PART I:
MANAGEMENT DISCUSSION AND ANALYSIS

APPALACHIAN REGIONAL COMMISSION STRUCTURE AND PROGRAMS

Congress established the Appalachian Regional Commission (ARC) to address the profound economic and social problems in the Appalachian Region that made it a "region apart" from the rest of the nation.

The Commission was charged to

- Provide a forum for consideration of problems of the Region and proposed solutions, and establish and use citizens' and special advisory councils and public conferences;
- Provide grants that leverage federal, state, and private resources to build infrastructure for economic and human resource development;
- Generate a diversified regional economy, develop the Region's industry, and build entrepreneurial communities;
- Serve as a focal point and coordinating unit for Appalachian programs;
- Make the Region's industrial and commercial resources more competitive in national and world markets;
- Improve the skills of the Region's workforce;
- Adapt and apply new technologies for the Region's businesses, including eco-industrial development technologies;
- Improve the access of the Region's businesses to the technical and financial resources necessary to the development of business; and
- Coordinate the economic development activities of, and the use of economic development resources by, federal agencies in the Region.

The challenges confronting Appalachia today are complex. In some areas of the Region, basic needs in infrastructure, the environment, workforce training, and health care still exist. But because the nation and the Region now compete in the global economy, the threshold for success is higher than it once was: high-technology jobs rather than manual labor, college education rather than basic literacy, and telecommunications arteries in addition to highways.

Federal agencies are typically national in focus and narrow in scope, but ARC was created to be regional in focus and broad in scope. No other government agency is charged with the unique role of addressing Appalachian problems and opportunities. No other agency is charged with being simultaneously an advocate for the Region, a knowledge builder, an investor, and a partner at the federal, state, and local levels. These roles represent elements that are essential to making federal investments work to alleviate severe regional disparities in the country: responsiveness to regional needs with a view to global competitiveness, emphasis on the most distressed areas, breadth of scope to address both human and physical capital needs, and flexibility in funding.

The Commission by law directs at least half of its grant funds to projects that benefit economically distressed counties and areas in the Region. In part, ARC gauges its long-term progress toward helping the Region achieve economic parity with the nation in terms of the gradual reduction in the number of such counties and areas over time. The maps on page 19 show the Region's high-poverty counties in 1960 and in FY 2008. The change is dramatic.

ARC is a federal-state partnership, with a governing board composed of a federal co-chair and the governors of the 13 Appalachian states. Because of its partnership approach, ARC is able to identify and help fund innovative grassroots initiatives that might otherwise languish. In many cases, the Commission functions as a predevelopment agency, providing modest initial funding that is unavailable from other sources. ARC funds attract capital from the private sector and from other public entities.

Through the years, ARC support has helped address the problem of historically low public and private investment in Appalachia. ARC has effectively used its funds to help communities qualify for, and make better use of, limited resources from other federal agencies. These federal funds, combined with state, local, and private money, provide a broad program of assistance to the Region. In addition, substantial private investment in business facilities and operations has accompanied ARC development projects.

Two independent studies have found that ARC's coordinated investment strategy has paid off for the Region in ways that have not been evident in parts of the country without a regional development approach. A 1995 study funded by the National Science Foundation compared changes in Appalachian counties with their socioeconomic "twin" counties outside the Region over 26 years, from 1965 to 1991. This analysis, controlled for factors such as urbanization and industrial diversification, found that the economies of the Appalachian counties grew significantly faster than their non-Appalachian counterparts'. A more recent analysis by Economic Development Research Group extended this analysis to 2000 and confirmed the earlier findings on the impact of ARC's investment. The study found that, on average, the gap between Appalachian counties and their non-Appalachian twin counties grew significantly in the 1990s.

In FY 2008, Congress completed work on a five-year reauthorization of ARC (through FY 2012). The legislation creates a new economic and energy development initiative and add ten counties to the Appalachian Region (effective in FY 2009).

ARC's appropriation for FY 2008 nonhighway activities was $73.0 million. Appendix A provides a history of appropriations to the Commission.

The Commission is a performance-driven organization, evaluating progress and results on an ongoing basis and relying on clearly defined priorities and strategies for achieving them.

Organization: The ARC Partnership Model

The Appalachian Regional Commission has 14 members: the governors of the 13 Appalachian states and a federal co-chair, who is appointed by the president and confirmed by the Senate. Each year one governor is elected by his or her peers to serve as the states' co-chair. The partnership nature of ARC is evident in its policy making: the governors and the federal co-chair share responsibility for determining all policies and for the control of funds. On all Commission decisions, the federal co-chair has one vote, and the 13 governors share one vote. Accordingly, all program strategies, allocations, and other policy must be approved by both a majority of the governors and the federal co-chair. All projects are approved by a governor and by the federal co-chair. This consensus model ensures close collaboration between the federal and state partners in carrying out the mission of the agency. It also gives the Commission a nonfederal character that distinguishes it from typical federal executive agencies and departments.

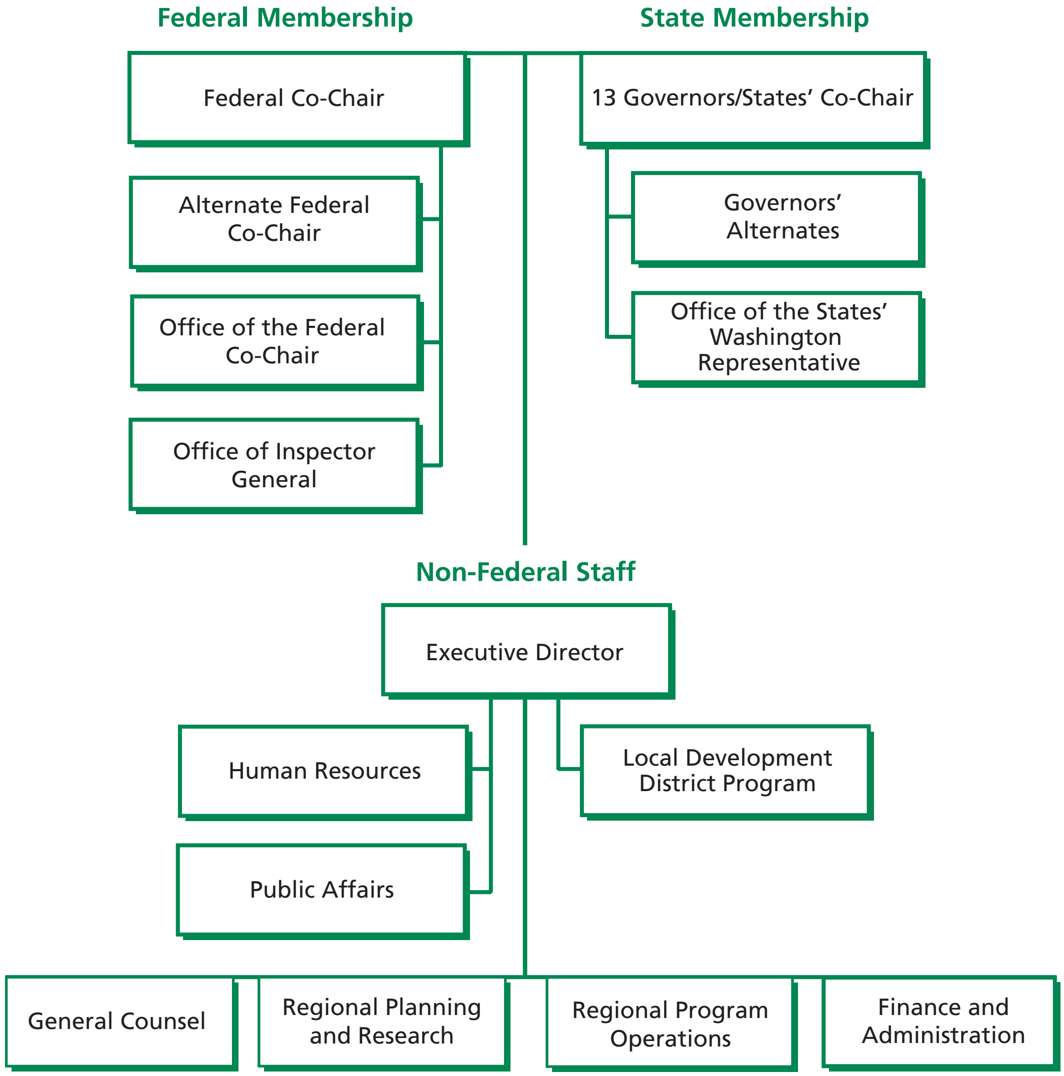
An alternate federal co-chair, who is appointed by the president and confirmed by the Senate, has authority to act as the federal co-chair in his or her absence. State alternates appointed by the governors oversee state ARC business and serve as state-level points of contact for those seeking ARC assistance.

By law, there is an inspector general for the Commission. The inspector general is under the general supervision of the federal co-chair and has a dual and independent reporting relationship to both the federal co-chair and Congress.

In all, there are only 11 federal employees of the Commission, including the federal co-chair's staff and the staff of the Office of Inspector General.

The Commission members appoint an executive director to serve as the chief executive, administrative, and fiscal officer. The executive director and staff are not federal employees. The 48 nonfederal Commission staff are charged with serving both the federal and the state members impartially in carrying out ARC programs and activities, and they provide the legal support, technical program management, planning and research, and financial/administrative management necessary for ARC's programs.

ARC Organization Chart



Public and Private Partnerships

ARC promotes economic and community development through a framework of joint federal and state initiatives. ARC's limited resources are necessary, but obviously not sufficient, for Appalachia to reach parity with the rest of the nation. Therefore, ARC continues a long tradition of building alliances among private and public organizations to focus technical, financial, and policy resources on regional problems. ARC's programs involve not only Appalachian governors' offices and state agencies, which control other substantial investment resources, but also 72 multi-county development districts in the Region, up to 20 federal agencies, and a host of private organizations and foundations. The Commission further helps create alliances through research, regional forums, advisory councils, and community meetings. One such alliance is ARC's partnership with the Centers for Disease Control and Prevention to implement programs in cancer control and diabetes education, prevention, and treatment.

In FY 2008, across all investment areas, each dollar of ARC funding was matched by $2.45 in non-ARC project funding (public and private) and leveraged $13.76 in private investment attracted as a result of the project. ARC continues its efforts to increase leveraged private investment through partnerships and collaborations with the private sector wherever possible, as in recent initiatives with the Ford Foundation, the eBay Foundation, Microsoft Corporation, the National Geographic Society, the Claude Worthington Benedum Foundation, Parametric Technology Corporation, and American Electric Power, Southern Company, and other utilities.

ARC is often a predevelopment resource, especially in economically distressed areas, providing modest amounts of initial funding that are unavailable from other sources because the community cannot qualify for the support or raise adequate matching funds. Congress recognized, and subsequent experience has shown, that Appalachia for many reasons has been relatively less likely to use the grant resources of large federal agencies. ARC has helped other federal agencies better deploy their programs in the Region through joint funding. The Commission can also allow other federal agencies to use ARC funds under their statutory authorities when their own funds are insufficient for projects; in effect, ARC can provide sufficient match for federal grants on behalf of the poorest Appalachian communities.

A special provision of the Appalachian Regional Development Act authorizes ARC to operate in part as a supplemental grant program. This authority allows ARC funds to be used to increase the allowable participation under federal grant programs, enabling grantees to participate in programs for which they would otherwise be ineligible. In addition, it involves appropriate federal entities to ensure not only program coordination but also compliance with all applicable laws, such as environmental and labor requirements. Accordingly, about half of past ARC grants have been administered under agreements with federal agencies, mainly the Economic Development Administration, Rural Development, the Tennessee Valley Authority, the U.S. Department of Housing and Urban Development, and the Federal Highway Administration. Other agreements have involved such agencies as the Army Corps of Engineers, the U.S. Environmental Protection Agency, and the U.S. Departments of Energy, Labor, and Health and Human Services.

Commission Activities: Getting the Job Done

Congress gave the Commission very broad program discretion to address problems and opportunities in the Region. Accordingly, ARC has emphasized a wide-ranging set of priorities in its grant activities. Projects in recent years have focused on business development, telecommunications and technology infrastructure and use, educational attainment, access to health care, and tourism development. ARC has consistently maintained a focus on the construction of development highways and basic water and waste management facilities.

Ann Hawthorne

ARC Strategic Plan

FY 2008 was ARC's fourth year of operating under its strategic plan, *Moving Appalachia Forward: Appalachian Regional Commission Strategic Plan 2005–2010*, which outlined ARC's mission to be a strategic partner and advocate for sustainable community and economic development in Appalachia, and identified four strategic goals to help Appalachia reach socioeconomic parity with the rest of the nation:

Ann Hawthorne

- *Increase job opportunities and per capita income in Appalachia to reach parity with the nation.*
- *Strengthen the capacity of the people of Appalachia to compete in the global economy.*
- *Develop and improve Appalachia's infrastructure to make the Region economically competitive.*
- *Build the Appalachian Development Highway System to reduce Appalachia's isolation.*

Ken Murray

As reported in Part II, the Commission demonstrated progress in FY 2008 toward achieving the 10-year performance goals set out in that plan.

Area Development Program

Area development funds are largely allocated to the Appalachian states by formula to provide flexible assistance for individual community projects. In FY 2008, the Commission allocated by formula $62.2 million, 85.2 percent of the total ARC appropriation, for use by the states in their area development activities. The states have wide discretion in the use of these funds, within the framework of the strategic plan. Priorities for area development funding are set forth in the Commission's strategic plan, and state and community leaders work together to package funding from public and private organizations to implement those priorities. All ARC nonhighway grants are approved by a governor and by the federal co-chair. See Appendix B for ARC grants approved in FY 2008, by state and category.

Special Focus on Distressed Counties

The Commission targets special resources to the most economically distressed counties and areas in the Region, using a very conservative measure of economic distress based on three economic indicators: three-year average unemployment rates, per capita market income, and poverty rates.

ARC uses an index-based classification system to compare each county in the nation with national averages on the three economic indicators. Based on that comparison, each Appalachian county is classified within one of five economic status designations—distressed, at-risk, transitional, competitive, or attainment.

- *Distressed counties* are those that rank in the worst 10 percent of the nation's counties.
- *At-Risk counties* rank between the worst 10 percent and the worst 25 percent of the nation's counties.
- *Transitional counties* rank between the worst 25 percent and the best 25 percent of the nation's counties.
- *Competitive counties* rank between the best 10 percent and the best 25 percent of the nation's counties.
- *Attainment counties* are those that rank in the best 10 percent of the nation's counties.

In FY 2008, 78 counties were designated distressed, 78 were designated at-risk, 226 were designated transitional, 22 were designated competitive, and 6 were designated attainment. ARC policy stipulates that competitive counties may receive limited assistance, while attainment counties are generally not eligible for funding.

See page 20 for a map of Appalachian counties classified by economic status.

Besides allocating funding to benefit distressed counties and areas, ARC has established other policies to reduce economic distress. ARC normally limits its maximum project funding contribution to 50 percent of costs, but it can increase its funding share to as much as 80 percent in distressed counties.

Regional Initiatives

Each year, the ARC partners identify a limited number of strategic objectives as regional initiatives. These initiatives support ARC's strategic plan by coordinating a concerted effort by the 13 Appalachian states and the federal government to address an area of critical importance. The initiatives can support and promote innovation in a particular goal area or focus on a sector of unique opportunity or underperformance. In FY 2008, in addition to providing special support for distressed counties, ARC supported regional initiatives on asset-based development and telecommunications. The initiatives were supported by a total allocation of $3.4 million.

The Asset-Based Development Initiative seeks to help communities identify and leverage local assets to create jobs and build prosperity. A focus under this initiative in FY 2008 was the promotion of energy-related job opportunities in Appalachia, as outlined in the Commission's strategic framework *Energizing Appalachia: A Regional Blueprint for Economic and Energy Development*. Another focus was travel and tourism, with investments aimed at protecting and promoting Appalachia's natural, cultural, and historic assets through projects in community assessment, hospitality training, trail development, and product branding. Other asset-based development strategies include the promotion of value-added agricultural development and hardwood products exports.

ARC's Telecommunications Initiative aims to bridge the digital divide between Appalachia and the nation, focusing on projects that increase affordable access to broadband services, promote technology training and the use of technology in education and workforce training programs, increase e-commerce development, and promote technology-sector job creation. In FY 2008, ARC funded projects that support telemedicine and distance-learning applications, workforce development, and e-commerce development in the government and the private sector. ARC also funded projects that directly help communities and commercial-industrial areas gain access to high-speed telecommunications services.

Business Development Revolving Loan Fund Grants

Business development revolving loan funds (RLFs) have been used by ARC since 1977 as an effective tool for economic development. The funds are pools of money used by grantees for the purpose of making loans to local businesses to create and retain jobs. As loans are repaid, money is returned to the fund and made available for additional loans.

The primary objective of ARC's business development RLF grants is creating and retaining private-sector jobs. Limited access to credit is one of the major problems in local business development in Appalachia, and is a significant contributing factor to local economic distress. In areas where credit is not available, or where the cost and terms of the credit are beyond the reach of local businesses, the result may be a community's loss of jobs, tax revenues, and private investment. RLFs are designed to fill gaps in existing local financial markets and to provide or attract capital that otherwise would not be available for economic development.

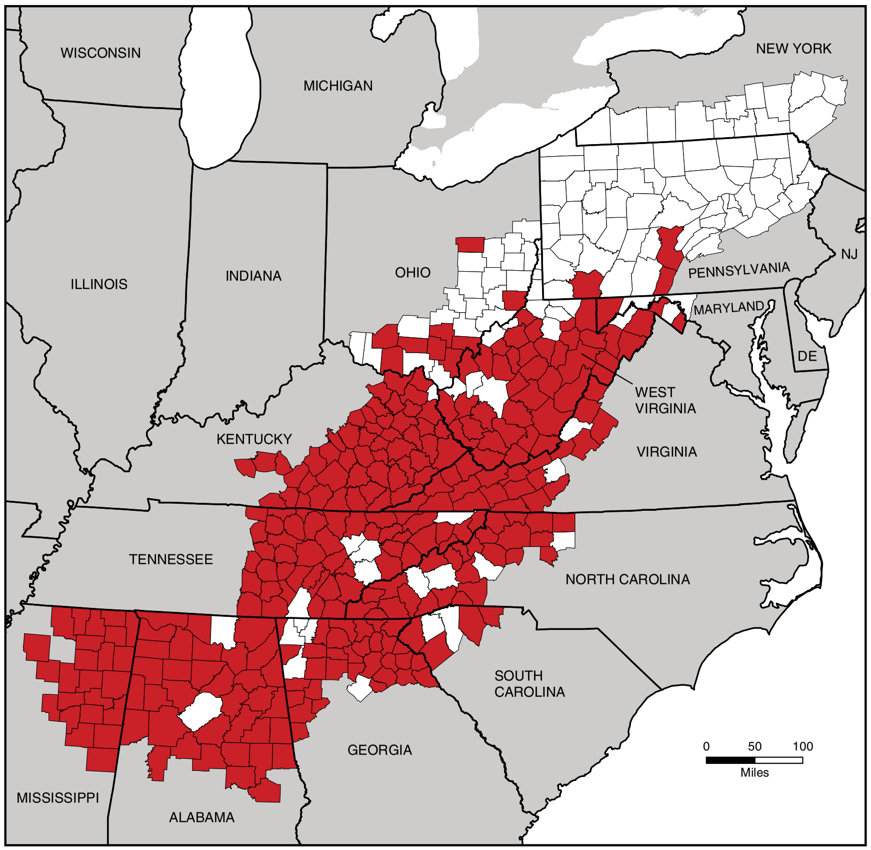
Since the first RLF grants were awarded, ARC-supported revolving loan funds have disbursed $132 million in 1,984 loans, resulting in 77,225 jobs created or retained and leveraging $1.1 billion in private investment for the Appalachian Region.

High-Poverty Counties in the Appalachian Region

(Counties with Poverty Rates at Least 1.5 Times the U.S. Average)

1960

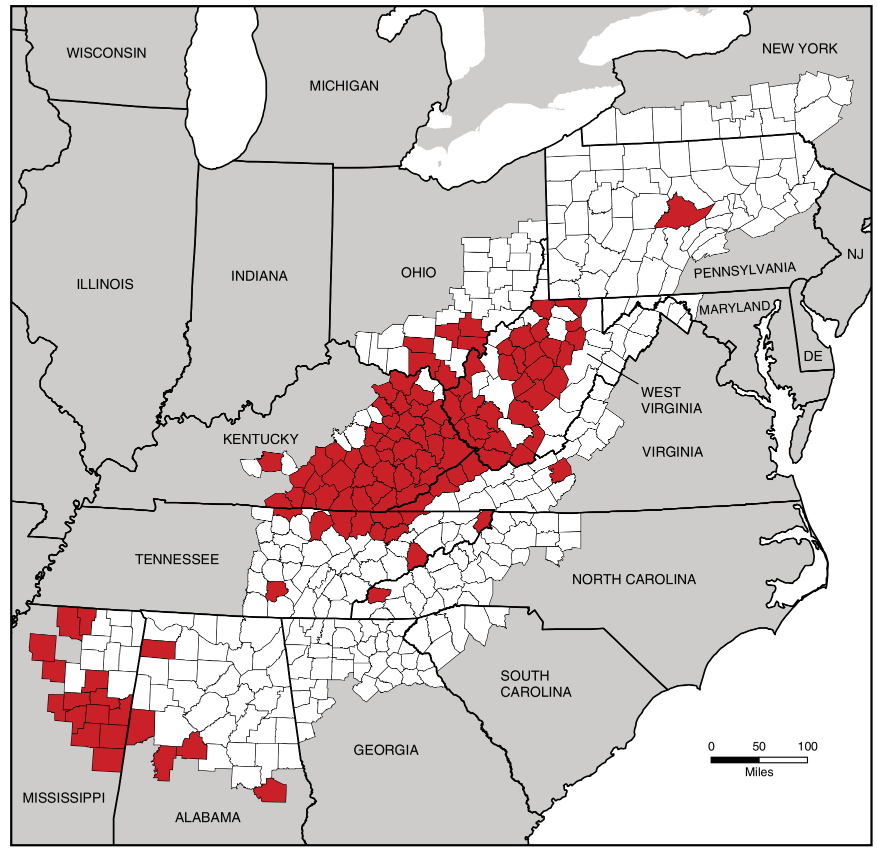
289 High-Poverty Counties



Data Source: Office of Economic Opportunity data from U.S. Department of Agriculture, Economic Research Service, 1960.

Fiscal Year 2008

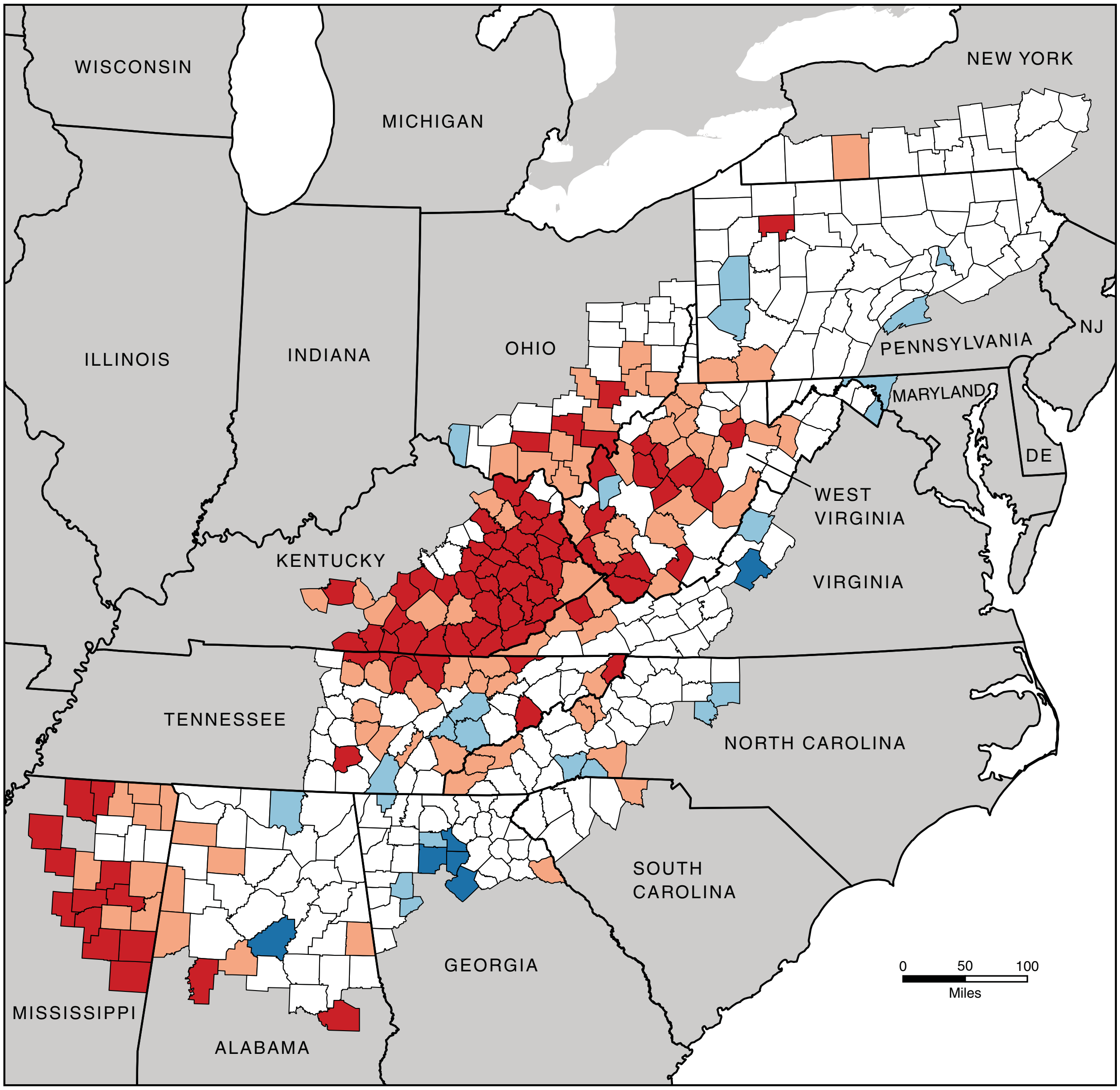
114 High-Poverty Counties



Data Source: U.S. Department of Commerce, Census Bureau, 2000.

County Economic Status in Appalachia, Fiscal Year 2008

(Effective October 1, 2007, through September 30, 2008)



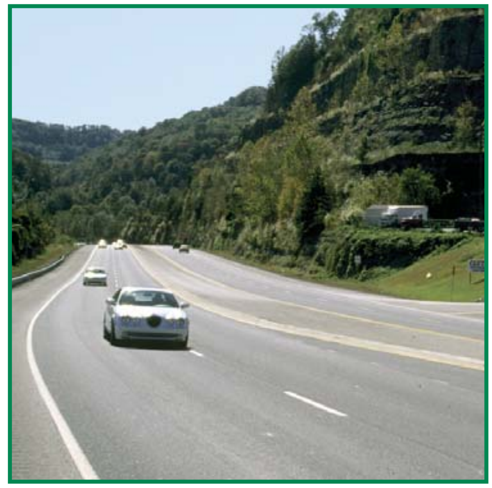
The Appalachian Regional Commission uses an index-based county economic classification system to identify and monitor the economic status of Appalachian counties.

County Economic Levels

- Distressed (78)
- At-Risk (78)
- Transitional (226)
- Competitive (22)
- Attainment (6)

Map Created October 2007.
Data Sources: U.S. Bureau of Labor Statistics, LAUS, 2003–2005;
U.S. Bureau of Economic Analysis, REIS, 2004;
U.S. Census Bureau, 2000 Census, SF3.

Highway Program: The Appalachian Development Highway System


Ken Murray

Congress created the Appalachian Development Highway System (ADHS) expressly to provide growth opportunities for the residents of Appalachia—the same benefits afforded the rest of the nation through the construction of the interstate highway system, which largely bypassed Appalachia because of the high cost of building roads through the Region's mountainous terrain. The ADHS, a 3,090-mile system of modern highway corridors that replaces a network of worn, winding two-lane roads, was designed to generate economic development in previously isolated areas, supplement the interstate system, and provide access to areas within the Region as well as to markets in the rest of the nation. (See the map of the ADHS on page 22.)


Ken Murray

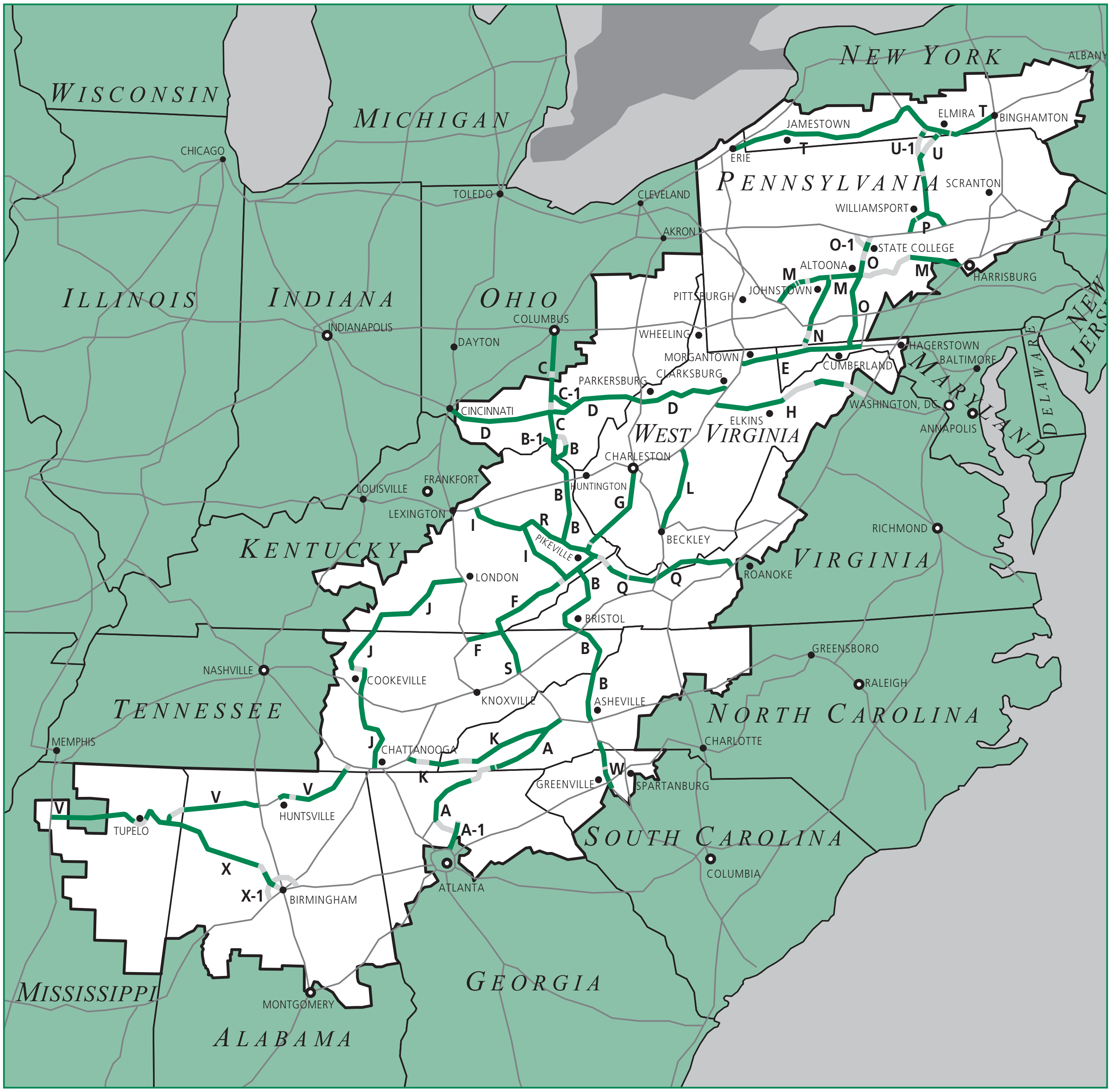
Authorizations for the ADHS in FY 2008 were provided through the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU). SAFETEA-LU authorizes $470 million per year through FY 2009 for the ADHS. Portions of some ADHS corridors have been identified as high priority and will receive additional funding. Although the funds are authorized from the Highway Trust Fund, ARC exercises policy control over the system and the allocation of funds to individual states. This ensures that the governors and the federal co-chair continue to determine where and how the money is used on ADHS highways. Appendices A and C provide information on ADHS authorizations and funding.

Local Development Districts

ARC's statute underlines the importance of supporting local development districts (LDDs) in the Region. These multi-county planning and development organizations serve as local partners for ARC across the Region and are essential contributors in the development of projects and activities that support ARC's mission. Every county in the Region is served by an LDD.

Each LDD is governed by a board of directors composed of both local elected officials and nonelected individuals. Many of these state-chartered entities were originally created by state executive orders, but over half are now authorized in state legislation. Some also have 501(c)(3) nonprofit status, enabling

Appalachian Development Highway System as of September 30, 2008



ADHS Miles Open to Traffic—September 30, 2008

ADHS Miles Not Open to Traffic

Interstate Highway System

them to access support from foundations and other nonpublic sources. The LDDs play four key roles in the development of the Region:

- Providing area-wide planning and program development, and coordination of federal and state funding sources;
- Assisting local governments in providing services, especially in poorer, more isolated communities;
- Promoting public-private partnerships and assisting in business development; and
- Helping communities assess, plan, and conduct a wide range of activities such as job training, business development, telecommunications planning and implementation, and municipal government support.

The Commission has also supported the training and technical assistance activities of the Development District Association of Appalachia (DDAA), an organization of the Region's LDDs. These activities improve member districts' organizational structure and operations, and their ability to effectively implement ARC's strategic plan and regional initiatives.

Appendix D provides a map and list of local development districts serving Appalachia.

Research and Technical Assistance Activities

ARC funds research and evaluation studies that produce specific information on socioeconomic and demographic conditions in the Region, including baseline data and trend analysis, economic impact analysis, project evaluation, and regional economic and transportation modeling. ARC-funded research focuses on strategic analyses of key economic, demographic, and quality-of-life factors that affect Appalachia's current and future development prospects. The aim of this research is to help policy makers, administrators, and staff target resources efficiently, and to provide high-quality research for the general public and research specialists.

ARC also funds project evaluations by outside researchers or consultants to assess whether Commission-funded projects have made a measurable difference in specific social or economic outcomes. The purpose of these evaluations is to determine the extent to which the projects have contributed to the attainment of economic development objectives identified in ARC's strategic plan. In addition, evaluations are used to verify project results and to assess the validity of specific performance measurements for monitoring and evaluating specific types of projects.

Reports and data products are distributed in print and posted on ARC's Web site.

Research started in FY 2008 includes:

- An analysis of oral health disparities and access to services in the Appalachian Region; and

- Energy training and management planning for water and wastewater treatment facilities.

Research completed or under way in 2008 includes:

- An analysis of ARC's tourism and asset-based economic development projects;
- An analysis of policy incentives for adoption of energy-efficiency measures, and potential gains from those incentives;
- An analysis of wind and solar industrial supply-chain opportunities in the Appalachian Region;
- An assessment of alternative measures for determining economically distressed counties and areas in the Appalachian Region; and
- An evaluation of ARC's Entrepreneurship Initiative from 1997 to 2005.

Impediments to Progress

Despite recent progress, Appalachia still does not enjoy the same economic vitality and living conditions as the rest of the nation. The Region continues to battle economic distress, concentrated areas of high poverty, unemployment, poor health, educational disparities, and population outmigration that are among the worst in the nation. Appalachia trails the rest of the nation by 17.9 percent in per capita income. Sixty-three percent of Appalachian counties have unemployment rates higher than the national average, and one-fourth of the Region's 410 counties have poverty rates more than 150 percent of the national average.

The Region's isolation and its difficulty in adapting to economic changes over past decades are major factors contributing to the gap in living standards and economic achievement between the Region and the rest of the nation.

The role of the Commission is to help Appalachia reach parity with the rest of the nation. In an era of global competition, that requires a special emphasis on helping the people of Appalachia become a globally competitive workforce.

Civic Capacity

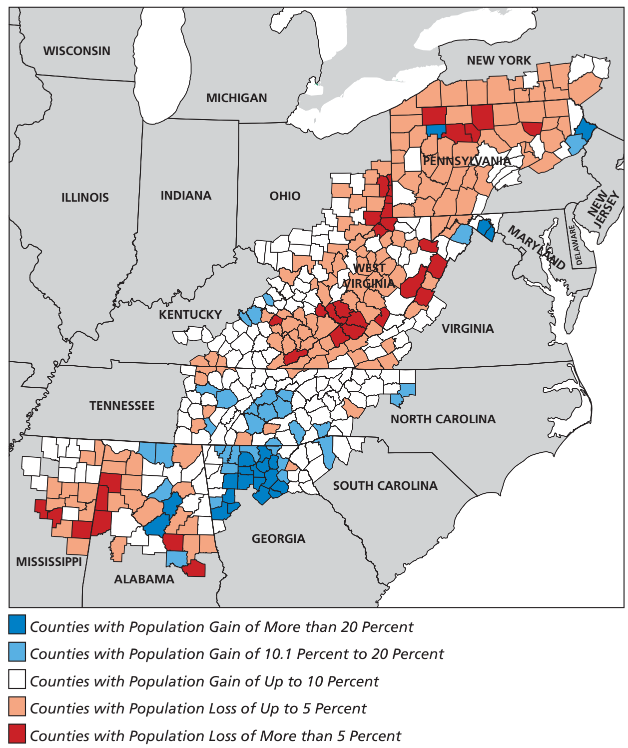
Civic capacity is vital for communities to be strategically ready to take advantage of economic opportunities. Weakness in civic capacity in Appalachia has inhibited the leadership, broad citizen involvement, local strategic planning, and collaboration that are necessary for a sense of empowerment and civic engagement. Low levels of per-capita private foundation funding have contributed to the lack of support for civic capacity, particularly the low rates of formation and survival of community-based nonprofit organizations in the Region.

Economic and Demographic Shifts

A rising number of counties in Appalachia experienced net population loss between 2000 and 2007. Net population loss occurred in 176 counties over that period, compared with 83 counties in the period 1990–2000. As a result, there is continued concern over the decline in Appalachia's "prime age" workforce—workers between the ages of 25 and 55.

The Appalachian Region has been battered by job losses and structural economic shifts because of global competition and because of the Region's disproportionate reliance on extractive industries and manufacturing.

Percent Change in Population in Appalachian Counties, 2000–2007



Data Source: U.S. Department of Commerce, Census Bureau, Population Division, 2007 Population Estimates.

- Regional restructuring of the manufacturing sector has led to a recovery in durable goods production and jobs, particularly in automotive supply chain employment in southern and central Appalachia; however, the non-durable manufacturing sector posted net losses of more than 22,000 jobs between 2001 and 2006. During that period the Appalachian apparel industry lost 6,500 jobs, the textile industry lost 7,300 jobs, and the chemicals production industry lost 7,400 jobs.

- The information services industry in Appalachia, once forecast to be a source of job growth, actually lost 3,000 jobs between 2001 and 2006, in both call center jobs and high-tech information jobs.

- The Region's computer and electronic equipment manufacturing industries lost 11,000 jobs between 2001 and 2006. Many of these losses were the result of imports and of plants relocating overseas.

- Appalachian coal-mining employment experienced a slight recovery in 2005, when total employment rose to over 53,000 jobs, up from 49,000 in 2004. However, more recent state data indicate some retrenchment in 2006, especially in central Appalachia.

Access to Capital and Credit

Access to capital and credit is essential to finance and nurture new and existing businesses and entrepreneurs. Chronic gaps in access to capital and credit have often stifled business formation in rural areas, including parts of Appalachia. Despite signs of progress, significant disparities continue to exist in small-business lending in Appalachia. Small-business lending is less accessible in Appalachia's non-metropolitan counties and in counties experiencing economic distress. In addition, the smallest businesses (those with assets under $1 million) and businesses in low- and moderate-income communities experience the least access to credit.

Underinvestment

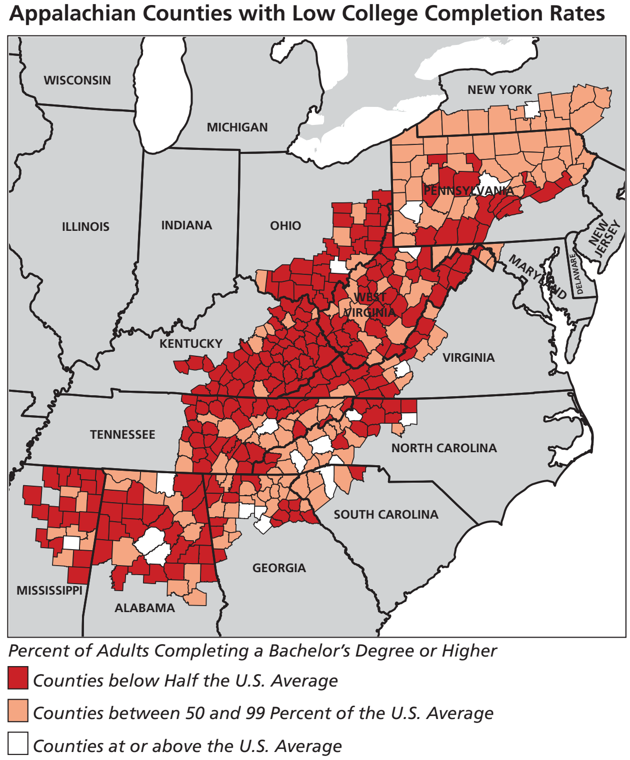
Research preceding the creation of ARC found that for many reasons, including dearth of leadership and lack of financial and technical resources, Appalachia had not been in a position to take advantage of many federal programs that could help mitigate long-standing problems, much less concentrate a range of investments on the greatest needs. In addition, many programs better addressed mitigation of growth in parts of the nation rather than basic stimulation of growth. This situation has improved over time, but the Region still receives federal economic development assistance disproportionately smaller than its population and its needs. Analyses of the *Consolidated Federal Funds Report for Fiscal Year 2002* by ARC and U.S. Census Bureau staff found that per capita total direct federal expenditures and obligations in Appalachia were $783 less than the national average. In federal grants alone, the Region falls short of parity with the nation as a whole by $5.4 billion each year.

Water and Wastewater Systems

Most Americans don't realize that access to basic water and wastewater systems remains a critical issue in many smaller, poorer communities in Appalachia. Twenty percent of Appalachian households are still not reached by community water systems, compared with 10 percent nationwide. Forty-seven percent of Appalachian households are not served by public sewer systems, compared with a national average of 24 percent. Appalachian counties require an investment of $26 billion to $40 billion for drinking water and wastewater system infrastructure needs, according to an ARC-funded study published in August 2005.

Small, rural Appalachian communities also face higher investment requirements to address pressing economic development needs while meeting environmental standards. Communities experiencing declining customer bases and low household incomes cannot rely on construction loans (and the resulting rate increases) to meet capital investment needs. The local ability to pay is particularly low in 123 Appalachian counties where the average household income is two-thirds or less of the national average, according to the 2000 Census. These communities need additional technical, managerial, and financial assistance to meet their future needs.

Appalachian Counties with Low College Completion Rates



Data Source: U.S. Department of Commerce, Census Bureau, Census 2000, Summary File 3.

Telecommunications

The Appalachian Region continues to lag behind the rest of the nation in access to affordable broadband telecommunications, which is essential to today's commerce. Without special advocacy, technical support, and financial assistance, rural Appalachia will continue to struggle with access to affordable telecommunications services.

Education and Workforce Skills

Vigorous job growth will not occur in areas that lack an educated workforce. Global competition is reinforcing the economic premium on workers in knowledge-based industries, leaving low-skilled or unskilled U.S. workers increasingly vulnerable. ARC seeks to increase the employment rate and productivity of Appalachia's workers, and to attract educated and skilled workers to the Region. Doing so will require considerable improvement in both educational attainment and educational achievement at all levels.

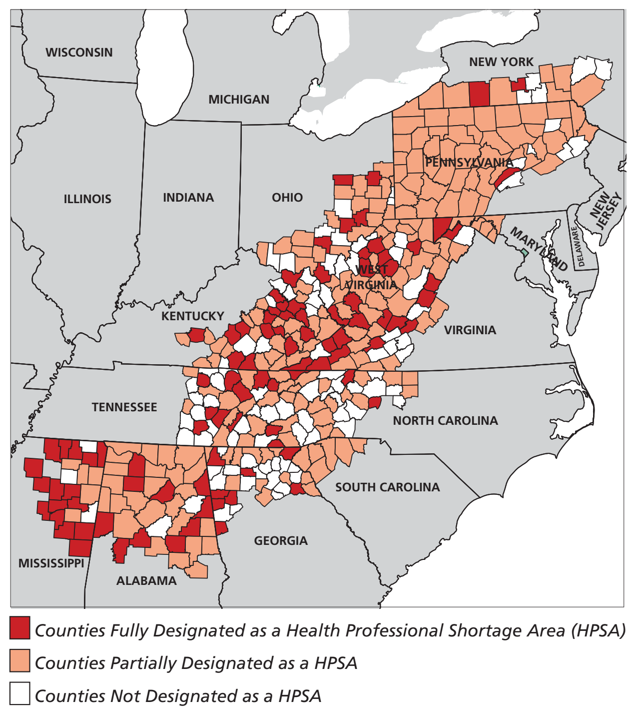
According to the Bureau of Labor Statistics, the 30 fastest-growing occupations will require post-secondary educational attainment levels, special post-secondary certification, or moderate–to–short-term training. The Region is not equipped to prepare its workforce for these high-growth occupations.

In the last decade, the education attainment gap between Appalachia and the rest of the nation has widened: in 1990 the difference between the Region and the nation's share of adults with college degrees was 6.0 percentage points; in 2000 the gap widened to 6.7 percentage points.

Health Care

Health problems continue to impede quality of life as well as economic prospects in some areas of the Region. More than two-thirds of the Region's counties are fully or partially designated by the U.S. Department of Health and Human Services as health professional shortage areas. Most Appalachian counties have had difficulty attracting or retaining basic services such as dentistry, outpatient alcohol treatment, outpatient drug treatment, and outpatient mental health services. In addition, Appalachia suffers from disproportionately high rates of chronic diseases such as cardiovascular disease, cancer, and diabetes.

Appalachian Counties Lacking Access to Health Care



Data Source: U.S. Department of Health and Human Services, Health Resources and Services Administration, Bureau of Health Professions, November 2008.

Program Assessment Rating Tool

In 2004, the Office of Management and Budget (OMB) conducted its first review of the ARC program using the Program Assessment Rating Tool (PART) and issued a score of adequate. ARC received high scores for clarity of purpose, planning, and management. OMB noted ARC's progress in developing outcome-related measures, but acknowledged the difficulty of performance measurement since ARC co-funds projects with other agencies. ARC revised its metrics to include performance goals for targeting resources to areas of greatest distress, and for leveraging other public and private funds. The agency continues to share performance data and research to clarify the links between federal investment and community change. Part II of this report includes updates to PART information.

SUMMARY OF ACHIEVEMENTS

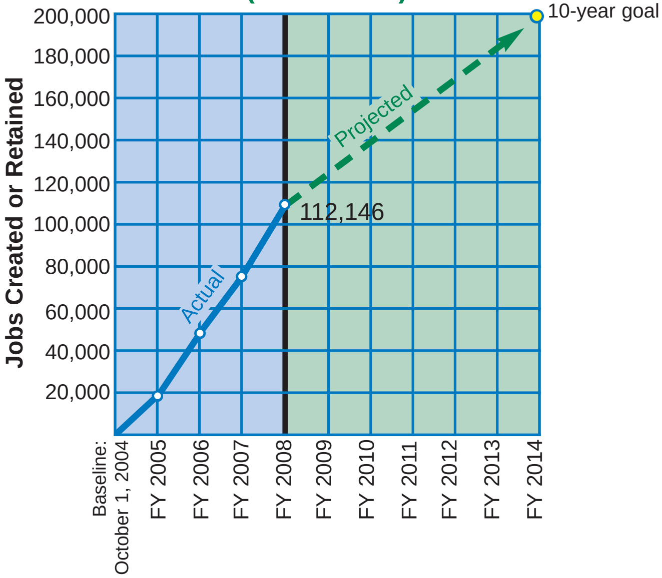
Performance Goals and Results for Fiscal Year 2008 Projects

ANNUAL PERFORMANCE GOALS	FISCAL YEAR 2008 INTERMEDIATE ESTIMATES	RESULTS ACHIEVED
Jobs and Income		
Outcome Goal: 20,000 jobs created or retained	35,292 jobs created or retained	Exceeded goal
Leveraging Goal: Achieve a 4:1 ratio of leveraged private investment to ARC investment for projects in General Goal 1	Achieved a 7:1 ratio	Exceeded goal
Targeting Goal: Direct 50% of grant funds to benefit distressed counties or areas for projects in General Goal 1	Directed 49% of funds*	Met 98% of goal
Competitiveness		
Outcome Goal: 20,000 students/trainees with improvements	20,432 students/trainees with improvements	Exceeded goal
Matching Goal: Achieve a 1:1 ratio of non-ARC to ARC investment for projects in General Goal 2	Achieved a 2:1 ratio	Exceeded goal
Targeting Goal: Direct 50% of grant funds to benefit distressed counties or areas for projects in General Goal 2	Directed 66% of funds*	Exceeded goal
Infrastructure		
Outcome Goal: 20,000 households served	21,538 households served	Exceeded goal
Matching Goal: Achieve a 2:1 ratio of non-ARC to ARC investment for projects in General Goal 3	Achieved a 4:1 ratio	Exceeded goal
Targeting Goal: Direct 50% of grant funds to benefit distressed counties or areas for projects in General Goal 3	Directed 64% of funds*	Exceeded goal
Highways		
Outcome Goal: 25 additional miles (net increase) of the ADHS opened to traffic	Opened 35.5 additional miles (net increase) of the ADHS to traffic	Exceeded goal

** ARC exceeded its overall goal of investing 50% of total ARC nonhighway funds in projects that benefit distressed counties or areas. Project funds are included if the project* primarily *or* substantially *benefits distressed counties or areas.*

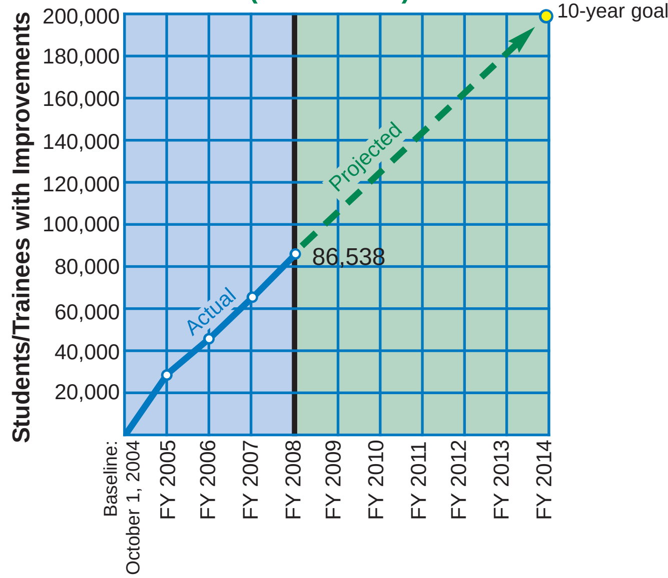
Progress toward ARC Strategic Plan Ten-Year Performance Goals
Fiscal Years 2005–2014

Goal 1: Jobs Created or Retained (Cumulative)



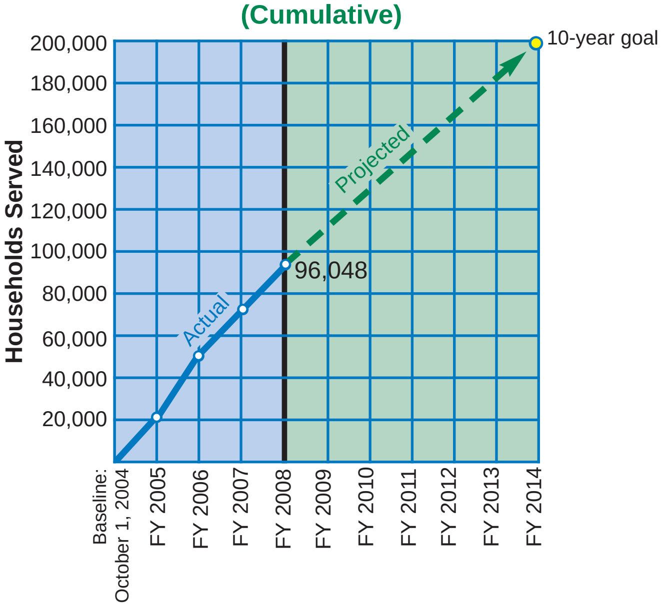
Ten-Year Performance Goal:
200,000 jobs will be created or retained.

Goal 2: Students/Trainees with Improvements (Cumulative)



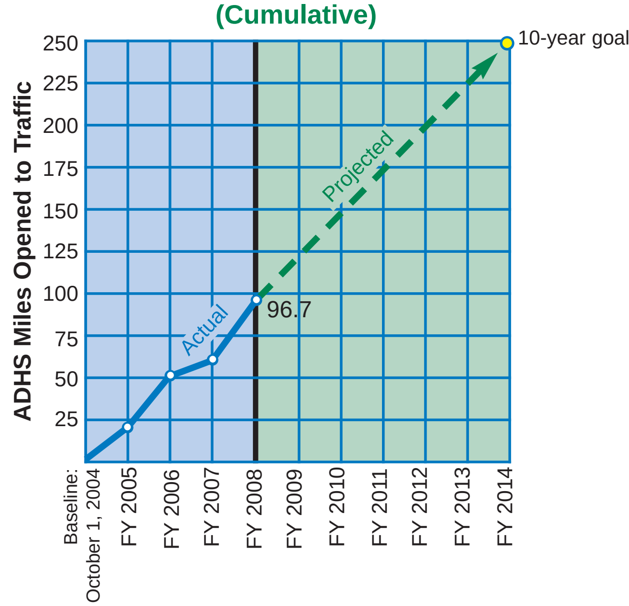
Ten-Year Performance Goal:
200,000 citizens will benefit from enhanced education and job-related skills.

Goal 3: Households Served (Cumulative)



Ten-Year Performance Goal:
200,000 households will be served with new or improved water and sewer infrastructure.

Goal 4: ADHS Miles Opened to Traffic (Cumulative)



Ten-Year Performance Goal:
250 additional miles (net increase) of the Appalachian Development Highway System will be opened to traffic.

FINANCIAL MANAGEMENT

Financial Management System

The Appalachian Regional Commission uses a commercial off-the-shelf core accounting system, GLOWS, that is intended for government financial management. The GLOWS system incorporates capabilities to manage obligations, disbursements, the general ledger, and financial reporting. This system, however, is no longer considered a Financial Systems Integration Office–certified financial management system. During FY 2007, ARC began to evaluate viable options for replacing its current system with a cost-efficient solution that meets required standards and the Commission's needs. ARC finalized its selection in FY 2008 and will implement the new system in FY 2009.

ARC supplements the GLOWS system with a management information system, ARC.net, that provides real-time funding, grant status, and performance measurement information, as well as grant-related financial data, in an intranet environment available to staff and key state officials. ARC.net applications are built using off-the-shelf software.

Management's Responsibility for Internal Control

ARC implemented a process for providing audited financial statements in fiscal year 2002, following the guidance of the Accountability of Tax Dollars Act of 2002. ARC, strictly speaking, is not a federal agency as defined in Titles 5 and 31 of the U.S. Code; it is a 501(c)(3) organization with a quasi-federal character. While the Accountability of Tax Dollars Act applies only to executive branch agencies, the Commission has elected to comply with OMB guidance because full disclosure of financial information is consistent with the governmental nature of ARC's mission and operations and its stewardship of public funds. ARC also follows OMB and Department of the Treasury financial reporting requirements, as appropriate.

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) represents sound management practice for managing federal appropriations. FMFIA establishes specific requirements with regard to management controls. The agency must establish controls that reasonably ensure that (1) obligations and costs comply with applicable law; (2) assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (3) revenues and expenditures are properly accounted for and recorded. In addition, the agency annually must evaluate and report on the control and financial systems that protect the integrity of federal programs. The FMFIA encompasses program, operational, and administrative areas as well as accounting and financial management. In addition, OMB Circular A-123 directs agencies to "take systematic and proactive measures to (1) develop and implement appropriate, cost-effective management controls for results-oriented management; (2) assess the adequacy of management controls in federal programs and operations; (3) identify needed improvements; (4) take corresponding corrective action; and (5) report annually on management controls." Management controls are the organizational structures, policies, and procedures used to help program and financial managers achieve results and safeguard the integrity of their programs.

ARC maintains a written plan of internal control development and testing. The agency's approach is to make management controls an integral part of the entire cycle of planning, budgeting, management, accounting, and auditing. Testing procedures are based on a team approach and are designed to provide feedback to management on a continuing basis throughout the cycle. ARC recognizes that an appropriate balance of controls must exist in programs and operations. Managers should benefit from controls, not be encumbered by them. Too many controls, especially in an organization as small as the Commission, can result in inefficient and ineffective government. ARC strives to maintain an environment of accountability in which all employees help ensure that government resources are used efficiently and effectively to achieve intended program results with minimal potential for waste, fraud, and mismanagement.

The Office of Inspector General (OIG) conducts independent program reviews and audits. Weekly management team meetings provide an opportunity to address control issues. Finance staff conduct pre-payment examinations of approved payments, as well as oversight reviews of program account obligation and payment details. Finally, the annual financial audit of the agency provides independent assessments of the adequacy of internal controls. The internal control plan assigns responsibility within the organization for follow-up action on any deficiencies.

ARC is authorized to allocate budget authority to other federal agencies to assist the Commission in performing its mission. Before FY 2007, the financial activity related to these allocated funds was reported by the agencies that received the allocation (the "child" agencies). Starting in FY 2007, an Office of Management and Budget directive required "parent" agencies to report activity related to allocated funds in their financial statements. In FY 2007, ARC experienced difficulty obtaining financial information from its much larger child agencies. Because of the inadequate information, ARC's independent auditor, WithumSmith+Brown, issued a disclaimer on the Commission's FY 2007 financial statements.

ARC made progress during FY 2008 in addressing child agency reporting deficiencies noted in the prior year. The Commission was able to obtain internal control and financial information from its child agencies, and to provide the auditors with information and representations from the child agencies necessary for ARC to assert it has implemented controls ensuring fair presentation of activity related to the allocated funds. ARC will implement further controls to enable it to identify improper balances and explain transactions recorded by some of the agencies.

WithumSmith+Brown issued a qualified opinion on ARC's FY 2008 financial statements due to the inability of the U.S. Department of Transportation (DOT), an ARC child agency, to properly support all of the recorded general ledger balances. DOT was unable to provide a detailed schedule of grant balances supporting the total recorded in the general ledger. In addition, DOT records showed a $1.2 million liability, which DOT has acknowledged as an error.

Management Follow-Up to Inspector General Recommendations

At the start of the fiscal year, all but two of the audit reports issued by the OIG in previous years had been addressed by ARC management. During fiscal year 2008, the OIG issued 14 reports concerning internal controls, grants, and other activities. The total dollar value of grants and programs audited during fiscal year 2008 was $2.5 million. The inspector general identified $747,065 of this amount as questioned costs. At the end of the fiscal year, management decisions regarding two prior-year reports involving $351,875 in questioned costs were still pending.

The OIG worked closely with ARC staff to prepare for the production of audited financial statements, and served as an important resource for workshops and meetings in the field to promote sound financial management on the part of ARC grantees. The semi-annual reports of the ARC inspector general, along with contact information, are available to the public at www.arc.gov.

Funding Waivers

As mentioned in the section “Appalachian Regional Commission Structure and Programs,” the Commission restricts project funding for economically strong counties. Section 14526 of the Appalachian Regional Development Act authorizes the Commission to grant waivers under certain conditions. In FY 2008, no waivers were granted.

SUMMARY OF FINANCIAL STATUS

Part III of this Performance and Accountability Report includes information about the financial status of the Appalachian Regional Commission. In FY 2007, ARC's financial statements underwent substantial and material changes as a result of new requirements under OMB Circular A-136. ARC is authorized to allocate budget authority to other agencies to assist the Commission in performing its mission. In prior years, the financial activity related to the allocated funds was reported by the agencies receiving the allocation ("child" agencies). Starting in FY 2007, "parent" agencies (those making the allocation) were required to report the activity in their financial statements.

This new requirement regarding "parent" and "child" agency reporting necessitated a change in ARC's financial reporting format, and in FY 2007 the Commission began reporting under the Federal Accounting Standards Advisory Board (FASAB) requirements. However, ARC experienced difficulty obtaining financial information from its much larger child agencies, and its independent auditor, WithumSmith+Brown, issued a disclaimer on the Commission's FY 2007 financial statements because of the inadequacy of child agency reporting. ARC made progress in FY 2008 in addressing child agency reporting deficiencies noted in FY 2007. It was able to obtain internal control and financial information from its child agencies, and to provide the auditors with information and representations from the child agencies necessary for ARC to assert it has implemented controls ensuring fair presentation of activity related to the allocated funds. ARC will implement further controls to enable it to identify improper balances and explain transactions recorded by some of the agencies.

WithumSmith+Brown issued a qualified opinion on ARC's FY 2008 financial statements due to the inability of the U.S. Department of Transportation (DOT), an ARC child agency, to properly support all of the recorded general ledger balances. DOT was unable to provide a detailed schedule of grant balances supporting the total recorded in the general ledger. In addition, DOT records showed a $1.2 million liability, which DOT has acknowledged as an error.

Assets on September 30, 2008, totaled $197.9 million, and liabilities equaled $6.7 million, versus $203.0 million in assets and $9.5 million in liabilities on September 30, 2007. Seventy-eight percent of ARC's assets were in the United States Treasury. In addition, 16 percent, or $30.9 million, represented advances to grantees and grant funds held by intermediary organizations in Appalachia for the operation of revolving loan funds promoting business development. The federal government retains a residual interest in the loan funds. ARC also advanced funds equaling $11.9 million to child agencies for the purpose of servicing grants. Remaining assets are cash.

Liabilities included $3.6 million in payments due to grantees to finance program expenditures and $2.4 million in accrued leave, pension liability, accrued salaries and benefits, and accrued health and flexible spending benefits. The remaining liabilities included $658,072 in intragovernmental advances and $96,167 in other agency transactions.

Net cost of operations for FY 2008 totaled $70.3 million. The statement of changes in net position was broken down between an earmarked fund and all other funds. The earmarked fund represents the operating costs of the Commission, of which 50 percent is paid by ARC's congressional appropriation and 50 percent by the 13 Appalachian states. Commission operating costs exclude costs for the Office of the Federal Co-Chair and the Office of Inspector General, which are fully covered by congressional appropriations. The net position of the earmarked fund is -$398,346, due to an account payable on the Commission's defined benefit retirement plan. The consolidated net position was $191.2 million.

ARC receives most of its resources from congressional appropriations, which totaled $73.032 million in FY 2008. In addition, ARC received $3.608 million from the 13 member states to pay for the Commission's operating costs. The statement of budgetary resources reported net outlays of $76.6 million. ARC incurred obligations of $86.2 million in FY 2008 and has an unpaid obligated balance (net end of period) of $126.3 million. Of FY 2008 obligations, $74 million funded ARC's Area Development Program, and the remainder was directed to the Appalachian Development Highway System.

The Commission must rely on congressionally appropriated funds to continue its operations, make grants, and meet its liabilities.

Notes are attached to the financial statements to describe and explain important disclosure information about line items in the statements and related financial policies and programs.