

## **PART 3 – COMPLIANCE REQUIREMENTS**

### **INTRODUCTION**

The objectives of most compliance requirements for Federal programs administered by States, local governments, Indian tribal governments, and non-profit organizations are generic in nature. For example, most programs have eligibility requirements for individuals or organizations. While the criteria for determining eligibility vary by program, the objective of the compliance requirement that only eligible individuals or organizations participate is consistent across all programs.

Rather than repeat these compliance requirements, audit objectives, and suggested audit procedures for each of the programs contained in Part 4 – Agency Program Requirements and Part 5 – Clusters of Programs, they are provided once in this part. For each program in this Compliance Supplement (this Supplement), Part 4 or Part 5 contains additional information about the compliance requirements that arise from laws and regulations applicable to each program, including the requirements specific to each program that should be tested using the guidance in this part.

### **Administrative Requirements**

The administrative requirements that apply to most programs arise from two sources: the “Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments” (also known as the “A-102 Common Rule”) and 2 CFR part 215 (hereafter, OMB Circular A-110), “Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations,” and the agencies’ codification (or other form of implementation) of OMB Circular A-110. The applicable guidance followed depends on the type of organization undergoing audit. Other administrative compliance requirements unique to a single program or a cluster of programs are provided in the Special Tests and Provisions sections of Parts 4 and 5.

### **State, Local, and Indian Tribal Governments**

Governmentwide guidance for administering grants and cooperative agreements to States, local governments, and Indian tribal governments is contained in the A-102 Common Rule, which was codified by each Federal funding agency in its title of the *Code of Federal Regulations*. The A-102 Common Rule section numbers are referred to without the Federal agency’s part number (e.g., §\_\_\_\_.37 would refer to sections in all agency regulations). This allows auditors to refer to the same section numbers when discussing administrative issues with different Federal funding agencies.

These requirements, which incorporate the cost principles by reference, apply to all grants and subgrants to governments, except grants and subgrants to State or local (public) institutions of higher education and hospitals, and except where they are inconsistent with Federal statutes or with regulations authorized in accordance with the exception provision of the A-102 Common Rule. Block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and several

other specifically identified programs are exempted from the A-102 Common Rule. Appendix I to this Supplement specifies legislation and programs where exclusions exist.

In some cases the A-102 Common Rule permits States to follow their own laws and procedures, e.g., when addressing equipment management. These are noted in the sections that follow. The auditor will have to refer to an individual State's rules in those situations.

### **Non-Profit Organizations**

The major source of requirements applicable to institutions of higher education, hospitals and other non-profit organizations is OMB Circular A-110, which incorporates the cost principles by reference. The provisions of OMB Circular A-110 are codified in agency regulations, generally following the section numbers in the circular. The OMB Circular A-110 section numbers are referenced in a manner similar to the A-102 Common Rule references. However, unlike the A-102 Common Rule, with OMB approval, agencies could modify certain provisions of A-110 to meet their special needs. OMB Circular A-110 states "Federal agencies responsible for awarding and administering grants . . . shall adopt the language in the circular unless different provisions are required by Federal statute or are approved by OMB." Subpart A, §\_\_\_\_.4, of OMB Circular A-110 states that "Federal awarding agencies may apply more restrictive requirements to a class of recipients when approved by OMB." Federal awarding agencies may apply less restrictive requirements when awarding small awards, except for those requirements which are statutory. Exceptions on a case-by-case basis may also be made by Federal awarding agencies.

Appendix II to this supplement contains a list of agencies that have codified OMB Circular A-110 and the CFR citations for these codifications. These remain unchanged by the reissuance of A-110 in Title 2 of the CFR. Auditors should continue to reference A-110 provisions and agency implementing citations, as appropriate.

### **Subrecipients**

Governmental subrecipients are subject to the provisions of the A-102 Common Rule. However, the A-102 Common Rule permits States to impose their own requirements on their governmental subrecipients, e.g., equipment management or procurement. Thus, in some circumstances, the auditor may need to refer to State rules and regulations rather than Federal requirements.

All subrecipients who are institutions of higher education, hospitals, or other non-profits, regardless of the type of organization making the subaward, shall follow the provisions of OMB Circular A-110, as implemented by the agency, when awarding or administering subgrants except under block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and the Job Training Partnership Act where State rules apply instead.

### **Compliance Requirements, Audit Objectives, and Suggested Audit Procedures**

Auditors shall consider the compliance requirements and related audit objectives in Part 3 and Part 4 or 5 (for programs included in this Supplement) in every audit of non-Federal entities conducted under OMB Circular A-133, with the exception of program-specific audits performed in accordance with a Federal agency's program-specific audit guide. In making a determination

not to test a compliance requirement, the auditor must conclude that the requirement either does not apply to the particular non-Federal entity or that noncompliance with the requirement could not have a material effect on a major program (e.g., the auditor would not be expected to test Procurement if the non-Federal entity charges only small amounts of purchases to a major program). The descriptions of the compliance requirements in Parts 3, 4, and 5 are generally a summary of the actual compliance requirements. The auditor should refer to the referenced citations (e.g., laws and regulations) for the complete statement of the compliance requirements.

The suggested audit procedures are provided to assist auditors in planning and performing tests of non-Federal entity compliance with the requirements of Federal programs. Auditor judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objective and whether additional or alternative audit procedures are needed.

The suggested procedures are in lieu of specifying audit procedures for each of the programs included in this Supplement. This approach has several advantages. First, it provides guidelines to assist auditors in designing audit procedures that are appropriate in the circumstance. Second, it helps auditors develop audit procedures for programs that are not included in this Supplement. Finally, it simplifies future updates to this Supplement.

The suggested audit procedures for compliance testing may be accomplished using dual-purpose testing.

### **Internal Control**

Consistent with the requirements of OMB Circular A-133, this Part includes generic audit objectives and suggested audit procedures to test internal control. However, the auditor must determine the specific procedures to test internal control on a case-by-case basis considering factors such as the non-Federal entity's internal control, the compliance requirements, the audit objectives for compliance, the auditor's assessment of control risk, and the audit requirement to test internal control as prescribed in OMB Circular A-133.

The suggested audit procedures for internal control testing may be accomplished using dual-purpose testing.

### **Improper Payments**

Under OMB budgetary guidance and Pub. L. No. 107-300, Federal agencies are required to review Federal awards and, as applicable, provide an estimate of improper payments. Improper payments mean:

1. Any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements, and includes any payment to an ineligible recipient; and
2. Any payment for an ineligible service, any duplicate payment, any payment for services not received, and any payment that does not account for credit for applicable discounts.

Auditors should be alert to improper payments, particularly when testing the following parts of section III. - A, "Activities Allowed or Unallowed;" B, "Allowable Costs/Cost Principles;" E, "Eligibility;" and, in some cases N, "Special Tests and Provisions."

## **A. ACTIVITIES ALLOWED OR UNALLOWED**

### **Compliance Requirements**

The specific requirements for activities allowed or unallowed are unique to each Federal program and are found in the laws, regulations, and the provisions of contract or grant agreements pertaining to the program. For programs listed in this Supplement, the specific requirements of the governing statutes and regulations are included in Part 4 – Agency Program Requirements or Part 5 – Clusters of Programs, as applicable. This type of compliance requirement specifies the activities that can or cannot be funded under a specific program.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
2. Determine whether Federal awards were expended only for allowable activities.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for activities allowed or unallowed and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

1. Identify the types of activities which are either specifically allowed or prohibited by the laws, regulations, and the provisions of contract or grant agreements pertaining to the program.
2. When allowability is determined based upon summary level data, perform procedures to verify that:
  - a. Activities were allowable.
  - b. Individual transactions were properly classified and accumulated into the activity total.

3. When allowability is determined based upon individual transactions, select a sample of transactions and perform procedures to verify that the transaction was for an allowable activity.
4. The auditor should be alert for large transfers of funds from program accounts which may have been used to fund unallowable activities.

## B. ALLOWABLE COSTS/COST PRINCIPLES

### Applicability of OMB Cost Principles Circulars

The following OMB cost principles circulars prescribe the cost accounting policies associated with the administration of Federal awards by: (1) States, local governments, and Indian tribal governments (State rules for expenditures of State funds apply for block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and for other programs specified in Appendix I); (2) institutions of higher education; and (3) non-profit organizations. Federal awards administered by publicly owned hospitals and other providers of medical care are exempt from OMB's cost principles circulars, but are subject to requirements promulgated by the sponsoring Federal agencies (e.g., the Department of Health and Human Services' 45 CFR part 74, Appendix E). The cost principles applicable to a non-Federal entity apply to all Federal awards received by the entity, regardless of whether the awards are received directly from the Federal Government or indirectly through a pass-through entity. The circulars describe selected cost items, allowable and unallowable costs, and standard methodologies for calculating indirect costs rates (e.g., methodologies used to recover facilities and administrative costs (F&A) at institutions of higher education). Federal awards include Federal programs and cost-type contracts and may be in the form of grants, contracts, and other agreements.

The three cost principles circulars are as follows:

- **OMB Circular A-87, "Cost Principles for State, Local, and Indian Tribal Governments" (2 CFR part 225).**
- **OMB Circular A-21, "Cost Principles for Educational Institutions" (2 CFR part 220)** – All institutions of higher education are subject to the cost principles contained in OMB Circular A-21, which incorporates the four Cost Accounting Standards Board (CASB) Standards and the Disclosure Statement (DS-2) requirements, as described in OMB Circular A-21, sections C.10 through C.14 and Appendices A and B.
- **OMB Circular A-122, "Cost Principles for Non-Profit Organizations" (2 CFR part 230)** – Non-profit organizations are subject to OMB Circular A-122, except those non-profit organizations listed in OMB Circular A-122, Attachment C that are subject to the commercial cost principles contained in the Federal Acquisition Regulation (FAR). Also, by contract terms and conditions, some non-profit organizations may be subject to the CASB's Standards and the Disclosure Statement (DS-1) requirements.

Although these cost principles circulars have been reissued in Title 2 of the CFR for ease of access, this Supplement refers to them by the circular title and numbering. Auditors should refer to them in the same manner.

The cost principles articulated in the three OMB cost principles circulars are in most cases substantially identical, but a few differences do exist. These differences are necessary because of the nature of the Federal/State/local/non-profit organizational structures, programs administered,

and breadth of services offered by some grantees and not others. Exhibit 1 of this part of the Supplement, Selected Items of Cost, lists the treatment of the selected cost items in the different circulars.

## LIST OF SELECTED ITEMS OF COST CONTAINED IN OMB COST PRINCIPLES CIRCULARS (Amended effective June 9, 2004)

The following exhibit provides an updated listing of selected items of cost contained in each of the OMB cost principles circulars based on the changes contained in the *Federal Register* notice dated May 10, 2004 (69 FR 25970-25995)

([http://www.whitehouse.gov/omb/fedreg/2004/040510\\_cost\\_principles.pdf](http://www.whitehouse.gov/omb/fedreg/2004/040510_cost_principles.pdf)). The primary changes are deletion of items, changes in language for consistency, and extension of certain items previously only in one or more—but not all—sets of OMB cost principles to another set(s) of OMB cost principles. Although these changes minimized the number of non-substantive differences among the OMB cost principles, there remain several cost items that are unique to one type of entity (e.g., commencement and convocation costs are applicable only to universities).

The exhibit lists the selected items of cost along with a cursory description of their allowability. The numbers in parentheses refer to the cost item in the applicable circular, as revised. The reader is strongly cautioned not to rely exclusively on the summary but to place primary reliance on the referenced circular text.

<b>Selected Items of Cost Exhibit 1 (amended 6/04)</b>			
<i>Selected Cost Item</i>	<i>OMB Circular A-87, Attachment B State, Local, &amp; Indian Tribal Gov'ts</i>	<i>OMB Circular A-21, Section J Educational Institutions</i>	<i>OMB Circular A-122, Attachment B Non-Profit Organizations</i>
Advertising and public relations costs	(1) Allowable with restrictions	(1) Allowable with restrictions	(1)-Allowable with restrictions
Advisory councils	(2)-Allowable with restrictions	(2) Allowable with restrictions	(2) Allowable with restrictions
Alcoholic beverages	(3)-Unallowable	(3)-Unallowable	(3)-Unallowable
Alumni/ae activities	Not specifically addressed	(4)-Unallowable	Not specifically addressed
Audit costs and related services	(4)-Allowable with restrictions <b>and</b> as addressed in OMB Circular A-133	(5)-Allowable with restrictions <b>and</b> as addressed in OMB Circular A-133	(4)-Allowable with restrictions <b>and</b> as addressed in OMB Circular A-133
Bad debts	(5)-Unallowable	(6)-Unallowable	(5)-Unallowable
Bonding costs	(6)-Allowable with restrictions	(7) Allowable with restrictions	(6)-Allowable with restrictions
Commencement and convocation costs	Not specifically addressed	(8)-Unallowable with exceptions	Not specifically addressed

<b>Selected Items of Cost</b> <b>Exhibit 1</b> (amended 6/04)			
<i>Selected Cost Item</i>	<i>OMB Circular A-87, Attachment B State, Local, &amp; Indian Tribal Gov'ts</i>	<i>OMB Circular A-21, Section J Educational Institutions</i>	<i>OMB Circular A-122, Attachment B Non-Profit Organizations</i>
Communication costs	(7)-Allowable	(9)-Allowable	(7)-Allowable
Compensation for personal services	(8)-Unique criteria for support	(10)-Unique criteria for support	(8)-Unique criteria for support
Compensation for personal services - organization-furnished automobile	Not specifically addressed	(10.g)- Unallowable for that portion of costs attributed to personal use	(8.g)- Unallowable for that portion of costs attributed to personal use
Compensation for personal services - sabbatical leave costs	Not specifically addressed	(10.f(4))- Allowable with restrictions	Not specifically addressed
Compensation for personal services - severance pay	(8)-Allowable with restrictions	(10.h)-Allowable with restrictions	(8.k)-Allowable with restrictions
Contingency provisions	(9)-Unallowable with exceptions	(11)-Unallowable with exceptions	(9)-Unallowable with exceptions
Deans of faculty and graduate schools	Not addressed	(12)-Allowable	Not addressed
Defense and prosecution of criminal and civil proceedings and claims	(10)-Allowable with restrictions	(13)-Allowable with restrictions (Defense and prosecution of criminal and civil proceedings, claims, appeals and patent infringement)	(10)-Allowable with restrictions (Defense and prosecution of criminal and civil proceedings, claims, appeals and patent infringement)
Depreciation and use allowances	(11)-Allowable with qualifications	(14)-Allowable with qualifications	(11)-Allowable with qualifications
Donations and contributions	(12)-Unallowable (made by recipient); not reimbursable but value may be used as cost sharing or matching (made to recipient)	(15)-Unallowable (made by recipient); not reimbursable but value may be used as cost sharing or matching (made to recipient)	(12)-Unallowable (made by recipient); not reimbursable but value may be used as cost sharing or matching (made to recipient)

<b>Selected Items of Cost</b> <b>Exhibit 1</b> (amended 6/04)			
<i>Selected Cost Item</i>	<i>OMB Circular A-87, Attachment B State, Local, &amp; Indian Tribal Gov'ts</i>	<i>OMB Circular A-21, Section J Educational Institutions</i>	<i>OMB Circular A-122, Attachment B Non-Profit Organizations</i>
Employee morale, health, and welfare costs	(13)-Allowable with restrictions	(16)-Allowable with restrictions	(13)-Allowable with restrictions
Entertainment costs	(14)-Unallowable	(17)-Unallowable	(14)-Unallowable
Equipment and other capital expenditures	(15)-Allowability based on specific requirements	(18)-Allowability based on specific requirements	(15)-Allowability based on specific requirements
Fines and penalties	(16)-Unallowable with exception	(19)-Unallowable with exception	(16)-Unallowable with exception
Fundraising and investment management costs	(17)-Unallowable with exceptions	(20)-Unallowable with exceptions (Fundraising)	(17)-Unallowable with exceptions
Gains and losses on depreciable assets	(18)-Allowable with restrictions (Gains and losses on disposition of depreciable property and other capital assets and substantial relocation of Federal programs)	(21)-Allowable with restrictions	(18)-Allowable with restrictions
General government expenses	(19)-Unallowable with exceptions	Not specifically addressed	Not specifically addressed
Goods or services for personal use	(20) Unallowable	(22)-Unallowable	(19)-Unallowable
Housing and personal living expenses	Not specifically addressed	(23)-Unallowable	(20)-Unallowable as overhead costs
Idle facilities and idle capacity	(21)-Idle facilities - unallowable with exceptions; idle capacity - allowable with restrictions	(24)-Idle facilities - unallowable with exceptions; idle capacity - allowable with restrictions	(21)-Idle facilities - unallowable with exceptions; idle - capacity allowable with restrictions
Insurance and indemnification	(22)-Allowable with restrictions	(25)-Allowable with restrictions	(22)-Allowable with restrictions
Interest	(23)-Allowable with restrictions	(26)-Allowable with restrictions	(23)-Allowable with restrictions

<b>Selected Items of Cost</b> <b>Exhibit 1</b> (amended 6/04)			
<i>Selected Cost Item</i>	<i>OMB Circular A-87, Attachment B State, Local, &amp; Indian Tribal Gov'ts</i>	<i>OMB Circular A-21, Section J Educational Institutions</i>	<i>OMB Circular A-122, Attachment B Non-Profit Organizations</i>
Interest - substantial relocation	Not specifically addressed	(26.b(6))-Possible adjustment in relocated within 20 years	(23.a(6)(d))-Possible adjustment in relocated within 20 years
Labor relations costs	Not specifically addressed	(27)-Allowable	(24)-Allowable
Lobbying	(24)-Unallowable	(28)-Unallowable with exceptions	(25)-Unallowable with exceptions
Lobbying - executive lobbying costs	(24.b)-Unallowable	(28.h)-Unallowable	(25.d)-Unallowable
Losses on other sponsored agreements or contracts	Not specifically addressed	(29)-Unallowable	(26)-Unallowable (Losses on other awards or contracts)
Maintenance and repair costs	(25)-Allowable with restrictions (Maintenance, operations, and repairs)	(30)-Allowable with restrictions	(27)-Allowable with restrictions
Materials and supplies costs	(26)-Allowable with restrictions	(31)-Allowable with restrictions	(28)-Allowable with restrictions
Meetings and conferences	(27)- Allowable with restrictions	(32)- Allowable with restrictions	(29)-Allowable with restrictions
Memberships, subscriptions, and professional activity costs	(28)-Allowable as a direct cost for civic, community and social organizations with Federal approval; unallowable for lobbying organizations.	(33)-Unallowable for civic, community, or social organizations	(30)-Allowable for civic and community organizations with Federal approval; unallowable for social organizations.
Organization costs	Not specifically addressed	Not specifically addressed	(31)-Unallowable except Federal prior approval
Page charges in professional journals	(34.b)-Allowable with restrictions (addressed under "Publication and printing costs")	(39.b)-Allowable with restrictions (addressed under "Publication and printing costs")	(32)-Allowable with restrictions
Participant support costs	Not specifically addressed	Not specifically addressed	(33)-Allowable with prior approval of the Federal awarding agency

<b>Selected Items of Cost</b> <b>Exhibit 1</b> (amended 6/04)			
<i>Selected Cost Item</i>	<i>OMB Circular A-87, Attachment B State, Local, &amp; Indian Tribal Gov'ts</i>	<i>OMB Circular A-21, Section J Educational Institutions</i>	<i>OMB Circular A-122, Attachment B Non-Profit Organizations</i>
Patent costs	(29)-Allowable with restrictions	(34)-Allowable with restrictions	(34)-Allowable with restrictions
Plant and homeland security costs	(30)-Allowable with restrictions	(35)-Allowable with restrictions	(35)-Allowable with restrictions
Pre-agreement costs	(31)-Allowable with restrictions (Pre-award costs)	(36)-Unallowable unless approved by the Federal sponsoring agency	(36)-Allowable with restrictions
Professional service costs	(32)-Allowable with restrictions	(37)-Allowable with restrictions	(37)-Allowable with restrictions
Proposal costs	(33)-Allowable with restrictions	(38)-Allowable with restrictions	Not specifically addressed
Publication and printing costs	(34)-Allowable with restrictions	(39)-Allowable with restrictions	(38)-Allowable with restrictions
Rearrangement and alteration costs	(35)-Allowable (ordinary and normal); allowable with Federal prior approval (special)	(40)-Allowable (ordinary and normal); allowable with Federal prior approval (special)	(39)-Allowable (ordinary and normal); allowable with Federal prior approval (special)
Reconversion costs	(36)-Allowable with restrictions	(41)-Allowable with restrictions	(40)-Allowable with restrictions
Recruiting costs	(1.c)-Allowable with restrictions (addresses costs of advertising only)	(42)-Allowable with restrictions	(1)-Allowable with restrictions
Relocation costs	Not specifically addressed	(42.d)-Allowable with restrictions	(42)-Allowable with restrictions
Rental cost of buildings and equipment	(37)-Allowable with restrictions	(43)-Allowable with restrictions	(43)-Allowable with restrictions
Royalties and other costs for use of patents	(38)-Allowable with restrictions	(44)-Allowable with restrictions	(44)-Allowable with restrictions
Scholarships and student aid costs	Not specifically addressed	(45)-Allowable with restrictions	Not specifically addressed
Selling and marketing costs	(39)-Unallowable with exceptions	(46)-Unallowable with exceptions	(45)-Unallowable with exceptions

<b>Selected Items of Cost</b> <b>Exhibit 1</b> (amended 6/04)			
<i>Selected Cost Item</i>	<i>OMB Circular A-87, Attachment B State, Local, &amp; Indian Tribal Gov'ts</i>	<i>OMB Circular A-21, Section J Educational Institutions</i>	<i>OMB Circular A-122, Attachment B Non-Profit Organizations</i>
Specialized service facilities	Not specifically addressed	(47)-Allowable with restrictions	(46)-Allowable with restrictions
Student activity costs	Not specifically addressed	(48)-Unallowable unless specifically provided for in the sponsored agreement	Not specifically addressed
Taxes	(40)-Allowable with restrictions	(49)-Allowable with restrictions	(47)-Allowable with restrictions
Termination costs applicable to sponsored agreements	(41)-Allowable with restrictions	(50)-Allowable with restrictions	(48)-Allowable with restrictions
Training costs	(42)-Allowable for employee development	(51)-Allowable for employee development	(49)-Allowable with limitations
Transportation costs	Not specifically addressed	(52)-Allowable with restrictions	(50)-Allowable
Travel costs	(43)-Allowable with restrictions	(53)-Allowable with restrictions	(51)-Allowable with restrictions
Trustees	Not specifically addressed	(54)-Allowable with restrictions	(52)-Allowable with restrictions

## **OMB CIRCULAR A-87**

### **COST PRINCIPLES FOR STATE, LOCAL, AND INDIAN TRIBAL GOVERNMENTS**

#### **Introduction**

OMB Circular A-87 (A-87) establishes principles and standards for determining allowable direct and indirect costs for Federal awards. This section is organized into the following areas of allowable costs: State/Local-Wide Central Service Costs; State/Local Department or Agency Costs (Direct and Indirect); and State Public Assistance Agency Costs.

#### ***Cognizant Agency***

A-87, Attachment A, paragraph B.6. defines “cognizant agency” as the Federal agency responsible for reviewing, negotiating, and approving cost allocation plans or indirect cost proposals developed under A-87 on behalf of all Federal agencies. OMB publishes a listing of cognizant agencies (*Federal Register*, 51 FR 552, January 6, 1986). References to cognizant agency in this section should not be confused with the cognizant Federal agency for audit responsibilities, which is defined in OMB Circular A-133, Subpart D. §\_\_\_\_.400(a).

#### ***Availability of Other Information***

Additional information on cost allocation plans and indirect cost rates is found in the Department of Health and Human Services (HHS) publications: *A Guide for State, Local and Indian Tribal Governments* (ASMB C-10); *Review Guide for State and Local Governments State/Local-Wide Central Service Cost Allocation Plans and Indirect Cost Rates*; and the *Review Guide for Public Assistance Cost Allocation Plans* which are available on the Internet at <http://rates.psc.gov/>.

#### **Allowable Costs – State/Local-Wide Central Service Costs**

Most governmental entities provide services, such as accounting, purchasing, computer services, and fringe benefits, to operating agencies on a centralized basis. Since the Federal awards are performed within the individual operating agencies, there must be a process whereby these central service costs are identified and assigned to benefiting operating agency activities on a reasonable and consistent basis. The State/local-wide central service cost allocation plan (CAP) provides that process. (Refer to A-87, Attachment C, State/Local-Wide Central Service Cost Allocation Plans, for additional information and specific requirements.)

The allowable costs of central services that a governmental unit provides to its agencies may be allocated or billed to the user agencies. The State/local-wide central service CAP is the required documentation of the methods used by the governmental unit to identify and accumulate these costs, and to allocate them or develop billing rates based on them.

Allocated central service costs (referred to as Section I costs) are allocated to benefiting operating agencies on some reasonable basis. These costs are usually negotiated and approved for a future year on a “fixed-with-carry-forward” basis. Examples of such services might include general accounting, personnel administration, and purchasing. Section I costs assigned to an operating agency through the State/local-wide central service CAP are typically included in the agency’s indirect cost pool.

Billed central service costs (referred to as Section II costs) are billed to benefiting agencies and/or programs on an individual fee-for-service or similar basis. The billed rates are usually based on the estimated costs for providing the services. An adjustment will be made at least annually for the difference between the revenue generated by each billed service and the actual allowable costs. Examples of such billed services include computer services, transportation services, self-insurance, and fringe benefits. Section II costs billed to an operating agency may be charged as direct costs to the agency's Federal awards or included in its indirect cost pool.

***1. Compliance Requirements – State/Local-Wide Central Service Costs***

***a. Basic Guidelines***

- (1) The basic guidelines affecting allowability of costs (direct and indirect) are identified in A-87, Attachment A, paragraph C.
- (2) To be allowable under Federal awards, costs must meet the following general criteria (A-87, Attachment A, paragraph C.1):
  - (a) Be necessary and reasonable for the performance and administration of Federal awards. (Refer to A-87, Attachment A, paragraph C.2 for additional information on reasonableness of costs.)
  - (b) Be allocable to Federal awards under the provisions of A-87. (Refer to A-87, Attachment A, paragraph C.3 for additional information on allocable costs.)
  - (c) Be authorized or not prohibited under State or local laws or regulations.
  - (d) Conform to any limitations or exclusions set forth in A-87, Federal laws, terms and conditions of the Federal award, or other governing regulations as to types or amounts of cost items.
  - (e) Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit.
  - (f) Be accorded consistent treatment. A cost may not be assigned to a Federal award as a direct cost if any other cost incurred for the same purpose in like circumstances has been allocated to the Federal award as an indirect cost.
  - (g) Be determined in accordance with generally accepted accounting principles, except as otherwise provided in A-87.

- (h) Not be included as a cost or used to meet cost sharing or matching requirements of any other Federal award, except as specifically provided by Federal law or regulation.
- (i) Be net of all applicable credits. (Refer to A-87, Attachment A, paragraph C.4 for additional information on applicable credits.)
- (j) Be adequately documented.

b. *Selected Items of Cost*

- (1) Sections 1 through 43 of A-87, Attachment B, provide the principles to be applied in establishing the allowability or unallowability of certain items of cost. (For a listing of costs, refer to Exhibit 1 of this part of the Supplement.) These principles apply whether a cost is treated as direct or indirect. Failure to mention a particular item of cost in this section of A-87 is not intended to imply that it is either allowable or unallowable; rather, determination of allowability in each case should be based on the treatment or standards provided for similar or related items of cost.
- (2) A cost is allowable for Federal reimbursement only to the extent of benefits received by Federal awards and its conformance with the general policies and principles stated in A-87, Attachment A.

c. *Submission Requirements*

- (1) Submission requirements are identified in A-87, Attachment C, paragraph D.
- (2) A State is required to submit a State-wide central service CAP to HHS for each year in which it claims central service costs under Federal awards.
- (3) A local government that has been designated as a “major local government” by OMB is required to submit a central service CAP to its cognizant agency annually. All other local governments claiming central service costs must develop a CAP in accordance with the requirements described in A-87 and maintain the plan and related supporting documentation for audit. Local governments are not required to submit the plan for Federal approval unless they are specifically requested to do so by the cognizant agency. If a local government receives funds as a subrecipient only, the primary recipient will be responsible for negotiating and/or monitoring the local government’s plan.
- (4) All central service CAPs will be prepared and, when required, submitted within the 6 months prior to the beginning of the governmental unit’s fiscal years in which it proposes to claim central service costs. Extensions may be granted by the cognizant agency.

- d. *Documentation Requirements*
- (1) The central service CAP must include all central service costs that will be claimed (either as an allocated or a billed cost) under Federal awards. Costs of central services omitted from the CAP will not be reimbursed.
  - (2) The documentation requirements for all central service CAPs are contained in A-87, Attachment C, paragraph E. All plans and related documentation used as a basis for claiming costs under Federal awards must be retained for audit in accordance with the record retention requirements contained in the A-102 Common Rule.
- e. *Required Certification* – No proposal to establish a central service CAP, whether submitted to a Federal cognizant agency or maintained on file by the governmental unit, shall be accepted and approved unless such costs have been certified by the governmental unit using the Certificate of Cost Allocation Plan as set forth in A-87, Attachment C.
- f. *Allocated Central Service Costs (Section I Costs)* – A carry-forward adjustment is not permitted for a central service activity that was not included in the previously approved plan or for unallowable costs that must be reimbursed immediately (A-87, Attachment C, paragraph G.3).
- g. *Billed Central Service Costs (Section II Costs)*
- (1) Internal service funds for central service activities are allowed a working capital reserve of up to 60 days cash expenses for normal operating purposes (A- 87, Attachment C, paragraph G.2). A working capital reserve exceeding 60 days may be approved by the cognizant Federal agency in exceptional cases.
  - (2) Adjustments of billed central services are required when there is a difference between the revenue generated by each billed service and the actual allowable costs (A-87, Attachment C, paragraph G.4). The adjustments will be made through one of the following methods:
    - (a) A cash refund to the Federal Government for the Federal share of the adjustment, if revenue exceeds costs,
    - (b) Credits to the amounts charged to the individual programs,
    - (c) Adjustments to future billing rates, or
    - (d) Adjustments to allocated central service costs (Section I) if the total amount of the adjustment for a particular service does not exceed \$500,000.

- (3) Whenever funds are transferred from a self-insurance reserve to other accounts (e.g., general fund), refunds shall be made to the Federal Government for its share of funds transferred, including earned or imputed interest from the date of transfer (A-87, Attachment B, paragraph 22).

**2. *Audit Objectives – State/Local-Wide Central Service Costs***

- a. Obtain an understanding of internal control over the compliance requirements for central service costs, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
- b. Determine whether the governmental unit complied with the provisions of A-87 as follows:
  - (1) Direct charges to Federal awards were for allowable costs.
  - (2) Charges to cost pools allocated to Federal awards through the central service CAPs were for allowable costs.
  - (3) The methods of allocating the costs are in accordance with the applicable cost principles, and produce an equitable and consistent distribution of costs, which benefit from the central service costs being allocated (e.g., cost allocation bases include all activities, including all State departments and agencies and, if appropriate, non-State organizations which receive services).
  - (4) Cost allocations were in accordance with central service CAPs approved by the cognizant agency or, in cases where such plans are not subject to approval, in accordance with the plan on file.

**3. *Suggested Internal Control Audit Procedures – State/Local-Wide Central Service Costs***

- a. Using the guidance provided in Part 6 – Internal Control for allowable costs/cost principles, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of non-compliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**4. *Suggested Compliance Audit Procedures – State/Local-Wide Central Service Costs***

- a. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.
  - (1) In reviewing the State/local-wide central service costs, the auditor may not need to test all central service costs (allocated or billed) every year; for example, the auditor in obtaining sufficient evidence for the opinion may consider testing each central service at least every 5 years, and perform additional testing for central services with operating budgets of \$5 million or more.
  - (2) If the local governmental entity is not required to submit the central service CAP and related supporting documentation, the auditor should consider the risk of the reduced level of oversight in designing the nature, timing and extent of compliance testing.
- b. *General Audit Procedures for State/Local-Wide Central Service CAPs* – The following procedures apply to direct charges to Federal awards as well as charges to cost pools that are allocated wholly or partially to Federal awards or used in formulating indirect cost rates used for recovering indirect costs under Federal awards.
  - (1) Test a sample of transactions for conformance with:
    - (a) The criteria contained in the “Basic Guidelines” section of A-87, Attachment A, paragraph C.
    - (b) The principles to establish allowability or unallowability of certain items of cost (A-87, Attachment B).
  - (2) If the auditor identifies unallowable costs, the auditor should be aware that directly associated costs might have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost, and would have not been incurred if the other cost had not been incurred. When an unallowable cost is incurred, directly associated costs are also unallowable. For example, occupancy costs related to unallowable general costs of government are also unallowable.
- c. *Special Audit Procedures for State/Local-Wide Central Service CAPs*
  - (1) Verify that the central service CAP includes the required documentation in accordance with A-87, Attachment C, paragraph E.
  - (2) *Testing of the State/Local-Wide Central Service CAPs – Allocated Section I Costs*

- (a) If new allocated central service costs were added, review the justification for including the item as Section I costs to ascertain if the costs are allowable (e.g., if costs benefit Federal awards).
  - (b) Identify the central service costs that incurred a significant increase in actual costs from the prior year's costs. Test a sample of transactions to verify the allowability of the costs.
  - (c) Determine whether the bases used to allocate costs are appropriate, i.e., costs are allocated in accordance with relative benefits received.
  - (d) Determine whether the proposed bases include all activities that benefit from the central service costs being allocated, including all users that receive the services. For example, the State-wide central service CAP should allocate costs to all benefiting State departments and agencies, and, where appropriate, non-State organizations, such as local government agencies.
  - (e) Perform an analysis of the allocation bases by selecting agencies with significant Federal awards to determine if the percentage of costs allocated to these agencies has increased from the prior year. For those selected agencies with significant allocation percentage increases, determine that the data included in the bases are current and accurate.
  - (f) Verify that carry-forward adjustments are properly computed in accordance with A-87, Attachment C, paragraph G.3.
- (3) *Testing of the State/Local-Wide Central Service CAPs – Billed Section II Costs*
- (a) For billed central service activities accounted for in separate funds (e.g., internal service funds), ascertain if:
    - (i) Retained earnings/fund balances (including reserves) are computed in accordance with the applicable cost principles;
    - (ii) Working capital reserves are not excessive in amount (generally not greater than 60 days for cash expenses for normal operations incurred for the period exclusive of depreciation, capital costs, and debt principal costs); and
    - (iii) Adjustments were made when there is a difference between the revenue generated by each billed service and the actual allowable costs.

Note: A 60-day working capital reserve is not automatic. Refer to the HHS publication, *A Guide for State, Local, and Indian Tribal Governments* (ASMB C-10) for guidelines.

- (b) Test to ensure that all users of services are billed in a consistent manner. For example, examine selected billings to determine if all users (including users outside the governmental unit) are charged the same rate for the same service.
- (c) Test that billing rates exclude unallowable costs, in accordance with applicable cost principles and Federal statutes.
- (d) Test, where billed central service activities are funded through general revenue appropriations, that the billing rates (or charges) are developed based on actual costs and were adjusted to eliminate profits.
- (e) For self-insurance and pension funds, ascertain if independent actuarial studies appropriate for such activities are performed at least biennially and that current period costs were allocated based on an appropriate study that is not over two years old.
- (f) Determine if refunds were made to the Federal Government for its share of funds transferred from the self-insurance reserve to other accounts, including imputed or earned interest from the date of the transfer.

### **Allowable Costs – State/Local Department or Agency Costs – Direct and Indirect**

The individual State/local departments or agencies (also known as operating agencies) are responsible for the performance or administration of Federal awards. In order to receive cost reimbursement under Federal awards, the department or agency usually submits claims asserting that allowable and eligible costs (direct and indirect) have been incurred in accordance with A-87.

While direct costs are those that can be identified specifically with a particular final cost objective, the indirect costs are those that have been incurred for common or joint purposes, and not readily assignable to the cost objectives specifically benefited without effort disproportionate to the results achieved. Indirect costs are normally charged to Federal awards by the use of an indirect cost rate.

The indirect cost rate proposal (ICRP) provides the documentation prepared by a State/local department or agency, to substantiate its request for the establishment of an indirect cost rate. The indirect costs include: (1) costs originating in the department or agency carrying out Federal awards, and (2) costs of central governmental services distributed through the State/local-wide central service CAP that are not otherwise treated as direct costs. The ICRPs are based on the most current financial data and are used to either establish predetermined, fixed, or provisional

indirect cost rates or to finalize provisional rates (for rate definitions refer to A-87, Attachment E, paragraph B).

**1. *Compliance Requirements – State/Local Department or Agency Costs – Direct and Indirect***

- a. *Basic Guidelines* – Refer to the previous section, “Allowable Costs – State/Local-Wide Central Service Costs, 1.a – Compliance Requirements-Basic Guidelines,” for the guidelines affecting the allowability of costs (direct and indirect) under Federal awards.
- b. *Selected Items of Cost* – Refer to the previous section, “Allowable Costs - State/Local-Wide Central Service Costs, 1.b - Compliance Requirements-Selected Items of Cost,” for the principles to establish allowability or unallowability of certain items of cost. These principles apply whether a cost is treated as direct or indirect.
- c. *Allocation of Indirect Costs and Determination of Indirect Cost Rates*
  - (1) The specific methods for allocating indirect costs and computing indirect cost rates are as follows:
    - (a) *Simplified Method* – This method is applicable where a governmental unit’s department or agency has only one major function, or where all its major functions benefit from the indirect cost to approximately the same degree. The allocation of indirect costs and the computation of an indirect cost rate may be accomplished through simplified allocation procedures described in the circular (A-87, Attachment E, paragraph C.2).
    - (b) *Multiple Allocation Base Method* – This method is applicable where a governmental unit’s department or agency has several major functions that benefit from its indirect costs in varying degrees. The allocation of indirect costs may require the accumulation of such costs into separate groupings which are then allocated individually to benefiting functions by means of a base which best measures the relative degree of benefit. (For detailed information, refer to A-87, Attachment E, paragraph C.3.)
    - (c) *Special Indirect Cost Rates* – In some instances, a single indirect cost rate for all activities of a department or agency may not be appropriate. Different factors may substantially affect the indirect costs applicable to a particular program or group of programs, e.g., the physical location of the work, the nature of the facilities, or level of administrative support required. (For the requirements for a separate indirect cost rate, refer to A-87, Attachment E, paragraph C.4.)

- (d) *Cost Allocation Plans* – In certain cases, the cognizant agency may require a State or local governmental unit’s department or agency to prepare a CAP instead of an ICRP. These are infrequently occurring cases in which the nature of the department or agency’s Federal awards makes impracticable the use of a rate to recover indirect costs. A CAP required in such cases consists of narrative descriptions of the methods the department or agency uses to allocate indirect costs to programs, awards, or other cost objectives. Like an ICRP, the CAP must be either submitted to the cognizant agency for review, negotiation and approval, or retained on file for inspection during audits.

d. *Submission Requirements*

- (1) Submission requirements are identified in A-87, Attachment E, paragraph D.1. All departments or agencies of a governmental unit claiming indirect costs under Federal awards must prepare an ICRP and related documentation to support those costs.
- (2) A State/local department or agency for which a cognizant Federal agency has been assigned by OMB must submit its ICRP to its cognizant agency. Smaller local government departments or agencies which are not required to submit a proposal to the cognizant Federal agency must develop an ICRP in accordance with the requirements of A-87, and maintain the proposal and related supporting documentation for audit. Where a local government receives funds as a subrecipient only, the primary recipient will be responsible for negotiating and/or monitoring the subrecipient’s plan.
- (3) Each Indian tribal government desiring reimbursement of indirect costs must submit its ICRP to the Department of the Interior.
- (4) ICRPs must be developed (and, when required, submitted) within 6 months after the close of the governmental unit’s fiscal year.

e. *Documentation and Certification Requirements*

The documentation and certification requirements for ICRPs are included in A-87, Attachment E, paragraphs D.2 and 3, respectively. The proposal and related documentation must be retained for audit in accordance with the record retention requirements contained in the A-102 Common Rule.

**2. *Audit Objectives – State/Local Department or Agency Costs – Direct and Indirect***

- a. Obtain an understanding of internal control over the compliance requirements for State/local department or agency costs, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).

- b. Determine whether the governmental unit complied with the provisions of A-87 as follows:
- (1) Direct charges to Federal awards were for allowable costs.
  - (2) Charges to cost pools used in calculating indirect cost rates were for allowable costs.
  - (3) The methods for allocating the costs are in accordance with the applicable cost principles, and produce an equitable and consistent distribution of costs (e.g., all activities that benefit from the indirect cost, including unallowable activities, must receive an appropriate allocation of indirect costs).
  - (4) Indirect cost rates were applied in accordance with approved indirect cost rate agreements (ICRA), or special award provisions or limitations, if different from those stated in negotiated rate agreements.
  - (5) For local departments or agencies that do not have to submit an ICRP to the cognizant Federal agency, indirect cost rates were applied in accordance with the ICRP maintained on file.

**3. *Suggested Internal Control Audit Procedures – State/Local Department or Agency Costs- Direct and Indirect***

Refer to the previous section, “Allowable Costs - State/Local-Wide Central Service Costs,” items 3.a through 3.c, for suggested internal control audit procedures.

**4. *Suggested Compliance Audit Procedures – State/Local Department or Agency Costs – Direct and Indirect***

- a. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance. If the local department or agency is not required to submit an ICRP and related supporting documentation, the auditor should consider the risk of the reduced level of oversight in designing the nature, timing, and extent of compliance testing.
- b. *General Audit Procedures (Direct and Indirect Costs)* – The following procedures apply to direct charges to Federal awards as well as charges to cost pools that are allocated wholly or partially to Federal awards or used in formulating indirect cost rates used for recovering indirect costs from Federal awards.
- (1) Test a sample of transactions for conformance with:
    - (a) The criteria contained in the “Basic Guidelines” section of A-87, Attachment A, paragraph C.

- (b) The principles to establish allowability or unallowability of certain items of cost (A-87, Attachment B).
  - (2) If the auditor identifies unallowable costs, the auditor should be aware that directly associated costs might have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost, and would have not been incurred if the other cost had not been incurred. When an unallowable cost is incurred, directly associated costs are also unallowable. For example, occupancy costs related to unallowable general costs of government are also unallowable.
- c. *Special Audit Procedures for State/Local Department or Agency ICRPs*
- (1) Verify that the ICRP includes the required documentation in accordance with A-87, Attachment E, paragraph D.
  - (2) *Testing of the ICRP* – There may be a timing consideration when the audit is completed before the ICRP is completed. In this instance, the auditor should consider performing interim testing of the costs charged to the cost pools and the allocation bases (e.g., determine from management the cost pools that management expects to include in the ICRP and test the costs for compliance with A-87). Should there be audit exceptions, corrective action may be taken earlier to minimize questioned costs. In the next year’s audit, the auditor should complete testing and verify management’s representations against the completed ICRP.
    - (a) When the ICRA is the basis for indirect cost charged to a major program, the auditor is required to obtain appropriate assurance that the costs collected in the cost pools and allocation methods are in compliance with the applicable cost principles. The following procedures are some acceptable options the auditor may use to obtain this assurance:
      - (i) *Indirect Cost Pool* – Test the indirect cost pool to ascertain if it includes only allowable costs in accordance with A-87.
        - (A) Test to ensure that unallowable costs are identified and eliminated from the indirect cost pool (e.g., capital expenditures, general costs of government).
        - (B) Identify significant changes in expense categories between the prior ICRP and the current ICRP. Test a sample of transactions to verify the allowability of the costs.
        - (C) Trace the central service costs that are included in the indirect cost pool to the approved State/local-

wide central service CAP or to plans on file when submission is not required.

- (ii) *Direct Cost Base* – Test the methods of allocating the costs to ascertain if they are in accordance with the applicable provisions of A-87 and produce an equitable distribution of costs.
  - (A) Determine that the proposed base(s) includes all activities that benefit from the indirect costs being allocated.
  - (B) If the direct cost base is not limited to direct salaries and wages, determine that distorting items are excluded from the base. Examples of distorting items include capital expenditures, flow-through funds (such as benefit payments), and subaward costs in excess of \$25,000 per subaward.
  - (C) Determine the appropriateness of the allocation base (e.g., salaries and wages, modified total direct costs).
- (iii) *Other Procedures*
  - (A) Examine the employee time report system results (where and if used) to ascertain if they are accurate, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged. (Refer to A-87, Attachment B, paragraph 8.h for additional information on support of salaries and wages.)
  - (B) For an ICRP using the multiple allocation base method, test statistical data (e.g., square footage, audit hours, salaries and wages) to ascertain if the proposed allocation or rate bases are reasonable, updated as necessary, and do not contain any material omissions.
- (3) *Testing of Charges Based Upon the ICRA* – Perform the following procedures to test the application of charges to Federal awards based upon an ICRA:
  - (a) Obtain and read the current ICRA and determine the terms in effect.

- (b) Select a sample of claims for reimbursement and verify that the rates used are in accordance with the rate agreement, that rates were applied to the appropriate bases, and that the amounts claimed were the product of applying the rate to the applicable base. Verify that the costs included in the base(s) are consistent with the costs that were included in the base year (e.g., if the allocation base is total direct costs, verify that current-year direct costs do not include costs items that were treated as indirect costs in the base year).
- (4) *Other Procedures – No Negotiated ICRA*
- (a) If an indirect cost rate has not been negotiated by a cognizant Federal agency, as required, the auditor should determine whether documentation exists to support the costs. Where the auditee has documentation, the suggested general audit procedures (direct and indirect costs under paragraph 4.b of this section) should be performed to determine the appropriateness of the indirect cost charges to awards.
  - (b) If an indirect cost rate has not been negotiated by a cognizant agency, as required, and documentation to support the indirect costs does not exist, the auditor should question the costs based on a lack of supporting documentation.

### **Allowable Costs – State Public Assistance Agency Costs**

State public assistance agency costs are (1) defined as all costs allocated or incurred by the State agency except expenditures for financial assistance, medical vendor payments, and payments for services and goods provided directly to program recipients (e.g., day care services); and (2) normally charged to Federal awards by implementing the public assistance cost allocation plan (CAP). The public assistance CAP provides a narrative description of the procedures that are used in identifying, measuring and allocating all costs (direct and indirect) to each of the programs administered or supervised by State public assistance agencies.

Attachment D of A-87 states that since the federally financed programs administered by State public assistance agencies are funded predominantly by HHS, HHS is responsible for the requirements for the development, documentation, submission, negotiation and approval of public assistance CAPs. These requirements are published in Subpart E of 45 CFR part 95.

Major Federal programs typically administered by State public assistance agencies include: Temporary Assistance for Needy Families (CFDA 93.558), Medicaid (CFDA 93.778), Food Stamps (CFDA 10.561), Child Support Enforcement (CFDA 93.563), Foster Care (CFDA 93.658), Adoption Assistance (CFDA 93.659), and Social Services Block Grant (CFDA 93.667).

**1. Compliance Requirements – State Public Assistance Agency Costs**

- a. *Basic Guidelines* – Refer to the previous section, “Allowable Costs – State/Local-Wide Central Service Costs, 1.a, Compliance Requirements-Basic Guidelines,” for the guidelines affecting the allowability of costs (direct and indirect) under Federal awards.
- b. *Selected Items of Cost* – Refer to the previous section, “Allowable Costs – State/Local-Wide Central Service Costs 1.b, Compliance Requirements-Selected Items of Cost,” for the principles to establish allowability or unallowability of certain items of cost. These principles apply whether a cost is treated as direct or indirect.
- c. *Submission Requirements*
  - (1) Unlike most State/local-wide central service CAPs and ICRPs, an annual submission of the public assistance CAP is not required. Once a public assistance CAP is approved, State public assistance agencies are required to promptly submit amendments to the plan if any of the following events occur (45 CFR section 95.509):
    - (a) The procedures shown in the existing cost allocation plan become outdated because of organizational changes, changes to the Federal law or regulations, or significant changes in the program levels, affecting the validity of the approved cost allocation procedures.
    - (b) A material defect is discovered in the cost allocation plan.
    - (c) The State plan for public assistance programs is amended so as to affect the allocation of costs.
    - (d) Other changes occur which make the allocation basis or procedures in the approved cost allocation plan invalid.

The amendments must be submitted to HHS for review and approval.
- d. *Documentation Requirements* – A State must claim Federal financial participation for costs associated with a program only in accordance with its approved cost allocation plan. The public assistance CAP requirements are contained in 45 CFR section 95.507.
- e. *Implementation of Approved Public Assistance CAPs* – Since public assistance CAPs are of a narrative nature, the Federal Government needs assurance that the cost allocation plan has been implemented as approved. This is accomplished by funding agencies’ reviews, single audits, or audits conducted by the cognizant audit agency (A-87, Attachment D, paragraph E.1).

**2. *Audit Objectives – State Public Assistance Agency Costs***

- a. Obtain an understanding of internal control over the compliance requirements for State public assistance agency costs, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
- b. Determine whether the governmental unit complied with the provisions of A-87 as follows:
  - (1) Direct charges to Federal awards were for allowable costs.
  - (2) Charges to cost pools allocated to Federal awards through the public assistance CAP were for allowable costs.
  - (3) The approved public assistance CAP correctly describes the actual procedures used to identify, measure, and allocate costs to each of the programs operated by the State public assistance agency. However, the actual procedures or methods of allocating costs must be in accordance with the applicable cost principles, and produce an equitable and consistent distribution of costs.
  - (4) Charges to Federal awards are in accordance with the approved public assistance CAP. This does not apply if the auditor first determines that the approved CAP is not in compliance with the applicable cost principles and/or produces an inequitable distribution of costs.
  - (5) The employee time reporting systems are implemented and operated in accordance with the methodologies described in the approved public assistance CAP.

**3. *Suggested Internal Control Audit Procedures – State Public Assistance Agency Costs***

Refer to the previous section, “Allowable Costs – State/Local-Wide Central Service Costs” items 3.a through 3.c, for suggested internal control audit procedures.

**4. *Suggested Compliance Audit Procedures – State Public Assistance Agency Costs***

- a. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.
- b. Since a significant amount of the costs in the public assistance CAP are allocated based on employee time reporting systems (e.g., effort certification, personnel activity report and/or random moment sampling), it is suggested that the auditor consider the risk when designing the nature, timing, and extent of compliance testing.

- c. *General Audit Procedures* – The following procedures apply to direct charges to Federal awards as well as charges to cost pools that are allocated wholly or partially to Federal awards.
- (1) Test a sample of transactions for conformance with:
    - (a) The criteria contained in the “Basic Guidelines” section of A-87, Attachment A, paragraph C.
    - (b) The principles to establish allowability or unallowability of certain items of cost (A-87, Attachment B).
  - (2) If the auditor identifies unallowable costs, the auditor should be aware that directly associated costs might have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost, and would have not been incurred if the other cost had not been incurred. When an unallowable cost is incurred, directly associated costs are also unallowable. For example, occupancy costs related to unallowable general costs of government are also unallowable.
- d. *Special Audit Procedures for Public Assistance CAPs*
- (1) Verify that the State public assistance agency is complying with the submission requirements, i.e., an amendment is promptly submitted when any of the events identified in 45 CFR section 95.509 occur.
  - (2) Verify that public assistance CAP includes the required documentation in accordance with 45 CFR section 95.507.
  - (3) *Testing of the Public Assistance CAP* – Test the methods of allocating the costs to ascertain if they are in accordance with the applicable provisions of the cost principles and produce an equitable distribution of costs. Appropriate detailed tests may include:
    - (a) Examine the results of the employee time reporting systems to ascertain if they are accurate, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged.
    - (b) Since the most significant cost pools in terms of dollars are usually allocated based upon the distribution of income maintenance and social services workers efforts identified through random moment time studies, determine whether the time studies are implemented and operated in accordance with the methodologies described in the approved public assistance CAP. For example, verify the adequacy of the controls governing the conduct and evaluation of the study, determine that the sampled observations were properly selected and performed, the documentation of the observations was

properly completed, and that the results of the study were correctly accumulated and applied. Testing may include observing or interviewing staff who participate in the time studies to determine if they are correctly recording their activities.

- (c) Test statistical data (e.g., square footage, case counts, salaries and wages) to ascertain if the proposed allocation bases are reasonable, updated as necessary, and do not contain any material omissions.
- (4) *Testing of Charges Based Upon the Public Assistance CAP* – If the approved public assistance CAP is determined to be in compliance with the applicable cost principles and produces an equitable distribution of costs, verify that the methods of charging costs to Federal awards are in accordance with the approved CAP and the provisions of the approval documents issued by HHS. Detailed compliance tests may include:
- (a) Verify that the cost allocation schedules, supporting documentation and allocation data are accurate and that the costs are allocated in compliance with the approved CAP.
  - (b) Reconcile the allocation statistics of labor costs to completed employee time reporting documents (e.g., personnel activity reports or random moment sampling observation forms).
  - (c) Reconcile the allocation statistics of non-labor costs to allocation data, (e.g., square footage or case counts).
  - (d) Verify direct charges to supporting documents (e.g., purchase orders).
  - (e) Reconcile the costs to the Federal claims.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## **OMB CIRCULAR A-21 COST PRINCIPLES FOR EDUCATIONAL INSTITUTIONS**

### **Introduction**

OMB Circular A-21 (A-21) establishes principles for determining the costs applicable to research and development, training, and other sponsored work performed by educational institutions under grants, contracts, and other agreements with the Federal Government. These agreements are referred to as sponsored agreements. These principles shall be used in determining the allowable direct and indirect costs under those agreements. At educational institutions, indirect costs are accounted for through Facilities & Administrative (F&A) Cost Proposals. F&A costs, for the purpose of A-21, mean costs that are incurred for common or joint objectives and, therefore, cannot be identified readily and specifically with a particular sponsored project, an instructional activity, or any other institutional activity. F&A costs are synonymous with “indirect” costs, as previously used in A-21 and as currently used in Appendices A and B of A-21. As described in A-21, section F.1, the F&A cost categories include: building and equipment depreciation or use allowance; operation and maintenance expenses; interest expenses; general administrative expenses; departmental administration expenses; sponsored project administration expenses; library expenses; and student administration expenses. F&A costs will be referred to as “indirect costs” in this section.

### ***Cognizant Agency***

A-21, section G.11.a, defines “cognizant agency” as the Federal agency responsible for negotiating and approving F&A rates for an educational institution on behalf of all Federal agencies. References to “cognizant agency” in this section should not be confused with the cognizant Federal agency for audit responsibilities, which is defined in OMB Circular A-133, Subpart D., §\_\_\_400(a). Section G.11 of A-21 assigns cost negotiation cognizance to the Department of Health and Human Services and the Department of Defense’s Office of Naval Research.

### ***Availability of Other Information***

#### ***University Long-Form F&A Cost Proposals***

Additional information on indirect cost rates is found in the HHS publication: *Review Guide for Long-Form University Facilities & Administrative Cost Proposals*, which is available on the Internet at <http://rates.psc.gov/>.

## **Allowable Costs – General Criteria**

### ***1. Basic Considerations to Determine Costs***

In addition to the general criteria applicable to both direct and indirect costs, the basic guidelines affecting the allowability of costs (direct and indirect) are identified in section C. of A-21. To be allowable under Federal awards, costs must meet the following general criteria:

- a. Be reasonable and necessary for the performance and administration of Federal awards (A-21, section C.3).
- b. Conform with the allocability provisions of A-21 (A-21, section C.4) or Cost Accounting Standards (CAS) Board for educational institutions, as applicable (see 48 CFR part 9905). See “Allowable Costs - Special Requirements - Cost Accounting Standards and Disclosure Statements” in this section for additional guidance on CAS.)
- c. Be given consistent accounting treatment within and between accounting periods. Consistency in accounting requires that costs incurred for the same purpose, in like circumstances, be treated as either direct costs only or indirect costs only with respect to final cost objectives (A-21, sections C.10 and C.11).
- d. Conform with the allowability of costs provisions of A-21, or limitations in the program agreement, program regulations, or program statute. When the maximum amount of allowable cost under a limitation is less than the total amount determined in accordance with A-21, the amount not recoverable under a sponsored agreement may not be charged to other sponsored agreements (A-21, section C.7).
- e. Be net of all applicable credits, e.g., volume or cash discounts, insurance recoveries, refunds, rebates, trade-ins, adjustments for checks not cashed, and scrap sales (A-21, section C.5).
- f. Be supported by appropriate documentation, such as approved purchase orders, receiving reports, vendor invoices, canceled checks, and time and attendance records, and correctly charged as to account, amount, and period. Documentation requirements for salaries and wages, and time and effort distribution are described in A-21. Documentation may be in an electronic form (A-21, section C.4).
- g. Be applied uniformly to Federal and non-Federal activities.
- h. With respect to fringe benefit allocations, charges, or rates, such allocations, charges, or rates are to be based on the benefits received by different classes of employees within the educational institution.

## **2. *Selected Items of Cost***

Section J. of Circular A-21 includes general provisions for selected items of costs. For a listing of these costs, see Exhibit 1 of this part of the Supplement. These principles apply irrespective of whether a particular item of cost is properly treated as a direct cost or an indirect cost. Failure to mention a particular item of cost is not intended to imply that it is either allowable or unallowable; rather, determination as to allowability in each case should be based on the treatment provided for similar or related items of cost.

### **Allowable Costs – Direct Costs**

#### **1. *Compliance Requirements – Direct Costs***

- a. Direct costs are those costs that can be identified specifically with a particular sponsored project, instructional activity, or any other institutional activity, or that can be directly assigned to such activities relatively easily with a high degree of accuracy. Identification with the sponsored work rather than the nature of the goods and services involved is the determining factor in distinguishing direct from indirect costs of a sponsored agreement.
- b. Costs incurred for the same purpose in like circumstances must be treated consistently. Where an educational institution treats a particular type of cost as a direct cost of sponsored agreements, all costs incurred for the same purpose in like circumstances shall be treated as a direct costs of all activities of the institution.

#### **2. *Audit Objectives – Direct Costs***

- a. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).
- b. Determine whether the educational institution complied with the provisions of A-21 and CAS as follows:
  - (1) Direct charges to Federal awards were for allowable costs.
  - (2) Cost accounting practice disclosures, described in the Disclosure Statement (DS-2), including amendments, represented actual practice consistently applied. This objective only applies to non-Federal entities that are required to submit the DS-2.
  - (3) Costs are not included as both a direct billing and as a component of indirect costs, e.g., excluded from cost pools, if charged directly to Federal awards.

**3. *Suggested Internal Control Audit Procedures – Direct Costs***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**4. *Suggested Compliance Audit Procedures – Direct Costs***

- a. Test a sample of transactions for conformance with the following criteria contained in A-21 and CAS, as applicable.
  - (1) If the auditor identifies unallowable direct costs, the auditor should be aware that “directly associated costs” might have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost, and would not have been incurred if the other cost had not been incurred. For example, fringe benefits are “directly associated” with payroll costs. When an unallowable cost is incurred, directly associated costs are also unallowable.
  - (2) Costs were approved by the Federal-awarding agency, if required (see Exhibit 1 in this part of the Supplement for selected items of cost that require agency approval when charged to an award as direct costs).
  - (3) Costs were not included as a cost or used to meet cost-sharing requirements of other federally supported activities of the current or a prior period.
  - (4) Costs represent charges for actual costs, not budgeted or projected amounts.
  - (5) Costs were estimated, accumulated, and reported consistently (A-21, section C.10).

- (6) Costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives (A-21, section C.11).
- (7) Costs charged directly to institutional activities (i.e. research and development, instruction, other institutional activities) are accounted for consistent with their disclosed practices, as described in their DS-2, if applicable (A-21, section C.14).
- (8) Departmental costs charged direct to institutional activities (i.e. research and development, instruction, other institutional activities) are consistently charged directly, in like circumstances and are in accordance with the provisions of A-21 and CAS. Salaries of administrative and clerical staff should normally be treated as indirect. Direct charging of these costs may be appropriate where a major project or activity explicitly budgets for the administrative or clerical services and the individuals involved can be specifically identified with the project or activity. "Major project" is defined as a project that requires an extensive amount of administrative or clerical support, which is significantly greater than the routine level of such services provided by academic departments. Examples are found in A-21, Exhibit C.
- (9) Costs for general-purpose equipment charged direct to institution activities (i.e., research and development, instruction, other institutional activities) are consistently charged as direct, were approved by the awarding agency, and are in accordance with the provisions of A-21 and CAS.
- (10) Salaries and wages charged to Federal awards are allowable to the extent that total compensation to the individual employee conforms to established policies of the institution, are consistently applied, and provided that the charges for work performed directly on sponsored awards have been determined in accordance with and supported by the provisions of A-21, section J.10 as follows:
  - (a) Distribution of salaries and wages is based on payrolls documented in accordance with the generally accepted practices of the institution.
  - (b) Apportionment of employees' salaries and wages which are chargeable to more than one sponsored agreement or other cost objective is accomplished by methods which--
    - (i) Comply with A-21, sections A.2 and C,
    - (ii) Produce an equitable distribution of charges for employees' activities, and

- (iii) Distinguish the employees' direct activities from their indirect activities.
- (c) The payroll distribution is based on an after-the-fact confirmation or determination that costs distributed represent actual costs. Confirmation should be by a responsible person with suitable means of verification that the work was performed. Confirmation by the employee is not required if other responsible persons make appropriate confirmations.

## **Allowable Costs – Indirect Costs**

### ***1. Compliance Requirements – Indirect Costs***

- a. In order to recover indirect costs, educational institutions must prepare indirect cost rate proposals (ICRPs) in accordance with the guidelines provided in A-21. Educational institutions must submit ICRPs to the cognizant agency for approval (A-21, section G.11).
- b. ICRPs prepared by educational institutions are based on the most current financial data supported by the educational institution's accounting system and audited financial statements. These ICRPs can be used to establish either predetermined rates, fixed rates with carry-forward provisions, or provisional rates (A-21, sections G.4, G.5, and G.6). The ICRP to be used to establish indirect cost rates must be certified by the educational institution in accordance with A-21, section K.2.
- c. Indirect costs are those costs that are incurred for common or joint objectives and, therefore, cannot be identified readily and specifically with a particular sponsored project, an instructional activity, or any other institutional activity.
- d. As described in A-21, section F.1, the indirect cost categories include: building and equipment depreciation or use allowance; operation and maintenance expenses; interest expenses; general administrative expenses; departmental administration expenses; sponsored project administration expense; library expenses; and student administration expenses. In general the cost groupings established within a category should constitute a pool of items of expense that are considered to be of like nature in terms of their relative contribution to the particular cost objectives to which distribution is appropriate (A-21, section E). Cost categories should be established considering the general guidelines in A-21, section E.2.c.
- e. Indirect costs are defined into two broad categories in A-21, section F.
  - (1) "Facilities" is defined as depreciation and use allowance, interest in debt associated with certain buildings, equipment, and capital improvements, operation and maintenance expenses, and library expenses.

- (2) “Administration” is defined as general administration and general expenses, departmental administration, sponsored project administration, student administration and services, and all other types of expenditures not listed specifically under one of the facility categories.
- f. Each educational institution’s indirect cost rate process must be appropriately designed to determine that Federal sponsors do not in any way subsidize the indirect costs of other sponsors, specifically activities sponsored by industry and foreign governments (A-21, section G.).
- g. Administrative costs charged to sponsored agreements awarded or amended with effective dates beginning on or after the start of the educational institution’s first fiscal year which begins on or after October 1, 1991, shall be limited to 26 percent of modified total direct costs, as defined in A-21, section G.2. Educational institutions should not change their accounting or cost allocation methods which were in effect on May 1, 1991, if the effect is to (1) change the charging of a particular type of cost from indirect to direct, or (2) reclassify or increase allocations from the administrative pools to the facilities pools or fringe benefits cost pools (but also see A-21, section G.8).
- h. *Submission Requirement for Standard Format for Long-Form Proposals* – For ICRPs submitted on or after July 1, 2001, educational institutions shall use the standard format shown in A-21, Appendix C to submit ICRP to the cognizant agency for indirect costs. The cognizant agency for indirect costs may, on an institution-by-institution basis, grant exceptions from all or portions of Part II of the standard format. This requirement does not apply to educational institutions that use the simplified method for calculating indirect cost rates, as described in A-21, section H.

## **2. *Audit Objectives – Indirect Costs***

- a. *For educational institutions that charge indirect costs to Federal awards based on federally approved rate(s):*
- (1) Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).
  - (2) Determine that the rate(s) used to charge indirect costs is consistent with the appropriate cognizant Federal agency rate agreement (A-21, section G.11).
  - (3) Determine that the federally approved rate in effect at the time of the initial award is applied throughout the life of the sponsored agreement. “Life” means each competitive segment of a project. A competitive segment is a period of years approved by the Federal-funding agency at the time of the award (A-21, section G.7).

- (4) Determine that the federally approved rate(s) were applied to the appropriate distribution base (A-21, section G.2).
  - (5) Determine that indirect costs billed to sponsored agreements are the result of applying the approved rate(s) to the appropriate base amount(s).
- b. *For educational institutions that charge indirect costs to Federal awards based on rate(s) which are not approved by the cognizant Federal agency:*
- (1) Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
  - (2) Determine the educational institution's cognizant Federal agency for approving indirect cost rates in accordance with A-21, section G.11.
  - (3) Determine whether an ICRP was prepared, certified, and submitted by the educational institution to their cognizant Federal agency. (The Federal agency is responsible for negotiating and approving indirect cost rates). Verify that billings are based on the ICRP.
  - (4) Determine that the submitted rate(s) were applied to the appropriate distribution base (a-21, section G.2).
  - (5) Determine that indirect costs billed to sponsored agreements are the result of applying the submitted rate(s) to the appropriate base amount(s).
- c. *For educational institutions that charge indirect costs to Federal awards based on award-specific rate(s) approved by an awarding agency:*
- (1) Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
  - (2) Determine that the award-specific rate(s) are the result of special circumstances such as required by law or regulation, in accordance with A-21, section G.11.
  - (3) Determine whether indirect cost rates were applied in accordance with the approved special award provisions or limitations. Associated billings were the result of applying the approved rate to the proper base amount.
  - (4) When the maximum amount of allowable indirect costs under a limitation (i.e. an award-specific rate) is less than the total amount determined in accordance with the principles in A-21, the amount not recoverable under a sponsored agreement may not be charged to other sponsored agreements (A-21, section C.7).

**3. *Suggested Internal Control Audit Procedures – Indirect Costs***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**4. *Suggested Compliance Audit Procedures – Indirect Costs***

- a. Test a sample of transactions for conformance with the following criteria contained in A-21 and CAS, as applicable.
- b. *For educational institutions that charge indirect cost to Federal awards based on federally approved rate(s):*
  - (1) Ascertain if indirect costs or centralized or administrative services costs were allocated or charged to a major program. If not, the following suggested audit procedures do not apply.
  - (2) Obtain and read the current indirect cost rate agreement and determine the terms in effect.
  - (3) Select a sample of claims for reimbursement and verify that the rates used are in accordance with the rate agreement, that rates were applied to the appropriate bases, and that the amounts claimed were the product of applying the rate to the applicable base. Verify that the costs included in the base(s) are consistent with the costs that were included in the base year (e.g., if the allocation base is total direct costs, verify that current year direct costs do not include costs items that were treated as indirect costs in the base year).
  - (4) Ascertain if the educational institution's accounting practices for determining direct and indirect costs for the fiscal year being audited are consistent with the accounting practices used to establish the federally approved rate and its DS-2. If there accounting changes have occurred, determine if they were approved by the cognizant Federal agency. If

accounting changes have not been approved and the accounting changes impact costs charged to federally funded awards, this should be considered a reportable finding. (A-21, section C.14 and CAS, as applicable).

- c. *For educational institutions that charge indirect cost to Federal awards based on rate(s) which are not approved by the cognizant Federal agency:*
- (1) If the ICRP has been certified and submitted to the cognizant Federal agency and is based on costs incurred in the year being audited, then the ICRP should be audited for compliance with the provisions of A-21 and CAS, as applicable.
  - (2) If the educational institution has a certified ICRP, which is based on costs incurred in the year being audited, but has not submitted it to their Federal cognizant agency. The ICRP should be audited using the procedures listed below.
    - (a) Test the indirect cost pool groupings for compliance with A-21, section F.
    - (b) Test the indirect cost pools to determine if costs are allowable.
    - (c) Test that indirect costs have been treated consistently when incurred for the same purpose, in like circumstances, as indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as a cost any cost, if another cost incurred for the same purpose, in like circumstances, has been included as a direct cost of that or any other final cost objective (A-21, section C.11).
    - (d) Test that the indirect cost pools in the rate proposal were developed consistent with the educational institution's disclosed practices as described in its DS-2, if applicable (A-21, section C.14).
    - (e) Test the *depreciation and use allowance* cost pool to determine if:
      - (i) Computations of depreciation or use allowance are based on the acquisition cost of the assets. Acquisition costs exclude (A) the cost of land; (B) any portion of the cost of buildings and equipment borne by the Federal Government, irrespective of where title was originally vested or where it is presently located; and (C) any portion of the cost of buildings and equipment contributed by or for the educational institution where law or agreement prohibit recovery (A-21, section J.14).

- (ii) The depreciation method used to charge the cost of an asset (or group of assets) to accounting periods reflects the pattern of consumption of the asset during its useful life (A-21, section J.14).
  - (iii) Charges for use allowances or depreciation are supported by adequate property records and physical inventories, which must be taken at least once every 2 years (A-21, section J.14).
  - (iv) The depreciation methods used to calculate the depreciation amounts for the ICRP are the same methods used by the educational institution for its financial statements (A-21, section J.12).
  - (v) The allocation method for the depreciation and use allowance cost pool complies with A-21, section F.2.
  - (vi) Gains and losses on the sale, retirement, or other disposition of depreciable property have been appropriately accounted for and complies with A-21, section J.21.
  - (vii) *Large research facilities* – Determine that large research facilities that are included in ICRPs negotiated after January 1, 2000, and on which the design and construction began after July 1, 1998, are compliant with the provisions for determining allowable costs in A-21, section F.2.c.
- (f) Test the *interest* cost pool to determine if:
- (i) Computations for interest comply with the provisions of A-21, section J.26.
  - (ii) The allocation method for the interest cost pool complies with A-21, section F.3.
- (g) Test the *operations and maintenance* cost pool to determine if:
- (i) Costs are appropriately classified in this cost pool (A-21, section F.4).
  - (ii) Rental costs comply with the provision of A-21, section J.43.
  - (iii) The educational institution's accounting practices for classifying (A) rearrangement and alteration costs and (B) reconversion costs, either as direct or indirect, result in consistent treatment in like circumstances.

- (iv) The allocation method for the operations and maintenance cost pool complies with A-21, section F.4.
- (h) Tests the *library* cost pool to determine if:
  - (i) Costs are appropriately classified in this cost pool (A-21, section F.8).
  - (ii) The allocation method for the library cost pool complies with A-21, section F.8.
  - (iii) If the allocation method is based on a cost analysis study in accordance with A-21, section E.2.d, determine that the study:
    - (A) Results in an equitable distribution of costs and represents the relative benefits derived,
    - (B) Is appropriately documented in sufficient detail for review by the cognizant Federal agency,
    - (C) Is statistically sound,
    - (D) Is performed specifically at the educational institution,
    - (E) Is reviewed every 2 years, and, if necessary, updated, and
    - (F) Assumptions are clearly stated and adequately explained.
- (i) Test the *administrative* cost pools to determine if:
  - (i) Costs are appropriately classified in these cost pools and the distribution bases are compliant with A-21, sections F.5, F.6, and F.7.
  - (ii) The administrative cost components comply with the limitation on reimbursement of administrative cost in A-21, section G.8. If the proposal is based on the alternative method for administrative cost in A-21, section G.9, then the limitation does not apply. If the proposal is based on the alternative method for administrative cost, determine that the educational institution meets the criteria of section G.9 and that this is adequately documented in the proposal.

- (iii) *Departmental administration expense pool* – test to determine that this cost pool complies with A-21, section F.6.
- (iv) *Academic Deans' Offices* – test that salaries and operating expenses are limited to those attributable to administrative functions.
- (v) *Academic Departments* – Salaries and fringes attributable to the administrative work (including bid and proposal preparation) of faculty (including department heads), and other professional personnel conducting research and/or instruction, is allowed at a rate of 3.6 percent of modified total direct costs. This category should not include professional business or administrative officers. Determine that this allowance is added to the computation of the indirect cost rate for major functions. Test to determine that the expense covered by this allowance are excluded from the departmental cost pool (A-21, section F.6).

Test for consistent treatment, in like circumstances, of other administrative and supporting expenses incurred within academic departments. For example, items such as office supplies, postage, local telephone, and memberships shall normally be treated as indirect costs.

- (3) If the ICRP has been certified and submitted to the cognizant Federal agency, but is based on costs incurred in a fiscal year prior to the fiscal year being audited, a review of the ICRP is not required.
  - (4) If an ICRP has not been prepared and, therefore, the indirect costs charged to Federal awards are not based on a certified ICRP, this may be required to be reported as an audit finding, in accordance with OMB Circular A-133, §\_\_.510(a)(5).
  - (5) *Application of an indirect cost rate(s) not approved by the cognizant agency* – Even though the rate(s) has not been approved by the cognizant agency, an unapproved indirect cost rate(s) should be reviewed for consistent application of the submitted rates to direct cost bases to ensure that the indirect cost rate(s) is applied consistent with the educational institution's policies and procedures that apply uniformly to both federally funded and other activities of the institutions.
- d. *For educational institutions that also have awards containing award-specific rates (approved by the Federal awarding agency) that take precedence over the negotiated rate for purposes of indirect cost recovery:*

- (1) Ascertain that the award-specific rate is in accordance with special circumstances required by law or regulation.
- (2) Obtain and review the award terms used to establish an award-specific indirect cost rate(s).
- (3) Select a sample of claims for reimbursement and verify that the award-specific rate(s) used are in accordance with the terms of the award, that rate(s) were applied to the appropriate bases, and that the amounts claimed were the product of applying the rate to the applicable base. Verify that the costs included in the base(s) are consistent with the terms of the agreement.

## **Allowable Costs – Special Requirements – Cost Accounting Standards and Disclosure Statements**

### ***1. Compliance Requirement – CAS and Disclosure Statements***

- a. A-21, section C.14 requires educational institutions (institutions) that receive more than \$25 million in Federal funding in a fiscal year to prepare and submit a Disclosure Statement (DS-2) that describes the institution's cost accounting practices. These institutions are required to submit a DS-2 within 6 months after the end of the institution's fiscal year that begins after May 8, 1996, unless the institution is required to submit a DS-2 earlier due to a receipt of a CAS-covered contract in accordance with 48 CFR section 9903.202-1.
- b. These institutions are responsible for maintaining an accurate DS-2 and complying with disclosed cost accounting practices. They are also responsible for filing amendments to the DS-2 when disclosed practices are changed or modified. Amendments should be provided to the cognizant Federal agency for approval.
- c. Federal Acquisition Regulation (FAR) Appendix subpart 9903.201-2, Types of CAS Coverage, requires educational institutions to comply with all of the CAS specified in part 9905 that are in effect on the effective date of a covered contract. Negotiated contracts in excess of \$500,000 are CAS-covered, except for CAS-covered contracts awarded to Federally Funded Research and Development Centers (FFRDCs) operated by an educational institution, which are subject to part 9904.

### ***2. Audit Objectives – CAS and Disclosure Statements***

- a. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
- b. Determine whether the educational institution's DS-2 is current, accurate, and complete and that it has been approved by the cognizant Federal agency as adequate and compliant with A-21 and CAS (48 CFR part 9905).

- c. Determined whether the educational institution's actual accounting practices are consistent with its disclosed accounting practices.
- d. Determine whether amendments have been filed with and approved by the cognizant Federal agency.
- e. Determine whether the educational institution's accounting practices for direct and indirect costs comply with CAS applicable to educational institutions (48 CFR part 9905).

**3. *Suggested Internal Control Audit Procedures – CAS and Disclosure Statements***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**4. *Suggested Compliance Audit Procedures – CAS and Disclosure Statements***

- a. Obtain a copy of the educational institution's DS-2, amendments, and letters of approval from the cognizant Federal agency.
- b. Read the DS-2 and its amendments and ascertain if the disclosure agrees with the policies prescribed in the educational institution's current policies and procedures documents.
- c. Test that the disclosure agrees with actual practices for the period covered by audit, including whether the practices were consistent throughout the period.
- d. Test direct and indirect charges to Federal awards to determine that the educational institution's practices used in estimating the costs in the proposal were consistent with the institution's cost accounting practices used in accumulating and reporting the costs (A-21, section C.10 and FAR Appendix subpart 9905.501).

- e. For those costs which are sometimes charged direct and sometimes charged indirect, test for consistent classification of these costs, when incurred for the same purpose and under like circumstances (A-21, section C.11 and FAR Appendix subpart 9905.502). For example:
  - (1) Salaries of administrative and clerical staff are normally treated as indirect costs; however, they may be charged direct to a major project or activity under certain conditions. Sample these costs when they have been charged direct to Federal awards to determine consistent treatment for non-Federal awards, instructional activity, or other institutional activity (A-21, section F.6.).
  - (2) Office supplies, postage, local telephone costs and memberships are normally treated as indirect. Sample these costs when they have been charged direct to Federal awards to determine consistent treatment for non-Federal awards, instructional activity, or other institutional activity (A-21, section F.6.).
- f. Capital expenditures for general and special-purpose equipment may be charged direct to awards with approval of the awarding agency. Sample these costs when they have been charged direct to Federal awards to determine consistent treatment for non-Federal awards, instructional activity, or other institutional activity (A-21, section J.18.).
- g. Test costs direct charged to Federal awards and indirect costs accumulated in the educational institution's accounting system for adequate accounting of unallowable costs (A-21 section C.12 and FAR Appendix subpart 9905.505).
- h. Determine that the educational institution's cost accounting period for accumulating costs on Federal awards and indirect cost pools are consistent with the institution's fiscal year. If not, determine that the institution has met the criteria for an exception described in A-21, section C.13 and that it has been approved by the cognizant Federal agency (A-21, section C.13 and FAR Appendix subpart 9905.506).

### **Allowable Costs – Special Requirements – Internal Service, Central Service, Pension, or Similar Activities or Funds**

#### ***1. Compliance Requirement***

Charges made from internal service, central service, pension, or similar activities or funds, must follow the applicable cost principles provided in A-21.

#### ***2. Audit Objectives***

Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c). Determine whether charges made from

internal service, central service, pension, or similar activities or funds are in accordance with A-21.

### **3. *Suggested Internal Control Audit Procedures***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in OMB Circular §\_\_\_.500(c)(3), including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **4. *Suggested Compliance Audit Procedures***

The auditor should consider procedures such as the following:

- a. For activities accounted for in separate funds, ascertain if: (1) retained earnings/fund balances (including reserves) were computed in accordance with A-21; (2) working capital reserves were not excessive in amount (generally not greater than 60 days for cash expenses for normal operations incurred for the period exclusive of depreciation, capital costs and debt principal costs); and (3) refunds were made to the Federal Government for its share of any amounts transferred or borrowed from internal service, central service, pension, insurance, or other similar activities or funds for purposes other than to meet the operating liabilities, including interest on debt, of the fund.
- b. Test that all users of services are billed in a consistent manner.
- c. Test that billing rates exclude unallowable costs, in accordance with A-21.
- d. Test, where activities are not accounted for in separate funds, that billing rates (or charges) are developed based on actual costs and were adjusted to eliminate profits.
- e. For educational institutions that have self-insurance and certain types of fringe benefit programs (e.g., pension funds), ascertain if independent actuarial studies appropriate for such activities are performed at least biennially and that current

period costs were allocated based on an appropriate study which is not over 2 years old.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## **OMB CIRCULAR A-122 COST PRINCIPLES FOR NON-PROFIT ORGANIZATIONS**

### **Introduction**

OMB Circular A-122 (A-122) establishes cost principles for determining costs of grants, contracts, and other agreements with non-profit organizations. The principles are designed to provide that the Federal Government bear its fair share of costs except where restricted or prohibited by law. These principles are used by all Federal agencies in determining the costs of work performed by non-profit organizations under grants, cooperative agreements, and cost reimbursement contracts, and other contracts in which costs are used in pricing, administration, or settlement. All of these instruments are hereafter referred to as “awards.” In addition to the cost principles established by A-122, the Cost Accounting Standards Board (CASB) has promulgated certain accounting standards that must be followed by non-profit organizations receiving procurement contracts that meet a defined dollar threshold. Generally, organizations are exempt from coverage under CAS unless a single CAS-covered contract or subcontract of at least \$7.5 million has been received. After receipt of this trigger contract, CAS coverage is applied to all negotiated awards over \$500,000 unless they meet certain exemptions. These exemptions and the requirements of CAS can be found in 48 CFR Chapter 99.

### ***Cognizant Agency***

A-122, Attachment A, paragraph E.1.a defines “cognizant agency” as the Federal agency responsible for negotiating and approving indirect cost rates for non-profit organizations on behalf of all Federal agencies. References to cognizant agency in this section should not be confused with the cognizant Federal agency for audit responsibilities, which is defined in OMB Circular A-133, Subpart D, §\_\_\_400(a).

### ***Availability of Other Information***

Additional information on indirect cost rate determination for non-profit organizations can be found at the following web sites:

- Department of Labor – <http://www2.dol.gov/oasam/programs/guide.htm>
- Department of Health and Human Services – [http://rates.psc.gov/fms/dca/np\\_exall2.html](http://rates.psc.gov/fms/dca/np_exall2.html)
- Department of Education – <http://www.ed.gov/about/offices/list/ocfo/fipao/abouticg.html> - [how-are indirect cost rates determined.](#)

## Allowable Costs – General Criteria

### 1. *Basic Considerations to Determine Cost*

The basic considerations used to determine costs (direct and indirect) are identified in A-122, Attachment A, paragraph A and include the following:

- a. *Composition of cost* – The total cost of an award is the sum of the allowable direct and allocable indirect costs less any applicable credits. The term “applicable credits” refers to those receipts, or reduction of expenditures that operate to offset or reduce expense items that are allocable to awards as direct or indirect costs.
- b. *Allowable costs* – A cost is allowable under an award if the cost meets the following general criteria:
  - (1) Be reasonable for the performance of the award and be allocable in accordance with A-122.
    - (a) A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. Consideration should be given to:
      - (i) Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.
      - (ii) The restraints or requirements imposed by such factors as generally accepted sound business practices, arms-length bargaining, Federal and State laws and regulations, and terms and conditions of the award.
      - (iii) Whether the individuals concerned acted with prudence in the circumstances.
      - (iv) Significant deviations from the established practices of the organization that may unjustifiably increase the award costs.
    - (b) A cost is allocable to a particular cost objective, such as a grant, contract, project, service or other activity, in accordance with the relative benefits received. Any cost allocable to a particular award or other cost objective under A-122 may not be shifted to other Federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or terms of the award. A cost is allocable to a Federal award if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:

- (i) Is incurred specifically for the award.
  - (ii) Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received.
  - (iii) Is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown.
- (2) Conform to any limitations or exclusions set forth in A-122 or in the award.
- (3) Be consistent with policies and procedures that apply uniformly to both federally financed and other activities of the organization.
- (4) Be accorded consistent treatment.
- (5) Be determined in accordance with generally accepted accounting principles (GAAP).
- (6) Not be included as a cost or used to meet cost-sharing or matching requirements of any other federally financed program in either the current or a prior period.
- (7) Be adequately documented.
- (8) Be net of all applicable credits.

## **2. *Selected Items of Cost***

A-122, Attachment B, paragraphs 1 through 52, provide principles to be applied in establishing the allowability of certain items of cost. These principles apply whether a cost is treated as direct or indirect. Failure to mention a particular item of cost is not intended to imply that it is unallowable; rather, determination as to allowability in each case should be based on the treatment or principles provided for similar or related items of cost.

### **Allowable Costs – Direct Costs**

#### **1. *Compliance Requirements – Direct Costs***

Direct costs are those that can be identified specifically with a particular final cost objective, i.e., award, project or other activity of the organization. Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where accounting treatment for such cost is consistently applied to all final cost objectives.

Certain direct costs are unallowable for computing charges to Federal awards, nonetheless they must be treated as direct costs for determining indirect cost rates and be allocated their share of indirect costs if they represent activities that (a) include the salaries of personnel, (b) occupy space, and (c) benefit from the organization's indirect costs. The cost of activities performed primarily as a service to members, clients, or the general public when significant and necessary to the organization's mission must be treated as direct costs—whether or not allowable—and be allocated a share of indirect costs. Examples can be found in A-122, Attachment A, subparagraph B.4.

If the auditor identifies unallowable direct costs, the auditor should be aware that directly associated costs might have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost that would not have been incurred if the other cost had not been incurred. For example, fringe benefits are directly associated with payroll costs. When a payroll cost is determined to be unallowable than the directly associated fringe benefit would be determined unallowable as well.

## **2. *Audit Objectives – Direct Costs***

- a. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
- b. Determine whether the organization complied with the provisions of A-122 and CAS (if applicable) as follows:
  - (1) Direct charges to Federal awards were for allowable costs.
  - (2) Unallowable costs, determined to be direct costs, should be included in the allocation base for the purpose of computing an indirect cost rate.

## **3. *Suggested Internal Control Audit Procedures – Direct Costs***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

#### **4. *Suggested Compliance Audit Procedures – Direct Costs***

Test direct costs charged to Federal awards with the following criteria:

- a. Costs were approved by the Federal awarding agency, if required. (See Exhibit 1, Selected Items of Cost, in this part of the Supplement.)
- b. Costs conform to the allowability of cost provisions of A-122, or limitations in the program agreement, program regulations, or program statute.
- c. Costs represent charges for actual costs, not budgeted or projected amounts.
- d. Costs are given consistent accounting treatment within and between accounting periods. Consistency in accounting requires that costs incurred for the same purpose, in like circumstances, be treated as either direct costs only or indirect costs only with respect to final cost objectives.
- e. Costs are calculated in conformity with generally accepted accounting principles, or CAS when required.
- f. Costs are not used to meet cost-sharing requirements of other federally supported activities.
- g. Costs are net of all applicable credits, e.g., volume or cash discounts, insurance recoveries, refunds, rebates, trade-ins, adjustments for checks not cashed, and scrap sales.
- h. Costs are not included as both a direct billing and as a component of indirect costs.
- i. Costs are supported by appropriate documentation, such as approved purchase orders, receiving reports, vendor invoices, canceled checks, and time and attendance records, and correctly charged as to account, amount, and period.

#### **Allowable Costs – Indirect Costs**

##### **1. *Compliance Requirements – Indirect Costs***

- a. Indirect costs are those costs that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective. Stated differently, indirect costs are those costs remaining after direct costs have been determined and assigned directly. While it is not possible to specify the types of costs that will be indirect, there are three major categories of indirect costs for non-profit organizations (NPOs):

- (1) *Depreciation and Use Allowance* – The expenses under this category are that portion of the costs of the organization’s buildings, capital improvements to land and buildings, and equipment, which are computed in accordance with A-122, Attachment B, section 11. Interest on debt associated with certain buildings, equipment, and capital improvements are computed in accordance with A-122, Attachment B, paragraph 23.
  - (2) *Operation and Maintenance* – The expenses under this category are those that have been incurred for the administration, operation, maintenance, preservation, and protection of the organization’s physical plant.
  - (3) *General and Administrative* – The expenses under this category are those that have been incurred for the overall general executive, and administration of the organization and other expenses of a general nature that do not relate solely to any major function of the organization.
- b. Indirect cost rate proposals (ICRPs) prepared by NPOs are based on the most current financial data, supported by the organization’s accounting system and audited financial statements. These ICRPs can be used to either establish predetermined rates, fixed rates with carry-forward provision, provisional, or final rates.
- (1) *Predetermined rates* are established for the current or multiple future period(s) based on current costs (usually costs from the most recently ended fiscal year, known as the base period).
  - (2) *Fixed rates with carry-forward provisions* – rates based on current costs in the same manner as predetermined rates. However, the difference between the base period indirect costs and actual indirect cost recovery are carried forward as an adjustment to the rate computation for the subsequent period.
  - (3) *Provisional rates* – temporary rates used for funding and billing indirect costs, pending the establishment of a final rate after actual costs are determined for the period.
  - (3) *Final rates* – indirect cost rates applicable to a specified past period based on actual costs of that period. Final rates are not subject to adjustment.
- c. Some Federal awards may contain cost limitations on recovery of indirect costs that differ from the federally negotiated indirect cost rates. Normally, this may be due to statutory requirements or limitations contained in program announcements. In these cases, the indirect cost rate approved for that award will be specified in the award letter or agreement. For these awards, the award-specific rate takes precedence over the negotiated rate for purposes of indirect cost recovery.

- d. To recover indirect costs, NPOs prepare ICRPs. The ICRP is the rate calculation and supporting schedules used to arrive at the indirect cost pool amounts and the base amounts. NPOs can select one of three different methods to calculate the indirect cost rate.

(1) *Simplified Allocation Method*

- (a) Where an organization's major functions benefit from its indirect costs to approximately the same degree, the allocation of indirect costs may be accomplished by (i) separating the organization's total costs for the base period as either direct or indirect, and (ii) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. The result of this process is an indirect cost rate, which is used to distribute indirect costs to individual awards. The rate should be expressed as the percentage that the total amount of allowable indirect costs bears to the base selected. This method should also be used where an organization has only one major function encompassing a number of individual projects or activities, and may be used where the level of Federal awards to an organization is relatively small.
- (b) For an organization that receives more than \$10 million in Federal funding of direct costs in a fiscal year, a breakout of the indirect cost component into two broad categories, Facilities and Administration, as defined in Circular A-122, Attachment A, paragraph C.3, is required. The rate in each case shall be stated as the percentage that the amount of the particular indirect cost category (i.e., Facilities or Administration) is of the distribution base identified with that category.
- (c) A full discussion of the simplified allocation method can be found in A-122, Attachment A, subparagraphs D.2.a. through D.2.e.

(2) *Multiple Allocation Base Method*

- (a) Where an organization's indirect costs benefit its major functions in varying degrees, indirect costs shall be accumulated into separate cost groupings, as described in A-122, Attachment A, subparagraph D.3.b. Each grouping shall then be allocated individually to benefiting functions by means of a base that best measures the relative benefits. The default allocation bases by cost pool are described in A-122, Attachment A, subparagraph D.3.c.
- (b) Cost groupings shall be established so as to permit the allocation of each grouping on the basis of benefits provided to the major functions. Each grouping shall constitute a pool of expenses that are of like character in terms of functions they benefit and in terms

of the allocation base which best measures the relative benefits provided to each function. The groupings are classified within the two broad categories: "Facilities" and "Administration," as described in A-122, Attachment A, subparagraph C.3.

- (c) Except where a special indirect cost rate(s) is required in accordance with A-122, Attachment A, subparagraph D.5, the separate groupings of indirect costs allocated to each major function shall be aggregated and treated as a common pool for that function. The costs in the common pool shall then be distributed to individual awards included in that function by use of a single indirect cost rate.
- (d) Indirect costs shall be distributed to applicable sponsored awards and other benefiting activities within each major function on the basis of modified total direct costs (MTDC). MTDC consists of all salaries and wages, fringe benefits, materials and supplies, services, travel, and subgrants and subcontracts up to the first \$25,000 of each subgrant or subcontract (regardless of the period covered by the subgrant or subcontract). Equipment, capital expenditures, charges for patient care, rental costs and the portion in excess of \$25,000 shall be excluded from MTDC. Participant support costs shall generally be excluded from MTDC. Other items may only be excluded when the Federal cost cognizant agency determines that an exclusion is necessary to avoid a serious inequity in the distribution of indirect costs.
- (e) A full discussion of the multiple allocation base method can be found in A-122, Attachment A, subparagraphs D.3.a. through D.3.g.

(3) *Direct Allocation Method*

- (a) Some NPOs treat all costs as direct costs except general administration and general expenses. These organizations generally separate their costs into three basic categories: (i) General administration and general expenses, (ii) fundraising, and (iii) other direct functions (including projects performed under Federal awards). Joint costs, such as depreciation, rental costs, operation and maintenance of facilities, telephone expenses, and the like are prorated individually as direct costs to each category and to each award or other activity using a base most appropriate to the particular cost being prorated.
- (b) This method is acceptable, provided each joint cost is prorated using a base which accurately measures the benefits provided to each award or other activity. The bases must be established in accordance with reasonable criteria, and be supported by current data.

- (c) A full discussion of the direct allocation base method can be found in A-122, Attachment A, subparagraph D.4.a. through D.4.c.

## **2. *Audit Objectives – Indirect Costs***

- a. *For NPOs that charge indirect costs to Federal awards based on federally approved rates:*
  - (1) Obtain an understanding of internal controls, assess risk, and test internal controls as required by OMB Circular A-133, §\_\_\_\_.500(c).
  - (2) Determine whether the organization complied with the provisions of A-122 and CAS (if applicable) as follows:
    - (a) Indirect cost rates were applied in accordance with approved rate agreements and any special award provisions/limitations (if different from those stated in the negotiated rate agreement).
    - (b) Associated billings were the result of applying the approved rate to the proper base amount(s).
  - (3) For fixed rate agreements, predetermined rate agreements, and provisional rate agreements determine whether the base used to distribute the approved indirect cost rate is accurate and reflects the terms of the agreement.
  - (4) For fixed rate agreements, determine whether the organization has adequately determined the actual indirect costs for the fiscal year being audited and performed the necessary computations to accurately report the carry-forward adjustment to the rate computation for the subsequent period.
- b. *For NPOs that charge indirect costs to Federal awards that are not based on federally approved rates:*
  - (1) Obtain an understanding of internal controls, assess risk, and test internal controls as required by OMB Circular A-133, §\_\_\_\_.500(c).
  - (2) Determine whether costs that are directly allocated to an award using the Direct Allocation Method are prorated using a base that accurately measures the benefits provided to each award or activity.
  - (3) Determine whether an ICRP was prepared and submitted to the organization's cognizant agency (the Federal agency responsible for negotiating and approving indirect cost rates) as required by A-122. Verify that billings are based on the ICRP.

- (4) Determine whether the NPO's calculated indirect cost rate is (a) consistent with policies and procedures that apply uniformly to both federally funded and other activities of the organization, and (b) applied consistently to the proper allocation bases.
  - (5) Determine whether the organization complied with the provisions of A-122 and CAS as follows:
    - (a) Charges to indirect cost pools were for allowable costs.
    - (b) The base used to distribute indirect costs includes both allowable and unallowable costs.
    - (c) The cost allocation methodology provides equitable and consistent allocation of indirect costs to benefiting awards or activities.
- c. *For NPOs that also have awards containing award-specific rates (approved by the Federal awarding agency) that take precedence over the negotiated rate for purposes of indirect cost recovery:*
- (1) Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_.500(c).
  - (2) Determine if the award-specific rate(s) is the result of special circumstances, e.g., required by law or regulation.
  - (3) Determine whether indirect cost rates were applied in accordance with the approved special award provisions or limitations. Associated billings were the result of applying the approved rate to the proper base amount.
  - (4) When the maximum amount of allowable indirect costs under a limitation (i.e. an award-specific rate) is less than the total amount determined in accordance with the principles in A-122, the amount not recoverable under a sponsored agreement may not be charged to other sponsored agreements.

### **3. *Suggested Internal Control Audit Procedures – Indirect Costs***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.

- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

#### **4. *Suggested Compliance Audit Procedures – Indirect Costs***

- a. *For NPOs that charge indirect costs to Federal awards based on federally approved rates:*
  - (1) Ascertain if indirect costs are material for the major programs being tested. If not, the following suggested audit procedures, b. through e., do not apply.
  - (2) Obtain and read the current indirect cost rate agreement, including the proposal used in the negotiation of the agreement, and determine the terms in effect.
  - (3) Ascertain whether the indirect cost rate agreement uses a pre-determined rate, fixed rate, provisional rate, or final rate. For definitions of these rates, see A-122, Attachment A, subparagraphs E (b) through (e).
    - (a) If a fixed rate agreement with carry-forward provisions has been negotiated with the cognizant agency, determine that the difference between the indirect costs recovered using the fixed rate and the actual indirect costs of the period has been calculated. This adjustment is to be carried forward to the rate computation of the subsequent period.
    - (b) If a provisional rate was used to bill for indirect costs, determine whether a final rate has been established and appropriate claim adjustments have been made based on the final approved rate.
  - (4) For NPOs required to file Disclosure Statements (48 CFR section 9903.202), ascertain if the cognizant agency for indirect cost negotiation has been appropriately notified of changes in the cost accounting practices that occurred during the year to which indirect cost rate agreements are being applied.
    - (1) Select a sample of claims for reimbursement:
      - (a) Verify that the rates used are in accordance with the rate agreement and the amounts claimed were the product of applying the rate to the applicable base.
      - (b) Verify that the base includes both allowable and unallowable costs.

- (c) When the base is total direct costs or modified total direct costs, verify that the distribution base has been properly calculated and excludes capital expenditures and other distorting items such as major subcontracts or subgrants in excess of \$25,000 as approved in the negotiated rate agreement or by the cognizant Federal agency.
- b. *For NPOs that charge indirect costs to Federal awards that are not based on federally approved rates:*
  - (1) Determine if the indirect costs are based on a certified ICRP that has been submitted to (but not approved by) the NPO's Federal cognizant agency as required by A-122, Attachment A, subparagraph E. If the ICRP is based on costs incurred in the year being audited, then the ICRP should be audited for compliance with the provisions of A-122 (see procedures in paragraphs 4.b(1)(a) through (1)(c) below).

Note: If the NPO has a certified ICRP, which is based on costs incurred in the year being audited, but it has not been submitted to the Federal cognizant agency, the ICRP should still be audited using the procedures in paragraphs 4.b(1)(a) through (1)(c) below.

- (a) The following procedures should be applied to costs in the indirect cost pool used for recovering indirect costs from Federal awarding agencies. These costs must:
  - (i) Be approved by the Federal awarding agency, if required.
  - (ii) Conform to the allowability of cost provisions of A-122, or limitations in the award agreement, program regulations, or program statute.
  - (iii) Conform to the allocability provisions of A-122 or CAS.
  - (iv) Represent charges for actual costs, not budgeted or projected amounts.
  - (v) With respect to fringe benefit allocations, charges, or rates, be based on the benefits received by different classes of employees within the organization.
  - (vi) Be applied uniformly to Federal and non-Federal activities.
  - (vii) Be calculated in conformity with CAS or generally accepted accounting principles, as required.
  - (viii) Not be used to meet cost-sharing requirements of other federally supported activities.

- (ix) Be net of all applicable credits, e.g., volume or cash discounts, insurance recoveries, refunds, rebates, trade-ins, adjustments for checks not cashed, and scrap sales.
  - (x) Not be included as both a direct billing and as a component of indirect costs.
  - (xi) Be supported by appropriate documentation, such as approved purchase orders, receiving reports, vendor invoices, canceled checks, and time and attendance records, and correctly charged as to account, amount, and period.
  - (xii) Be given consistent accounting treatment within and between accounting periods. Consistency in accounting requires that costs incurred for the same purpose, in like circumstances, be treated as either direct costs only or indirect costs only with respect to final cost objectives.
- (b) The following procedures should be applied to costs in the base(s) for recovering indirect costs from Federal awarding agencies. Determine whether:
- (i) All direct costs, including unallowable costs, are identified and included in the base for indirect cost allocations.
    - (A) For fixed price agreements, all direct costs are recorded for the purpose of allocating indirect costs.
    - (B) For cost-reimbursement awards or contracts that include line item costs that exceed budget limits, all direct costs are recorded for the purpose of allocating indirect costs.
  - (ii) Costs have been recorded in accordance with CAS, generally accepted accounting principles, or other comprehensive basis of accounting, as appropriate.
  - (iii) Costs have been assigned to the correct cost objective or activity.
  - (iv) Costs have been given consistent accounting treatment within and between accounting periods.
- (c) The following procedures should be applied to costs allocated using the Direct Allocation Method:
- (i) Test statistical data (e.g., square footage, case counts, salaries and wages) to ascertain if the proposed allocation

bases are reasonable, updated as necessary, and do not contain any material omissions.

- (ii) Review time studies or time and effort reports (where and if used) to ascertain if they are accurate, are implemented as approved, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged.
    - (iii) Review the allocation methodology for consistency and test the appropriateness of allocation methods used.
  - (2) Determine if the indirect costs are based on a certified ICRP that has been submitted to (but not approved by) the NPO's Federal cognizant agency as required by A-122, Attachment A subparagraph E. If the ICRP is not based on costs incurred in the year being audited (e.g., the year being audited is fiscal year 2004, but the ICRP is based on fiscal year 2003 costs), a review of the ICRP is not required.
  - (3) If the indirect costs are not based on a certified and submitted ICRP, in accordance with A-122, this may be required to be reported as an audit finding in accordance with OMB Circular A-133, §\_\_.510(a)(5).
  - (4) *Application of indirect cost rates which are not approved by the cognizant agency* – Even though the rate(s) have not been approved by the cognizant agency, unapproved indirect cost rate(s) should be reviewed for consistent application of the submitted rates to direct cost bases to ensure that the indirect cost rate(s) are applied consistent with the NPO's policies and procedures that apply uniformly to both federally-funded and other activities of the NPO (A-122, Attachment A, paragraph A.(2)(c)).
- c. For NPOs that also have awards containing award-specific rates (approved by the Federal awarding agency) that take precedence over the negotiated rate for purposes of indirect cost recovery:
- (1) Ascertain that the award-specific rate is only being used for the approved award.
  - (2) Obtain and read the award terms used to establish an award-specific indirect cost rate(s).
  - (3) Select a sample of claims for reimbursement and verify that the award specific rate(s) is in accordance with the terms of the award, that the rate(s) was applied to the appropriate base(s), and that the amount claimed is the product of applying the rate to the applicable base. Verify that the cost included in the base(s) is consistent with the terms of the agreement.

**Allowable Costs – Special Requirements – Unallowable Direct Costs****1. Compliance Requirements – Unallowable Direct Costs**

- a. The costs of certain activities are not allowable as charges to Federal awards (see, for example, fundraising costs in A-122, Attachment B, paragraph 17.a). However, even though these costs are unallowable for purposes of computing charges to Federal awards, they nonetheless must be treated as direct costs for purposes of determining indirect cost rates and be allocated their share of the organization's indirect costs if they represent activities which (1) include the salaries of personnel, (2) occupy space, and (3) benefit from the organization's indirect costs.
- b. Costs should be recorded in the organization's cost records as direct or indirect costs based on their relationship to the cost objectives or activities. The costs of activities performed primarily as a service to members, clients, or the general public when significant and necessary to the organization's mission must be treated as direct costs—whether or not allowable—and be allocated an equitable share of indirect costs.

**2. Audit Objectives – Unallowable Direct Costs**

- a. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
- b. Determine whether all unallowable costs categorized as direct costs are included in the allocation base for the purpose of allocating indirect costs.

**3. Suggested Internal Control Audit Procedures – Unallowable Direct Costs**

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**4. Suggested Compliance Audit Procedures – Unallowable Direct Costs**

- a. Determine whether all unallowable costs categorized as direct costs are included in the allocation base for the purpose of allocating indirect costs.
- b. Determine whether the following costs are charged as direct costs and allocated an equitable share of indirect costs.
  - (1) Maintenance of membership rolls, subscriptions, publications, or related functions.
  - (2) Providing services and information to members, legislative or administrative bodies, or the public.
  - (3) Meetings and conferences except those held to conduct the general administration of the organization.
  - (4) Maintenance, protection, and investment of special funds not used in operation of the organization.
  - (5) Administration of group benefits on behalf of members or clients, including life and hospital insurance, annuity or retirements plans, financial aid, etc.

**Special Requirements – Disclosure Statements (DS-1) Required by Cost Accounting Standards****1. Compliance Requirements – CAS and Disclosure Statements**

- a. Pub. L. 100-679 (41 USC 422) requires certain contractors and subcontractors (which includes NPOs) to comply with CAS and to disclose in writing and follow consistently their cost accounting practices.
- b. 48 CFR section 9903.201-1 (FAR Appendix) describes the rules for determining whether a proposed contract or subcontract is exempt from CAS. Negotiated contracts not exempt in accordance with 48 CFR section 9903.201-1(b) are subject to CAS. A CAS-covered contract may be subject to either full or modified coverage. The rules for determining whether full or modified coverage applies are in 48 CFR section 9903.201-2 (FAR Appendix).
  - (1) Full coverage requires that a business unit comply with all the CAS specified in part 9904 that are in effect on the date of the contract award and with any CAS that become applicable because of later award of a CAS-covered contract. Full coverage applies to contractor business units that (a) receive a single CAS-covered contract award of \$50 million or more; or (b) receive \$50 million or more in net CAS-covered awards during their preceding cost accounting period (48 CFR section 9903.201-2(a)).

- (2) *Modified Coverage* (48 CFR section 9903.201-2(b))
- (a) Modified CAS coverage requires only that the contractor comply with Standard 9904.401, Consistency in Estimating, Accumulating, and Reporting Costs; Standard 9904.402, Consistency in Allocating Costs Incurred for the Same Purpose; Standard 9904.405, Accounting for Unallowable Costs; and Standard 9904.406, Cost Accounting Standard—Cost Accounting Period. Modified, rather, than full, CAS coverage may be applied to a covered contract of less than \$50 million awarded to a business unit that received less than \$50 million in net CAS-covered awards in the immediately preceding cost accounting period.
  - (b) If any one contract is awarded with modified CAS coverage, all CAS-covered contracts awarded to that business unit during that cost accounting period must also have modified coverage with the following exception: if the business unit receives a single CAS-covered contract award of \$50 million or more, that contract must be subject to full CAS coverage. Thereafter, any covered contract awarded in the same cost accounting period must also be subject to full CAS coverage.
  - (c) A contract awarded with modified CAS coverage shall remain subject to such coverage throughout its life regardless of changes in the business unit's CAS status during subsequent cost accounting periods.
- b. 48 CFR section 9903.202 (FAR Appendix) describes the general Disclosure Statement requirements. A Disclosure Statement is a written description of a contractor's cost accounting practices and procedures. The submission of a new or revised Statement is not required for any non-CAS covered contract or from any small business concern. Completed Disclosure Statements are required under the following circumstances:
- (1) Any business unit that is selected to receive a CAS-covered contract or subcontract of \$50 million or more shall submit a Disclosure Statement before award.
  - (2) Any company which, together with its segments, receive net awards of negotiated prime contracts and subcontracts subject to CAS totaling \$50 million or more in its most recent cost accounting period, must submit a Disclosure Statement before award of its first CAS-covered contract in the immediately following cost accounting period. However, if the first CAS-covered contract is received within 90 days of the start of the cost accounting period, the contractor is not required to file until the end of the 90 days.

- c. 48 CFR section 9903.201-7 (FAR Appendix) describes the cognizant Federal agency responsibilities.
  - (1) The requirements of part 9903 shall, to the maximum extent practicable, be administered by the cognizant Federal agency responsible for a particular contractor organization or location, usually the Federal agency responsible for negotiating indirect cost rates on behalf of the Government.
  - (2) The cognizant Federal agency should take the lead role in administering the requirements of Part 9903 and coordinating CAS administrative actions with all affected Federal agencies. When multiple CAS-covered contracts or more than one Federal agency are involved, agencies should discourage Contracting/Grants Officers from individually administering CAS on a contract-by-contract basis. Coordinated administrative actions will provide greater assurances that individual contractors follow their cost accounting practices consistently under all their CAS-covered contracts and that changes in cost accounting practices or CAS noncompliance issues are resolved, equitably, in a uniform overall manner.

## **2. *Audit Objectives – CAS and Disclosure Statements***

- a. Determine whether the NPO's accounting practices, for direct and indirect costs, are compliant with CAS, based on its required CAS coverage (full or modified).
- b. Determine whether the NPO's Disclosure Statement (including amendments) is current, accurate, complete, and properly filed with the cognizant Federal Administrative Officer in accordance with 48 CFR section 9903.202-5.
- c. Determine whether the NPO's actual accounting practices are consistent with its disclosed practices.

## **3. *Suggested Internal Control Audit Procedures – CAS and Disclosure Statements***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and

extent (e.g., number of transactions to be selected) of substantive tests of compliance.

#### **4. *Suggested Compliance Audit Procedures – CAS and Disclosure Statements***

- a. Determine whether the NPO has any CAS-covered contract or subcontracts. If so, determine which type of CAS coverage is applicable (full or modified) and if a Disclosure Statement is required to be submitted to the cognizant Federal agency.
- b. Test the NPO's actual accounting practices for direct and indirect costs are compliant with applicable CAS.
- c. If a Disclosure Statement is required, obtain a copy and any amendments. Review these to ensure the disclosures are current, accurate, compliant with CAS, and approved by the cognizant Federal agency.
- d. Test whether the NPO's actual accounting practices are consistent with the disclosed practices.

### **Allowable Costs – Special Requirements – Internal Service, Central Service, Pension, or Similar Activities or Funds**

#### **1. *Compliance Requirement***

NPOs using internal service, central service, pension, or similar activities or funds must follow the applicable cost principles found in A-122.

#### **2. *Audit Objectives***

Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c). Determine whether charges are made from internal service, central service, pension, or similar activities or funds, are in accordance with A-122.

#### **3. *Suggested Internal Control Audit Procedures***

- a. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan the testing of internal control to support a low assessed level of control risk for allowable costs/cost principles and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.

- c. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

#### **4. *Suggested Compliance Audit Procedures***

Perform the following procedures as applicable:

- a. For activities accounted for in separate funds, ascertain that: (1) retained earnings/fund balances (including reserves) were computed in accordance with the applicable cost principles; (2) working capital reserves were not excessive in amount (generally not greater than 60 days for cash expenses for normal operations incurred for the period exclusive of depreciation, capital costs, and debt principal costs); and (3) refunds were made to the Federal Government for its share of any amounts transferred or borrowed from internal service, central service, pension, insurance, or other similar activities or funds for purposes other than to meet the operating liabilities, including interest on debt, of the fund.
- b. Test that all users of services are billed in a consistent manner.
- c. Test that billing rates exclude unallowable costs in accordance with A-122.
- d. Test, where activities are not accounted for in separate funds, that billing rates (or charges) are developed based on actual costs and were adjusted to eliminate profits.
- e. For organizations that have self-insurance and a certain type of fringe benefit programs (e.g., pension funds), ascertain if independent actuarial studies appropriate for such activities are performed at least biennially and that current period costs were allocated based on an appropriate study which is not over two years old.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## C. CASH MANAGEMENT

### Compliance Requirements

When entities are funded on a reimbursement basis, program costs must be paid for by entity funds before reimbursement is requested from the Federal Government. When funds are advanced, recipients must follow procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement. When advance payment procedures are used, recipients must establish similar procedures for subrecipients.

Pass-through entities must establish reasonable procedures to ensure receipt of reports on subrecipients' cash balances and cash disbursements in sufficient time to enable the pass-through entities to submit complete and accurate cash transactions reports to the Federal awarding agency or pass-through entity. Pass-through entities must monitor cash drawdowns by their subrecipients to assure that subrecipients conform substantially to the same standards of timing and amount as apply to the pass-through entity.

Interest earned on advances by local government grantees and subgrantees is required to be submitted promptly, but at least quarterly, to the Federal agency. Up to \$100 per year may be kept for administrative expenses. Interest earned by non-State non-profit entities on Federal fund balances in excess of \$250 is required to be remitted to Department of Health and Human Services, Payment Management System, P.O. Box 6021, Rockville, MD 20852.

U. S. Department of the Treasury (Treasury) regulations at 31 CFR part 205, which implement the Cash Management Improvement Act of 1990 (CMIA), as amended (Pub. L. No. 101-453; 31 USC 6501 *et seq.*), require State recipients to enter into agreements that prescribe specific methods of drawing down Federal funds (funding techniques) for selected large programs. The agreements also specify the terms and conditions in which an interest liability would be incurred. Programs not covered by a Treasury-State Agreement are subject to procedures prescribed by Treasury in Subpart B of 31 CFR part 205 (Subpart B).

The requirements for cash management are contained in the OMB Circular 102 (Paragraph 2.a.), the A-102 Common Rule (§\_\_\_\_.21), OMB Circular A-110 (§\_\_\_\_.22), Treasury regulations at 31 CFR part 205, Federal awarding agency regulations, and the terms and conditions of the award.

### Availability of Other Information

Treasury's Financial Management Service maintains a Cash Management Improvement Act page on the Internet (<http://www.fms.treas.gov/cmia/>).

### Audit Objectives

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).

2. Determine whether the recipient/subrecipient followed procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury, or pass-through entity, and their disbursement.
3. Determine whether States have complied with the terms and conditions of the Treasury-State Agreement or Subpart B procedures prescribed by Treasury.
4. Determine whether the pass-through entity implemented procedures to assure that subrecipients conformed substantially to the same timing requirements that apply to the pass-through entity.
5. Determine whether interest earned on advances was reported/remitted as required.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for cash management and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

Note: The following procedures are intended to be applied to each program determined to be major. However, due to the nature of cash management and the system of cash management in place in a particular entity, it may be appropriate and more efficient to perform these procedures for all programs collectively rather than separately for each program.

#### *States*

1. For programs tested as major for States, verify which of those programs are covered by the Treasury-State Agreement in accordance with the materiality thresholds in 31 CFR section 205.5, Table A).
2. For those programs identified in procedure 1, determine the funding techniques used for those programs. For those funding techniques that require clearance patterns to schedule the transfer of funds to the State, review documentation supporting the clearance pattern and verify that the clearance pattern conforms to the requirements for developing and

maintaining clearance patterns as specified in the Treasury-State Agreement (31 CFR sections 205.12, 205.20, and 205.22).

3. Select a sample of Federal cash draws and verify that:
  - a. The timing of the Federal cash draws was in compliance with the applicable funding techniques specified in the Treasury-State Agreement or Subpart B procedures, whichever is applicable (31 CFR sections 205.11 and 205.33).
  - b. To the extent available, program income, rebates, refunds, and other income and receipts were disbursed before requesting additional Federal cash draws as required by the A-102 Common Rule (§\_\_.21) and OMB Circular A-110 (§\_\_.22).
4. Where applicable, select a sample of reimbursement requests and trace to supporting documentation showing that the costs for which reimbursement was requested were paid prior to the date of the reimbursement request (31 CFR section 205.12(b)(5)).
5. Review the calculation of the interest obligation owed to or by the Federal Government, reported on the annual report submitted by the State to ascertain that the calculation was in accordance with Treasury regulations and the terms of the Treasury-State Agreement or Subpart B procedures. Trace amounts used in the calculation to supporting documentation.

#### *States and Other Recipients*

6. For those programs where Federal cash draws are passed through to subrecipients:
  - a. Select a representative sample of subrecipients and ascertain the procedures implemented to assure that subrecipients minimize the time elapsing between the transfer of Federal funds from the recipient and the pay out of funds for program purposes (A-102 Common Rule §\_\_.37(a)(4)).
  - b. Select a representative sample of Federal cash draws by subrecipients and ascertain that they conformed to the procedures.

#### *Other Recipients and Subrecipients*

7. For those programs that received advances of Federal funds, ascertain the procedures established with the Federal agency or pass-through entity to minimize the time between the transfer of Federal funds and the pay out of funds for program purposes.
8. Select a sample of Federal cash draws and verify that:
  - a. Established procedures to minimize the time elapsing between drawdown and disbursement were followed.

- b. To the extent available, program income, rebates, refunds, and other income and receipts were disbursed before requesting additional cash payments as required by the A-102 Common Rule (§\_\_\_\_.21) and OMB Circular A-110 (§\_\_\_\_.22).
- 9. Where applicable, select a sample of reimbursement requests and trace to supporting documentation showing that the costs for which reimbursement was requested were paid prior to the date of the reimbursement request.
- 10. Review records to determine if interest was earned on Federal cash draws. If so, review evidence to ascertain whether it was returned to the appropriate agency.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## D. DAVIS-BACON ACT

### Compliance Requirements

When required by the Davis-Bacon Act, the Department of Labor's (DOL) governmentwide implementation of the Davis-Bacon Act, or by Federal program legislation, all laborers and mechanics employed by contractors or subcontractors to work on construction contracts in excess of \$2000 financed by Federal assistance funds must be paid wages not less than those established for the locality of the project (prevailing wage rates) by the DOL (40 USC 3141-3144, 3146, and 3147 (formerly 40 USC 276a to 276a-7)).

Non-federal entities shall include in their construction contracts subject to the Davis-Bacon Act a requirement that the contractor or subcontractor comply with the requirements of the Davis-Bacon Act and the DOL regulations (29 CFR part 5, "Labor Standards Provisions Applicable to Contacts Governing Federally Financed and Assisted Construction"). This includes a requirement for the contractor or subcontractor to submit to the non-Federal entity weekly, for each week in which any contract work is performed, a copy of the payroll and a statement of compliance (certified payrolls) (29 CFR sections 5.5 and 5.6). This reporting is often done using Optional Form WH-347, which includes the required statement of compliance (*OMB No. 1215-0149*).

The requirements for Davis-Bacon are also contained in the A-102 Common Rule (§\_\_\_\_.36(i)(5) and OMB Circular A-110 (Appendix A Contract Provisions).

### Availability of Other Information

The U.S. Department of Labor, Employment Standards Administration, maintains a Davis-Bacon and Related Acts Internet page (<http://www.dol.gov/esa/programs/dbra/index.htm>). Optional Form WH-347 and instructions are available on this Internet page.

### Audit Objectives

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).
2. Determine whether the non-Federal entity notified contractors and subcontractors of the requirements to comply with the Davis-Bacon Act and obtained copies of certified payrolls.

### Suggested Audit Procedures – Internal Control

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.

2. Plan the testing of internal control to support a low assessed level of control risk for Davis-Bacon Act and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

1. Select a sample of construction contracts and subcontracts greater than \$2000 that are covered by the Davis-Bacon Act and perform the following procedures:
  - a. Verify that the required prevailing wage rate clauses were included.
  - b. Verify that the contractor or subcontractor submitted weekly the required certified payrolls.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## **E. ELIGIBILITY**

### **Compliance Requirements**

The specific requirements for eligibility are unique to each Federal program and are found in the laws, regulations, and the provisions of contract or grant agreements pertaining to the program. For programs listed in the Compliance Supplement, these specific requirements are in Part 4 – Agency Program Requirements or Part 5 – Clusters of Programs, as applicable. This compliance requirement specifies the criteria for determining the individuals, groups of individuals, or subrecipients that can participate in the program and the amounts for which they qualify.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
2. Determine whether required eligibility determinations were made, (including obtaining any required documentation/verifications), that individual program participants or groups of participants (including area of service delivery) were determined to be eligible, and that only eligible individuals or groups of individuals (including area of service delivery) participated in the program.
3. Determine whether subawards were made only to eligible subrecipients.
4. Determine whether amounts provided to or on behalf of eligibles were calculated in accordance with program requirements.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for eligibility and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

## Suggested Audit Procedures – Compliance

### 1. *Eligibility for Individuals*

- a. For some Federal programs with a large number of people receiving benefits, the non-Federal entity may use a computer system for processing individual eligibility determinations and delivery of benefits. Often these computer systems are complex and will be separate from the non-Federal entity's regular financial accounting system. Typical functions a computer system for eligibility may perform are:
- Perform calculations to assist in determining who is eligible and the amount of benefits
  - Pay benefits (e.g., write checks)
  - Maintain eligibility records, including information about each individual and benefits paid to or on behalf of the individual (regular payments, refunds, and adjustments)
  - Track the period of time an individual is eligible and stop benefits at the end of a predetermined period unless, there is a redetermination of eligibility
  - Perform matches with other computer data bases to verify eligibility (e.g., matches to verify earnings or identify individuals who are deceased)
  - Control who is authorized to approve benefits for eligibles (e.g., an employee may be approving benefits on-line and this process may be controlled by passwords or other access controls)
  - Produce exception reports indicating likely errors that need follow-up (e.g., when benefits exceed a certain amount, would not be appropriate for a particular classification of individuals, or are paid more frequently than normal)

Because of the diversity of computer systems, both hardware and software, it is not practical for this Supplement to provide suggested audit procedures to address each system. However, generally accepted auditing standards provide guidance for the auditor when computer processing relates to accounting information that can materially effect the financial statements being audited. Similarly, when eligibility is material to a major program, and a computer system is integral to eligibility compliance, the auditor should follow this guidance and consider the non-Federal entity's computer processing. The auditor should perform audit procedures relative to the computer system for eligibility as necessary to support the opinion on compliance for the major program. Due to the nature and controls of computer systems, the auditor may choose to perform these tests of the computer systems as part of testing the internal controls for eligibility.

- b. *Split Eligibility Determination Functions*
- (1) *Background* – Some non-Federal entities pay the Federal benefits to the eligible participants but arrange with another entity to perform part or all of the eligibility determination. For example, a State arranges with local government social services agencies to perform the “intake function” (e.g., the meeting with the social services client to determine income and categorical eligibility) while the State maintains the computer systems supporting the eligibility determination process and actually pays the benefits to the participants. The State is fully responsible for Federal compliance for the eligibility determination as the benefits are paid by the State and State shows the benefits paid as Federal awards expended on the State’s Schedule of Expenditures of Federal Awards. Therefore, the auditor of the State is responsible for meeting the internal control and compliance audit objectives for eligibility. This may require the auditor of the State to perform or arrange for additional procedures to ensure compliant eligibility determinations when another entity performs part of the eligibility determination functions.
  - (2) Ensure that eligibility testing includes all benefit payments regardless of whether another entity, by arrangement, performs part of the eligibility determination functions.
- c. Perform procedures to ascertain if the non-Federal entity’s records/database includes all individuals receiving benefits during the audit period (e.g., that the population of individuals receiving benefits is complete).
- d. Select a sample of individuals receiving benefits and perform tests to ascertain if
- (1) The required eligibility determinations and redeterminations, (including obtaining any required documentation/verifications) were performed and the individual was determined to be eligible. Specific individuals were eligible in accordance with the compliance requirements of the program. (Note that some programs have both initial and continuing eligibility requirements and the auditor should design and perform appropriate tests for both. Also, some programs require periodic redeterminations of eligibility, which should also be tested.)
  - (2) Benefits paid to or on behalf of the individuals were calculated correctly and in compliance with the requirements of the program.
  - (3) Benefits were discontinued when the period of eligibility expired.
- e. In some programs, the non-Federal entity is required to use a quality control process to obtain assurances about eligibility. Review the quality control process and perform tests to ascertain if it is operating to effectively meet the objectives of the process and in compliance with applicable program requirements.

2. *Eligibility for Group of Individuals or Area of Service Delivery*

- a. In some cases, the non-Federal entity may be required to perform procedures to determine whether a population or area of service delivery is eligible. Test information used in determining eligibility and ascertain if the population or area of service delivery was eligible.
- b. Perform tests to ascertain if:
  - (1) The population or area served was eligible.
  - (2) The benefits paid to or on behalf of the individuals or area of service delivery were calculated correctly.

3. *Eligibility for Subrecipients*

- a. If the determination of eligibility is based upon an approved application or plan, obtain a copy of this document and identify the applicable eligibility requirements.
- b. Select a sample of the awards to subrecipients and perform procedures to verify that the subrecipients were eligible and amounts awarded were within funding limits.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## F. EQUIPMENT AND REAL PROPERTY MANAGEMENT

### Compliance Requirements

#### *Equipment Management*

Title to equipment acquired by a non-Federal entity with Federal awards vests with the non-Federal entity. Equipment means tangible nonexpendable property, including exempt property, charged directly to the award having a useful life of more than one year and an acquisition cost of \$5000 or more per unit. However, consistent with a non-Federal entity's policy, lower limits may be established.

A State shall use, manage, and dispose of equipment acquired under a Federal grant in accordance with State laws and procedures. Subrecipients of States who are local governments or Indian tribes shall use State laws and procedures for equipment acquired under a subgrant from a State.

Local governments and Indian tribes shall follow the A-102 Common Rule for equipment acquired under Federal awards received directly from a Federal awarding agency. Institutions of higher education, hospitals, and other non-profit organizations shall follow the provisions of OMB Circular A-110. Basically, the A-102 Common Rule and OMB Circular A-110 require that equipment be used in the program for which it was acquired or, when appropriate, other Federal programs. Equipment records shall be maintained, a physical inventory of equipment shall be taken at least once every two years and reconciled to the equipment records, an appropriate control system shall be used to safeguard equipment, and equipment shall be adequately maintained. When equipment with a current per unit fair market value of \$5000 or more is no longer needed for a Federal program, it may be retained or sold with the Federal agency having a right to a proportionate (percent of Federal participation in the cost of the original project) amount of the current fair market value. Proper sales procedures shall be used that provide for competition to the extent practicable and result in the highest possible return.

The requirements for equipment are contained in the A-102 Common Rule (§\_\_\_\_.32), OMB Circular A-110 (§\_\_\_\_.34), Federal awarding agency program regulations, and the terms and conditions of the award.

#### *Real Property Management*

Title to real property acquired by non-Federal entities with Federal awards vests with the non-Federal entity. Real property shall be used for the originally authorized purpose as long as needed for that purpose. For non-Federal entities covered by OMB Circular A-110 and with written approval from the Federal awarding agency, the real property may be used in other federally sponsored projects or programs that have purposes consistent with those authorized for support by the Federal awarding agency. The non-Federal entity may not dispose of or encumber the title to real property without the prior consent of the awarding agency.

When real property is no longer needed for federally supported programs or projects, the non-Federal entity shall request disposition instructions. For purposes of this compliance requirement, the recipient makes the request to the Federal awarding agency. Subrecipients make requests through the recipient (pass-through entity) and do not make requests directly to the Federal awarding agency. The pass-through recipient is required to comply (ensure compliance) with the direction of the Federal awarding agency and the terms and conditions of its award. When real property is sold, sales procedures should provide for competition to the extent practicable and result in the highest possible return. If sold, non-Federal entities are normally required to remit to the awarding agency the Federal portion (based on the Federal participation in the project) of net sales proceeds. If the property is retained, the non-Federal entity shall normally compensate the awarding agency for the Federal portion of the current fair market value of the property. Disposition instructions may also provide for transfer of title in which case, the non-Federal entity is entitled to compensation for its percentage share of the current fair market value.

The requirements for real property are contained in the A-102 Common Rule (§\_\_\_\_.31), OMB Circular A-110 (§\_\_\_\_.32), Federal awarding agency regulations, and the terms and conditions of the award.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).
2. Determine whether the non-Federal entity maintains proper records for equipment and adequately safeguards and maintains equipment.
3. Determine whether disposition or encumbrance of any equipment or real property acquired under Federal awards is in accordance with Federal requirements and that the awarding agency was compensated for its share of any property sold or converted to non-Federal use.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for equipment and real property management and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

## Suggested Audit Procedures – Compliance

*(Procedure 1 only applies to subrecipients of States that are local governments or Indian tribal governments. Procedure 2 only applies to States and to subrecipients of States that are local governments or Indian tribal governments.)*

1. Obtain entity's policies and procedures for equipment management and ascertain if they comply with the State's policies and procedures.
2. Select a sample of equipment transactions and test for compliance with the State's policies and procedures for management and disposition of equipment.

*(Procedures 3-4 only apply to institutions of higher education, hospitals, and other non-profit organizations, and Federal awards received directly from a Federal awarding agency by a local government or an Indian tribal government.)*

### 3. *Inventory Management of Equipment*

- a. Inquire if a required physical inventory of equipment acquired under Federal awards was taken within the last two years. Test whether any differences between the physical inventory and equipment records were resolved.
- b. Identify equipment acquired under Federal awards during the audit period and trace selected purchases to the property records. Verify that the property records contain the following information about the equipment: description (including serial number or other identification number), source, who holds title, acquisition date and cost, percentage of Federal participation in the cost, location, condition, and any ultimate disposition data including, the date of disposal and sales price or method used to determine current fair market value.
- c. Select a sample of equipment identified as acquired under Federal awards from the property records and physically inspect the equipment including whether the equipment is appropriately safeguarded and maintained.

### 4. *Disposition of Equipment*

- a. Determine the amount of equipment dispositions for the audit period and perform procedures to verify that dispositions were properly classified between equipment acquired under Federal awards and equipment otherwise acquired.
- b. For dispositions of equipment acquired under Federal awards, perform procedures to verify that the dispositions were properly reflected in the property records.
- c. For dispositions of equipment acquired under Federal awards with a current per-unit fair market value of \$5000 or more, test whether the awarding agency was reimbursed for the appropriate Federal share.

*(Procedure 5 applies to States, local governments, Indian tribal governments and non-profit organizations regardless of whether funding is received as a recipient or subrecipient.)*

5. *Disposition of Real Property*

- a. Determine real property dispositions for the audit period and ascertain such real property acquired with Federal awards.
- b. For dispositions of real property acquired under Federal awards, perform procedures to verify that the non-Federal entity followed the instructions of the awarding agency, which will normally require reimbursement to the awarding agency for the Federal portion of net sales or fair market value at the time of disposition, as applicable.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## G. MATCHING, LEVEL OF EFFORT, EARMARKING

### Compliance Requirements

The specific requirements for matching, level of effort, and earmarking are unique to each Federal program and are found in the laws, regulations, and the provisions of contract or grant agreements pertaining to the program. For programs listed in this Supplement, these specific requirements are in Part 4 – Agency Program Requirements or Part 5 – Clusters of Programs, as applicable.

However, for matching, the A-102 Common Rule (§\_\_\_\_.24) and OMB Circular A-110 (§\_\_\_\_.23) provide detailed criteria for acceptable costs and contributions. The following is a list of the basic criteria for acceptable matching:

- Are verifiable from the non-Federal entity's records.
- Are not included as contributions for any other federally assisted project or program, unless specifically allowed by Federal program laws and regulations.
- Are necessary and reasonable for proper and efficient accomplishment of project or program objectives.
- Are allowed under the applicable cost principles.
- Are not paid by the Federal Government under another award, except where authorized by Federal statute to be allowable for cost sharing or matching.
- Are provided for in the approved budget when required by the Federal awarding agency.
- Conform to other applicable provisions of the A-102 Common Rule and OMB Circular A-110 and the laws, regulations, and provisions of contract or grant agreements applicable to the program.

Matching, level of effort, and earmarking are defined as follows:

1. *Matching* or cost sharing includes requirements to provide contributions (usually non-Federal) of a specified amount or percentage to match Federal awards. Matching may be in the form of allowable costs incurred or in-kind contributions (including third-party in-kind contributions).
2. *Level of effort* includes requirements for (a) a specified level of service to be provided from period to period, (b) a specified level of expenditures from non-Federal or Federal sources for specified activities to be maintained from period to period, and (c) Federal funds to supplement and not supplant non-Federal funding of services.
3. *Earmarking* includes requirements that specify the minimum and/or maximum amount or percentage of the program's funding that must/may be used for specified activities,

including funds provided to subrecipients. Earmarking may also be specified in relation to the types of participants covered.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
2. *Matching* – Determine whether the minimum amount or percentage of contributions or matching funds was provided.
3. *Level of Effort* – Determine whether specified service or expenditure levels were maintained.
4. *Earmarking* – Determine whether minimum or maximum limits for specified purposes or types of participants were met.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for matching, level of effort, earmarking and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

1. **Matching**
  - a. Perform tests to verify that the required matching contributions were met.
  - b. Ascertain the sources of matching contributions and perform tests to verify that they were from an allowable source.
  - c. Test records to corroborate that the values placed on in-kind contributions (including third party in-kind contributions) are in accordance with the OMB cost principles circulars, the A-102 Common Rule, OMB Circular A-110, program regulations, and the terms of the award.

- d. Test transactions used to match for compliance with the allowable costs/cost principles requirement. This test may be performed in conjunction with the testing of the requirements related to allowable costs/cost principles.

### 2.1 **Level of Effort** – *Maintenance of Effort*

- a. Identify the required level of effort and perform tests to verify that the level of effort requirement was met.
- b. Perform test to verify that only allowable categories of expenditures or other effort indicators (e.g., hours, number of people served) were included in the computation and that the categories were consistent from year to year. For example, in some programs, capital expenditures may not be included in the computation.
- c. Perform procedures to verify that the amounts used in the computation were derived from the books and records from which the audited financial statements were prepared.
- d. Perform procedures to verify that non-monetary effort indicators were supported by official records.

### 2.2 **Level of Effort** – *Supplement Not Supplant*

- a. Ascertain if the entity used Federal funds to provide services which they were required to make available under Federal, State, or local law and were also made available by funds subject to a supplement not supplant requirement.
- b. Ascertain if the entity used Federal funds to provide services which were provided with non-Federal funds in the prior year.
  - (1) Identify the federally funded services.
  - (2) Perform procedures to determine whether the Federal program funded services that were previously provided with non-Federal funds.
  - (3) Perform procedures to ascertain if the total level of services applicable to the requirement increased in proportion to the level of Federal contribution.

## 3. **Earmarking**

- a. Identify the applicable percentage or dollar requirements for earmarking.
- b. Perform procedures to verify that the amounts recorded in the financial records met the requirements (e.g., when a minimum amount is required to be spent for a specified type of service, perform procedures to verify that the financial records

show that at least the minimum amount for this type of service was charged to the program; or, when the amount spent on a specified type of service may not exceed a maximum amount, perform procedures to verify that the financial records show no more than this maximum amount for the specified type of service was charged to the program).

- c. When earmarking requirements specify a minimum percentage or amount, select a sample of transactions supporting the specified amount or percentage and perform tests to verify proper classification to meet the minimum percentage or amount.
- d. When the earmarking requirements specify a maximum percentage or amount, review the financial records to identify transactions for the specified activity which were improperly classified in another account (e.g., if only 10 percent may be spent for administrative costs, review accounts for other than administrative costs to identify administrative costs which were improperly classified elsewhere and cause the maximum percentage or amount to be exceeded).
- e. When earmarking requirements prescribe the minimum number or percentage of specified types of participants that can be served, select a sample of participants that are counted toward meeting the minimum requirement and perform tests to verify that they were properly classified.
- f. When earmarking requirements prescribe the maximum number or percentage of specified types of participants that can be served, select a sample of other participants and perform tests to verify that they were not of the specified type.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## H. PERIOD OF AVAILABILITY OF FEDERAL FUNDS

### Compliance Requirements

Federal awards may specify a time period during which the non-Federal entity may use the Federal funds. Where a funding period is specified, a non-Federal entity may charge to the award only costs resulting from obligations incurred during the funding period and any pre-award costs authorized by the Federal awarding agency. Also, if authorized by the Federal program, unobligated balances may be carried over and charged for obligations of the subsequent funding period. Obligations means the amounts of orders placed, contracts and subgrants awarded, goods and services received, and similar transactions during a given period that will require payment by the non-Federal entity during the same or a future period (A-102 Common Rule, §\_\_\_23; OMB Circular A-110, §\_\_\_28).

Non-Federal entities subject to the A-102 Common Rule shall liquidate all obligations incurred under the award not later than 90 days after the end of the funding period (or as specified in a program regulation) to coincide with the submission of the annual Financial Status report (SF-269). The Federal agency may extend this deadline upon request (A-102 Common Rule, §\_\_\_23).

An example used by a program to determine when an obligation occurs (is made) is found under Part 4, Department of Education, CFDA 84.000 (Cross-Cutting Section).

### Audit Objective

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_500(c).
2. Determine whether Federal funds were obligated within the period of availability and obligations were liquidated within the required time period.

### Suggested Audit Procedures – Internal Control

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for period of availability of Federal funds and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**Suggested Audit Procedures – Compliance**

1. Review the award documents and regulations pertaining to the program and determine any award-specific requirements related to the period of availability and document the availability period.
2. Test a sample of transactions charged to the Federal award after the end of the period of availability and verify that the underlying obligations occurred within the period of availability and that the liquidation (payment) was made within the allowed time period.
3. Test a sample of transactions that were recorded during the period of availability and verify that the underlying obligations occurred within the period of availability.
4. Select a sample of adjustments to the Federal funds and verify that these adjustments were for transactions that occurred during the period of availability.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## I. PROCUREMENT AND SUSPENSION AND DEBARMENT

### Compliance Requirements

#### *Procurement*

States, and governmental subrecipients of States, shall use the same State policies and procedures used for procurements from non-Federal funds. They also shall ensure that every purchase order or other contract includes any clauses required by Federal statutes and executive orders and their implementing regulations.

Local governments and Indian tribal governments which are not subrecipients of States will use their own procurement procedures provided that they conform to applicable Federal law and regulations and standards identified in the A-102 Common Rule.

Institutions of higher education, hospitals, and other non-profit organizations shall use procurement procedures that conform to applicable Federal law and regulations and standards identified in OMB Circular A-110.

All non-Federal entities shall follow Federal laws and implementing regulations applicable to procurements, as noted in Federal agency implementation of the A-102 Common Rule and OMB Circular A-110.

Requirements for procurement are contained in the A-102 Common Rule (§\_\_\_\_.36), OMB Circular A-110 (§\_\_\_\_.40 through §\_\_\_\_.48), Federal awarding agency regulations, and the terms of the award. The specific references for the A-102 Common Rule and OMB Circular A-110, respectively are given for each procedure indicated below. (The first number listed refers to the A-102 Common Rule and the second refers to A-110.)

#### *Suspension and Debarment*

Non-Federal entities are prohibited from contracting with or making subawards under covered transactions to parties that are suspended or debarred or whose principals are suspended or debarred. Under nonprocurement suspension and debarment rules in effect prior to November 26, 2003, covered transactions included procurement contracts for goods or services equal to or in excess of \$100,000 (the “small purchase” or “simplified acquisition threshold”). A change in the nonprocurement suspension and debarment rule took effect on November 26, 2003. As of that date “covered transactions” include those procurement contracts for goods and services awarded under a nonprocurement transaction (e.g., grant or cooperative agreement) that are expected to equal or exceed \$25,000 or meet certain other specified criteria. §\_\_.220 of the governmentwide nonprocurement debarment and suspension common rule contains those additional limited circumstances. All nonprocurement transactions (i.e., subawards to subrecipients), irrespective of award amount, are considered covered transactions—this was the case before November 26, 2003, and was not changed by the revised rules.

Under rules in effect prior to November 26, 2003, contractors receiving individual awards for \$100,000 or more and all subrecipients must certify that the organization and its principals are not suspended or debarred. Effective November 26, 2003, when a non-federal entity enters into a covered transaction with an entity at a lower tier, the non-federal entity must verify that the entity is not suspended or debarred or otherwise excluded. This verification may be accomplished by checking the *Excluded Parties List System (EPLS)* maintained by the General Services Administration (GSA), collecting a certification from the entity, or adding a clause or condition to the covered transaction with that entity (§\_\_\_.300).. The information contained in the EPLS is available in printed and electronic formats. The printed version is published monthly. Copies may be obtained by purchasing a yearly subscription from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by calling the Government Printing Office Inquiry and Order Desk at (202) 783-3238. The electronic version can be accessed on the Internet (<http://epls.arnet.gov>).

Requirements for suspension and debarment are contained in the Federal agencies' codification of the governmentwide nonprocurement debarment and suspension common rule (see Appendix II for CFR cites), which implements Executive Orders 12549 and 12689, Debarment and Suspension, and the terms of the award. Note that on November 15, 2006, OMB reissued its debarment and suspension guidance in 2 CFR part 180. This guidance is substantially the same as the common rule published November 26, 2003. Some Federal agencies have adopted this guidance and relocated their associated agency rules in Title 2 of the CFR as final rules; others have issued their adopting rules as "proposed" or "interim final rules." For these latter agencies, pending completion of that adoption, agency implementations of the common rule remain in effect (see Appendix II for current CFR citations for all agencies).

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
2. Determine whether procurements were made in compliance with the provisions of the A-102 Common Rule, OMB Circular A-110, and other procurement requirements specific to an award.
3. For covered transactions determine whether the non-Federal entity verified that entities are not suspended or debarred or otherwise excluded.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.

2. Plan the testing of internal control to support a low assessed level of control risk for procurement and suspension and debarment and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

*(Procedures 1 - 4 apply only to institutions of higher education, hospitals, and other non-profit organizations; and Federal awards received directly from a Federal awarding agency by a local government or an Indian tribal government.)*

1. Obtain entity's procurement policies. Verify that the policies comply with applicable Federal requirements (§\_\_\_\_.36(b)(1) and §\_\_\_\_.43).
2. Ascertain if the entity has a policy to use statutorily or administratively imposed in-State or local geographical preferences in the evaluation of bids or proposals. If yes, verify that these limitations were not applied to federally funded procurements except where applicable Federal statutes expressly mandate or encourage geographic preference (§\_\_\_\_.36(c)(2) and §\_\_\_\_.43).
3. Examine procurement policies and procedures and verify the following:
  - a. Written selection procedures require that solicitations incorporate a clear and accurate description of the technical requirements for the material, product, or service to be procured, identify all requirements that the offerors must fulfill, and include all other factors to be used in evaluating bids or proposals (§\_\_\_\_.36(c)(3) and §\_\_\_\_.44(a)(3)).
  - b. There is a written policy pertaining to ethical conduct (§\_\_\_\_.36(b)(3) and §\_\_\_\_.42).
4. Select a sample of procurements and perform the following:
  - a. Examine contract files and verify that they document the significant history of the procurement, including the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis of contract price (§\_\_\_\_.36(b)(9) and §\_\_\_\_.46).
  - b. Verify that procurements provide full and open competition (§\_\_\_\_.36(c)(1) and §\_\_\_\_.43).

- c. Examine documentation in support of the rationale to limit competition in those cases where competition was limited and ascertain if the limitation was justified (§\_\_\_\_.36(b)(1) and (d)(4); and §\_\_\_\_.43 and §\_\_\_\_.44(e)).
- d. Verify that contract files exist and ascertain if appropriate cost or price analysis was performed in connection with procurement actions, including contract modifications and that this analysis supported the procurement action (§\_\_\_\_.36(f) and §\_\_\_\_.45).
- e. Verify that the Federal awarding agency approved procurements exceeding \$100,000 when such approval was required. Procurements (1) awarded by noncompetitive negotiation, (2) awarded when only a single bid or offer was received, (3) awarded to other than the apparent low bidder, or (4) specifying a “brand name” product (§\_\_\_\_.36(g)(1) and §\_\_\_\_.44(e)) may require prior Federal awarding agency approval.
- f. Verify compliance with other procurement requirements specific to an award.

*(Procedure 5 only applies to States and Federal awards subgranted by the State to a local government or Indian tribal government.)*

- 5. Test a sample of procurements to ascertain if the State’s laws and procedures were followed and that the policies and procedures used were the same as for non-Federal funds.

*(Procedure 6 applies to all non-Federal entities)*

- 6. Test a sample of procurements and subawards and, depending on the timing of the transaction (i.e., before, on, or after November 26, 2003): .
  - a. Before November 26, 2003
    - (1) Ascertain if the required suspension and debarment certifications were received or determinations were made for subawards and covered contracts, and
    - (2) Test a sample of procurements and subawards against the *EPLS*, and ascertain if contracts or subawards were awarded to suspended or debarred parties.
  - b. On or after November 26, 2003
    - (1) Test whether the non-Federal entities performed a verification check for covered transactions, by checking the *EPLS*, collecting a certification from the entity, or adding a clause or condition to the covered transaction with the entity; and

- (2) Test a sample of procurements and subawards against the EPLS, and ascertain if contracts or subawards were awarded to suspended or debarred parties.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## **J. PROGRAM INCOME**

### **Compliance Requirements**

Program income is gross income received that is directly generated by the federally funded project during the grant period. If authorized by Federal regulations or the grant agreement, costs incident to the generation of program income may be deducted from gross income to determine program income. Program income includes, but is not limited to, income from fees for services performed, the use or rental of real or personal property acquired with grant funds, the sale of commodities or items fabricated under a grant agreement, and payments of principal and interest on loans made with grant funds. Except as otherwise provided in the Federal awarding agency regulations or terms and conditions of the award, program income does not include interest on grant funds (covered under “Cash Management”), rebates, credits, discounts, refunds, etc. (covered under “Allowable Costs/Cost Principles”), or interest earned on any of them (covered under “Cash Management”). Program income does not include the proceeds from the sale of equipment or real property (covered under “Equipment and Real Property Management”).

Program income may be used in one of three methods: deducted from outlays, added to the project budget, or used to meet matching requirements. Unless specified in the Federal awarding agency regulations or the terms and conditions of the award, program income shall be deducted from program outlays. However, for research and development activities by institutions of higher education, hospitals, and other non-profit organizations, the default method is to add program income to the project budget. Unless Federal awarding agency regulations or the terms and conditions of the award specify otherwise, non-Federal entities have no obligation to the Federal Government regarding program income earned after the end of the grant period.

The requirements for program income are found in the A-102 Common Rule (§\_\_\_\_.21(payment) and §\_\_\_\_.25), OMB Circular A-110 (§\_\_\_\_.2 (program income definition), §\_\_\_\_.22(payment), and §\_\_\_\_.24), Federal awarding agency laws, program regulations, and the provisions of the contract or grant agreements pertaining to the program.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).
2. Determine whether program income is correctly determined, recorded, and used in accordance with the program requirements, A-102 Common Rule, and OMB Circular A-110, as applicable.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.

2. Plan the testing of internal control to support a low assessed level of control risk for program income and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

1. *Identify Program Income*
  - a. Review the laws, regulations, and the provisions of contract or grant agreements applicable to the program and ascertain if program income was anticipated. If so, ascertain the requirements for determining or assessing the amount of program income (e.g., a scale for determining user fees, prohibition of assessing fees against certain groups of individuals, etc.), and the requirements for recording and using program income.
  - b. Inquire of management and review accounting records to ascertain if program income was received.
2. *Determining or Assessing Program Income* – Perform tests to verify that program income was properly determined or calculated in accordance with stated criteria, and that program income was only collected from allowable sources.
3. *Recording of Program Income* – Perform tests to verify that all program income was properly recorded in the accounting records.
4. *Use of Program Income* – Perform tests to ascertain if program income was used in accordance with the program requirements, the A-102 Common Rule, and OMB Circular A-110.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## **K. REAL PROPERTY ACQUISITION AND RELOCATION ASSISTANCE**

### **Compliance Requirements**

The Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended, (URA) provides for uniform and equitable treatment of persons displaced by Federally-assisted programs from their homes, businesses, or farms. Property acquired must be appraised by qualified independent appraisers. All appraisals must be examined by a review appraiser to assure acceptability. After acceptance, the review appraiser certifies the recommended or approved value of the property for establishment of the offer of just compensation to the owner. Federal requirements govern the determination of payments for replacement housing assistance, rental assistance, and down payment assistance for individuals displaced by federally funded projects. The regulations also cover the payment of moving-related expenses and reestablishment expenses incurred by displaced businesses and farm operations.

Governmentwide requirements for real property acquisition and relocation assistance are contained in Department of Transportation's single governmentwide rule at 49 CFR part 24, Uniform Relocation Assistance and Real Property Acquisition Regulations for Federal and Federally-Assisted Programs.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
2. Determine whether the non-Federal entity complied with the real property acquisition, appraisal, negotiation, and relocation requirements.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for real property acquisition and relocation assistance and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**Suggested Audit Procedures – Compliance**

1. Inquire of management and review the records of Federal programs to ascertain if the non-Federal entity administers Federally-assisted programs that involve the acquisition of real property or the displacement of households or businesses.

2. *Property Acquisitions*

For a sample of acquisitions:

- a. *Appraisal* – Test records to ascertain if: (1) the just compensation amount offered the property owner was determined by an appraisal process; (2) the appraisal(s) was examined by a review appraiser; and, (3) the review appraiser prepared a signed statement which explains the basis for adjusting comparable sales to reach the review appraiser’s determination of the fair market value.
  - b. *Negotiations* – Test supporting documentation to ascertain if: (1) a written offer of the appraised value was made to the property owner; and (2) a written justification was prepared if the purchase price for the property exceeded the amount offered and that the documentation (e.g., recent court awards, estimated trial costs, valuation problems) supports such administrative settlement as being reasonable, prudent, and in the public interest.
  - c. *Residential Relocations* – Test supporting documentation to ascertain if the non-Federal entity made available to the displaced persons one or more comparable replacement dwellings.
3. *Replacement Housing Payments* – For a sample, test the non-Federal entity’s records to ascertain if there is documentation that supports the following:
    - a. The owner occupied the displacement dwelling for at least 180 days immediately prior to initiation of negotiations.
    - b. The non-Federal entity examined at least three comparable replacement dwellings available for sale and computed the payment on the basis of the price of the dwelling most representative of the displacement dwelling.
    - c. The asking price for the comparable dwelling was adjusted, to the extent justified by local market data, to recognize local area selling price reductions.
    - d. The allowance for increased mortgage cost “buy down” amount was computed based on the remaining principal balance, the interest rate, and the remaining term of the old mortgage on the displacement dwelling.
    - e. The non-Federal entity prepared written justification on the need to employ last resort housing provisions, if the total replacement housing payment exceeded \$22,500.

4. *Rental or Downpayment Assistance* – For a sample, test the non-Federal entity’s records to ascertain if there is documentation that supports the following:
  - a. The displacee occupied the displacement dwelling for at least 90 days immediately prior to initiation of negotiations.
  - b. The displacee rented, or purchased, and occupied a decent, safe, and sanitary replacement dwelling within one year.
  - c. The non-Federal entity prepared written justification if the payment exceeded \$5,250.
  
5. *Business Relocations* – For a sample of business relocations:
  - a. *Moving Expenses* – Test that payments for moving and related expenses were for actual costs incurred or that fixed payments, in lieu of actual costs, were limited to a maximum of \$20,000 and computed based on the average annual net earnings of the business, as evidenced by income tax returns, certified financial statements, or other reliable evidence.
  - b. *Business Reestablishment Expense* – Verify that (1) the displacee was eligible as a farm operation, a non-profit organization, or a small business to receive reestablishment assistance, and (2) the payment was for actual costs incurred and did not exceed \$10,000.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## L. REPORTING

### Compliance Requirements

#### *Financial Reporting*

Recipients should use the standard financial reporting forms or such other forms as may be authorized by OMB (approval is indicated by an OMB paperwork control number on the form). These other forms may include financial, performance, and special reporting. Each recipient must report program outlays and program income on a cash or accrual basis, as prescribed by the Federal awarding agency. If the Federal awarding agency requires accrual information and the recipient's accounting records are not normally maintained on the accrual basis, the recipient is not required to convert its accounting system to an accrual basis but may develop such accrual information through analysis. The awarding agency may accept identical information from the recipient in machine-readable format, computer printouts, or electronic outputs in lieu of the prescribed formats.

The reporting requirements for subrecipients are as specified by the pass-through entity. In many cases, these will be the same as or similar to the following requirements for recipients.

The standard financial reporting forms are as follows:

1. *Financial Status Report (FSR) (SF-269 (OMB No. 0348-0039) or SF-269A (OMB No. 0348-0038))*. Recipients use the FSR to report the status of funds for all non-construction projects and for construction projects when the FSR is required in lieu of the SF-271.
2. *Request for Advance or Reimbursement (SF-270 (OMB No. 0348-0004))*. Recipients use the SF-270 to request Treasury advance payments and reimbursements under non-construction programs.
3. *Outlay Report and Request for Reimbursement for Construction Programs (SF-271 (OMB No. 0348-0002))*. Recipients use the SF-271 to request funds for construction projects unless advances or the SF-270 is used.
4. *Federal Cash Transactions Report (SF-272 (OMB No. 0348-0003) or SF-272-A (OMB No. 0348-0003))*. Recipients use the SF-272 when payment is by advances or reimbursements. The Federal awarding agency may waive the requirement for an SF-272 when electronic payment mechanisms provide adequate data.

Electronic versions of these standard forms are located on OMB's Internet home page ([http://www.whitehouse.gov/omb/grants/grants\\_forms.html](http://www.whitehouse.gov/omb/grants/grants_forms.html)).

### *Reporting Under the Payment Management System*

Many recipients utilize the Payment Management System (PMS) operated by the Division of Payment Management (DPM) within the Department of Health and Human Services' Program Support Center. After a Federal agency awards a grant, DPM is responsible for controlling payments to the recipient; receiving collections for unexpended funds, duplicate payments, and interest earned on Federal funds; accounting for disbursement information provided by the recipient; and reporting data equivalent to the SF-272, *Federal Cash Transactions Report*, to the recipient and the Federal agency.

Federal awarding agencies enter authorization amounts in PMS to allow recipients to draw Federal funds. There are three methods by which recipients can request funds: (1) the PMS 270 cash request, (2) SMARTLINK II, or (3) CASHLINE systems. SMARTLINK II enables recipients to request Federal funds through computer link with DPM, while CASHLINE allows funds to be requested via a touch-tone telephone. Once a quarter, using the authorization amounts provided by the Federal agency, payments requested by recipients, cash collection activity, and disbursement information provided by recipients, DPM generates PSC-272 reports.

The PSC 272 is a series of reports consisting of:

1. PSC 272, *Federal Cash Transactions Report, Status of Federal Cash (OMB No. 0937-0200)*. This report provides a total accountability of all Federal cash received by the recipient. It is partially prepared by DPM based on data reported to DPM, and is completed and certified by the recipient.
2. PSC 272-A, *Federal Cash Transactions Report (OMB No. 0937-0200)*. This report is a continuation of the PMS-272 and is used by the recipient to report cash disbursements to DPM.
3. PSC 272-B, *Statement of Cash Accountability (OMB No. 0937-0200)*. This report is furnished for the recipient's information and shows how the recipient's cash accountability was derived by DPM.
4. PSC 272-C, *Error Correction Document (OMB No. 0937-0200)*. This report can be used by the recipient to report data reconciliation problems for awards on the PSC 272-A or the Advances to Payee portion of the PSC 272-B.
5. PSC 272-E, *Major Program Statement (OMB No. 0937-0200)*. This report is furnished to States, Indian tribes, and cross-serviced organizations for their information only. This report lists individual payments during the quarter among the various programs, and provides a cash accountability for all advances received through PMS by major program. All information provided is pre-printed by DPM.
6. PSC 272-F, *Authorizations for Future Periods (OMB No. 0937-0200)*. This report is provided for information only and requires no action by the recipient. It represents all awards posted in the PMS database that have effective dates in future reporting periods.

7. PSC 272-G, *Inactive Documents Report (OMB No. 0937-0200)*. This report lists all awards posted in the PMS database that have become inactive or fully disbursed during the current period or a previous period. In the event that disbursement adjustments are required, they should be reported via the PSC 272-A.

The reports are either mailed to the recipient or electronically downloaded by the recipient using DPM's Electronic 272 System. Recipients should verify the reported amounts. If discrepancies are noted, the report is annotated (or the PSC 272-C is completed) and returned to DPM. The recipient uses the PSC 272-A to report the amount of disbursements made; then signs, dates, and returns the report to DPM. Recipients may report disbursements data electronically using the Electronic 272 process. PSC 272 reporting requirements do not apply to block grant programs; however, DPM does provide block grant recipients with a PSC 272-E, *Major Program Statement*, quarterly. This report is provided solely for information and no action is required by the recipient.

### *Performance Reporting*

Recipients shall submit performance reports at least annually but not more frequently than quarterly. Performance reports generally contain, for each award, brief information of the following types:

1. A comparison of actual accomplishments with the goals and objectives established for the period.
2. Reasons why established goals were not met, if appropriate.
3. Other pertinent information including, when appropriate, analysis and explanation of cost overruns or high unit costs.

### *Special Reporting*

Non-Federal entities may be required to submit other reporting which may be used by the Federal agency for such purposes as allocating program funding.

Compliance testing of performance and special reporting are only required for data that are quantifiable and meet the following criteria:

1. Have a direct and material effect on the program.
2. Are capable of evaluation against objective criteria stated in the laws, regulations, contract or grant agreements pertaining to the program.

Performance and special reporting data specified in Part 4, Compliance Requirements, meet the above criteria.

Reporting requirements are contained in the following documents:

- a. A-102 Common Rule - Financial reporting, §\_\_\_\_.41; Performance reporting, §\_\_\_\_.40(b).
- b. OMB Circular A-110 - Financial reporting, §\_\_\_\_.52; Performance reporting, §\_\_\_\_.51.
- c. The laws, regulations, and the provisions of contract or grant agreements pertaining to the program.

### **Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).
2. Determine whether required reports for Federal awards include all activity of the reporting period, are supported by applicable accounting or performance records, and are fairly presented in accordance with program requirements.

### **Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for reporting and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

### **Suggested Audit Procedures – Compliance**

Note: For recipients using PMS to draw Federal funds, the auditor should consider the following steps numbered 1 through 5 as they pertain to the PSC 272, PSC 272-A, PSC 272-B, and PSC 272-E, regardless of the source of the data included in the PMS reports. Although certain data is supplied by the Federal awarding agency (i.e., award authorization amounts) and certain amounts are provided by DPM, the auditor should ensure that such amounts are in agreement with the recipient's records and are otherwise accurate.

1. Review applicable laws, regulations, and the provisions of contract or grant agreements pertaining to the program for reporting requirements. Determine the types and frequency

of required reports. Obtain and review Federal awarding agency, or pass-through entity in the case of a subrecipient, instructions for completing the reports.

- a. For financial reports, ascertain the accounting basis used in reporting the data (e.g., cash or accrual).
  - b. For performance and special reports, determine the criteria and methodology used in compiling and reporting the data.
2. Perform appropriate analytical procedures and ascertain the reason for any unexpected differences. Examples of analytical procedures include:
- a. Comparing current period reports to prior period reports.
  - b. Comparing anticipated results to the data included in the reports.
  - c. Comparing information obtained during the audit of the financial statements to the reports.

Note: The results of the analytical procedures should be considered in determining the nature, timing, and extent of the other audit procedures for reporting.

3. Select a sample of each of the following report types:
- a. Financial reports
    - (1) Ascertain if the financial reports were prepared in accordance with the required accounting basis.
    - (2) Trace the amounts reported to accounting records that support the audited financial statements and the schedule of expenditures of Federal awards and verify agreement or perform alternative procedures to verify the accuracy and completeness of the reports and that they agree with the accounting records.
    - (3) For any discrepancies noted in PSC-272 reports, review subsequent PSC-272 reports to ascertain if the discrepancies were appropriately resolved with the Department of Health and Human Services' Division of Payment Management.
  - b. Performance and special reports
    - (1) Trace the data to records that accumulate and summarize data.
    - (2) Perform tests of the underlying data to verify that the data were accumulated and summarized in accordance with the required or stated

criteria and methodology, including the accuracy and completeness of the reports.

- c. When intervening computations or calculations are required between the records and the reports, trace reported data elements to supporting worksheets or other documentation that link reports to the data.
  - d. Test mathematical accuracy of reports and supporting worksheets.
4. Test the selected reports for completeness.
- a. For financial reports, review accounting records and ascertain if all applicable accounts were included in the sampled reports (e.g., program income, expenditure credits, loans, interest earned on Federal funds, and reserve funds).
  - b. For performance and special reports, review the supporting records and ascertain if all applicable data elements were included in the sampled reports.
5. Obtain written representation from management that the reports provided to the auditor are true copies of the reports submitted or electronically transmitted to the Federal awarding agency, the Department of Health and Human Services' Division of Payment Management for recipients using the Payment Management System, or pass-through entity in the case of a subrecipient.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## M. SUBRECIPIENT MONITORING

### Compliance Requirements

A pass-through entity is responsible for:

- *Award Identification* – At the time of the award, identifying to the subrecipient the Federal award information (e.g., CFDA title and number, award name, name of Federal agency) and applicable compliance requirements.
- *During-the-Award Monitoring* – Monitoring the subrecipient’s use of Federal awards through reporting, site visits, regular contact, or other means to provide reasonable assurance that the subrecipient administers Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- *Subrecipient Audits* – (1) Ensuring that subrecipients expending \$500,000 or more in Federal awards during the subrecipient’s fiscal year for fiscal years ending after December 31, 2003 (or \$300,000 prior to that date) as provided in OMB Circular A-133 have met the audit requirements of OMB Circular A-133 (the circular is available on the Internet at <http://www.whitehouse.gov/omb/circulars/a133/a133.html>) and that the required audits are completed within 9 months of the end of the subrecipient’s audit period; (2) issuing a management decision on audit findings within 6 months after receipt of the subrecipient’s audit report; and (3) ensuring that the subrecipient takes timely and appropriate corrective action on all audit findings. In cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity shall take appropriate action using sanctions.
- *Pass-Through Entity Impact* – Evaluating the impact of subrecipient activities on the pass-through entity’s ability to comply with applicable Federal regulations.

#### *During-the-Award Monitoring*

Following are examples of factors that may affect the nature, timing, and extent of during-the-award monitoring:

- *Program complexity* – Programs with complex compliance requirements have a higher risk of non-compliance.
- *Percentage passed through* – The larger the percentage of program awards passed through the greater the need for subrecipient monitoring.
- *Amount of awards* – Larger dollar awards are of greater risk.

- *Subrecipient risk* – Subrecipients may be evaluated as higher risk or lower risk to determine the need for closer monitoring. Generally, new subrecipients would require closer monitoring. For existing subrecipients, based on results of during-the-award monitoring and subrecipient audits, a subrecipient may warrant closer monitoring (e.g., the subrecipient has (1) a history of non-compliance as either a recipient or subrecipient, (2) new personnel, or (3) new or substantially changed systems).

Monitoring activities normally occur throughout the year and may take various forms, such as:

- *Reporting* – Reviewing financial and performance reports submitted by the subrecipient.
- *Site Visits* – Performing site visits at the subrecipient to review financial and programmatic records and observe operations.
- *Regular Contact* – Regular contacts with subrecipients and appropriate inquiries concerning program activities.

#### *Agreed-upon procedures engagements*

A pass-through entity may arrange for agreed-upon procedures engagements for certain aspects of subrecipient activities, such as eligibility determinations. Since the pass-through entity determines the procedures to be used and compliance areas to be tested, these agreed-upon procedures engagements enable the pass-through entity to target the coverage to areas of greatest risk. The costs of agreed-upon procedures engagements is an allowable cost to the pass-through entity if the agreed-upon procedures are performed for subrecipients below the A-133 threshold for audit (currently at \$500,000 for fiscal years ending after December 31, 2003) for the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and reporting (OMB Circular A-133 (§\_\_\_230(b)(2)).

#### **Source of Governing Requirements**

The requirements for subrecipient monitoring are contained in 31 USC 7502(f)(2)(B) (Single Audit Act Amendments of 1996 (Pub. L. 104-156)), OMB Circular A-133 (§\_\_\_225 and §\_\_\_400(d)), A-102 Common Rule (§\_\_\_37 and §\_\_\_40(a)), and OMB Circular A-110 (§\_\_\_51(a)), Federal awarding agency program regulations, and the terms and conditions of the award.

**Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_.500(c).
2. Determine whether the pass-through entity properly identified Federal award information and compliance requirements to the subrecipient, and approved only allowable activities in the award documents.
3. Determine whether the pass-through entity monitored subrecipient activities to provide reasonable assurance that the subrecipient administers Federal awards in compliance with Federal requirements.
4. Determine whether the pass-through entity ensured required audits are performed, issued a management decision on audit findings within 6 months after receipt of the subrecipient's audit report, and ensures that the subrecipient takes timely and appropriate corrective action on all audit findings.
5. Determine whether in cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity took appropriate action using sanctions.
6. Determine whether the pass-through entity evaluates the impact of subrecipient activities on the pass-through entity.

**Suggested Audit Procedures – Internal Control**

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
2. Plan the testing of internal control to support a low assessed level of control risk for subrecipient monitoring and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control.
3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

**Suggested Audit Procedures – Compliance**

(Note: The auditor may consider coordinating the tests related to subrecipients performed as part of Cash Management (tests of cash reports submitted by subrecipients), Eligibility (tests that subawards were made only to eligible subrecipients), and Procurement (tests of ensuring that a subrecipient is not suspended or debarred) with the testing of Subrecipient Monitoring.)

1. Gain an understanding of the pass-through entity's subrecipient procedures through a review of the pass-through entity's subrecipient monitoring policies and procedures (e.g., annual monitoring plan) and discussions with staff. This should include an understanding of the scope, frequency, and timeliness of monitoring activities and the number, size, and complexity of awards to subrecipients.
2. Test award documents and agreements to ascertain if: (a) at the time of award the pass-through entity made subrecipients aware of the award information (e.g., CFDA title and number, amount of award, award name, name of Federal agency) and requirements imposed by laws, regulations and the provisions of contract or grant agreements; and (b) the activities approved in the award documents were allowable.
3. Review the pass-through entity's documentation of during-the-award monitoring to ascertain if the pass-through entity's monitoring provided reasonable assurance that subrecipients used Federal awards for authorized purposes, complied with laws, regulations, and the provisions of contracts and grant agreements, and achieved performance goals.
4. Review the pass-through entity's follow-up to ensure corrective action on deficiencies noted in during-the-award monitoring.
5. Verify that the pass-through entity:
  - a. Ensured that the required subrecipient audits were completed. For subrecipients that are not required to submit a copy of the reporting package to a pass-through entity because there were "no audit findings" (i.e., because the schedule of findings and questioned costs did not disclose audit findings relating to the Federal awards that the pass-through entity provided and the summary schedule of prior audit findings did not report the status of audit findings relating to Federal awards that the pass-through entity provided, as prescribed in OMB Circular A-133 §\_\_320(e)), the pass-through entity may use the information in the Federal Audit Clearinghouse (FAC) database (available on the Internet at <http://harvester.census.gov/sac>) as evidence to verify that the subrecipient had "no audit findings" and that the required audit was performed. This FAC verification would be in lieu of reviewing submissions by the subrecipient to the pass-through entity when there are no audit findings.
  - b. Issued management decisions on audit findings within 6 months after receipt of the subrecipient's audit report.
  - c. Ensured that subrecipients took appropriate and timely corrective action on all audit findings.
6. Verify that in cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity took appropriate action using sanctions.

7. Verify that the effects of subrecipient noncompliance are properly reflected in the pass-through entity's records.
8. Verify that the pass-through entity monitored the activities of subrecipients not subject to OMB Circular A-133, using techniques such as those discussed in the "Compliance Requirements" provisions of this section with the exception that these subrecipients are not required to have audits under OMB Circular A-133.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.

## N. SPECIAL TESTS AND PROVISIONS

### Compliance Requirements

The specific requirements for Special Tests and Provisions are unique to each Federal program and are found in the laws, regulations, and the provisions of contract or grant agreements pertaining to the program. For programs listed in this Supplement, the compliance requirements, audit objectives, and suggested audit procedures for Special Tests and Provisions are in Part 4 – Agency Program Requirements or Part 5 – Clusters of Programs. For programs not listed in this Supplement, the auditor shall review the program’s contract and grant agreements and referenced laws and regulations to identify the compliance requirements and develop the audit objectives and audit procedures for Special Tests and Provisions which could have a direct and material effect on a major program. The auditor should also inquire of the non-Federal entity to help identify and understand any Special Tests and Provisions.

Additionally, for both programs included and not included in this Supplement, the auditor shall identify any additional compliance requirements which are not based in law or regulation (e.g., were agreed to as part of audit resolution of prior audit findings) which could be material to a major program. Reasonable procedures to identify such compliance requirements would be inquiry of non-Federal entity management and review of the contract and grant agreements pertaining to the program. Any such requirements which may have a direct and material on a major program shall be included in the audit.

### Internal Control

The following audit objective and suggested audit procedures should be considered in tests of special tests and provisions in addition to those provided in Part 4 – Agency Program Requirements; Part 5 – Clusters of Programs; and in accordance with Part 7 – Guidance for Auditing Programs Not Included in This Compliance Supplement:

### Audit Objective

Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §\_\_\_\_.500(c).

### Suggested Audit Procedures

1. Using the guidance provided in Part 6 – Internal Control, perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- 2.. Plan the testing of internal control to support a low assessed level of control risk for special tests and provisions and perform the testing of internal control as planned. If internal control over some or all of the compliance requirements is likely to be ineffective, see the alternative procedures in §\_\_\_\_.500(c)(3) of OMB Circular A-133, including assessing the control risk at the maximum and considering whether

additional compliance tests and reporting are required because of ineffective internal control.

3. Consider the results of the testing of internal control in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

Note: The suggested audit procedures above for internal control and compliance testing may be accomplished using dual-purpose testing.