that, since inception in SFYE June 2002, all monies granted to eligible institutions under the Commonwealth Universal Research Enhancement (CURE) program have been paid upfront and in full to the grant recipients at the start of each fiscal year's grant, without adequate monitoring of these funds by DOH.

The majority of DOH contracts with the approximately 40 CURE grant recipients extend beyond one fiscal year, and can range up to four years in length. In addition, as reported in the 2009-2010 Annual CURE Report maintained on the DOH website, during the past four years, only $141.6 million of $268.0 million, or 52.8 percent of all CURE funds distributed in the aggregate in the past four years have been expended by grant recipients as of June 30, 2010, the most recent date available. Since the $126.4 million in unexpended grant funds (or 47.2 percent of the CURE grant program) is no longer in Commonwealth accounts, the Commonwealth does not have direct control over this excess cash and these grant funds being held by the outside grant recipients are subject to an increased risk of loss to the Commonwealth. Furthermore, since DOH decided to pay out this grant money upfront at the start of each grant year, internal controls over DOH monitoring of these grantee cash balances should have been significantly enhanced. However, DOH did not perform monitoring of CURE grantees' cash balances to ensure that CURE funds deposited at financial institutions are adequately insured or collateralized, or invested in suitable low risk investments. DOH simply obtained a yearly statement signed by each grantee indicating the type of acceptable deposit or investment accounts that funds were maintained in during the year.

Several of our prior-year audits have disclosed the same internal control weaknesses noted above over this CURE funding with inadequate corrective action by DOH continuing through the end of the current year.

Criteria: According to Management Directive 305.20, dated May 26, 2000, titled Grant Administration, payment terms on grant agreements should normally be on a reimbursement/invoice basis. Other payment methods may only be used upon written approval by the agency's Comptroller prior to solicitation of signatures on the grant agreements. DOH management could not provide documentation of this approval. Additionally, prudent use of Commonwealth funds also dictates that payments to grantees normally be made as reimbursements or as close to a grantee's cash needs as is reasonably possible. If advanced payments are deemed necessary by management, steps should be taken to significantly increase the monitoring of the program.

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 low risk interest bearing accounts or investments.

Effect: Since $126.4 million in Tobacco Settlement funds (or about 47.2 percent of the entire CURE program during the past four years) remain unexpended in the possession of grantees as of June 30, 2010, and in addition are not being properly monitored by DOH, 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. This condition has been occurring for the last ten years since the inception of the CURE grant program.

Recommendation: DOH should ensure compliance with Management Directive 305.20 and, in conjunction with OB, establish procedures to either reimburse grant recipients for the actual cost of research services performed or, at a minimum, allow for advancing of grant funds in a manner that resembles the grant recipient's needs, but with significantly enhanced DOH program monitoring. We noted, for example, that if DOH more closely limited and/or monitored the advance cash of at least 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.

Further, DOH needs, at a minimum, to adequately monitor CURE grantees cash balances to ensure that all CURE funds deposited at financial institutions are properly insured or collateralized, or invested in suitable low risk investments.

Agency Response: DOH is taking this matter [of enhanced program monitoring of the advancement of grant funds] under advisement, and will look further into this issue.

As stated in DOH's response to the first recommendation above, DOH will take this matter [to ensure that all CURE funds deposited at financial institutions are properly insured or collaterized] under advisement, and will look further into this issue.

In response to this recommendation as it applies to the audit period, DOH provides the following response:

The funding provisions of the grant agreements require that grant recipients deposit grant funds within 10 days of receiving the funds in an insured interest-bearing account or invest the funds according to investment requirements contained in the funding provisions. The investment requirements were provided to DOH by Comptroller Operations after consulting with the Department of Treasury. It is DOH's understanding that these investment options were used by the Department of Treasury to invest Commonwealth funds. Other investment options were permitted because many grant recipients received more than $100,000, the maximum FDIC-insured deposit amount at the time the funding provisions were prepared. Limiting investment options to FDIC-insured interest-bearing accounts would have required most grantees to invest their funds in multiple banks to meet the requirement.

During the 2010-11 state fiscal year, 18 of 38 grant recipients received more than $250,000, the current maximum FDIC-insured deposit amount, so requiring investment in FDIC-insured accounts would pose a problem for these grant recipients. The funding provisions require that grant recipients invest funds using the investment guidelines used by the Department of Treasury, which were considered to be low-risk.

The grant recipient must confirm on a *Certification of Confirmation of Grant Funds* form that the funds have been deposited into an insured interest-bearing account, or invested according to the requirements specified in the grant agreement.

Grantees are also required to submit a report of interest earned as part of their annual and final expenditure reports, which are submitted 30 days after the end of the state fiscal year (annual expenditure report) or 60 days after the end of the grant (final expenditure report).

To ensure that grantees comply with grant agreement investment requirements throughout the duration of the grant, DOH implemented a certificate of compliance as part of the required annual and final expenditure reports. The *Certificate of Compliance with Investment Requirements* form, which is submitted with the annual and final expenditure reports, requires grantees to certify that they complied with the funding provisions of the grant agreement during the reporting period. On the form, grantees also indicate how they invested funds to meet the investment requirements in the grant agreement.

Auditors' Conclusion: We are encouraged that the DOH is taking under advisement our recommendation that it ensure compliance with Management Directive 305.20 and, in conjunction with the Office of the Budget (OB), establish procedures to either reimburse grant recipients for the actual cost of research services performed or, at a minimum, allow for the advancing of grant funds in a manner that resembles the grant recipients' needs, but with significantly enhanced DOH program monitoring. We propose that DOH immediately begin to implement corrective action based on our recommendation. We will evaluate the progress of DOH in the near future.

Additionally, we welcome DOH's willingness to take under advisement our recommendation that it adequately monitor CURE grantees cash balances to ensure that all CURE funds deposited at financial institutions are properly insured or collateralized, or invested in suitable low risk investments. While we note the procedures already put in place by DOH, we encourage the agency to strengthen its monitoring practices so that it is not solely reliant on the grantees' corroboration of insured deposits and proper investment. We will evaluate the progress of DOH in the near future.

Finding 11 – 4:

Department of Public Welfare

Internal Control Weaknesses in Uncompensated Care and Extraordinary Expense Payments to Hospitals (A Similar Condition Was Noted in Prior Year 10-4)

Condition: Since SFYE June 30, 2002, DPW has not developed an adequate audit or monitoring plan to prevent, detect, and resolve the submission of erroneous data by hospitals, which may cause improper and inaccurate TSF payments regarding Uncompensated Care (UC). By April 1 of each year, DPW determines which hospitals are eligible to apply for UC payments for the forthcoming fiscal year according to Section 1104(B) of the Tobacco Settlement Act (act). Sections 1104 (C and D) of the act define how the hospitals' reported data is used to assign a UC score to each hospital, which is used in the calculation of the UC payment amounts. Three key percentages determine the UC score; the number of Medicare SSI days as a percentage of total inpatient days, the number of Medical Assistance days as a percentage of total inpatient days, and the amount of UC provided as a percentage of net patient revenue. As noted in prior years' findings, the reported hospital data has not been subject to independent on-site audits or DPW reviews since SFYE June 30, 2002. Thus, the data could be unsupported and inaccurate, directly impacting UC payments.

Additionally, hospitals that are eligible to apply, but fail to qualify for UC payments based on the calculation described above, or in lieu of the determined UC payments, may elect to receive Extraordinary Expense (EE) payments. Section 1105 of the act established the EE program to reimburse hospitals for extraordinary expenses in treating the uninsured on an inpatient basis. EE payments are based on EE claims data submitted by hospitals. Historically, and as reported for the 2009 EE payments, the Department of the Auditor General, in separate reviews, has found errors in EE claims data reported to DPW by hospitals. To date, DPW has not implemented adequate oversight or follow up procedures to ensure EE claims data is valid and accurate prior to paying hospitals.

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

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.

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: DPW indicated that audited information is used whenever possible and there are various data validation steps. DPW stated data is derived from information submitted by hospitals directly to the DPW or the Pennsylvania Health Care Cost Containment Council (PHC4). The MA days are extracted from hospital MA cost reports submitted to the Office of Medical Assistance Programs (OMAP) for review. The PHC4 data is verified by PHC4, and prior to use in Tobacco calculations, the data undergoes two verifications and is sent to each individual hospitals for final verification prior to the commencement of calculations. Based on these verifications DPW personnel do not believe any undetected errors would be significant, and therefore, audits or on-site reviews of Section 1103 payment data are unnecessary. However, DPW can provide no support for its statements in this regard.

Section 1105 payments are in error due to a lack of DPW follow up on incorrect patient payor designations within the EE claim data submissions by hospitals. DPW also noted that the Department of the Auditor General continues to review the Tobacco Extraordinary Expense payment funds. The reviews cover all EE payments made annually during each state fiscal year. Therefore, the DPW considers these reviews to be an effective monitoring/reconciliation tool, and recalculates the Extraordinary Expense payments based on the findings contained in the summary report issued. However, Department of the Auditor General independent reviews are not an internal control and Extraordinary Expense payments represent only 15 percent of the Tobacco Settlement UC program.

Effect: In order to ensure the TSF funds earmarked for the UC and EE programs are properly paid to hospitals for services provided to uninsured patients, the hospital-supplied data used to calculate payments must be valid and accurate. Without audits or on-site reviews of this data, the risk of improper and inaccurate payments not only exists, but also has been validated through the errors historically found during the Department of the Auditor General's reviews of EE payments. If the noted internal control weaknesses are not corrected, improper payments will continue to occur.

Recommendation: DPW should establish procedures to ensure that Section 1103 and 1105 claims data submitted by hospitals is valid and properly supports payments per the act. This should include an 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 payments made to hospitals after ensuring that they are based on correct and accurate data and make any necessary payment adjustments to each hospital.

Agency Response: The Department of Public Welfare (DPW) disagrees with this finding. We note that audited information is used whenever possible and there are various data validation steps.

The three Uncompensated Care (UC) data sets: MA days, SSI Days, Uncompensated Care and Net Patient Revenue data are derived from information submitted by hospitals directly to the DPW or the Pennsylvania Health Care Cost Containment Council (PHC4). The MA days are extracted from hospital MA cost reports submitted to the Office of Medical Assistance Programs (OMAP) for review. The PHC4 data is verified by PHC4, and prior to use in Tobacco calculations, the data undergoes two verifications and is sent to each individual hospital for final verification prior to the commencement of calculations.

The three-year average of Medicare SSI days is a percentage of total inpatient days from fiscal years 2002-03, 2003-04 and 2004-05 instead of the immediately preceding three years. The Centers for Medicare and Medicaid Services (CMS) has acknowledged there is a problem with SSI percentages and is requiring hospitals to submit Medicare Advantage days that should be used in the calculation. Since the SSI data set is incomplete and Medicare Advantage related SSI days were provided by CMS, the DPW has no choice but to use the complete SSI data from the past two fiscal years.

The DPW is of the same opinion that a retrospective review determines that the data used to calculate the UC payment is not completely accurate; however, the Tobacco Settlement Act (Act 77) requires the DPW to apply calculations to data supplied by PHC4. In January 2005, PHC4, in conjunction with the DPW, initiated a process that would give hospitals an additional verification opportunity prior to PHC4 submitting claims data. For the FYE 2011 Tobacco Extraordinary Expense Program, staff in OMAP, Division of Rate Setting made contact, via email messages, with each hospital that received an EE payment in FYE 2010 and requested their cooperation in accessing PHC4's website to verify claims data. The DPW will continue to work with PHC4 and the Hospital and Healthsystem Association of Pennsylvania (HAP) to encourage hospitals to access PHC4's website during the claims verification process timeframes and make corrections to previously submitted claims data, as necessary.

Please note that the Department of the Auditor General continues to audit the Tobacco Extraordinary Expense Payments made annually during each state fiscal year. The DPW considers these audits to be an effective monitoring/reconciliation tool, and recalculates the Extraordinary Expense payments based on the audit findings contained in the summary report issued.

Auditors' Conclusions: The response of DPW mirrored its prior year response almost verbatim; again, DPW disagreed with our finding despite the admission "that the data used to calculate the UC payment is not completely accurate; …." Therefore, we must reiterate our position that DPW's agency response does not resolve the internal control weaknesses reported in the finding, and verification procedures described by DPW do not adequately ensure that data is accurate.

With regard to the Department of the Auditor General auditing Extraordinary Expense payments, this represents payments of only 15 percent of the Tobacco Settlement UC program. Payments made using MA days, SSI days, and Net Patient Revenue represent 85 percent of the UC payments and are not subject to any independent on-site audits or reviews by DPW, as noted in the condition above.

DPW notes in its response that problems exist with SSI percentages, which reaffirms the need for on-site audits or reviews. If DPW had performed on-site audits or reviews in the past, they may have detected and corrected the errors with Medicare SSI days in prior years. DPW cannot afford to allow such a deficiency to continue simply because it wishes to rely on external organizations to determine accuracy.

Additionally, although DPW references its verification process that involves PHC4, such a process does not negate the responsibility of DPW to verify the accuracy of data through independent on-site audits or reviews.

Based on the agency response, our finding and recommendations remain as previously stated. We will review any corrective action in the subsequent audit.

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