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Federal grants-in-aid : accounting and auditing practices

Cornelius E. Tierney

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Federal Grants-In-Aid:
Accounting and
Auditing Practices

Cornelius E. Tierney, CPA

AICPA

American Institute of
Certified Public Accountants

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Cornelius E. Tierney, CPA

**Issued by the
Federal Government Division
American Institute of
Certified Public Accountants**

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Director's Preface

Since the mid-1960s the involvement of certified public accountants in the grant programs of the federal government has greatly expanded the audit and advisory roles of the profession. Many laws and federal agency regulations require that recipients of federal monies be audited annually; that records and systems be established in accordance with generally accepted accounting principles and sound internal control procedures; and that audit work be performed in accordance with governmental auditing standards.

There is no common body of knowledge or single reference work to which the accountant can turn. The officials of 1,000 grant programs administered by some 50 federal departments, agencies, and commissions have published specific guidelines for the financial management and control of these grant funds.

The involvement of the profession has increased to such a degree that the American Institute of Certified Public Accountants has established a continuing subcommittee for federally assisted programs to monitor and advise its members on the continual growth, change, issues, problems, and other aspects of these significant governmental funding programs. Federal agencies that award these grants are retaining public accounting firms to perform audits and evaluations of grant programs and render technical, fiscal, and financial management services to grant recipients. Additionally, firms are directly retained by thousands of grantees to assist in establishing fiscal and accounting systems as well as internal control systems and procedures and to perform audits.

This book brings together in a single reference work the general criteria that most governmental grantors require. It describes the federal grant process and provides the certified public accountant with the necessary background and knowledge that may not be apparent from an examination of the federal requirements of a single grant program. Also included is a discussion of the general requirements for the management of the federal government's grant programs, the federal grantor's internal accounting and financial management requirements, and the responsibilities

of federal grantees. The potential risks and liabilities are identified as well as the opportunities to serve grantees as an auditor, adviser, and provider of technical assistance. The study describes the requirements for the audit of federal grant programs, the nature of the services provided by certified public accountants, the types and procedures of audit, and the AICPA position with respect to audit reports relating to governmental programs.

This study is based on federal promulgations, many other government publications and studies, and the knowledge that many individuals have gleaned from years of experience with grant programs. Congressional statutes are the basis for some of the financial, accounting, reporting, and auditing requirements imposed on the federal grantor agencies. Some of the material from a prior Institute study, *Federal Financial Management: Accounting and Auditing Practices* (1976) is also presented in this study to provide the reader with a full understanding of all matters pertinent to federal grant-in-aid programs in a single reference source.

In attempting to make this study as readable as possible, the author has for the most part refrained from including footnote references to various sources of information. However, these sources are listed in the bibliography.

This publication is the work of Cornelius E. Tierney, CPA, who has years of personal experience as a federal auditor and financial manager. Mr. Tierney is a partner in the firm of Arthur Young & Co. He began his career with the U.S. General Accounting Office and later served as the manager of internal audit and as director of financial management for the Office of Economic Opportunity. Prior to entering public accounting he was the assistant director for accounting at the Civil Aeronautics Board.

As with any work of this nature, the resulting product is the culmination of the efforts and contributions of many individuals. The author wishes to thank particularly members of the AICPA task force who provided technical assistance: Robert Armbruster, Edward Haller, Lysle Hollenbeck, John Lordan, Ellsworth Morse, and James Walls. In addition, thanks go to Marie Bareille for her editorial assistance.

Joseph Moraglio, Director
Federal Government Division

Contents

1	An Overview of Grant Programs	1
	Types of Grants	1
	Revenue-Sharing Grant Program	2
	Responsibility for Grant Programs	3
	Central Financial Control Agencies	5
	Responsibilities of Grantor Agencies	9
	Financial Management Implementation	10
	Funding Federal Grant Programs	11
	The Federal Budget	12
	The Budget Cycle	13
	Federal Grantor's Financial Process	17
	Methods of Financing Grantees	18
2	Funding and Financing of Federal Grants	19
	Funding of Federal Grant Programs	19
	Applying for Federal Grants	21
	Establishing Federal Eligibility Criteria	21
	Grant Submission Requirements	22
	Preparation of Grant Application	23
	Execution of Advance Understandings	24
	Grantor Review	24
	Grant Closeout Requirements	26
	Financing of a Grant	26
	Incremental Funding of Grants	27
	Payment of Federal Money to Grantees	27
	Letter-of-Credit Conditions	30
	Reporting Requirements	32
3	Accounting by a Federal Grantor	35
	Fund Accounting	35
	Account Structure	36
	Integrated Federal Fund Accounting	36
	Uniqueness of Federal Systems	37
	Accounting for Federal Funds	39

Budget Process	39
Appropriation and Expenditure Process	39
Appropriation Warrants	40
Accounting for Apportionments	41
Accounting for Allotments	41
Anti-Deficiency Act	42
Supplemental Appropriation Act	43
Classification of Obligations	44
Value of Obligations	45
Administrative Requirements for Grant Programs	45
Systems of Accounting and Controls	46
Purpose of Grantee Reporting	46
Reporting Frequency	46
Documentation for Grant Expenditures	47
Purpose of the Grant Agreement	47
Grant Financing and Payment Documents	48
Grantor Accounting for Grants	49
Commitment of Funds	50
Execution of the Grant	50
Establishing the Advance Receivable	51
Recording Grantee Claims	51
Disbursements to the Grantee	52
Illustrative Accounting Entries	52
Prepayment Audit or Review	54
4 Requirements for Federal Grantees	57
Grantor Accounting Requirements	57
Requirements of General Accounting Office	58
Requirements of Office of Management and Budget and General Services Administration	59
Grantee Responsibility for Accounting and Internal Controls	60
Accounting Control Criteria	62
Internal Control Criteria	62
Structure of Accounting System	64
Assets, Liabilities, Investment, or Net Worth	64
Receipts and Expenses	66
Definition and Required Documentation for Grant Resources and Expenditures	70
Accounting for Project or Program Resources	70
Accounting for Project or Program Expenditures	71
Construction Grants	77
Accounting for Property	77
Record Retention Period	79

5	Financial Statements and Reporting	81
	Financial Statements of Governmental Units	81
	Financial Statements of Voluntary Health and Welfare Organizations	82
	Statements for Federal Grants	83
	Statement Required From Governmental Grantees	84
	Nonfinancial Reports	92
6	Federal Cost Principles	93
	Cost Accounting for Grants	93
	Responsibility for Cost Principles	93
	Applicability of OMB Circulars	94
	Cost Guides of Other Agencies	95
	Department of HEW	95
	Hierarchy of Cost Principles	96
	Definition of General Cost Principles	97
	Total Costs	97
	Direct Costs	97
	Indirect Costs	98
	Allowable Costs	102
	Unallowable Costs	103
	Allowability of Indirect Cost Plans	105
	Matching Share and In-Kind Contributions	106
	Matching Share Definition	106
	Valuation of In-Kind Contributions	107
7	Federal Audit Requirements	109
	Federal Audit Policies and Responsibilities	109
	Reporting Relationships	113
	Types of Grant Audits and Reviews	113
	Preaward Review or Survey	113
	Postaward Review or Survey	114
	Fiscal or Cost Audits	114
	Periodic Audits	115
	Compliance Audits	115
	Operational Audits	116
	Federal Standards of Audit	116
	Background of Federal Standards	117
	Definition and Scope of Governmental Audits	117
	Absence of Criteria for Economy and Efficiency and Program Audits	118
	GAO <i>Standards for Audit</i>	120
	General Standards	120

Examination and Evaluation Standards	121
Reporting Standards	121
AICPA's Position on Standards for Audit	123
Obligation to Meet Governmental Engagement Responsibilities	124
Audit Guides Issued by Governmental Agencies	124
Qualifications of Independent Auditors	125
8 Federal Use of Public Accountants	127
Factors Affecting Use of Public Accountants	127
Services Provided by Certified Public Accountants	128
Federal Contracting Procedures	128
Selection of Firm by Grantee	130
Contract by Federal Grantor	131
Methods of Reimbursement	131
Areas of Concern in Governmental Auditing	132
Definition of Scope of Work	133
Reporting Responsibility	134
Types of Audit Reports	134
Access to Working Papers	135
Fee Arrangements	135
Government Survey of Use of Public Accountants	136
AICPA's Program for Substandard Reports	137
9 Conducting Audits of Federal Grantees	139
Prescription of Scope of Audit	139
Orientation for Governmental Audits	140
Congressional Legislation and History	140
Agency Policies, Rules, and Regulations	141
Specific Grant Conditions	141
General Cost Principles	142
Referenced or Published Audit Guides	142
Auditing of Governmental Grantees	143
Accounting Systems and Internal Controls	143
Audit of Cost Incurred	144
Standards for Supporting Documentation	145
Sufficient and Competent Documentation	147
Opinions Required of Certified Public Accountants	148
Adequacy of Systems	148
Allowability of Costs	150
Compliance With Terms of Grant Agreement	150
Opinions on Financial Statements	151
The Audit Work Plan	151

10 The Grant Audit Report	155
Standards of Reporting	155
AICPA Standards of Reporting	156
Governmental Audit Standards—Reporting	157
Federal Grantor Reporting Requirements	157
Form and Content of Grant Audit Reports	158
Short Form Reporting	158
Criteria for Questioning Cost	159
Narrative Reports	161
Compliance With Grant Conditions	162
Report Distribution	163
Discussion of Audit Report Contents	163
Reporting and Distribution Procedures	164
Use of Audit Reports of Federal Grant Programs	165
Grantor Report Review Procedures	165
Assistance to Grantees	166
Review by Grantor’s Audit Staff	166
Review by Grantor Program Manager	167
Responding to, or Rebutting, Audit Findings	167
Review of Grant Conditions and Requirements	168
Gathering Evidence to Support Compliance With Grant Conditions	169
Timely Presentation	169
Negotiation of Costs Questioned	170
Formal Disallowance Action and Method of Refund	170
Nature of Decision Appeal	171
Methods of Restitution	171
Significance of Disallowance Actions	172
Role of the Accountant	172

Bibliography 175

Index 181

I An Overview of Grant Programs

Annually, federal grantor agencies spend billions of dollars under grant-in-aid programs. More than a thousand grant programs are administered by some fifty federal departments, agencies, commissions, and councils. In recent years, these programs have been of increasing concern to the accounting profession. Certified public accounting firms have been retained to conduct preaward surveys, systems reviews, compliance audits, financial statement audits, and grant closeout examinations and to provide other advice and assistance.

Until the 1960s, federal grants were viewed almost as endowments to the recipient organizations. For the most part, the period of performance was open, minimal accounting was required for expenditures, and no audits were made. Today, the services and purposes for which grants are issued make it difficult to distinguish between a grant and a contract. Both grants and contracts are now viewed as legally binding instruments between agency and recipient. Possibly the only difference is that whereas a private contractor is generally entitled to a profit or fee, grants do not generally provide for remuneration in excess of costs.

The Office of Management and Budget (OMB) defines a grant or grant-in-aid as money, or property in lieu of money, paid or furnished by the federal government to a grantee under a program that provides financial assistance through grant or contractual arrangements. OMB excludes from this definition technical assistance programs, revenue sharing, loans, loan guarantees, and insurance. Grants are used to provide assistance for specified purposes, ranging from studies and research to operating and construction programs and can be awarded to private as well as public organizations.

Types of Grants

The federal government supports a variety of projects, conducts a variety of programs, and receives a variety of services through the

use of grants. There are myriad ways of awarding grants and myriad purposes for which they are awarded. Grant payments range from disbursements that are all but pure subsidies to procurements that are indistinguishable from those normally made under contracts.

Descriptive titles have been applied to grants although there is no generally accepted terminology. The titles usually indicate the purposes for which the grants or the methods by which the grants are awarded. The terminology is not mutually exclusive—a particular grant could fit two or more categories. Among the more common classifications of grants are these:

- *Formula grants* are issued to grantees or recipients in an amount specified in a law passed by Congress. The funding level is expressed in a formula; little or no discretion is exercised by the grantor agency.
- *Project grants* closely resemble contracts in the objectives of the awards since the agencies agree to pay for the provision of particular services or the completion of specific projects.
- *Construction grants* are awarded specifically for the construction of buildings and such other permanent facilities as sewerage systems, hospitals, and educational institutions.
- *Block grants* are intended to consolidate funds for a broad purpose, such as education, into a single funding action on the part of a grantor agency or agencies. These grants are often made to states, with minimal restrictions on funds.
- *Categorical grants* are awarded for specific, limited objectives or purposes.
- *Noncompetitive grants* may be awarded to all applicants meeting the criteria outlined in law or the implementing regulations of the agency.
- *Competitive grants* may be awarded to a select number of applicants having the same general qualifications or characteristics; awards are often made on the basis of a formal review and ranking of proposals received.

Revenue-Sharing Grant Program

In 1971, revenue-sharing grant programs were being proposed by the federal government as a method of returning to state and local governments some of the federal control and responsibilities for public programs. The initial attempt to share revenues between the federal government and other governmental levels was

referred to as *general* revenue sharing. The concept implied a distribution of federal funds to state and local governments with limited restrictions on the use of these funds.

In addition, several *special* revenue-sharing programs were identified and proposed with the objective of consolidating many special-purpose or categorical grant-in-aid programs. The special revenue-sharing programs were to streamline the administrative procedures while simultaneously transferring the responsibility for resource allocation decisions to the state and local governments. At that time some 130 grant programs, costing the taxpayers about \$11 billion, were to be consolidated into six special revenue-sharing programs: Urban community development, rural community development, education, manpower training, law enforcement, and transportation.

The Congress enacted laws for several programs that fell within a broad definition of special revenue sharing (urban community development, manpower training, law enforcement, transportation). Additionally, general revenue sharing has been law since 1972.

In no instance has a revenue-sharing program become law with no strings attached, as conceived of by the initial designers. Recipients of revenue-sharing funds have had to comply with federal objectives, and accordingly, design accounting system and control procedures, and arrange for audits. Further, the grantees have to document their compliance with the federal law. Failure to meet the several requirements of the specific legislation will place a revenue-sharing program in jeopardy. At a minimum, the flow of funds into a governmental organization could be reduced or halted altogether. At a maximum, the recipient could be required to repay misapplied funds and could be assessed substantial financial penalties as well.

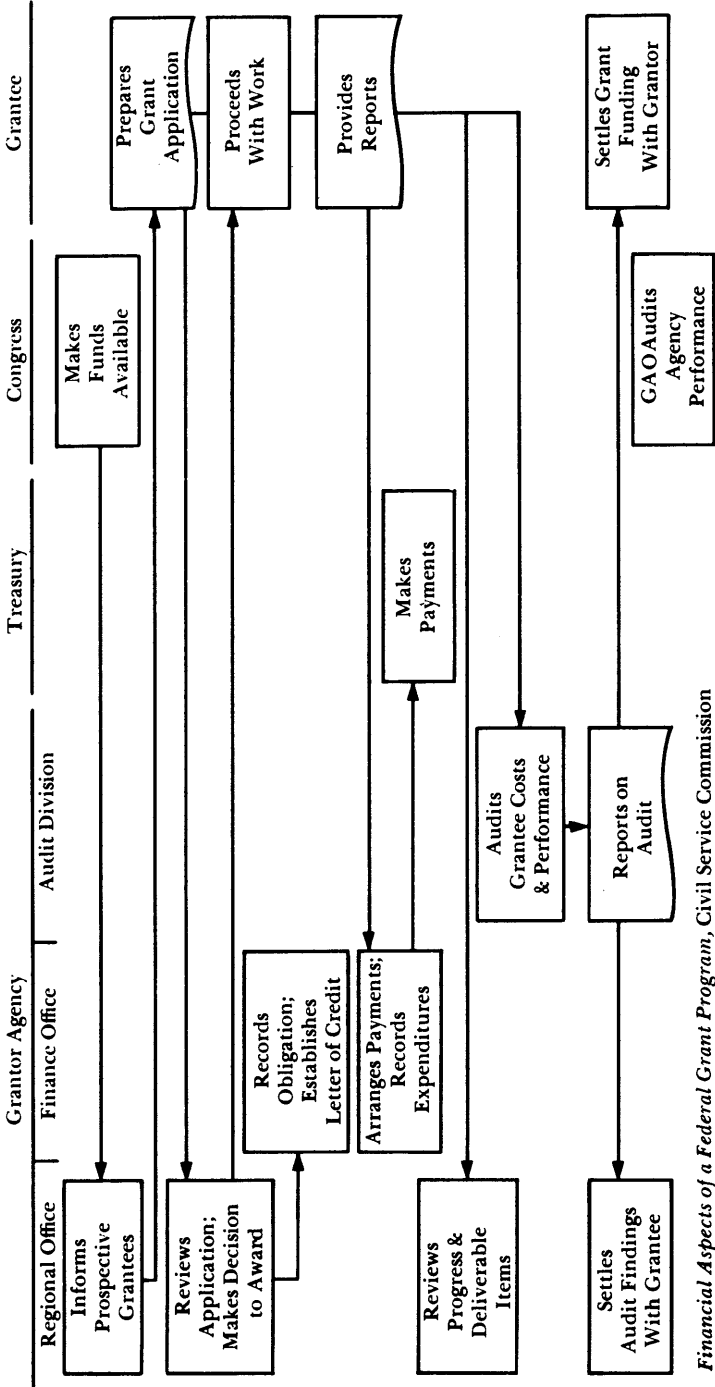
Responsibility for Grant Programs

Within the federal government, the responsibility for administering, monitoring, and reviewing grant-in-aid programs is divided between central financial control agencies and the individual executive department, agency, commission, or council which issues the grant.

A familiarity with these interrelationships is important for a public accountant who works with federal grant programs. Exhibit 1-1, page 4, is an overview of the typical grant cycle, showing

Exhibit 1-1

OVERVIEW OF THE GRANT PROCESS



Financial Aspects of a Federal Grant Program, Civil Service Commission

the interrelationships and functions of many organizations and agencies.

Central Financial Control Agencies

The central agencies are the General Accounting Office, Office of Management and Budget, Treasury Department, General Services Administration. Each of these agencies has distinct responsibilities with respect to grant-in-aid programs.

General Accounting Office The General Accounting Office (GAO) has a direct influence on the full spectrum of financial management in the federal government. This central agency makes independent reviews and audits of the manner in which federal departments and agencies are disbursing and applying the funds appropriated by Congress. The General Accounting Office was established by the Budget and Accounting Act of 1921 as a legislative agency, independent of the executive branch. As an additional assurance of independence, Congress provided that the comptroller general of the United States, who heads the General Accounting Office, be appointed by the president and serve with the advice and consent of the Senate. He may serve only one fifteen year term and is subject to removal only by a joint resolution of the Congress for specific causes or by impeachment.

The powers of the General Accounting Office are rooted in several laws that provide this agency with broad responsibilities for review, evaluation, adjudication, and reporting. Three principal responsibilities directly affect the many federal grantors and their grant programs. The GAO—

- Recommends ways and means for improving financial management, prescribes accounting principles and standards, and assists in improving agency financial management systems.
- Audits or reviews grantor financial and management systems, the efficiency of management's use of resources, and the effectiveness of the grantor's programs in achieving the objectives of the Congress.
- Assists Congress and its committees by conducting special audits, surveys, and investigations of governmental programs; and provides financial and technical advice on matters considered to be within the competence of the GAO.

Much of the policy and procedural guidance of the General Accounting Office is available to the general public and provides detailed descriptions of federal accounting and auditing require-

ments. Illustrative of the guidance provided to the federal grantor and to the auditing profession in particular are the following:

- *The GAO Policy and Procedures Manual for Guidance of Federal Agencies* sets forth the fiscal, accounting, auditing, and financial management requirements to be adhered to by all federal grantors.
- *The Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* relates to the requirements and suggestions to improve the character and quality of auditing and evaluating federal grant programs.
- The various reports of GAO audits, surveys, and investigation of governmental activities, including grant programs, set forth the GAO position with respect to the activities examined and recommendations for corrective action where necessary.
- Other GAO publications of direct interest to the public accountant involved in federal grants-in-aid include:

What GAO Is Doing to Improve Governmental Auditing Standards

Auditors—Agents for Good Government

Case study: *Illinois Use of Public Accountants for Auditing State Activities*

Examples of Findings From Governmental Audits

Illustrative report prepared in accordance with GAO audit standards: *Air Pollution Control Program, Sassafras County, Maryland.*

Questions and Answers on Standards for Audit of Governmental Organizations, Programs, Activities, and Functions

Suggested State Auditing Acts and Constitutional Amendments

This material is available from the General Accounting Office or the Government Printing Office in Washington.

Office of Management and Budget The Office of Management and Budget (OMB) has established uniform principles for determining the costs allowable under federal grant-in-aid programs as well as for reviewing the guidelines of the general and special revenue-sharing programs. It also devoted considerable effort to streamlining and making uniform the administrative procedures of these programs. The Office of Management and Budget was established in the executive office of the president, pursuant to Reorganization Plan 2 of 1970, by renaming the Bureau of the

Budget. With this reorganization, greater emphasis was placed on management and fiscal analysis.

Some OMB responsibilities affect the financial management function of all federal grantor agencies—for example, assisting the president in preparing the budget and formulating fiscal policy, supervising and controlling the administration of the budget, conducting research and promoting development of improved plans of administrative management, and providing advice for agency organization, policy, procedures, and practices.

OMB exerts considerable influence on the activities of a federal grantor through the procedures for apportioning the funds appropriated by Congress and through its budget reviews. All federal grantors must have advance OMB approval to obligate and spend funds. This control is inherent in OMB's right to approve an apportionment of the grantor agency's appropriation *before* the grantor incurs any obligation or liability.

OMB makes known its policy and procedural requirements in the form of bulletins and circulars, which are generally issued directly to the federal grantor departments and agencies and relate to specific subjects of interest to the government. Included in these publications is guidance on accounting, budgeting, and financial management relating to the operations of the grantor as well as its grant-in-aid and other programs.

Treasury Department The oldest of the central agencies, the Treasury Department, was organized in 1789. Although its role and responsibilities have changed, it continues to exercise control over the fiscal and financial management of federal departments and agencies. Three Treasury functions most directly affect the federal grantor:

- Performing functions of fiscal service operations, including accounting for public monies and issuing and processing federal checks.
- Maintaining the government's uniform central accounts for disbursing monies for most federal grantors and designating federal depositories for receiving, holding, and paying out public funds.
- Maintaining and monitoring the federal letter-of-credit system through which grantees receive funds.

The policies and procedures relating to fiscal and accounting requirements are made known to the many federal departments and agencies in a series of Treasury notices and circulars issued on specific subjects to each of the governmental organizations. In

addition, more permanent or continuing guidance is formalized in Treasury's *Fiscal Requirements Manual for Guidance of Departments and Agencies*.

As the federal disbursing office, the Treasury Department plays a vital role in agency grant-in-aid and revenue-sharing programs. It also prescribes the methods and procedures to be utilized by federal agencies in providing funds to grantees in the form of checks.

General Services Administration In May 1973, Executive Order 11717 assigned to the General Services Administration (GSA) many of the functions that had been exercised by the Office of Management and Budget with respect to financial management, systems development, procurement contracting, property management, and automatic data processing management. Included in the transfer of functions was the responsibility to exercise executive branch leadership in the financial management field. This responsibility extended to federal grants-in-aid. Subsequently, in January 1976, the functions transferred from OMB to GSA were returned to OMB.

The series of OMB circulars spelling out governmentwide regulations were reissued in 1973 and 1974 under the GSA imprint, with a new numbering sequence but essentially the same contents. Both references continue to be used by federal grantor staff and by grantees. The comparable circulars are itemized in the accompanying list.

<u>General Content of Circulars</u>	<u>OMB Circular</u>	<u>GSA Financial Management Circular</u>
Cost principles for educational institutions and nonprofit organizations	OMB A-21	FMC 73-8
Audits of operations and programs by federal organizations	OMB A-73	FMC 73-2
Cost principles for state and local governments	OMB A-87	FMC 74-4
Coordinating indirect cost rates and auditing at educational institutions	OMB A-88	FMC 73-6
Guidelines for federal agencies concerning participation by the performing organizations in the cost of research supported by federal agencies	OMB A-100	FMC 73-3

<u>General Content of Circulars</u>	<u>OMB Circular</u>	<u>GSA Financial Management Circular</u>
Uniform administrative requirements for grants to state and local governments	OMB A-102	FMC 74-7
Grants and agreements with institutions of higher education, hospitals, and other nonprofit organizations	OMB A-110	*
Grants and contracts with certain nonprofit organizations—principles for determining cost		**

* OMB Circular A-110 was issued on July 30, 1976, after financial management responsibility was transferred back to OMB.

** Proposed draft of OMB circular; not issued at publication date.

Until the return of some of these responsibilities to OMB, federal grantors and grantee organizations were becoming familiar with the newer FMC series. In the future all new documents issued will be denoted as OMB circulars. Circulars which are revised will revert to the original OMB circular number; for example, FMC 74-7 (OMB Circular A-102) has been updated and denoted as *OMB Circular A-102, revised*.

Responsibilities of Grantor Agencies

Federal grantor agencies include the individual executive department, agency, commission, or council which issues the grant.

By law, each department and agency must develop an adequate system of financial management, including planning, budgeting, accounting, property control, and internal control. The statutory requirements have been supplemented by regulations and promulgations issued by the central financial agencies as well. Pursuant to the Budget and Accounting Procedures Act of 1950, the head of each executive agency must establish and maintain systems of accounting and control designed to provide full disclosure of the financial results of the agency's activities; to provide adequate financial information for the agency's management; and to provide effective control over and accountability for all funds, property, and other assets for which the agency is responsible.

In addition to this governmentwide act and the requirements prescribed by each of the central financial control agencies, the

authorization and appropriation acts of the individual executive agencies contain provisions relating specifically to the management of their financial affairs. The laws covering some grant-in-aid and revenue-sharing programs contain provisions, for example, relating to expenditure limitations; funding allocations and criteria; ceilings on the rates or time periods for obligating the appropriated funds; and accounting, auditing, and possibly special evaluations. These requirements must be considered when the agency designs or modifies its system of accounting or internal controls.

Accountability for Grants The grantor department or agency must see to it that the purpose or objective of each grant is achieved, that grant funds are applied solely in accordance with the conditions of the grant, and that unused balances of grant funds as well as funds that were improperly applied are returned to the U.S. Treasury. Property or facilities purchased with such funds, or otherwise made available, must be utilized and disposed of in accordance with the terms of the grant or other instructions of the grantor agency, and advance payments made to the grantee under the terms of the grant must not exceed current or revised needs.

Organizational Coordination In practice, the implementation of an agency's grant responsibilities could require the coordinated efforts of several functional organizations. For example, the determinations to award, to monitor, or terminate a grant are often done by the agency's regional or program offices.

Additionally, the agency's investigating office as well as its auditors conduct reviews to corroborate that each grant program is being carried out in the manner and for the purpose intended by the program offices when the grant was made. Providing funds to support grant activities is the responsibility of the agency's finance division.

Financial Management Implementation

The responsibilities for sound financial management of a governmental grantor department, agency, commission, or council apply equally to the organizations to which a grantor disburses federal funds. These organizations may include contractors, grantees, borrowers, and others with which a financial relationship exists. To discharge these responsibilities, grantors issue policies and procedures to the recipients providing guidance to insure adherence to the intent of the Congress. Failure to comply with these

promulgations could result in the severance of financial relations.

The grantor's systems must meet all the central agency criteria and at the same time provide for full accounting and reporting of all funds transferred or disbursed to others, including grantees. The financial system and controls of an executive department or agency will encompass subsystems and functions such as the following:

- *Accounting*, including the recording, summarizing, and reporting of all fiscal transactions of the agency by such formats as the types of appropriations, programs, organizations, activities, and object classes of expenditures.
- *Management information*, including statistical and other data evidencing the activity level or accomplishments of the agency.
- *Budgeting*, including the annual presentation, monitoring, and control of funds requested from and appropriated by the Congress.
- *Procurement*, including the method of contracting for, receiving, and paying for supplies, services, and property required by the agency to perform its mission.
- *Grants management*, including the method of awarding, monitoring, and controlling the services rendered or programs operated by recipients of grant funds.
- *Property*, including control over receipts, records, inventory, and disposal of property in possession of the agency, other government agencies, contractors, and grantees.
- *Internal controls and audits*, including the policies and procedures for monitoring, preserving, reviewing, and otherwise safeguarding the agency's funds, property, and other assets.

In the case of grants, some grantor departments and agencies have prescribed the accounting, internal control, and auditing that are a condition for receipt of federal funds. The specific requirements imposed on the grantee vary with the individual grantor. Familiarization with the regulations of each of the grant agreements under which funds are received is necessary.

Funding Federal Grant Programs

Some insight into the method by which federal programs are funded is basic to a comprehension of how monies are provided to grantees. The process is of importance to certified public ac-

countants who want to do business with these public sector clients. The federal financial process, from a grantee's view, consists of three distinct phases: the budget process; the grantor's internal fiscal procedures; and financing through grants-in-aid.

The Federal Budget

The federal budget is the spending plan on which the president bases his annual message to the people and the Congress. Historically, the budget was amended and approved by the Congress, then took effect the following July in the form of appropriations to the various departments and agencies of the executive branch. With the passage of the Congressional Budget and Impoundment Control Act of 1974, the federal fiscal year was changed. Commencing October 1, 1976, the government's new fiscal year extends from October 1 to September 30.

The format and content of the federal budget have been modified over the years. The budget document is the volume containing the budget message of the president and the summary information being presented to the Congress. In the broadest sense, the budget is a group of documents:

- *The United States Budget in Brief* is a pamphlet containing concise presentations, less technical than the other budget documents.
- *Special Analyses, Budget of the United States Government* highlights specific programs and other significant presentations of budget data.
- *The Budget of the United States Government* is a compact volume containing the president's message and summary budget recommendations, as well as the facts and figures most widely used in and out of government.
- *The Budget of the United States Government—Appendix* is the text of the appropriation estimates proposed by the president for each federal department and agency, with details on various program levels.
- *Budget of the United States Government—District of Columbia* consists of estimates for the support of the District of Columbia's municipal government.

All these documents, describing the federal budget in varying detail, are available annually from the Government Printing Office in Washington. All are valuable sources of background information on federal programs, including grants. These documents

contain agency-by-agency details of programs, level of funding available from past years, number and grade level of agency staffing, and dollars of proposed program costs by types of expenditures.

The Budget Cycle

When dealing with programs financed by federal funds, the certified public accountant has to be familiar with the federal budget process. Out of this process come the funds provided to the grantee organizations that use the accountant's services. In most instances, the cycle and approval process begins within the federal department or agency at least sixteen months in advance of the time when funds reach the grantee. The full budget cycle has four identifiable phases.

- Preparation and submission of the budget by the executive branch to Congress.
- Congressional authorization and appropriation reviews.
- Implementation and monitoring of the congressionally approved budget.
- Review and audit of the manner in which the budgeted resources were applied or expended.

In recent years, certified public accountants have become increasingly involved in the final phase of the federal budget cycle, helping to review and audit grantees in an attempt to assess how well budgeted programs have been executed.

Budget Preparation Phase The president's transmittal of his budget proposals to the Congress climaxes months of planning and analysis in the executive branch. Federal grantors are required to recommend and support those programs necessary to presidential goals, policy, and direction.

Prior to October 1, 1976, during the 16-month budget process grantors evaluated their programs, identified policy issues, and made budgetary projections, giving attention both to important modifications and innovations in programs and to alternative long-range plans. The Office of Management and Budget reviewed these preliminary plans and then presented them to the president for his consideration. After reviewing the plans and considering the economic projections and revenue estimates prepared by the Treasury Department, the Council of Economic Advisers, OMB, and others, the president established general budget and fiscal policy guidelines. Individual budgets were then formu-

lated by each department and agency, reviewed in detail by OMB, and then presented to the president.

The Congressional Budget and Impoundment Act of 1974, which moved the start of the fiscal year from July 1 to October 1, also altered the time-sequence of these activities. The timetable under the 1974 act is as follows:

<u>Date of Action</u>	<u>Action Required</u>
November 10	President submits the current services budget
15th day after Congress meets	President submits his budget
May 15	President submits year-ahead request for new budget authority to continue old and enact new programs or activities

The current services budget contains the estimated outlays and proposed budget authority for the ensuing fiscal year at the same level as the fiscal year in progress and without policy changes in the programs and activities. The request for the enactment of new budget authority for new programs or activities which would continue for more than one fiscal year must be submitted for at least the first two fiscal years.

Congressional Authorization and Appropriation Phase Congressional review begins when the president formally transmits his budget to the Congress, which changes or eliminates or adds programs and increases or decreases the recommended funding. Congress then legislates the means by which revenues are to be raised to support the budget.

Under the act of 1974 the congressional budget timetable is as follows:

<u>Date of Action</u>	<u>Action Required</u>
March 15	Committee and joint committees submit reports to Congressional Budget Committee
April 1	Congressional Budget Office submits report to budget committees
April 15	Budget committees report first concurrent resolution on the budget authority
May 15	Committees report bills and resolutions authorizing new budget authority
May 15	Congress completes action on first concurrent resolution on the budget

<u>Date of Action</u>	<u>Action Required</u>
Seventh day after Labor Day	Congress completes action on bills and resolutions providing new budget authority and new spending authority
September 15	Congress completes action on second required concurrent resolution on the budget
September 25	Congress completes action on reconciliation bill or resolution, or both, implementing required concurrent resolution
October 1	Fiscal year begins

Under the historical *authorization procedures* the Congress initially enacted legislation through its authorization committees. This legislation authorized a department or agency to carry out a particular program and perhaps also set a limit on the amount that could be subsequently appropriated by other congressional committees for that specific program.

The *appropriation procedure* is more complex. The granting of budget authority—which permits an agency to enter into obligations requiring the immediate or future payment of money—is a separate action subsequent to the authorization phase. It is important to note that many authorized programs do not receive an appropriation, and no appropriation means no financial budget. Generally, appropriations must be voted by the Congress each year; but in some cases permanent budget authority is voted, under which funds become available annually without further congressional action.

Once approved by the Congress, the appropriation act is forwarded to the president for his approval or veto. If approved, the appropriation amount is apportioned by the Office of Management and Budget to the federal departments and agencies for obligation and expenditure.

The grantee's financing from the federal government is affected by the terms of the appropriation act. The appropriation has a term of availability for obligation and expenditures by the federal grantor. This availability is defined (1) as a fiscal time period, or (2) by a purpose for which funds may be obligated. An appropriation could be available for obligation on a one-year, multiple-year, or no-year basis. A no-year appropriation is available to a grantor for obligation and expenditure until the purpose designated by the Congress is accomplished or until the funds are spent. An appropriation that is not obligated or spent within the specified time is said to have expired or lapsed. Once lapsed, no further grant awards or obligations can be made by the grantor.

Implementation and Monitoring Phase After approval by the Congress and the president, the appropriated funds are available for use in accordance with the department's or agency's operating plan. The operating plan must conform with the authorization and appropriation legislation.

The following is a summary of the budgetary and other fiscal responsibilities of the organizations involved in the events leading to the obligation and expenditure of federal funds.

Federal grantors may only obligate funds in accord with administrative actions of the Office of Management and Budget known as *apportionments*. The apportionment system is a control over the effective and orderly use of the available obligational authority and, in the case of annual *appropriations*, is intended to forestall requests for supplemental spending authority.

Within a department or agency, the funds apportioned by the OMB are distributed to the various program offices by an administrative procedure known as *allotments*. The heads of the grantor program offices are generally the allottees and as such are the officials responsible for insuring that the obligations and expenditures of their programs do not exceed the apportioned and allotted funds. It is generally at the allottee level that the decision is made to fund a grant.

Once funds have been allotted, usually on a quarterly basis, each allottee is authorized to incur *obligations* on behalf of the agency. In the case of a grantee, evidence of an obligation would be the approval of a grant award instrument or the extension or modification of the earlier approved grant agreement. The obligation procedure is an internal financial control that reserves or restricts portions of the allotted funds as goods and services are ordered, grants are awarded, or other liabilities are incurred by various program offices. The amounts obligated must not exceed the total of allotted funds.

As services are obtained, goods received, or performance rendered by grantees and others, the earlier obligations are turned into *liabilities* of the grantor that must be paid. While the Treasury Department actually disburses funds, checks are issued only upon written request from the departments and agencies. No disbursements may be made unless an earlier valid obligation had been established.

Review and Audit Phase The review and audit phase constitutes the final step in the budget cycle. Federal grantors are responsible for assuring—through their own review and control systems—that the obligations they incur and the resulting expenditures and disbursements conform with the provisions of the

authorizing and appropriation legislation. Most such reviews take the form of audits performed by agency audit staffs, state, and local government auditors, and certified public accountants.

Federal Grantor's Financial Process

With respect to grant programs, federal grantor departments and agencies have several responsibilities including the following:

- Assuring that the purpose or objective of the grant is achieved.
- Determining that grant funds are applied solely in accordance with the condition of the grants.
- Insuring that unused balances of grant funds as well as improperly applied funds are returned to the U.S. Treasury.
- Controlling property and facilities purchased with grant funds.
- Determining that advance payments to grantees under grants do not exceed current or revised expenditure needs.

The grantor's finance function accounts for the funds to support grant activities. The grantor's investigation or audit function reviews, audits, and surveys grantees.

Within the federal grantor organization the financial process related to the funding of grants consists of several required controls or checks. In summary, the financial process includes the following tasks:

- Once a grant application has been reviewed and accepted by the grantor (a step not necessary with respect to revenue-sharing grant assistance), a *preaward* or *commitment* form is generally completed to make a reservation of the grantor's unobligated funds for the purpose of the approved grant application.
- Subsequently, a *grant award* is made; generally, a grant agreement is executed between the grantor and the grantee.
- Next, the grantor may permit the establishment of a *letter of credit* in favor of the grantee, or provide for a *check* to be drawn, or place the grantee on a *cost reimbursement* basis.
- The Treasury Department then prepares and mails checks at the request and pursuant to the instructions received from the grantor.

These tasks are discussed in greater detail in later chapters.

Methods of Financing Grantees

Grantees can be financed by one of these three different methods.

Cost Reimbursement Method Many grant-in-aid programs are funded on a cost reimbursement basis. This is the least desirable method from the view of the grantee since it cannot receive payment for expenses until a report and claim have been submitted and approved by the grantor. In effect, the grantee is forced to finance the grant efforts. Depending upon the efficiency of the grantor's payment system, the grantee could be out-of-pocket considerable sums of money for significant periods of time.

To the extent possible, grantees should be advised to accept this payment method only when there is an advance agreement that invoices or claims will be paid by the grantor within a specified period.

Advance Method Some federal grantors permit full or partial advance funding of anticipated grant expenses. Advance funding by check is primarily utilized when the grant is below a certain amount or for a short time. Often, an initial advance is provided to the grantee and a method of reimbursement is established whereby the grantee submits regular bills to the grantor. Payments by the grantor then replenish the initial advance.

Letter-of-Credit Method Most governmental grantees and many nonprofit and educational institutions are permitted to make withdrawals under a letter-of-credit. This method of federal financing is designed to provide the grantee with cash shortly before the date the grantee must make payment. Once established, the letter-of-credit method is extremely efficient. The grantee does not have to get an expenditure claim approved before receiving cash. Reports of expenditures must be submitted to the grantor in accordance with the grant conditions. Withdrawals under the letter-of-credit method can be at intervals that correspond to the cash requirement cycles, which are often more frequent than the reporting cycles.

2 Funding and Financing of Federal Grants

An understanding of the government's funding and financing process with respect to grants is of considerable value in the effective management of a program at the grantee level. With few exceptions, government officials adhere to a formal process and have no authority to deviate or make significant exceptions for the benefit of individual grantees. Terms are often used interchangeably in describing the financial process. Throughout this chapter, *funding* refers to the federal actions or steps that precede the actual disbursement of cash to a grantee. Financing refers to those actions taken by a grantee which lead to the receipt of federal money to operate the grant program.

This chapter explains the details of preparing, submitting, and reviewing a grant application, executing a grant agreement, and funding the grant project or program.

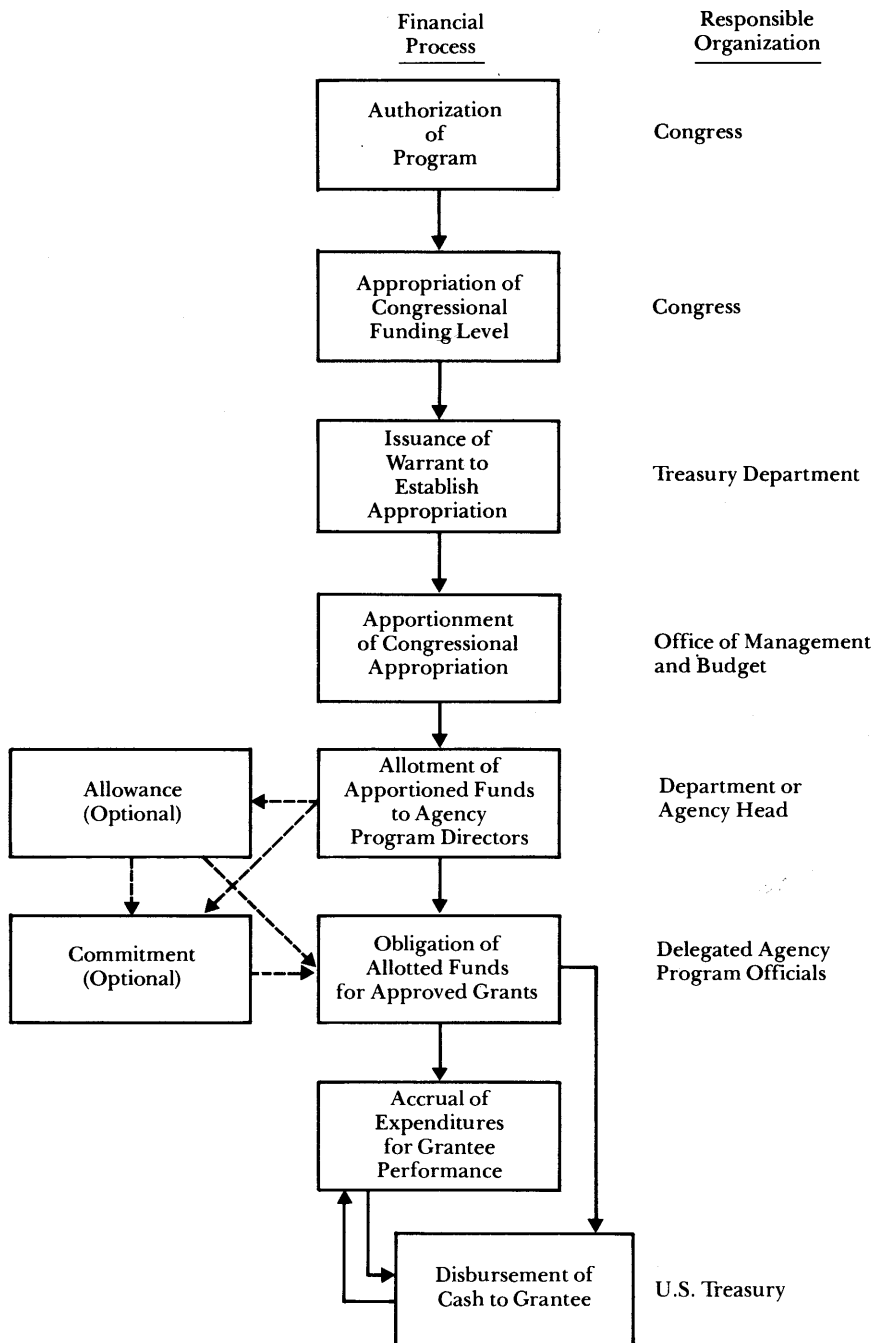
Funding of Federal Grant Programs

Until a grant program has been authorized and funds have been appropriated by Congress, federal officials have no authority to make commitments on behalf of their agency. After congressional approval has been received, federal officials have the authority to commence a program involving the expenditure of funds and binding the government for liabilities incurred by officials of these programs. This authority, while broad, must be exercised in compliance with the congressional intent which appears in legislative history records and objectives and restrictions set forth by the Congress in legislation.

Exhibit 2-1, page 20, illustrates the several steps in the financial process, in which many organizations have a responsibility: the Congress, the Treasury Department, the Office of Management and Budget, and the grantor department or agency.

Exhibit 2-1

FINANCIAL PROCESS OF FEDERAL GRANTS



The obligation step and following actions have a direct impact upon the grantee. The grantor evaluates applications received from many organizations and governments. The conclusions or decisions are reflected in formal executed grant agreements. The grant agreement is the authorization for a grantee to commence the actions that will result in the receipt of cash to support the approved grant program.

Applying for Federal Grants

Federal grants may be classified into two general groupings: non-competitive and competitive. All applicants for noncompetitive grants who meet the criteria outlined in the law or implementing regulations of a federal grantor agency are eligible to apply. Applicants for competitive grants must meet the general qualifications for eligible organizations; however, legal restrictions limit the number of grants that can be awarded. Formula grants, are usually noncompetitive, but other grants—project, construction, block, categorical—could be competitively awarded.

Regardless of the type of grant, the grant process is in many respects similar.

Establishing Federal Eligibility Criteria

No grant may be awarded by a federal grantor unless there exists an approved program for which the grant application may be considered. Each federal grantor establishes uniform, but not inflexible, standards of eligibility for each of the grant programs under its jurisdiction. These standards, implementing regulations, and other procedures related to applying for federal money are likely to be published in the *Federal Register*¹ by the responsible grantor.

These eligibility criteria emphasize the nature of the grant awards that will be made and identify the types of grantee organizations that will be considered, the goals and objectives of the program, and the extent of federal financial participation.

An applicant must in general have the power under state and

1. A daily publication of the General Services Administration, available to the public on a subscription basis, containing the text of executive orders, federal program administrative regulations, and other information of interest to organizations involved with the federal government. Rules and regulations appearing in the *Federal Register* are compiled annually into the Code of Federal Regulations.

local laws to develop plans or conduct programs in the field for which it is requesting a federal grant. The prospective grantee may have to be officially designated by the jurisdictional authority having legal authority to conduct such programs. The objective of this requirement is to stimulate the development of comprehensive planning that will represent the official thinking of a community or geographic area.

A project notification and review system facilitates coordination of federal, state, and local government planning, development, and services. Pursuant to OMB Circular A-95 (Evaluation, Review, and Coordination of Federal Assistance Programs and Projects) a project notification and review system has been established for many federal grant programs. This system includes a network of statewide and areawide comprehensive plans to evaluate the significance of proposed grant projects as they relate to the plans or programs of particular state agencies and local governments.

Grant Submission Requirements

The Office of Management and Budget has set forth uniform administrative requirements for grants-in-aid to state and local governments in OMB Circular A-102. In Circular A-110, OMB prescribes uniform administrative requirements for grants to institutions of higher education, hospitals, and other nonprofit organizations. These requirements have been implemented by the various federal grantor agencies with varying degrees of conformance. The submission requirements and the steps of the process are generally similar, whether the applicant is a government agency or a nonprofit organization. Typically, the process includes the following steps:

- A preapplication or advance request is made by the applicant to the federal grantor. The objectives of this step are to (1) establish communication between the applicant and the grantor, (2) determine the applicant's eligibility, (3) determine the relative competitiveness of the applicant's proposal, and (4) determine whether the application is likely to be funded before significant development costs are incurred.
- A formal application is made for a grant. The application is a complete proposal not unlike the presentation made by the corporations in competition for a contract.
- The application is reviewed in detail by the grantor, often in accordance with documented grant review and processing procedures which provide for coordination with other federal grantors and state and local governments. The proposed

project is examined as to objectives, scope, budgets, fiscal details, staffing competence and availability, work plan or study approach, and legal and other requirements.

As a result of this review, the scope of the negotiated program could be significantly different from the scope in the application. Extreme care should be exercised before accepting a grant agreement that reflects a modified scope. It is the position of the General Accounting Office that acceptance of a grant from the United States creates a legal duty to use the funds or property in accordance with the conditions of the agreement. Grants, like contracts, may be terminated by a federal grantor for convenience of the government or for cause. Should a grant be terminated for cause, payments to grantees or recoveries by the grantor are in accord with the legal rights and liabilities of the parties. The comptroller general's position is that, at the time of termination, unused or improperly applied funds are to be collected by the grantor agency, appropriately adjusted for any offset due to the grantee.

Preparation of Grant Application

A grant application is a proposal by an applicant, developed in considerable detail, which contains information such as the following:

- Purpose, scope, objectives, and timetable for the development, performance, or completion of the applicants work program.
- Project organization, administration, and staffing, including the education, experience, and related knowledge of key personnel who will be employed by the grantee.
- Requirements to coordinate the application with other organizations and governments that might have an interest or a legal obligation in the project.
- Financing formula, including the amount, method, and payment schedules of the various parties.
- Legal and other requirements for which clearances or approvals must be obtained.
- Detailed financial budget, with specifics on the total project and time-phased costs for each major project or task of the grant program; the organizations or individuals responsible for performing the specific work tasks, including subgrantees and delegated program participants, the funding formula, and volunteered or required matching contributions.

More complicated grant applications often require that the applicant establish milestones or deliverables to permit the periodic determination of progress. Grantors commonly require that the work program be displayed in a Gantt chart and PERT chart (program evaluation and review technique) format to facilitate review of a complex work program. These devices are usually incorporated as progress monitoring tools once the grant agreement is executed.

Execution of Advance Understandings

With a few exceptions, grantors have established standard grant conditions to protect the federal government and insure that the objectives of the grant are met. These general and specific conditions are often accepted without change by grantees. Though few grantees make the effort, they do have the option to secure the grantor's assent to an advance understanding setting forth the grantee's unique operating conditions, differing procedures, alternative cost accounting methods, and other conditions that might preclude full compliance with the conditions of the grant agreement.

Under any grant the reasonableness, allowability, or allocability of certain items or costs may be difficult to determine. This is particularly true of nonprofit institutions, which are diverse in nature and purpose and are not subject to competitive restraints. To avoid subsequent disallowance or disputes, it is important that applicants about to enter into grant agreements with the government seek a formal advance understanding for those categories of the grantor's agreement for which it will later be difficult to assess reasonableness, allowability, or allocability of costs.

Failure to negotiate an advance understanding could subject the grantee to disallowance at the time of final audit. The resolution of audit disallowance actions can be time-consuming and of considerable expense to a grantee. Further, final audits are usually made well after the grant is completed, at a time when project management and personnel have been dispersed to other assignments and knowledgeable staff are no longer available to assist in the preparation of a defense. Inability to overcome a disallowance action may compel the grantee to make a financial refund to the grantor.

Grantor Review

For grants of any dollar significance, federal grantors will attempt to determine that the applicant is a responsible and qualified or-

ganization, capable of performing services of the scope outlined in the application and exercising prudent business practices in the control of the federal funds and property for which it might be accountable as a grantee. Often, in advance of executing the grant agreement, a grantor will attempt several actions to ascertain that the applicant has or appears capable of prudent business management practices. These actions may include—

- A survey of the applicant's accounting and management control systems by conducting on-site tests of the procedures in effect for current activities or by consulting other government grantors with which the grantee may have done business in the past.
- An insistence on special bank accounts and the early contribution of the applicant's share of funding.
- An assessment of the applicant's management personnel.
- An evaluation of personnel practices.
- A check on controls for the protection and preservation of property, supplies, and equipment.

The objective of such inquiries is to assess the applicant's ability to administer the proposed program. Upon execution of the grant agreement, the grantee assumes a diversity of responsibilities:

- Satisfactory and timely completion of the work, services, or performance set forth in the agreement.
- Sound management and control of personnel, including quality, performance, and personnel practices.
- Adequate control over government funds and property.
- Installation, maintenance, and adherence to an adequate system of internal accounting controls.
- Effective control over withdrawal of funds and the timely provision of all matching or local contributions.
- Surveillance of all subgrantees, contractors, and delegated programs under the grant program.
- Submission of timely financial and progress reports.
- Orderly closeout of the grant at the completion or termination of the program.

At the time of completion or termination a grantee is responsible for the conclusion of several administrative tasks and for the final settlement or adjustments due to or from the federal grantor.

Grant Closeout Requirements

It is government policy that there be a final accounting and settlement of the receipts and disbursement of monies under a federally supported program. This settlement must include the satisfactory accounting for and disposition of any properties furnished by the grantor or purchased by the grantee with federal funds. In sum, federal grantors generally require:

- That the grantee submit a final financial report within a specific period, usually sixty to ninety days after completion or termination of the grant.
- That a final report on the progress, accomplishments, or other results of the program be submitted for the grantor's review and approval.
- That, at the discretion of the federal grantor, a final audit be made, with the grantor agency retaining the right to recover an appropriate amount after fully considering the audit recommendations on any disallowed costs identified during this audit.
- That a final inventory be made of all nonexpendable property furnished by the grantor or acquired by the grantee with federal funds.
- That procedures be implemented to retain or dispose of the grant property in accordance with the guidelines provided by the grantor.

It is important that grantees understand the applicable closeout procedures early in the grant period to insure sufficient time to clarify the details and information that will be required for a proper and expeditious settlement of the grant.

Financing of a Grant

As discussed in chapter 3, the execution of the grant agreement creates a legal obligation on the part of a federal grantor to the grantee. The grantor is liable for all proper claims made by the grantee. As the grantee withdraws money under a letter of credit, receives advances by check, or makes claims for reimbursement, the grantor reduces the amount of its recorded obligation accordingly. Some exceptions to this accounting are also discussed in chapter 3.

Unless the executed agreement contains a condition that per-

mits the charging of pregrant costs, the grantee is not allowed to incur and claim costs for the grant project in advance of the effective date of the agreement. Unless approved by the grantor, such costs have to be borne by the grantee.

Incremental Funding of Grants

It is important that the grantee be clear about the amount of the obligation recorded in the grantor's official records. It is common for a grant agreement to be negotiated for a specific sum, possibly covering several time periods. However, the federal grantor may obligate itself to pay only a portion of the total amount initially, the remainder of the financial liability being met in subsequent periods, depending on the availability of grant funds.

Under these conditions, the grant is said to be incrementally funded and the grantor is liable for only the amount allotted and obligated for the grant. The incremental funding clause serves to limit the liability of the grantor. The obligation of additional funds increases the grantor's liability up to but not exceeding the amount cited in the modified grant agreement, should the subsequent fundings be equal to the grant amount.

Grantee expenditures in excess of the amount obligated on the grantor's records are at the risk of the grantee.

Payment of Federal Money to Grantees

Federal grantors use many methods to provide payments to grantees. The method selected for a specific grant will depend on such factors as these:

- The dollar amount and time period of the grant.
- The financial independence and available resources of the grantee organization.
- Whether the grantee is a profit, nonprofit, or governmental organization.
- In the case of advances, whether there is to be a continuing relationship for at least twelve months and whether the advance in this period will exceed \$250,000.
- The grantee's willingness to adhere to procedures that will minimize the time lapse between the transfer of funds and their disbursement.
- The extent to which the grantee's financial management system provides for accountability and fund control over the advanced funds.

The several methods of financing grant programs can be grouped into three categories: (1) cost reimbursement after an expenditure report has been submitted by the grantee, (2) advance funding in total or in part, and (3) letter of credit utilizing Federal Reserve facilities and Treasury Department disbursing offices. In addition to these three methods the Department of Health, Education, and Welfare utilizes its own Federal Assistance Financing System.

The selection of the method of financing a grant project is generally at the discretion of the grantor.

Cost Reimbursement Method Some federal grantors adhere to a cost reimbursement basis of financing their grantees. This basis is preferred in the absence of continuing relationships with the grantee for smaller grant projects or when the grantee's financial management system seems inadequate.

Under this method the grantee is permitted to submit periodic claims (public vouchers) for reimbursement after the funds have been disbursed for grant purposes. This method has the advantage of minimizing the federal money in the hands of the grantee, but could cause a financial hardship to the grantee. Considerable problems arise when for any reason the federal grantor is slow in honoring the reimbursement claim.

Exhibit 2-2, page 29, shows how payment is obtained under the cost reimbursement method.

Advance by Check Method Under certain circumstances, grantors issue Treasury checks to grantees when the advance is below a certain amount or when the grant is for a short period. The grantor must comply with Treasury Department Circular 1075, which says in part that advances by check may be made—

- If the annual advance is less than \$250,000.
- If the annual advance aggregates more than \$250,000 but there is not a continuing relationship for at least one year.
- If advances by check are only enough to meet the grantees current disbursement needs.

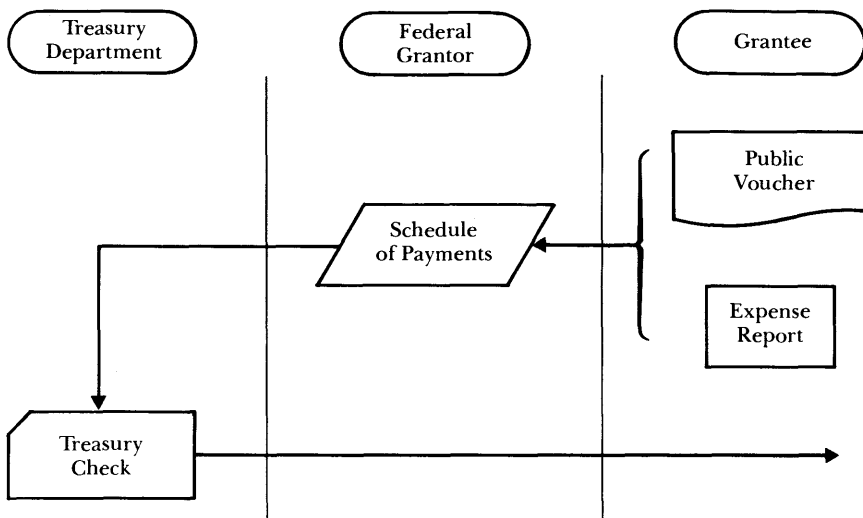
Grantor agencies must schedule advance check payments so that grantees receive the funds immediately prior to disbursement. If disbursements are made biweekly, for instance, Treasury checks are issued biweekly.

The check issuance cycle for advance payments is similar to the cycle for reimbursing grantees illustrated in exhibit 2-2.

In the case of advances, the grantee may have to submit an

Exhibit 2-2

REIMBURSEMENT OF EXPENDITURES OR REPLENISHMENT OF ADVANCE TO GRANTEE



invoice or public voucher to formally request the advance. The grantor prepares a voucher and schedule of payments, a document advising the Treasury Department to prepare a check for a specific amount, payable to a particular grantee, and chargeable to a designated appropriation. The check may be sent directly to the grantee or it may be returned to the grantor agency for transmittal. This latter method is often used when the grant is to be funded in advance. At the time of grant execution, the check usually accompanies the notification of grant award sent to the grantee.

Letter-of-Credit Method The Treasury Department requires that all grantors administering grant programs pay by letter of credit whenever possible. This is a fund and interest conservation technique that has as its objective the minimizing of cash in the hands of grantees. This reduces the interest payment period and the cost of money to government. Under this method, the federal grantor establishes a line of credit through the Treasury Department. The procedure may utilize the facilities of the Federal Reserve System and the grantee's local commercial bank or, alternatively, the Treasury Department's own regional disbursing offices.

Exhibit 2-3, page 31, illustrates the distribution of the various forms required to initiate a letter of credit. Included among them are these:

- An *authorized signature card* is a card identifying the authorized certifying officer of the grantee or the grantor agency, as required by the specific grant program. The Treasury Department must maintain a file of this record.
- A *letter of credit* is a form completed by the federal grantor, with copies forwarded to the Treasury Department and the grantee. This form identifies the Federal Reserve Bank or Treasury disbursing office, identifies the grantee, and establishes the total amount of the letter of credit, periodic withdrawal amounts, and the period for which the letter of credit is to be available.
- *Request for payment on letter of credit* is a form prepared by the grantee in accordance with the conditions of the letter of credit to withdraw funds required to operate the program. The form provides for a reconciliation of balances, withdrawals, and other transactions under the letter of credit and for a classification of the program for which the funds are being requested.

For some years the Department of Health, Education, and Welfare (HEW) has maintained a simplified financing procedure referred to as the Departmental Federal Assistance Financing System (DFAFS). This system is used to provide financing to most institutions of higher education, some nonprofit institutions, and some states. It is a consolidated letter of credit and direct payment system. All payments to a grantee under this system are maintained by individual grant to permit HEW to periodically request reimbursement from each appropriation for the amount of funds it has paid to grantees. The advantage to a grantee with several HEW grants is that it can receive all its federal funds from a single source, thus minimizing the agency procedures it must adhere to, eliminating the need to file a variety of forms, and giving both the grantee and the grantor better control over the money outstanding at any one time.

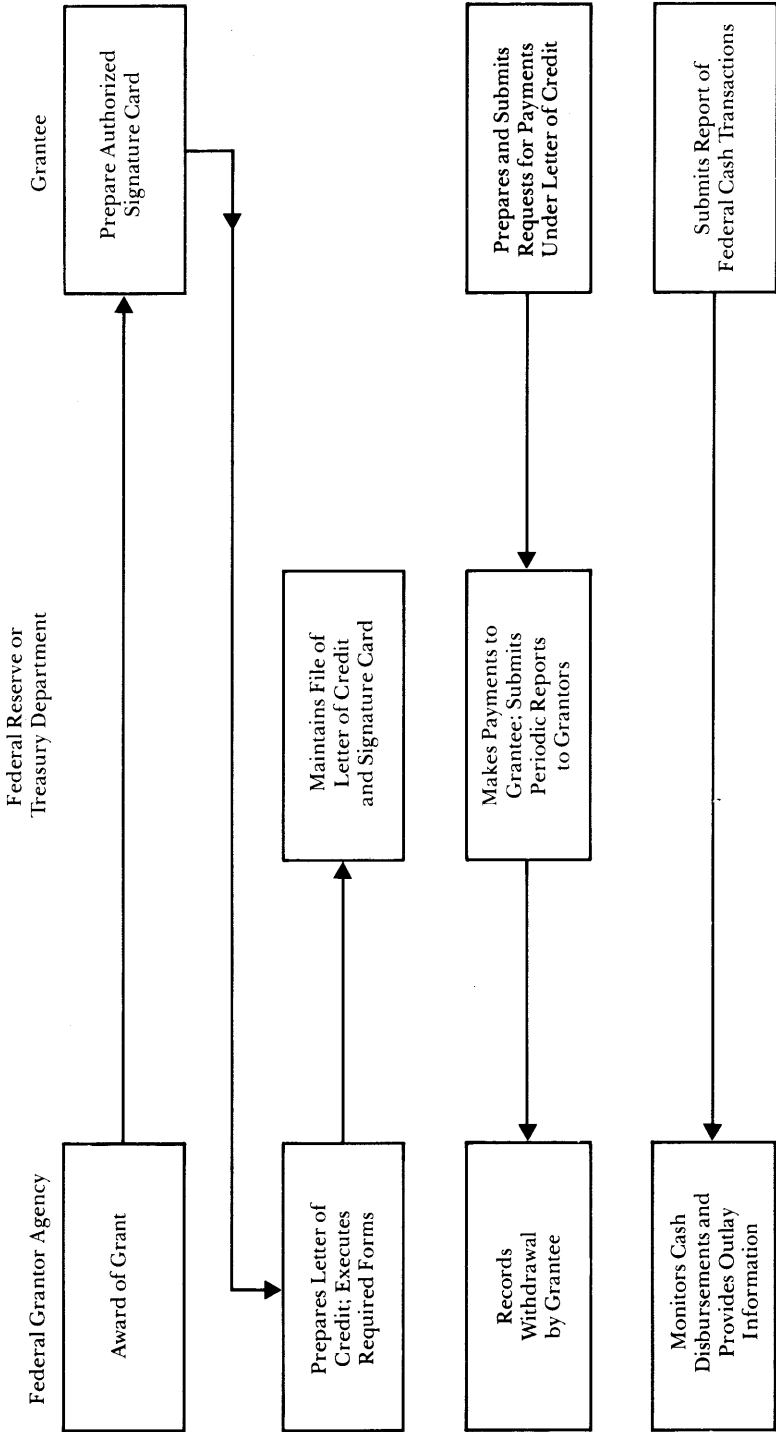
Letter-of-Credit Conditions

Grantors using the letter-of-credit method are required to include a clause in the funding agreement whereby the grantee agrees to

- Initiate cash drawdowns only when actually needed for disbursement.
- Timely report cash disbursements and balances as required by the grantor.

Exhibit 2-3

LETTER OF CREDIT FUNDING PROCESS



- Impose the same standards of timing and amounts on secondary recipients, including the reports of cash disbursements and balances.
- Maintain a financial management system for effective control and accountability for federal funds.

The administrative requirements with respect to state and local governments are set forth in OMB Circular A-102; and similar requirements for institutions of higher education, hospitals, and other nonprofit organizations are specified in OMB Circular A-110.

Reporting Requirements

Reporting requirements are not uniform among the several federal grantors with respect to nongovernmental grantees. However, uniform governmentwide reporting requirements have been established by the Office of Management and Budget for state and local governmental grantees.

Financial Status Report Each federal grantor is required to obtain from its governmental grantees a standard report, the financial status report, showing the status of funds for all nonconstruction grant programs. As an alternative, federal grantors may substitute another form, the request for advance or reimbursement, when this latter form provides information that meets the needs of the grantor. If the request is adequate, the financial status report is required only at the completion of the grant. Similar reports are required from nongovernmental grantees.

The financial status report may be on a cost or accrual basis. When accrual reporting is required, and the grantee's records are not normally kept on the accrual basis, OMB Circular A-102 allows the grantee to develop such information through an analysis of records on hand or on the basis of best estimates. The grantor agency determines the frequency of submission, but not more than quarterly or less than annually. A final report is required at the completion of the grant.

Report of Federal Cash Transactions Each grantor must obtain the standard report of federal cash transactions from governmental grantees when funds are advanced through letters of credit or Treasury checks. This report is used to monitor cash advanced and obtain outlay information for each grant.

The report of federal cash transactions must be submitted quarterly. For grantees with annual grants of \$1 million or more,

monthly reporting may be required. When monthly advances do not exceed \$10,000 per grantee, this reporting requirement may be waived.

Outlay Report and Request for Reimbursement for Construction Programs and the Request for Advance or Reimbursement A separate standard report may be required by federal grantors for construction grant programs. A federal grantor may desire that the outlay report and request for reimbursement be submitted monthly for construction programs. Should the grantor so determine, a less detailed standard report, the request for advance or reimbursement, could be substituted for the outlay report. The request for advance or reimbursement must be adopted by each federal grantor for all nonconstruction grant programs when letters of credit or predetermined automatic advance methods are not used. Grantees are authorized to submit requests for advances or reimbursement at least monthly when letters of credit are not used.

3 Accounting by a Federal Grantor

The accounting process within a federal agency includes recording and reporting by appropriation, apportionments, obligation, expenditure, and disbursement for grants and other transactions. The requirements imposed upon each grantee for recordkeeping and disclosure generally are related to the grantor's need to comply with standards prescribed by the General Accounting Office, instructions of the Office of Management and Budget, issuances of the General Services Administration, and the laws under which the Congress established the grant-in-aid program. This chapter describes, in summary, the internal accounting process of a federal grantor and outlines the integral nature of the grantee's reporting to the grantor's own records.

The General Accounting Office prescribes general standards of management control, accounting, and reporting to be observed by agencies of the executive branch. However, each agency designs its own accounting system and controls, including the account and account coding structure, subsidiary records, and financial procedures and practices.

Fund Accounting

The predominant system of accounting among executive agencies is fund accounting related to individual congressional appropriations. In an accounting sense, each appropriation is a legally earmarked fund of money or resource that must be controlled, from inception to expiration, by the responsible agency. An agency's financial system must be capable of accounting for different transactions within a fund. The award of a grant would be such a transaction from the grantor's view.

Account Structure

The federal account structure consists of the transaction classification system and the accounting records of the grantor, segregated by the specific appropriation fund. The accounts—usually maintained on the double entry basis—reflect transactions relating to assets, liabilities, fund balances, revenues, and expenditures. Only accounts appropriate to a particular kind of undertaking are maintained.

Depending upon the nature of the fund to be accounted for, an agency maintains certain groupings of accounts, except where a separate group is not warranted to meet full disclosure requirements. The following are the more common groupings:

- *Balance sheet accounts* include assets, liabilities, and investments of the federal government for an agency whose operations are supported by congressional appropriations.
- *Income and expense accounts* are applicable to a business operation. Income accounts are records of fees and the proceeds from sales. Expense accounts record such items as cost of goods or services sold as well as operation, maintenance, administrative, and other expenses.
- *Other accounts*, such as the general ledger accounts maintained for net worth (reflecting the federal investment), provide details about the status of appropriation balances.

Further, the grantor's account structure must permit the recording of expenditures by organizational units, functions, and object classes.

Integrated Federal Fund Accounting

A federal grantor's accounting system must be designed to accommodate the integrated and multidimensional accounting and reporting requirements of the federal government. In addition to the summary accounts (showing federal assets, liabilities, investments, and expenditures), the system's subsidiary account structuring and integrated coding must also provide for needs such as the following:

- Financial statement and reporting requirements for each organization and suborganization.
- Budgetary control and accounting.
- Accrual basis of accounting.
- Cost accounting.
- Property accounting.

Uniqueness of Federal Systems

The unique characteristic that sets a federal grantor's accounting system apart from commercial systems is the incorporation of fund and budgetary accounts into the more common asset, liability, net worth, revenue, and expense accounts.

Budgetary Accounts The insertion or integration of budgetary accounts into an agency's account structure is to insure that appropriation and other fund balances are neither overobligated nor overexpended. Either action would be a statutory violation for which a reporting would have to be made immediately and directly to both the president and the Congress. As safeguards, many legislative, executive, and administrative controls have been enacted into law.

Accounting by Fund Each federal agency is an accounting entity that must be capable of rendering reports on its stewardship agencywide for all funds. What is more, the accounts must be structured so as to permit the full disclosure of receipts, disbursements, and outstanding obligations of every appropriation or fund for which the agency is accountable.

Exhibit 3-1, page 38, outlines the organizational and account relationships involved in accounting for a federal appropriation. Each appropriation must be accounted for by the federal agency as a separate fund. Obligations, expenditures, disbursements, and other transactions must continually be related to a specific congressional appropriation. This fiscal integrity of each appropriation is maintained throughout the life of the appropriation. At any one time, a grantor may be responsible for several appropriations.

Appropriation and Apportioned Status As mentioned, the agency's overall general ledger must provide for the full segregation of financial data by appropriation. The same set of accounts must also be capable of providing the status of the appropriation in relation to the apportionments made by OMB.

Program or Allottee Within the single accounting system the agency maintains the financial status of each program office by monitoring the allotments of funds to certain officials. In the case of grant-in-aid programs, the approving official is generally an allottee.

Functional Accounting Depending on the size and geographical

Exhibit 3-1
FEDERAL AGENCY ACCOUNTING PROCESS

<u>Appropriation Process</u>	<u>Organization</u>	<u>Formal Documents</u>	<u>Pro-Forma Entries</u>		
			<u>General Account</u>	<u>DR</u>	<u>CR</u>
Appropriation Law Passes Authority to Withdraw Funds	Congress Treasury	Public Law Treasury Warrant	Balance With Treasury Unapportioned Appropriations	X	X
Apportionment of Funds	Office of Management and Budget	Apportionment Schedule	Unapportioned Appropriations Unallotted Appropriations	X	X
Allotment of Apportionment	Federal Agency Head	Allotment Advice	Unallotted Appropriations Unobligated Allotments	X	X
Obligation of Funds	Federal Program Officials	Grant Contract Purchase Order Interagency Agreement Loan Agreement	Unobligated Allotments Unliquidated Obligations	X	X
Liquidation of Obligations	Federal Program Officials	Grantee Financial Reports Vendor Invoices Receiving Reports Transfers Between Agencies Payroll Vouchers Travel Vouchers	Unliquidated Obligations Expended Appropriations	X	X
Record Assets, Expenses	Federal Program Officials	Grantee Financial Reports Vendor Invoices Receiving Reports Transfers Between Agencies Payroll Vouchers Travel Vouchers	Assets Inventory Expenses Accounts Payable	X X X	X
Payment of Funds	Treasury	Schedule of Voucher and Payments Prepared by Federal Agency	Accounts Payable Balance With Treasury	X	X

location of a federal program and the agency's organization, the allottee may be required to subdivide the allotment in such a way that each suballotment, program function, or activity is identifiable.

Capital or Current Operations Every agency must also make a distinction between capital expenditures and current operational expenditures. This distinction between capital and current operational expenditures may be required in accounting for transactions throughout the obligation, expenditure, and disbursement phases of the program.

Accounting for Federal Funds

Budget Process

Legislation to centralize responsibility for financial matters was enacted in 1921 with the Budget and Accounting Act, generally recognized as the first federal budgetary legislation. This act provided for a national budget system and an independent review of the total expenditures by the executive branch. It placed the budget system under the Treasury Department. Later the function was transferred to the executive office of the president, specifically the Bureau of the Budget, now known as the Office of Management and Budget. In addition, the act established the General Accounting Office as an organization to assist Congress in monitoring the execution of the budget. With the passage of the Congressional Budget and Impoundment Act of 1974, the Congress established its own budget office. The budget process is described in more detail in chapter 1. The appropriation requests are elements of the budget submitted annually by the president. Most agencies have budget authority only as voted each year by Congress. However, a program may be given permanent budget authority, under which the funds become available annually without further congressional action.

Appropriation and Expenditure Process

As an appropriation passes through the various stages, several organizations are charged with its recording, accounting, obligation, and expenditure. Fulfilling these fiscal responsibilities may

take several years. The following is the appropriation sequence:

1. The Congress appropriates funds.
2. The Treasury Department issues a warrant granting an agency the authority to withdraw funds for disbursement.
3. The Office of Management and Budget apportions the appropriated funds to each agency.
4. The head of an agency allots monies to other officials within the agency.
5. The agency's program officials obligate funds, incur expenditures, and approve the amount of funds to be disbursed.
6. The agency's fiscal officer certifies to the validity of funds to be disbursed.
7. The Treasury Department makes the cash disbursements that settle federal obligations and debts.

Each appropriation must be separately accounted for. At any one time an agency may be responsible for several appropriations.

- *General fund appropriation expenditure accounts* are established to record transactions arising under congressional authorizations permitting the use for public purposes of any resources not otherwise appropriated.
- *Special fund accounts* are established to record the receipt and disbursement of government funds earmarked under the law for specific purposes.
- *Trust fund accounts* are established for fund receipts held in trust to meet the costs of specific programs in accordance with an agreement or statute and to support a business type activity.
- *Transfer appropriation accounts* are established by one agency to receive allocations of funds and later to disburse funds for another agency. The transfer is considered a nonexpenditure transaction at the time of transfer or allocation.

Appropriation Warrants

Regardless of the appropriation made by Congress, no federal agency has any authority to obligate and spend money until an appropriation warrant has been issued by the Treasury Department. Once the warrant is issued, funds appropriated to agencies are made available on the books of the Treasury. The warrant forms the basis for recording the appropriation in the central

accounts of the Treasury Department and on the accounting records of the agency.

The agency makes an accounting entry equal in amount to the entry appearing in the central accounts. An entry is made for each appropriation; subsequent obligations, accrued expenditures, and disbursements are referenced to the same appropriation. The agency's entry establishes the obligational authority—in other words, the right to obligate—as an asset on the agency's records and recognizes the total, but unapportioned, appropriation of the Congress.

Accounting for Apportionments

The Congress appropriates funds, but these funds are not available to federal agencies for expenditure until the Office of Management and Budget apportions them. Amounts apportioned limit the obligations or expenditures that can be made by an agency. In federal financial management, the process of apportionment has several purposes.

The apportionment or reservation of funds prevents the over-obligation or overexpenditure of an appropriation. The system of apportionment is dependent upon the manner in which funds are made available by Congress since apportionment actions must be consistent with the intent of Congress in making the appropriation. Depending on the purpose or nature of the appropriation, an apportionment may be for a calendar quarter, for the year as a whole, or for some other time periods when such periods are pertinent to program activities, thus regulating a grantor's rate of expenditure.

Accounting for Allotments

The General Accounting Office requires that an agency's accounting procedures provide for recognizing the apportioned appropriations as well as for subdividing or allotting funding authorizations. This gives control over the expenditure of funds and insures compliance with any applicable funding limitations.

An agency official responsible for any agency program is formally provided with funds to support an approved budget level by an advice of allotment. Such authorization would be required, for example, by the official responsible for a federal grant program. Allottees may delegate the authority to approve the reservation of funds for approved grant applications. The legal obligation of the grantor does not arise until the formal grant agreement is executed.

Obligation of Funds The term *obligation* has both financial and legal meaning within the government. From the financial viewpoint, an obligation must be recorded to restrict appropriated funds for future expenditure. The obligation and expenditures must be in accordance with the purposes determined by Congress and set forth in the agency's appropriation legislation. The legal definition of an obligation is precise and prescribes specific obligation instruments, along with the consequences of overobligating and thus overspending an agency's appropriated funds.

In federal accounting, *obligation* has been defined as—

Amounts of orders placed, contracts awarded, services received, and similar transactions during a given period requiring disbursements of money. Such amounts shall include disbursements not preceded by the recording of obligations, and shall reflect adjustments for differences between obligations and actual disbursements.

Because funds are normally obligated well in advance of expenditures, the same funds are not available for other purposes. In other words, the obligation of funds serves to prevent duplicate and possible later overexpenditure of the fund authority.

The Constitution itself sets forth the requirement for a system of control over appropriated funds in Article 1, Section 9: "No money shall be drawn from the treasury, but in consequence of appropriations made by law. . . ."

An overobligation of an appropriation would be a commitment of federal monies which had not been appropriated. Control over disbursements would be minimal protection if the agencies had already incurred obligations, debts, or liabilities in excess of the appropriation.

Anti-Deficiency Act

The Anti-Deficiency Act of 1870 (31 USC 665) increased the control over the expenditure of appropriated funds and reaffirmed that no funds could be expended without being earlier appropriated. The law was enacted to control the use and expenditure of appropriated funds and to prevent deficiencies, with the consequent need for supplemental appropriations.

The provisions of the Anti-Deficiency Act directly affect the obligation and expenditure of appropriated funds by an official or employee of the government and would be equally applicable to federal grant-in-aid funds. This act states in part:

- No officer or employee of the United States shall make or

authorize an expenditure from or create or authorize an obligation under any appropriation or fund in excess of the amount available therein; nor shall any such officer or employee involve the government in any contract or other obligation, for the payment of money for any purpose, in advance of appropriation made for such purpose, unless such contract or obligation is authorized by law.

- No officer or employee of the United States shall accept voluntary service for the United States or employ personal service in excess of that authorized by law, except in cases of emergency involving the safety of human life or the protection of property.
- No officer or employee of the United States shall authorize or create any obligation or make any expenditure (a) in excess of an apportionment or reappropriation, or (b) in excess of the amount permitted by regulations.

The prohibitions in the Anti-Deficiency Act are generally known as Section 3679 statutes, and violations are referred to as 3679 violations.

Supplemental Appropriation Act

For an obligation to be valid and legally binding on an agency of the federal government, it must meet one of the criteria in the Supplemental Appropriation Act of 1955 (31 USC 200). This act defines the documentary evidence that must support legally binding obligations. Section 1311 provides that no funds with limited time for obligation are to be spent after that time, except in satisfying obligations validly made during the period of the appropriation. According to Section 1311, the eight following documents constitute valid supporting evidence for obligations of the federal government.

- A binding agreement in writing between the parties thereto, including government agencies, in a manner and form and for a purpose authorized by law, executed before the expiration of the period of availability for obligation of the appropriation or fund concerned for specific goods to be delivered, real property to be purchased or leased, or work or services to be performed; or
- A valid loan agreement, showing the amount of the loan to be made and the terms of repayment thereof; or

- An order required by law to be placed with a government agency; or
- An order issued pursuant to a law authorizing purchases without advertising when necessitated by public exigency or for perishable subsistence supplies or within specific monetary limitations; or
- A grant or subsidy payable (i) from appropriations made for payment of, or contributions toward, sums required to be paid in specific amounts fixed by law or in accord with formulae prescribed by law, or (ii) pursuant to agreement authorized by law, or plans approved in accord with and authorized by law; or
- A liability which may result from pending litigation brought under authority of law; or
- Employment or services of persons or expenses of travel in accord with law, and services performed by public utilities; or
- Any other legal liability of the United States against an appropriation or fund legally available therefor.

Although the record required by Section 1311 may exist, generally the obligation is not established until the document has been signed by the prospective recipient of the funds and by the person having obligational authority within the agency.

Classification of Obligations

The Treasury and Office of Management and Budget provide a consistent classification of a federal agency's obligations, costs, and cash disbursements. (OMB Circular A-11). The standard object classification, one of which covers grants, includes the following categories, not all of which apply to every agency:

- Personnel compensation.
- Personnel benefits.
- Benefits for former personnel.
- Travel and transportation of persons.
- Transportation of things.
- Rent, communications, and utilities.
- Printing and reproduction.
- Other services.
- Supplies and materials.

- Equipment.
- Lands and structures.
- Investments and loans.
- Grants, subsidies, and contributions.
- Insurance claims and indemnities.
- Interest and dividends.
- Refunds.

Value of Obligations

Critical in accounting for obligations and appropriated funds is the decision as to the amount of the obligation. Such a decision may seem routine because a dollar amount appears on the obligating document. However, the dollar amount cited on the supporting documents may not be the amount that an agency obligates.

For example, a partially or incrementally funded grant limits the government's liability to the amount of funds allotted to the grant and provides an initial funding ceiling that is less than the total estimated cost of the grant. Thus an incremental funding clause serves as a limit on the amount to be recorded as the grantor's obligation. Allotting additional funds to the grant raises that limit and can increase the obligation up to, but not exceeding, the increased amount.

The value of the obligation is of importance to a grantee, for this amount establishes the limit of the federal grantor's liability to the grantee. A federal grantor is liable to a grantee only to the extent of the total of the incrementally funded amount cited in the grant document. Amounts in excess of the incremental funding are incurred by the grantee at its own risk.

Administrative Requirements for Grant Programs

Federal grantors' internal records and procedures for accounting for grants are rather uniform. The reports required of grantees are the supporting or authorizing documentation for the accounting entries made in the agency's own records.

Systems of Accounting and Controls

Each agency is expected to have an adequate system of accounting and internal controls over its grant programs. Agency procedures insure that the prescribed documents and approvals are obtained and that there is a timely and orderly flow of supporting documents. Audits or reviews are made by the agency before grant funds are disbursed or final settlements are made. The agency's system must also provide for the adequate funding of all grantees. There must be a full accounting for all funds, and supporting documentation must be preserved pursuant to the government's record retention requirements.

Purpose of Grantee Reporting

Grantee financial reports become the supporting documentation for the agency's official records and for monitoring outstanding advances. Periodic reports of costs reimbursed under grants are required as support in recording the agency's liability for costs incurred by the grantee and in reducing the government's obligation as performance is rendered under the grant.

Where necessary for monthly reports, an agency may use estimates in an attempt to reflect the level of unliquidated obligation and accrued expenditures.

The data reported by grantees varies in detail. Some agencies require a periodic reporting of only the total funding received during the period, the total expenditures made, and the unspent balance of grant funds. Other agencies require an expenditure report that details several object classes of expenses. These latter agencies may record only the total of the reported expenditures in the agency accounts. The detailed report containing the object classes is maintained in the official grant file and preserved for review and analysis. The grant report file provides subsidiary support for the amounts appearing in the agency's own ledger accounts.

Reporting Frequency

Reporting frequencies vary widely among agencies with respect to grantees. Some agencies require monthly expenditure reports, others prefer quarterly, semiannual, or annual reports, and still others require only a final report. Generally, periodic and timely financial reports are required from all grantees, regardless of

whether they have received advance funding or are on a cost-reimbursable basis.

Since January 1, 1973, pursuant to OMB Circular A-102, state and local government grantees have been reporting the status of grant funds in a standard governmentwide format. This report cannot be required more often than quarterly or less often than annually, and a final report must also be made in the same format at the completion of the grant. The periodic status report must be submitted within thirty days after the specified reporting period, and final reports are required within ninety days after the grant period or completion of the grant program.

Documentation for Grant Expenditures

In many federal agencies, accounting for a grant begins when the grant application is received, reviewed, and approved for funding. Prior to the formal grant award, either the program office or the agency's finance office completes a preaward commitment form or makes an entry in a summary commitment register. This action certifies that agency funds do exist for the contemplated grant and reserves part of the agency's unobligated and unexpended funds.

Purpose of the Grant Agreement

The first step in the formal accounting process is the execution of an agreement or the approval of an application or similar document describing the amount and purpose of the grant, the performance period, the obligations of the parties, and other applicable basic terms. This action establishes and formalizes the obligation of funds; in other words, the agreement, approved application, or similar document is the obligating instrument. The amount on the face of the agreement is often the basis for the accounting entry which records the obligation of the agency's appropriated funds.

Grant recipients should know how much money is formally obligated by the agency since this is the limit of the agency's liability unless the agreement is modified to change the amount of the grant. Many agencies award a multiyear grant, but obligate funds annually to support the program. In such cases, the grant document generally limits the government's liability to the amount of the appropriated funds reserved for the grant. That is, in any given year, the government's obligation would extend only to the funds obligated for the grant in that particular year. Thus a gran-

tee would incur excess costs at its own peril, since the agency may or may not choose to assume liabilities that exceed the amount formally obligated.

Grant Financing and Payment Documents

The following paragraphs outline the methods by which federal grantors generally make payments to grantees. The payment procedures for nongovernmental grantees are not standard. In the case of state and local governmental grantees, the method of financing grants should comply with OMB Circular A-102 (FMC 74-7), the uniform administrative requirements for grants-in-aid to state and local governments.

Advance Financing by Check Some agencies have a procedure whereby a grant awarded for a minor amount or for a short period is financed in total by check when the grant agreement is executed by both parties. In other instances, the grantee is provided with an advance, the remaining money being disbursed in accordance with some predetermined plan that closely approximates the need for disbursements.

Whether a total or partial advance has been made, the grantor's program offices must prepare a form which advises its finance personnel that a grantee is entitled to an advance. The total amount of the advance is also provided, as well as a payment schedule for the particular grantee.

In the case of state or local governments, where a grantee has received an advance of money by check or under a letter-of-credit arrangement, the Office of Management and Budget requires that the federal agency receive a report of the cash advanced to, or funds disbursed by, the grantee. This report of federal cash transactions might be required at varying frequencies depending on specific circumstances, as the following table shows.

<u>Classification of Grantees</u>	<u>Reporting Frequency</u>	<u>Report Due</u>
All grantees, unless otherwise qualified	Quarterly	15 working days after period
Grantees receiving annual grants in excess of \$1 million	May be required monthly	15 working days after period
Grantees receiving monthly advances less than \$10,000	May be waived if other requirements are met or grantees' systems are adequate to minimize excessive advances	

Federal grantors are authorized to permit grantees to submit requests for advances or for reimbursement of costs on a monthly basis. A standard form is used for all nonconstruction governmental grant programs when letter-of-credit or predetermined automatic advance methods are not used. A similar form is used for many nongovernmental grantees. Additionally, when the request for advance provides adequate information for the grantor's purposes, the financial status report may be waived.

Advance Financing by Letter of Credit The criteria and procedures for the letter of credit are detailed in Treasury Circular 1075. Under these procedures the grant-making agency establishes a line of credit with the Treasury Department's designated disbursing office against which a grantee organization can draw funds. Letter-of-credit financing requires that the grantor or the grantee complete and submit the following forms at designated times during the life of the grant (see chapter 2); authorized signature cards, letter of credit, payment voucher on letter of credit, and report of federal cash transactions.

Reimbursement Basis of Financing Some agencies still adhere to a cost reimbursement basis of financing grantees under which each grantee is permitted to submit a claim for payment or reimbursement after funds have been disbursed. For agencies utilizing the reimbursable basis of funding, the grantee's financial expenditure report could be both an accounting of grant expenditures and a claim for payment. Usually there is no need for the grantee to submit a claim in addition to the required financial report, but the standard form federal voucher is sometimes required.

Once the initial advance has been received, the advance financing method is similar to the reimbursement method. The first direct advance is initiated when the grantee submits a public voucher with a claim for an advance. Usually, in each succeeding reporting period the grantee is required to submit a statement of expenses or claim for reimbursement of the grant advance expended. In the case of an advance, the reimbursement replenishes the original advance. If no advance has been received, the reimbursement replenishes the money spent by the grantee.

Grantor Accounting for Grants

A federal grantor must take many specific actions and obtain many approvals before and during the grant period. The timelines of these actions often depends on the responsiveness of the

grantee in forwarding the required documents. Many grant recipients are unaware of the interrelationship of their reports and the entries and administrative actions of the agency.

Generally, every action of the federal grantor is reflected in summary, in its accounting records. For example, the grantor makes an accounting entry for (1) the intent to commit funds for a grant; (2) the execution of the grant agreement and final award of the grant; (3) the establishment of an account receivable for any advance funding provided to the grantee; (4) the recording of all expense claims under the grant agreement; and (5) the disbursement of funds to the grantee throughout the grant period.

Commitment of Funds

With many grantors, accounting for a grant begins with the approval of the application, before the award of the grant. At that time an entry is made in a summary commitment register, or a preaward commitment form is processed by the grantor, signifying or certifying that (1) agency funds are available for the imminent grant, and (2) the unexpended appropriation fund balance has been restricted in the amount of the grant.

Procedures vary as to whether the agency's originating program office or the finance office maintains the register or completes the preaward commitment form. But the amounts on these records are periodically reconciled with the amounts ultimately obligated in the agency's accounting records since the amount of the grant award could differ from the earlier commitment of funds.

Execution of the Grant

The first formal accounting entry relating to a grant is usually made when the grant is awarded, and the grant document itself supports the formal obligation of agency funds.

At the time of award, an entry is made by the agency to restrict a portion of the grantor's unobligated fund balance. This accounting action has two objectives: (1) to reduce the unobligated appropriated funds of the agency and (2) to restrict these previously unobligated funds to meet the claims contemplated under the approved grant agreement.

If the amount of this entry is less than the full amount shown on the agreement, the grant is said to have been incrementally funded. Such agreements usually state that the continuation or full funding is dependent on the future availability of funds.

It is incumbent upon each grantee to determine whether it has

been awarded an incrementally funded grant and the extent of the government's liability for program costs. A multiyear program that is funded incrementally will lapse if the funds are not forthcoming on the prescribed dates.

Establishing the Advance Receivable

If the grantor deems it to be in the government's interest to provide advance financing at the time of the grant award, this would be recorded by reducing the grantor's cash balance and establishing an account receivable for the money advanced. The receivable would be reduced by offsetting the amounts later reported or claimed by the grantee for expenses.

It should be noted that an advance constitutes a receivable until performance has been rendered by the grantee. The document to support the advance of funds and the corresponding receivable entry is a public voucher (Standard Form 1034), prepared by the grantee, or the grant agreement—showing the grantor has approved an advance and presented a check to the grantee at the time of grant award. The procedure varies slightly for a letter of credit. The receivable is recorded and supported by the grantor at the time it receives a payment voucher on a letter of credit, signifying that the grantee has made a withdrawal of grant funds.

If a nongovernmental grantee is to receive full or partial advance financing, the agency generally requires that the grantee prepare and submit the public voucher, which is the claim for payment used by all agencies. This form is prominently labeled an advance of funds and is entered on the grantor's schedule and voucher of payments, which is submitted to the Treasury Department for the issuance of a check to the grantee organization.

An alternative is to have the Treasury Department issue the advance check to the grantor. The grantor releases the check to the grantee when all documents and agreements have been completed. This has the advantage of immediately providing the money necessary to set the program in motion.

Recording Grantee Claims

An administrative regulation may prohibit advances, or a grantee may not want an advance. In such cases the grantee makes a claim, usually monthly, for reimbursement of expenditures incurred under the grant program. Claims for reimbursement could be made on a required expense report or on a public voucher, depending on the procedures of the grantor. These documents support the entries necessary to (1) record the grantor's

full liability to the grantee, (2) adjust any earlier expenditure accruals made on an estimated basis, (3) reduce or liquidate any applicable amounts previously obligated, and (4) reflect the cash disbursement if grantee claims are paid immediately.

Where a grantee has received an advance of cash, any claim must be reduced by the outstanding or unsettled advance receivable, in accordance with the grant agreement.

Disbursements to the Grantee

The government pays grantees by check or by letter-of-credit withdrawals. The processes were outlined earlier in chapter 2. The forms that must be submitted in a timely manner to support the agency accounting requirements differ for each method.

Payment by Treasury Check The actual disbursement by check to a grantee for expenses is supported by the schedule and voucher of payments prepared by the grantor's finance office and submitted to the Treasury Department for the issuance of checks to the payees listed on the schedule. The entries on this schedule are in turn supported by the grantee's financial report, its public voucher, or advance requests, which were submitted to the grantor.

The entry for the actual disbursement of cash must be made and the amounts due to grantees adjusted to the extent that the grantee had any outstanding advances.

Payment by Letter-of-Credit Withdrawals Where a grantee obtains funds by withdrawal under a letter of credit, an entry must also be made to record an account receivable and the disbursement of cash. This entry amount equals the amount of the withdrawal appearing on the copies of the payment voucher on letter-of-credit forms which evidence payments by the Treasury Department.

The withdrawal receivable is reduced and the grant expenses are recorded when the grantee submits an expense report or a public voucher evidencing an outlay of the funds withdrawn under the letter of credit.

Illustrative Accounting Entries

The specific account titles vary by federal grantor, but accounting for expenditures of federal grants-in-aid must conform with the accounting principles and standards issued by the General Ac-

counting Office. The following entries illustrate an acceptable method of recording the several grant-related entries on the grantor's records.

Execution of the Grant Agreement

Entry: Unobligated allotments XX—Debit
Unliquidated obligations XX—Credit

Purpose: Reserve a portion of the grantor's unobligated allotment and establish an obligation to the grantee.

Document: The grant agreement executed by the grantor and grantee.

Establish the Advance

Entry: Receivable due from grantee XX—Debit
Balance with Treasury—cash XX—Credit

Purpose: Record the payment of cash and a receivable on the grantor's records.

Document: Public voucher or letter of credit withdrawal, most often prepared by grantee.

Recording Grantee Claims

Entry: 1. Grant costs XX—Debit
Accounts payable—grantee XX—Credit
2. Unliquidated obligations XX—Debit
Expended appropriations XX—Credit

Purpose: Record grantee's expenditures in total and the grantor's liability to the grantee; adjust earlier expenditure accruals made on estimated basis; reduce or liquidate amounts previously obligated.

Document: Public voucher or submission of grantee expenditure reports.

Payments to Grantees

Entry: Accounts payable—grantee XX—Debit
Balance with Treasury—cash XX—Credit

Purpose: Reduce liability to grantee and record actual payment of cash to grantee.

Document: Grantor prepares a schedule of voucher and payments requesting Treasury Department to issue a check to grantee.

With many data processing systems, some entries are made automatically and are not entered into the system separately. For example, typically the recording of the expenditure entry could simultaneously reverse the original obligation. Similarly, the grantor's procedures might require the automatic reduction of any outstanding advances prior to reimbursing grantees for claimed expenses. Further, larger grantors do not necessarily make an entry for each grant, preferring to record the accounting transactions in batches.

Prepayment Audit or Review

Many grantors make prepayment audits or reviews of grantee's claims for reimbursement or of the expenditure reports submitted subsequent to advances or letter-of-credit withdrawals. Federal grantors usually insure that a function has been established and personnel charged with making a prepayment audit or review of the grant document, invoices, reports, and vouchers before funds are advanced or reimbursed. This function is often performed by finance personnel because it is critical to the certification made by the agency's officer that the release of funds for the claimed purpose be proper.

Objectives of Prepayment Review The principal objectives of a prepayment review are to insure that all disbursements, whether in the form of advances or reimbursements, are legal, proper, and correct and that all are fully documented, properly approved, and accurately reported and recorded.

Each grantor's system of internal control and related procedures for disbursements must be based on its operating needs and must conform with the related principles and standards for internal management control prescribed by the General Accounting Office and with the regulations of the Treasury Department.

Nature of Review The prepayment audit or review is designed to insure that each request for the release of federal funds is examined critically before disbursements are made. The following are typical of the inquiries made prior to the release of funds to grantees.

- Have all the required authorizations and the approvals of grantor officials been obtained?
- Will the payment to the grantee be permitted under the law, and is the immediate request for a payment of funds in ac-

cordance with the grant agreement and the conditions thereof?

- Is the dollar amount correct, and is the named payee the one designated in the grant agreement?
- Does the imminent payment represent a duplicate reimbursement or a duplicate recovery by the grantee of funds earlier provided through an advance funding or under a letter-of-credit withdrawal?
- If the payment is a reimbursement, have the required financial reports been filed by the grantee? Have the services been performed?
- Have all the necessary documents been properly completed and filed, considering the nature of the disbursement?
- If a grantee's claim is for a payment, should the claim be more properly shown as a reduction of funds previously advanced?
- Have any agency audits questioned the propriety of disbursements made by the grantee for which payment should be withheld pending final resolution?

Often the questions raised during this prepayment audit are the bases or causes for delay in the payment of a grantee's claim or invoice.

4 Requirements for Federal Grantees

The guidance and requirements given to grantees by federal grantors concerning the method and system of accounting are often general and varied. This chapter describes the accounting and internal controls that are generally required, although the conditions of specific grants might impose other requirements that will have to be met.

Grantor Accounting Requirements

Often, the adequacy of the grantee's system is not assessed until the performance of a federal audit, which could be conducted well after the termination or completion of the grant program. Federal grantors often prescribe accounting requirements in broad terms, leaving the interpretation and detailed definition to the grantee. For example, federal agencies have prescribed the fiscal, financial, and accounting conditions in these terms, among others:

- Grantees must use or establish the fiscal, accounting, and other records which conform to the guidelines of the federal grantor.
- Grantees must assure that the accounting and internal controls assure the proper accounting for payments received and disbursements made.
- Grantees must maintain the fiscal and financial records and the system of accounts in accordance with generally accepted accounting procedures.
- Grantees must maintain accounting and fiscal records ade-

quate to reflect the receipt, expenditures, application, purpose, and balance of funds received from the federal grantor.

- Grantees must keep such records to disclose the amount and disposition of grant funds, the total cost of the project, funds supplied by other sources, and the accounting of funds received from the grantor.
- Grantees are not required to change formal accounting systems, but are required to plan, control, and report costs in accordance with the cost categories set forth in the grant agreement or budget.

Practical definitions of acceptable procedures evolve with time. When the grantee is a public agency, the existing system of that agency or the central system imposed by the responsible government is deemed acceptable as a basis for meeting a significant portion of the accounting requirements of a federal grantor. When a grantee is a nonprofit organization, an incorporated authority, or a single-purpose grantee, the acceptable procedure is to establish a formal accounting system capable of reporting on the assets, liabilities, fund balances, revenues, and expenses related to the federal funds received.

In either instance, a system might still be found by the grantor to be inadequate for the full disclosure and support or documentation of grant funds and expenditures. Typically, existing systems must be modified or an auxiliary subsystem implemented to comply fully with federal grantor requirements for adequacy.

Requirements of General Accounting Office

The federal grantor assesses the adequacy of an accounting system in terms of the grantee's ability to meet the financial and fiscal requirements imposed by the Congress and others. The requirements of Congress vary with specific laws. Generally, though, the grantor is additionally concerned with the grant accounting principles set forth by the General Accounting Office. These principles or guides include requirements such as:

- The acceptance of a grant creates a legal duty on the part of the grantee to use funds in accordance with the grant conditions.
- Grant payments made in advance of work performed, ser-

vices rendered, or programs completed are to be accounted by the grantor as an advance until the grantee submits evidence of performance or completion.

- The federal government has a reversionary interest in the unused balances of advance payments, any funds improperly applied, and in property and facilities purchased or otherwise made available under the grant.
- The term *accounting for grants* includes all aspects of grant transactions from approval of the grant to final action by the grantee and the grantor.
- Reporting under grants shall be at reasonably frequent intervals and used as support for recording the necessary accounting transactions at the grantor level.

The General Accounting Office has defined an accounting system as including formal books and accounts; supporting records, documents, papers, and reports; and related procedures used to account for an agency's resources and operations. These records must embrace all funds, property, other assets, liabilities, obligations, receipts, revenues, expenditures, disbursements, and costs. Financial transactions must be adequately supported, with pertinent documents available for audit. The transactions must be recorded to permit tracing from the originating documents to summary records and to the financial reports and statements.

Requirements of Office of Management and Budget and General Services Administration

Other requirements relating to grantee financial management systems have been defined for federal grantors in OMB Circular A-102, revised. In summary these standards, while applicable directly to grants-in-aid to state and local governments, are applied to most grant programs. These requirements are:

- Financial results for each grant program must be accurately, currently, and completely disclosed in accordance with the federal reporting requirements.
- Where grantors require accrual basis reporting and accounting records are not maintained on this basis, such information must be capable of being developed through analysis of

documentation or on the basis of best estimates.

- Records must adequately identify the source and application of funds and contain information pertaining to the grant award and authorizations, obligations, unobligated balances, assets, liabilities, outlays, and income.
- Grantees shall adequately safeguard all funds, property, and other assets.
- The system must provide for a comparison of actual and budgeted amounts for each grant. Also, the system must provide for relating financial information with performance or productivity data, including unit costs, when appropriate and required by the grantor.
- Drawdowns under letters of credit shall be as close as possible to the time of disbursements at the grantee level.
- Accounting records must be supported by source documentation.

Considerable effort has been expended by the Office of Management and Budget in an attempt to simplify and make uniform the financial reporting and accounting requirements for grantees receiving funds under governmental grant-in-aid programs. However, legal and other requirements of grantors still specify that accountability be unique to individual grant programs and, in some instances, to individual grants. As mentioned, the administrative requirements for state and local government grantees are set forth in OMB Circular A-102. Exhibit 4-1, page 61, itemizes the several attachments of this circular.

Grantee Responsibility for Accounting and Internal Controls

The grantee is responsible for establishing and maintaining its own adequate system of internal accounting controls and for insuring that an adequate system exists for each of its subgrantees, contractors, and delegate programs. The grantee is not required to establish new or specific systems, if the existing systems are adequate or can be modified to meet minimum criteria that generally applies to all grant programs. A grantee's system should also provide for the following:

- Financial data for planning, control, measurement, and evaluation to permit the assessment of the efficiency and economy of the funded programs.

Exhibit 4-1

Summary of OMB Circular A-102

UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS- IN-AID TO STATES AND LOCAL GOVERNMENTS

<u>Document and Attachment Reference</u>	<u>Subject or Content</u>
October 19, 1971 transmittal memo	Superseded OMB Circular A-96; implemented parts of Intergovernmental Cooperation Act of 1968: <ul style="list-style-type: none">• No grant-in-aid to a state shall be required to be deposited in a separate bank account.• Federal grantors are responsible for scheduling transfer of funds to minimize time elapsed between transfer of funds from the Treasury and disbursement by state.• States shall not be held accountable for interest earned on grant-in-aid funds, pending disbursement.

Attachments

Attachment A	Requirements for cash depositories
Attachment B	Bonding and insurance requirements
Attachment C	Retention and custodial requirements for records
Attachment D	Waiver of "single" state agency requirements
Attachment E	Requirements for accounting for program income
Attachment F	Criteria and procedures for allowability and evaluation of cash and in-kind contributions
Attachment G	Standards for grantee financial management systems
Attachment H	Financial reporting requirements
Attachment I	Monitoring and reporting of program performance
Attachment J	Grant payment requirements
Attachment K	Budget revision procedures
Attachment L	Grant closeout procedures
Attachment M	Standard forms for applying for federal assistance
Attachment N	Property management standards
Attachment O	Procurement standards

- Control of funds and other resources to insure that expenditures are made in conformance with the grantor's guides and grant conditions.
- Data to meet the prescribed reporting requirements and cost accounting of the grant activities.

Accounting Control Criteria

To minimize audit exceptions and permit the kind of reporting required by many grantors, a grantee's accounting system should meet the following criteria:

- The accounting records, including the ledger and supporting books of accounts, should refer to subsidiary records and documentation that can be readily located and identified with the grant to support each transaction.
- The accounting system must provide accurate, current, and complete financial information.
- The transaction coding and account classification of the system must permit the summarization and reporting of grant expenditures by specific programs, projects, uniform receipt and expenditure classifications, and possibly major activities funded in the approved grant budget.
- The support documentation must be sufficient to identify the several characteristics of each transaction—purpose, amount, activity, source of funds, and so on.
- The accounting records must identify adequately the receipt and expenditure of funds for each grant, subgrant, contractor, and delegated program.

Internal Control Criteria

The accounting system must be integrated with a system of internal controls that can safeguard the grant funds and property and determine the accuracy and reliability of accounting data. In designing their accounting and internal control systems, grantees should consider the criteria published by the General Accounting Office for federal grantors.

The grantee's management and operating policies must be clearly stated; systematically communicated throughout the organization; and conform with applicable laws and external regulations.

The grantee's organizational structure must define and assign responsibility for the performance of all duties necessary to carry out the financial management functions of the grantee.

The responsibility for assigned duties and functions must be classified according to authorization, performance, recordkeeping, custody of resources, and review, to provide for proper internal checks on performance and to minimize unauthorized, fraudulent, or irregular acts.

The system of planning must embrace all phases of the grantee's operations and be developed to determine and justify financial, property, and personnel requirements and carry out grant operations.

The operating procedures must be simple, efficient, and practical giving consideration to the nature of the grant and legal and regulatory requirements. Factors such as feasibility, cost, risk of loss or error, and availability and suitability of personnel must be considered in formulating the procedures.

There must be an adequate system of authorization, recordkeeping, and transaction coding procedures designed to ensure compliance with prescribed grant requirements and restrictions of laws, regulations, and internal management policies; to prevent illegal or unauthorized transactions; and to provide proper accounting records for the expenditure of grant funds.

The system must provide prompt, essential, and reliable operating and financial data to officials responsible for making decisions or reviewing performance.

The performance of all duties and functions of grantee personnel should be properly supervised. Where possible, performance should be subject to adequate internal audit and management review to determine if performance is effective, efficient, and economical; if management policies are adhered to; whether applicable laws, regulations, and grant conditions are obeyed; and, to the extent possible, if unauthorized, fraudulent or irregular activities and transactions are prevented, minimized, or discovered.

The qualifications of officials and other personnel, with respect to education, training, experience, competence and integrity must be appropriate for the responsibilities, duties, and functions assigned to them.

The officials and employees must be fully aware of assigned responsibilities and understand the nature and consequences of their performance. Each person should be held accountable for the honest and efficient discharge of duties and functions, including where applicable, the custody and administration of funds, property, and compliance with grant regulations and legal requirements.

The procedures should provide that needed goods and services are acquired at reasonable prices, consistent with quality; that the goods and services are actually received; that the quantity, quality, and prices paid are in accordance with the applicable contract or other authorization by grantee officials, and that such authoriza-

tions are consistent with applicable statutes, regulations, policies and grant conditions.

The funds, property, and other resources for which the grantee is responsible must be safeguarded and periodically inventoried to prevent misuse, waste, destruction, or misappropriation.

Structure of Accounting System

Among the accounting system requirements for federal grants are two levels of account structures of analytic capability.

At the summary level, typically, are the general ledger accounts. At this level the information is aggregated in a format and structure that parallels the account structure required by generally accepted accounting procedures—except when the grantee is a governmental agency whose account structure might be modified to meet unique legal prescriptions.

The second level generally includes subsidiary or auxiliary accounts. Usually, grantees find it convenient to establish a project cost accounting subsystem that will relate revenues and expenses to individual grants or projects. Exhibit 4-2, page 65, outlines the general relationships of the account categories and subsystems.

The inability or failure to establish this more detailed level of accounting is of greatest concern to federal grantors and a source of much criticism directed toward grantee systems.

Often, the federal grantor states that it will not impose additional accounting standards on a governmental grantee or that it does not require a change in the grantee's formal accounting system to accommodate financial requirements of the grant. However, requirements for specific reporting and costing responsibilities and for expenditure detail all have the effect of mandating the development of a subsidiary or auxiliary cost accounting system to preclude continual and repetitive analysis of data for grant reporting purposes.

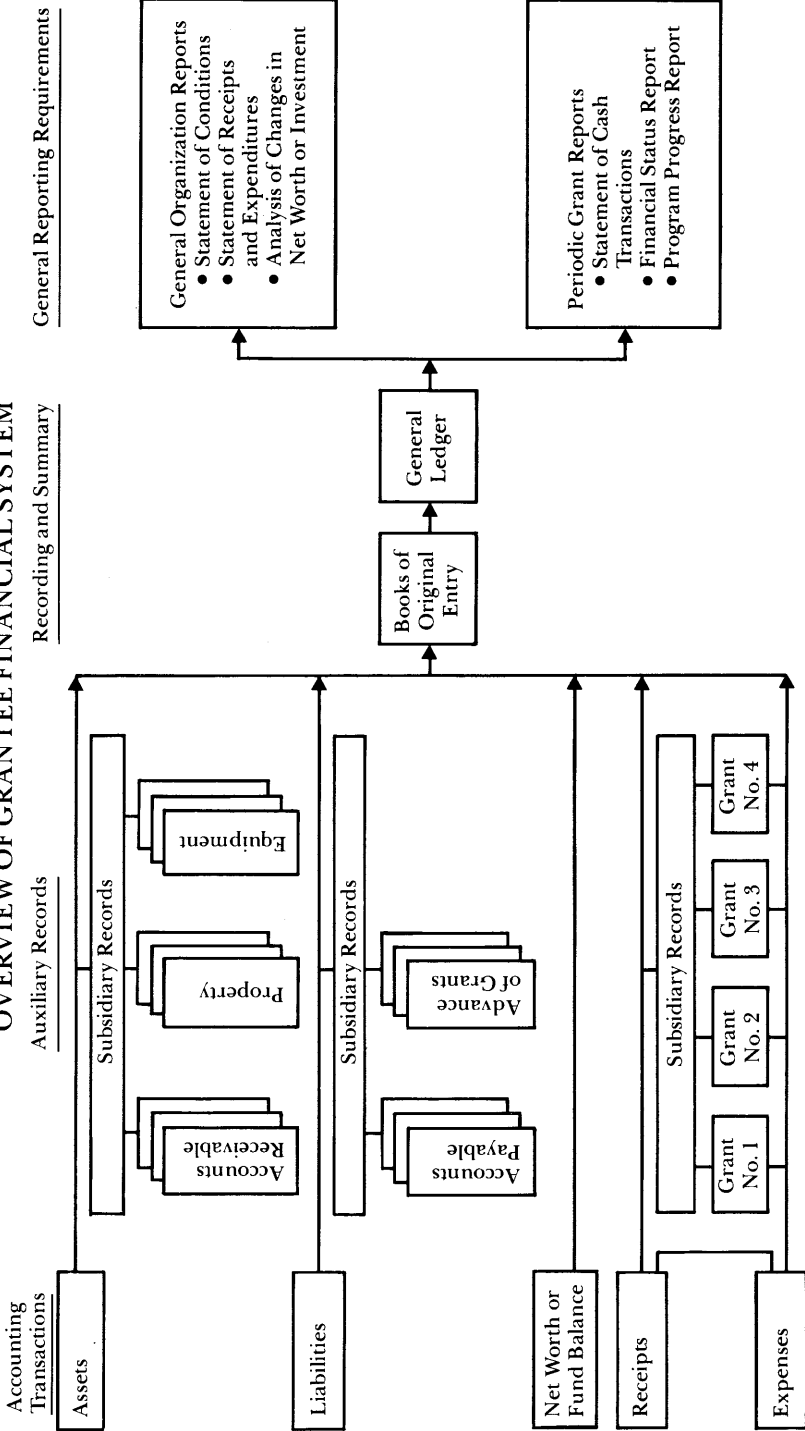
A governmental grantee's system of accounts may be adequate for recording appropriations and encumbrances, cash disbursements, and commitments. But unless it also provides for a detailed accumulation of receipts and expenses by specific grants, programs, activities, or projects, the system may not be adequate for a federal grantor.

Assets, Liabilities, Investment, or Net Worth

The preference of federal grantors is an accounting system that formally records all transactions relating to the assets, liabilities,

Exhibit 4-2

OVERVIEW OF GRANTEE FINANCIAL SYSTEM



and net worth or the investment of the government. In accordance with accrual accounting, the system should provide for the recording of receivables and payables. Where applicable and significant, property and supplies should be recorded as inventories. Property and other fixed assets should be recorded in the accounting records.

The underlying premise of accounting for assets, liabilities, and investment accounts in grantee accounting is similar in many respects to those required for governmental agencies and commercial organizations. Variations will depend upon the status of the grantee—a governmental agency grantee, for example, will have an account structure different from a nonprofit organization. Aside from having an interest in those records that permit the identification of grant assets, federal grantors are also concerned with the accounting procedures employed for the grantee's total receipts and expenses.

Receipts and Expenses

All federal grantors impose requirements for accumulating and reporting grant receipts and expenses. Often, although not governmentwide, grantors require that several aspects of receipts and expenditures be accounted for, such as source of the funds, type of receipt or expense, purpose of the transaction, and the activity benefiting from the transaction. It is these latter requirements that make it necessary to develop subsidiary or auxiliary systems in order to comply with the federal grantor requirements. Exhibit 4-3, pages 68–69, provides an overview of the transactions and desired documentation as well as the relationship of the transactions to the project or grant cost accounting that must be performed to satisfy most federal grant requirements.

The grantee's financial records must fully identify receipts and expenses for each grant. The coding or classification of transactions must permit the collection, summarization, and reporting of receipts and expenditures in the manner required by the grantor to meet its financial and fiscal responsibilities. These responsibilities also require the retention of specific types of supporting documentation for grant transactions.

Accrual Reporting Federal grantors commonly require that the receipts and expenditures of the grant be reported on an accrual basis. While not applicable to nongovernmental grantees, OMB Circular A-102 states that when a federal grantor agency requires reporting on an accrual basis and the grantee's accounting rec-

ords are not kept on that basis, the grantee should develop such information (1) through analysis of the documentation on hand or (2) on the basis of best estimates.

Accrued income is defined as the earnings during a given period which is a source of funds resulting from (1) services performed by the grantee, (2) goods and other tangible property delivered to purchasers, and (3) amounts becoming owed to the grantee for which no current services or performance are required by the grantee.

Accrued expenditures are defined as the charges incurred by the grantee during a given period requiring the provision of funds for: (1) goods and other tangible property received; (2) services performed by employees, contractors, subgrantees, and other payees; and (3) amounts becoming owed under programs for which no current services or performance are required.

Typically, grantees maintain their records on a cash basis—an acceptable basis of accounting for grants, provided the data exists for conversion to the accrual basis for reporting purposes. The terms *cash* or *disbursements* have been defined as payments by the grantee in cash or by check.

Obligation Reporting For financing purposes, federal grantors require periodic reports of obligations. This information is particularly relevant to the grantor at the time of refunding or forward funding grant programs to insure that the grantee has money enough to meet its outstanding program liabilities.

Reporting of obligation requires familiarity with the following definitions:

- *Obligations* are the amounts of orders placed, contracts and grants awarded, services received, and similar transactions during a given period that will require payment during the same or a future period.
- *Outlays* represent charges made to the grant project or program. Outlays can be reported on a cash or an accrued expenditure basis.
- *Unobligated balance* is the portion of the grant amount approved by the federal agency which has not been obligated by the grantee and is determined by deducting the cumulative obligations from the authorized grant amount.
- *Unpaid obligations* represent the amount of grantee's incurred obligations that have not been paid.

Care should be taken by the grantee in determining and reporting obligations of the project or program. The grantor com-

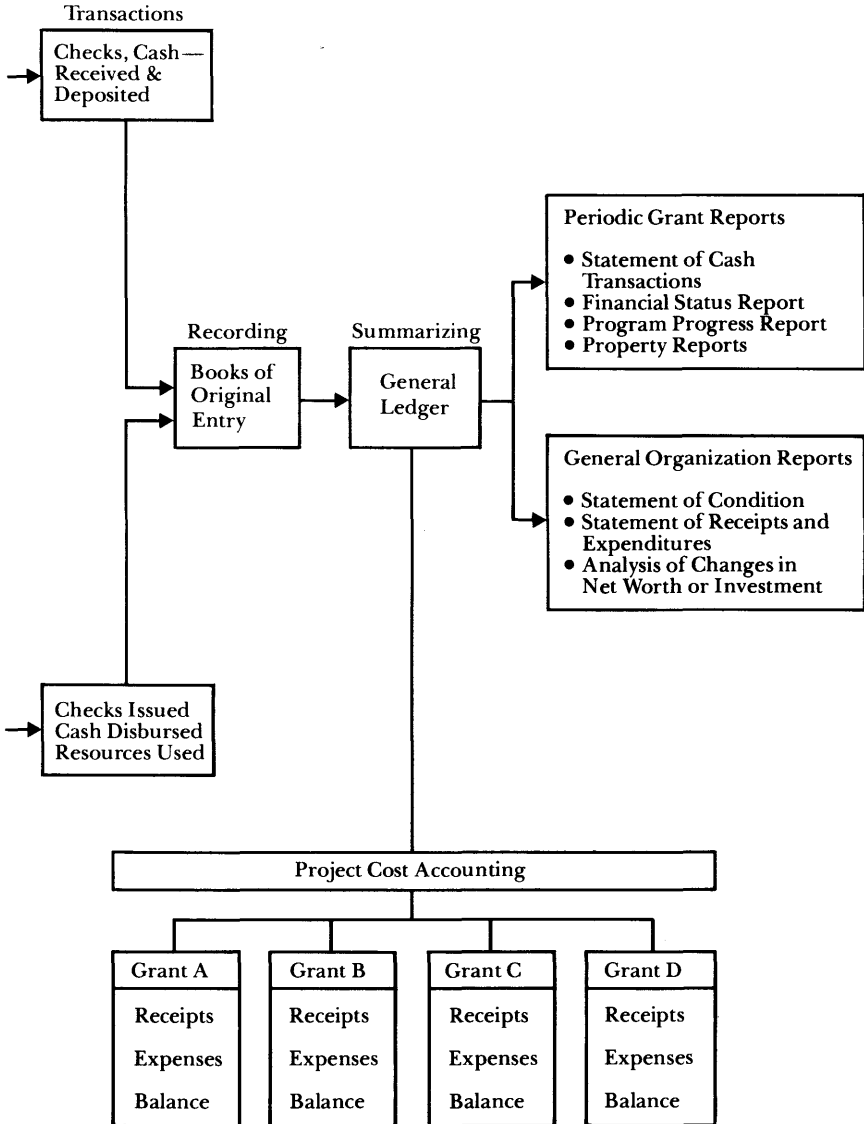
Exhibit 4-3

GRANT TRANSACTION — CLASSIFICATION, SUPPORT, REPORTING

Categories	Documentation
<u>Grant Resources</u>	
Federal Receipts	Deposit Slips, Letter of Credit Withdrawals, Financial Reports
Program and Other Income	Record of Service, Purpose, Amount, Deposit Slips
Matching Cash Contributions	Record of Source of Donor, Dates, Rates, Amounts, Deposit Slips
Matching Noncash Contributions	Record of Donor, Dates, Rates, Amount
<u>Grant Expenditures</u>	
Personnel	Attendance Records; Time Distribution Sheets
Travel	Evidence of Authorized Travel, Expense Statement
Equipment	Quotations; Purchase Orders; Receiving Reports; Invoices; Property Records
Supplies	Invoices; Receipts
Contractual	Evidence of Completion; Contracts; Billings for Service; Rental or Lease Agreement or Contract
Other Direct Charges	Invoices; Receipts
Indirect Charges	Analysis of Indirect Costs in Pools; Distribu- tion Base; Allocation Plans
Noncash Contributions	Record of Application to Grant; Certification of Cost, Market/ Appraised Values

Accounting System & Internal Controls

Required Reporting



mits funds on the basis of the obligational status reported. A correct calculation by the grantee is important to insure sufficient funding to meet all known, but unpaid or unaccrued, liabilities of the grant.

Definition and Required Documentation for Grant Resources and Expenditures

Accounting for Project or Program Resources

Resources include all monies received and services and property provided by either the federal grantor or the grantee for the purpose of supporting the grant project or program. As illustrated in exhibit 4-4, page 72, grant resources differ for nonconstruction and construction grants, but include cash receipts from federal and nonfederal sources, program income, and matching contributions. Resources received, whatever their origin, should be formally recorded in the grantee's accounting records. The necessary supporting documentation must be retained for the full period cited in the grant agreement. Periodically, the grantee is required to render a report of total resources provided to the project or program.

Federal Receipts Federal receipts include the total amount of cash received from the grantor under the specific grant and may normally constitute the largest single source of money provided to the project or program.

A complete record must be maintained of all funds authorized and cash received from the federal grantor to permit a full accounting and periodic reconciliations. Letter-of-credit withdrawal forms, claims for reimbursement where applicable, validated deposit slips for each receipt, and the basic grant agreement and all modifications should be permanently retained.

Nonfederal Receipts Nonfederal project or program receipts could include monies provided by the grantee through its appropriation process (in the case of a governmental grantee) or other revenue-producing activities. Additionally, there may be program income available to the project. Program income represents earnings by the grantee from grant-supported activities (service fees, sale of commodities, usage or rental fees, sale of assets, royalties on patents and copyrights). The disposition procedures and avail-

ability of program income are generally set forth in the grant agreement. On occasion there may be other sources of nominal income, such as grantee investment of excess federal funds in short-term government securities.

A complete record must be maintained for all nonfederal receipts benefiting the project or program. There must be a full accounting for each transaction, identifying the source, purpose, and amount of all such receipts. The files should also contain validated deposit slips, correspondence, copies of legislation, and evidence of other financing efforts of the grantee.

Matching Contributions Matching or in-kind contributions represent the value of contributions provided by (1) the grantee, (2) other public agencies and institutions, and (3) private organizations and individuals. Cash contributions must be accounted for with the same degree of controls normally employed for the federal monies received. The in-kind contributions might consist of charges for real property, equipment, or the value of goods and services directly benefiting and identifiable with the grant project or program.

In the case of state and local governmental grantees, OMB Circular A-102 states that when authorized by federal legislation, federal funds received from other grants may be considered as the grantee's own cash contribution.

Each matching contribution must be supported by records describing the contribution and identifying the source or donor involved as well as the date, rate, amount, and value of the contribution. A responsible grantee official must certify that noncash items have been furnished at actual cost (less depreciation), at market value, or at a reasonable, independently appraised value. The Office of Management and Budget criteria for valuing contributions are discussed under allowable costs in chapter 6.

Accounting for Project or Program Expenditures

Grant expenditures include expenses for which payment has been made by the grantee as well as other liabilities incurred for services rendered, goods received, or other performance (if accrual reporting is required.) The expenditures must also include accounting for matching contributions, cash or in-kind, consumed or used by the project or program.

As illustrated in exhibit 4-4, grant expenditures for nonconstruction and construction grants consist of several classifications. Few grants include funds for all the listed expenses in a standard grant application budget. Additionally, classifications of expendi-

Exhibit 4-4

EXAMPLES OF RECEIPT AND EXPENDITURE CLASSIFICATIONS FOR FEDERAL GRANTS-IN-AID

Operational, Categorical, Formula, Nonconstruction Grants

Grant Resources

Federal receipts
Nonfederal receipts
 Appropriations (by grantee)
 Program income
 Other income
Matching cash contributions
Matching noncash contributions

Grant Expenditures

Personnel
Fringe benefits
Travel
Equipment, capital expenditures
Supplies
Contractual
Construction
Other direct charges
Indirect charges

Construction Grants

Grant Resources

Federal receipts
Nonfederal receipts
 Securities
 Mortgages
 Appropriations (by grantee)
 Bonds
 Tax levies
 State
 Other
Noncash contributions

Grant Expenditures

Administration expense
Preliminary expense
Land, structures, right of way
Architectural engineering
 basic fees
Other architectural engineering fees
Project inspection fees
Land development
Relocation expenses
Relocation payments to individuals and businesses
Demolition and removal
Construction and project improvement
Equipment
Miscellaneous
Contingencies

tures should be grouped in different formats to show cost by activities, tasks, subgrantees, program components, geographical areas served, and so on.

The supporting documentation must be retained for the full period cited in the grant agreement. Periodically, the grantee is required to render a report of the expenditures charged to the grant.

Personnel Compensation for personnel services includes all remuneration, paid currently or accrued, for services rendered during the period of the grant. Personnel costs include, but are not limited to, wages, salaries, supplementary compensation and benefits, directors' and executive committee members' fees, bonuses, incentive awards, employee insurance, fringe benefits, contributions to pension funds, off-site pay, location allowances, and hardship pay. Personnel costs are considered allowable if incurred in accordance with the grant agreement and if the compensation for individual employees is reasonable (1) for the services rendered in relation to the compensation paid to other governmental employees or (2) for similar work performed in the labor market in which the grantee must compete for employees. Compensation surveys are also an acceptable alternative for evaluating reasonableness.

Amounts charged to grants for personnel salaries and wages must be based on payrolls that have been documented and approved in accordance with generally accepted practices of the grantee or the government of which the grantee may be a part. Generally, the payrolls must be supported by time and attendance or equivalent records for individual employees. Where salaries and wages or other personnel costs are chargeable to more than one grant project or other cost objective, such costs must be supported by appropriate time distribution records. Any method used must produce an equitable distribution of time and effort.

With educational and selected nonprofit organizations, less formal time distribution methods might be permitted. For example, an adequate appointment and a monthly after-the-fact certification system by officials having firsthand knowledge of the services performed could be acceptable for grants to educational institutions.

Support for other personnel compensation and allowances—such as insurance plans and retirement plans—must be documented for the individual employee or for a group of employees.

Travel Travel costs include transportation, lodging, subsistence, and related costs incurred by the grantee's employees in

travel status while on official business. The charge may be based upon actual costs incurred or on a per diem or mileage rate in lieu of actual costs, or on a combination of the two, provided that the method used does not result in an unreasonable charge. Reasonableness is often determined by a comparison with the travel and transportation costs allowed under standardized government travel regulations.

Generally, the full cost of first-class transportation is not chargeable to government grants. When first-class transportation is used, only the cost of the less-than-first-class accommodations is chargeable to the grant; the difference is not allowable. Exceptions are usually made when less-than-first-class accommodations would require circuitous routing, would require travel during unreasonable hours, would extend the trip duration, thus adding costs that would offset the transportation savings, or when other accommodations are not reasonably adequate because of the traveler's medical condition.

Travel and transportation expenses must be supported by evidence that such costs are permitted by the grant agreement. Additionally, these expenses should be supported by a record indicating that the traveler had obtained advance approval for the trips, that the estimates of costs were reasonable, and that the travel was properly authorized. The disbursement support must include a statement of expenses from the individual traveler showing the purpose, destination, time period, mode of travel, type of living accommodations, and costs or per diem rates claimed.

Equipment Equipment costs cover office machines, furniture, fixtures, outdoor equipment, and special equipment like computers and copiers. Also included would be any transportation and installation expenses related to location of the equipment. Capital expenditures of this kind are likely to be unallowable unless specifically provided for in the executed grant agreement.

However, compensation for the use of buildings, capital improvements, and usable equipment on hand may be received by a grantee through depreciation or use allowances. The depreciation must be based on the distribution of cost over the useful asset life. The use allowance is a means of allowing compensation when depreciation or equivalent costs are not considered or cannot be computed. In both instances, the allowability of such costs should be specifically recognized in the grant agreement.

The costs of equipment and other capital expenditures could be incurred pursuant to a rental or lease agreement as well as a purchase.

Expenditures for the rental, lease, or purchase of equipment or

capital expenditures must be supported by competitive quotations, approved purchase orders, receiving reports, purchase requisitions, vendor's invoices, and evidence of payment. In the case of depreciation charges, complete property records must be maintained showing original costs, estimated service life, rates of depreciation, and periodic inspections to evaluate continuing usefulness and value of the property. Use charges should be supported by evidence of studies, comparisons, and other documents illustrating the overall reasonableness of assessing the use charge against the grant project or program.

Supplies Expenses for supplies and materials generally relate to items such as stationery, postage, and small items of equipment. Expenditures must be limited to supplies that can be reasonably expected to be consumed during the grant period. All purchases should be charged to the grant at actual cost, net of any purchase discounts, trade discounts, rebates, or other allowances received by the grantee. When withdrawals are made from general stores or stockrooms, acceptable costs would be the recognized method of pricing that is consistently applied to all users.

Expenditures for consumable supplies and materials must be supported by copies of vendor's invoices, receiving reports, receipts, authorization records, supply or materials requisitions, and evidence of payment or transfer of funds in the case of a central store or stockroom.

Contracts Contractual expenditures would include payments to approved consultants and experts for professional and technical services and for services rendered by other qualified individuals and organizations.

Contractual expenditures must be supported by documents evidencing efforts to obtain qualified services or performance on a competitive basis at reasonable prices. Where feasible, the records should indicate efforts to solicit more than one reputable and qualified source. Billings for contracts must provide a clear statement of the services rendered or performance received by the grantee. A purchase order or other contractual document should be approved and executed by the appropriate officials in advance of performance.

Construction Construction expenditures for buildings, facilities, improvements, or other efforts that increase the value or useful life of the building or facility generally require specific advance approval in the grant agreement in order to be allowable as a charge to the grant.

Construction expenditures must be supported by documents which evidence that effective competition was considered, that the construction was performed in accordance with a properly executed formal agreement, and that payment was proper and in accord with the agreement.

Other Direct Charges Other direct charges include repairs, bonding surety costs, insurance, telephone, publication and printing, meetings, and so on, which cannot be applied to one of the other direct charges. When significant, federal grantors generally identify and specify a budget amount for elements that might, by their nature, be classified as other direct charges.

Expenditures for other direct charges must be supported by purchase orders and requisitions where appropriate, vendors' invoices, receipts for goods or services, and evidence that funds were disbursed for the purpose of the project or program.

Indirect Charges Indirect charges are charges incurred for a common or joint purpose, benefiting more than one cost objective—such as grants, contracts, projects, or activities—and not readily assignable to the specific cost objective benefited without effort disproportionate to the results achieved. Under federal grantor cost principles, minor direct costs may be treated as indirect costs on the basis of practicality. Additional information on indirect charges appears in chapter 6.

Indirect costs charged to a grant must be supported by an analysis of the budgeted cost elements that constitute the indirect expense pools, an explanation of the account structure of the distribution base, the cost allocation rationale, and at least an annual comparison to actual indirect costs experienced. Under government procedures, an indirect cost plan or budget should be prepared at the outset of the grantee's fiscal year. Later, often at the close of the fiscal year, this plan is modified to the actual expenses incurred. Adjustments are then usually made to the provisional indirect expense rates that might have been used during the grant period.

Noncash Matching Contributions Noncash or in-kind matching contributions include the total cost and/or the cash equivalent of approved goods, facilities, services, or other contributions provided from nonfederal sources.

OMB Circular A-102 provides that when authorized by federal legislation, property purchased with federal funds may be considered as the grantee's in-kind contribution.

Additional information relating to matching contributions appears in chapter 6.

Noncash matching or in-kind contributions must be supported by records describing each contribution and identifying its source or donor as well as the dates, rates, values, and amounts of the contributed service or goods. A responsible grantee official must certify that the noncash items have been furnished to the grantee at actual cost (less depreciation), at market value, or at a reasonable independently appraised value.

Construction Grants

Within the federal government, a construction grant is a grant for a project or program whose major purpose entails construction, land acquisition, and land development. As provided in the specific grant agreement, the costs charged to a construction grant might include preliminary planning and engineering feasibility efforts as well as engineering, architectural, legal, fiscal, and economic investigation, studies, surveys, designs, plans, working drawings, and specifications. Also included might be the cost of erecting the building, acquisitions expenses, and alteration, remodeling, improvement, or expansion costs.

Under such grants, the actual construction work is usually performed by a contractor on a lump-sum (fixed price) or unit-price basis. Grantees are required to have or to adhere to adequate methods of obtaining competitive bidding prior to the award of the construction contract. The grantee must award the contract to the responsible bidder submitting the lowest acceptable bid.

Accounting for Property

A federal grantor may provide property to its grantees (1) as government furnished property, or (2) as an allowable cost to the grant. Under the latter method, the grantee is authorized to purchase the property for use in furthering the objectives of the grant project. Considerable care must be taken by grantees that have grantor property in their possession. Grantees are responsible for the procurement, use, and management of the property in a proper, efficient, and effective manner. Accurate and reliable quantitative and financial records and controls must be maintained.

The grantee should establish and maintain a system of internal controls adequate to safeguard grant property acquired with grant funds or furnished by the grantor. A property management system, having procedures that meet the following criteria, is considered adequate for the purposes of managing and accounting for grant property:

- Records currently maintained on both a quantitative and monetary basis for the various units of property.
- Periodic physical inventories taken to verify the condition, location, and continued utility of the grant property.
- Periodic reconciliations made of the physical inventories to the property entries in records, with provisions to notify the grantor promptly of all lost, destroyed, damaged, stolen, or excess property.
- Periodic surveillance to ensure that the property is available and used for grant purposes only.
- Reasonably prudent control and care taken for all property, including preservation, preventive maintenance, handling, and storage.
- Financial records adjusted to reflect both the quantitative and monetary value of property inventoried.

The Office of Management and Budget has prescribed uniform standards governing the utilization and disposition of property furnished by a federal grantor or acquired in whole or in part with federal funds by state and local grantees (see OMB Circular A-102, now FMC Circular 74-7). Nongovernmental grantees must be guided by the conditions of the grant agreement or by the published policies or regulations of the federal grantor. In summary, the OMB standards require the following:

- Governmental grantees may use any real property for purposes of the grant or for other projects if approval is obtained from the grantor. Real property furnished to the grantee or purchased in whole from federal funds must be returned to control of the grantor. Where real property was purchased in part with the grantee funds, the grantee may take title to the federal share under a sharing formula.
- Title for nonexpendable personal property acquired with federal funds will vest in the governmental grantee so long as there is a need for the property to accomplish the grant program or it may be used in connection with another federal program.

- Detailed disposition procedures have been established by the Office of Management and Budget should the property become excess to the needs of the governmental grantee.

Periodically, and within a specified period after completion of the grant, a grantee must provide a complete inventory of all property acquired, furnished, or constructed with grant funds. This inventory must generally be placed on forms provided by the grantor and may have to be completed within 60 to 90 days after the completion of the grant.

Record Retention Period

The retention period for grantee records has not been uniformly prescribed throughout the federal government. The usual requirement is that the grantee retain all records for a three- or five-year period. However, the time varies. For example, the period could be from the date of submission of the final grant report, completion of the grant program, last payment received from the federal government, or final settlement made under the grant by the grantee.

The General Services Administration has prescribed a uniform retention period for governmental grantees under FMC 74-7, which provides that financial records, supporting documents, statistical records, and all other pertinent records be retained for three years, with the following qualifications:

The records are to be retained beyond the three-year period if audit findings have not been resolved.

Property records are to be retained for three years after final disposition of nonexpendable property.

When grant records are transferred to a federal grantor, the retention period is not applicable to the grantee.

The retention period starts from the date of submission of the final expenditure report or, for grants which are renewed annually, from the date of submission of the annual expenditure report.

For nongovernmental grantees of the Department of Health, Education, and Welfare, the major grant-making agency of the government, a different retention period exists and is affected by the audit. This department's Grants Administration Manual prescribes the following retention periods for grantees that are not state and local units of government:

Records may be destroyed three years after the end of the budget period if audit by or on behalf of the department has occurred by that time.

If audit by or on behalf of the department has not occurred by that time, the records must be retained until audit or until five years following the end of the budget period, whichever is earlier.

In all cases an overriding requirement exists to retain records until resolution of any audit questions relating to individual grants.

Other governmental grantors may have differing record retention periods. Generally, though, no grantee should permit the destruction of records until there has been a resolution of all audit questions relating to a grant program.

5 Financial Statements and Reporting

The requirements for grantee financial statements and other cost reports vary between governmental and nonprofit organizations. The requirements for governmental grantees are relatively minimal with respect to overall financial statements. These grantees are usually not required to prepare and publish periodic separate financial statements of their activities. At the end of a fiscal year, the government of which the grantee is a part usually publishes a statement of operations and often a statement of financial position. The specifics on resources received and expenditures made for individual grants are usually the reports required by the federal grantor.

Nongovernmental grantees are often required to prepare and submit to the grantor periodic statements of financial position and statements of resources and expenditures for the organization as a whole, in addition to specific resource and expenditure reports for individual grants.

Financial Statements of Governmental Units

An authoritative body of acceptable governmental financial management practices for municipal, county, and other nonfederal governmental units is *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR) published by the Municipal Finance Officers Association. Many of its general standards and other procedures continue to be valid and are generally applied in the practice of governmental accounting. That text describes in considerable detail the principles and procedures of accounting, budgeting, auditing, and financial reporting for all governmental units except federal bodies, departments, and agencies.

A requirement of GAAFR adhered to by most governmental

units, is that three principal financial statements constitute adequate reporting of governmental finances:

- *Balance sheets*, which show assets, liabilities, reserves, and fund balances or retained earnings for individual funds or for all funds of the total governmental unit at a specified date.
- *Statements analyzing changes in fund balances or retained earnings*, which contain an analysis of the additions and reductions in particular balance sheet accounts between successive balance sheet dates.
- *Operating statements*, which show sources of revenue and purposes of expenditures for each fund.

Financial Statements of Voluntary Health and Welfare Organizations

Nongovernmental grantees, which could include voluntary health and welfare organizations, institutes, private foundations, and other nonprofit organizations, have placed reliance on *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, published in 1964 by the National Health Council and the National Social Welfare Assembly, with the support of over 50 voluntary organizations. That text expressly does not attempt to define principles of accounting, although it does attempt to establish rules governing the content and quality of the financial statements published by the cooperating organizations. While the rules have not been universally and uniformly adopted by nonprofit organizations, considerable reliance is placed on many of the standards enunciated in that text.

The operating statements developed in those standards for uniform reporting by voluntary health and welfare organizations include these:

- *Balance sheet*, which shows the assets owned and liabilities and debts owed by the organization, with separate balance sheets required for each homogeneous group of funds in order to demonstrate the segregations or restrictions that might be applicable to specific funds.
- *Statement of changes in fund balances*, which identifies the additions to and deductions from the balances of the various funds to provide a full accounting of the difference between the beginning and ending balances of funds.

- *Summary of financial activities*, which identifies the sources of receipts and other resources and the purposes or objective of expenditures made for a stated fiscal period.
- *Analysis of functional expenditures*, which identifies expenditures on a functional basis for each of the direct and support services.

Statements for Federal Grants

Uniform, governmentwide financial reporting requirements have been established by the Office of Management and Budget for state and local governmental grantees. The reporting practice for nongovernmental grantees is not uniform. Often, the principal reporting of these grantees relates to the reports required by the grantor.

At the time of audit, the grantor's audit representative is concerned with the relationship of the expenditures reported during the grant period to the expenditures recorded in the grantee's official books of account. Grantees should periodically make an accounting reconciliation of the data reported to grantors and the information appearing in the organization's certified financial statements or, in their absence, the legal equivalent.

The following statements are generally required of federal grantees, in addition to those statements that might be prepared to comply with other accounting requirements.

- Governmental grantees, pursuant to OMB Circular A-102, are required to submit a financial status report, a report of federal cash transactions, an outlay report and request for reimbursement for construction programs, and a request for advance or reimbursement.
- Other grantees, pursuant to specific conditions of the grant agreement, could be required to submit periodic reports and invoices supported by detailed expenditure analyses.
- Both governmental and nongovernmental grantees should adhere to a practice of annually preparing a statement of resources and expenditures.
- Both governmental and nongovernmental grantees must annually compute the actual indirect costs incurred and submit a statement of these costs to the designated reviewing agency or office.

Statement Required From Governmental Grantees

As already mentioned, governmental grantees are required to report financial information on a minimal number of forms. The four forms required by the Office of Management and Budget were identified earlier.

Other statements often required of grantees by federal grantors, include—

- Periodic invoices for reimbursement of costs incurred or for replenishment of an earlier advance received from the grantor.
- A summary statement of total resources and expenditures of the grantee organization.
- A statement of indirect costs to support the recovery of the indirect or overhead costs of the grantee organization.

Periodic Invoices for Reimbursements or Replenishment of Advance Some federal grantors require that grantees obtain remuneration for grant expenditures on a reimbursement basis. Other grantors may provide the grantee with an advance of funds at the commencement of the grant project. Periodically, often monthly, these grantees must submit invoices with supporting information to claim reimbursement for expenditures or replenishment of the advance funding. In either case, the grantees would probably be required to make the requests for payment on a public voucher (Federal standard form 1034), with an attachment detailing the expenditures made during the period for which payments are claimed and showing the cumulative costs incurred to date under the grant agreements.

Statement of Resources and Expenditures The depth of federal audit scrutiny and audit issues can be materially reduced if federal grantees prepare a summary of all resources received and expenditures made for both federal and other purposes. Time devoted by federal auditors will be significantly reduced if a reconciliation is prepared to show by program, project, or activity all receipts and expenditures and the amounts reported to the federal grantor during the interim reporting submissions of the fiscal periods. This statement should be a part of any audit report and show both direct and indirect expenditures for the total organization.

Exhibit 5-1, page 86, illustrates a statement of resources and expenses for a nongovernmental grantee. A similar statement might be prepared by the financial officer of a governmental grantee, with the inclusion of the appropriate sources of receipts and expenditures.

Statement of Indirect Cost Rates Indirect costs are costs incurred by a grantee that are not readily identifiable to a specific grant, program, project, activity, or similar cost center. While it is theoretically possible for all such costs to be specifically identified and charged directly to each cost center or objective, there may be practical impediments to such accounting and the costs might be prohibitive.

Federal grantors favor the calculation of indirect costs at the end of the grantee's fiscal year. Whenever possible, a grantee should incorporate an analysis of its indirect costs along with a statement of resources and expenditures in its certified financial statements.

Submission of Indirect Cost Proposal The federal government, principally with the lead of the Department of Health, Education, and Welfare, has established a procedure for permitting grantees to recover indirect costs throughout the year under an approved provisional overhead or indirect cost rate. This rate is initially negotiated on the basis of historical indirect cost levels experienced by the grantee or on the basis of a projected overhead or indirect cost budget for the fiscal period of the grant. Annually, grantees are required to calculate the actual indirect costs incurred, adjust these costs to eliminate any known unallowable costs, and submit a proposal to the federal grantor for the purpose of adjusting any provisional indirect cost rates to actual or for the purpose of establishing a new fixed, provisional, or predetermined indirect for the grantee's next fiscal period.

The timely submission of the documentation for an indirect cost proposal is important to the grantee. The administrative regulations of some federal grantors provide that if there is a failure to comply with the submission of actual indirect costs, future grant awards will be deemed not to have a current indirect cost rate. In the absence of such a rate, future grants will not provide for the reimbursement of indirect costs. Further, if a rate is established on the basis of a late submission, the indirect cost reimbursement may be limited to the indirect costs applicable to the period *following* the date when the proposal was actually submitted. Thus indirect costs previously incurred or reimbursed may be disallowed.

Exhibit 5-1

THE INSTITUTE FOR RESEARCH
STATEMENT OF RESOURCES AND EXPENDITURES YEAR ENDED _____

	Total Per Operating Statement (Exhibit—)	Government Projects Grant Nos.				Nongovernmental Projects				Fund Raising		
		A	B	C	D	E	WW	XX	YY		ZZ	
<u>Resources Available</u>												
Federal Receipts	\$ XXXX	XXX	XXX	XXX	XXX	XXX	XX	XX	XX	XX		
Nonfederal Receipts	XXX	XX	XX	XX	XX	XX	X	X	X	X		XXX
Matching Cash Contributions	XXX											XXX
Matching Noncash Contributions	XXX	XX	XX	X								
Total Resources	\$ XXXX	XXX	XXX	XXX	XXX	XXX		XX	XX	XX		XXX
<u>Expenditures</u>												
Salaries and Wages	XXXX	XX	XX	XX	XX	XX	X	X	X	X		X
Fringe	XXX	X	X	X	X	X						X
Travel	XXX											
Rent, Utilities	XX	X	X	X	X	X						
Printing	XX	X	X	X	X	X						
Supplies, Materials	XXX	X	X	X	X	X		X				XX
Equipment	XX	X	X	X	X	X						X
Communications	XXX	X	X	X	X	X						XX
Contracts	XXX	X	X	X	X	X						
Other Direct Costs	XX	X	X	X	X	X		X		X		X
Indirect Costs (% of Salaries and Wages ¹)	XXXX	XX	XX	XX	XX	XX		X	X	X		X
Matching Expenditures	XXX											XX
Total Expenditures	XXXXX	XX	XX	XX	XX	XX		XX	XX	XX		XX
<u>Available Resources Over (Under) Expenditures</u>	\$ XXXX	XX	XX	XX	X	(X)		X	(X)	X		XX

¹See Exhibit 5-2, Statement of Indirect Costs.

Methods of Preparing Indirect Cost Proposals While individual federal grantors may establish separate regulations for determining indirect costs, procedures published by the Department of Health, Education, and Welfare have found wide acceptability. These procedures are in booklet form and may be obtained from any HEW Regional Office or direct from the Government Printing Office in Washington. The documents describe the procedures for determining the indirect cost rates for several types of federal grantee organizations:

- A Guide for Colleges and Universities (OASC-1, Revised)
- A Guide for Hospitals (OASC-3, Revised)
- A Guide for Nonprofit Institutions (OASC-5, Revised)
- A Guide for State and Local Government Agencies (OASC-10)

Statements of Indirect Costs The cited documents set forth the generally accepted procedures for developing indirect or overhead costs under federal grants to several kinds of grantee organizations. Although published by HEW, these procedures are used by other federal grantors in support of payments for indirect costs.

The Department of Health, Education, and Welfare and most federal grantors recognize that grantee organizations vary and so do their methods of cost accounting. There is a general consensus, though, that indirect costs may be allocated to federal grants on a single rate basis or on a multiple rate basis when the simpler calculation would not be equitable.

Reports of indirect costs applicable to local government agencies required by the Department of Health, Education and Welfare are outlined in DHEW Document OASC-10, *A Guide for Local Government Agencies—Establishing Cost Allocation Plans and Indirect Cost Proposals for Grants and Contracts With the Federal Government*. Following is a discussion of alternative methods of allocating costs as presented in OASC-10.

Single Rate Cost Proposal Report A single, simplified indirect cost rate proposal is acceptable when federal and local organizational activities or grantees benefit to the same relative degree from the functions that generate the indirect costs. This calculation is also acceptable when the federal activity is not relatively significant.

The single or simplified method involves the following steps:

- Reviewing the total cost and eliminating unallowable costs and capital expenditures.

- Classifying the allowable costs as direct or indirect.
- Computing an indirect cost rate by dividing total indirect costs by total costs.

Multiple Rate Cost Report The multiple rate basis, a step-down cost allocation basis, provides for a more refined determination of indirect costs. While it is more complicated than the single rate method, the multiple rate basis should be used when the single rate would cause significantly inequitable distributions of indirect costs to organizations and activities, including federal programs, of the grantee organization.

The multiple rate method involves the following steps:

- Classifying indirect costs into functional cost pools which benefit the grantee's organizations or activities in significantly different proportions.
- Selecting an appropriate distribution base for each pool of indirect costs.
- Distributing each indirect cost pool to the activities in the base.
- Calculating an indirect cost rate for each organization or activity of the grantee by relating the indirect costs allocated to the appropriate direct cost base.
- Applying the rates to the direct cost base of the organization or activity. Bases in common use include total direct salaries and wages; total direct salaries and wages plus applicable fringe benefit expense; and total direct costs less capital expenditures.

Direct Allocation Rate Reports Many grantees, particularly those receiving federal grants for the first time, will elect to account for all costs as program costs, except for the costs of general administration and fund raising. Under this direct allocation method, expenditures are segregated between general and administrative expenses, fund-raising costs, and other direct program and activity costs.

Joint or common costs (rent, telephone, other utilities, supplies, and so on) that cannot be specifically related to a function, program, or activity, may be prorated on a basis that is reasonable and equitable.

The Department of Health, Education, and Welfare (in OASC-5, Revised) found this method to be accurate for costing under

grants. The indirect costs are the residue or undistributed costs classified as general and administrative.

HEW requires that the direct allocation method be applied by institutions using *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations* (cited earlier) when reporting to nonfederal agencies.

The direct allocation method requires that—

- All expenditures, whether from general or restricted funds, be listed.
- Capital expenditures and unallowable costs to which indirect costs are not allocable are eliminated from the total expenditures. Classification by these categories may generally be taken from the grantee's financial statements.
- Residual costs are then allocated to general and administrative expenses, fund-raising expenses, and expenses of the grantee's direct programs and activities.

Nongovernmental Grantee Indirect Cost Proposal Exhibit 5-2, pages 90-91, illustrates a method of determining the allowable indirect costs for other nongovernmental grantees not required to adhere to the voluntary health and welfare organization standards. Also contained in this exhibit are alternative calculations of indirect cost rates, assuming different cost bases. In practice, a grantee must select one method and use it consistently from one accounting period to the next. Any change in the base or method of calculating indirect costs must be reported to the grantors immediately, with a full explanation of the change as well as its impact on the federal grants issued to the grantee.

Nongovernmental grantees generally have several kinds of unallowable costs not associated with governmental grantees. These include costs associated with membership rolls and listings, subscriptions, publications, public relations, lobbying, services to members, meetings and conferences not associated with the general administration of the grantee institution, fund raising, investment activities of special funds, and administration of group benefits for members for insurance, retirement, and financial aid. While such costs are considered unallowable for government purposes, they are properly includable in the total direct cost base of the institution and should receive their applicable portion of indirect cost assignment.

Exhibit 5-2

**NONGOVERNMENTAL GRANTEE STATEMENT OF
INDIRECT COSTS—YEAR ENDED—**

<u>Indirect Costs</u>	<u>Total Indirect Costs</u>	<u>Unallow- able Costs</u>
Salaries, wages	\$100,000	
Fringe benefits	20,000	
Travel	5,000	
Rent, utilities	15,000	
Printing	5,000	
Supplies	5,000	
Equipment	70,000	\$70,000(A)
Communications	5,000	
Interest	10,000	10,000(B)
Contributions	5,000	5,000(B)
Entertainment	5,000	5,000(B)
Public relations	20,000	20,000(C)
Fundraising	10,000	10,000(C)
Contracts	20,000	
Professional fees	15,000	
Taxes	5,000	
Other	10,000	
	<u>\$325,000</u>	<u>\$110,000</u>

Calculation of Indirect Cost Rates:

	<u>Total Direct</u>	<u>Direct Costs (D)</u>	
		<u>Salaries, Wages</u>	<u>Fringe Benefits</u>
•Total—Federal and Private Activities	<u>\$1,000,000</u>	<u>\$400,000</u>	<u>\$80,000</u>
	(2)	(3)	(4)
•Indirect Rate— <u>Direct Salaries & Wages</u> \$215,000 (1): \$400,000 (3) = 53.7%			
•Indirect Rate— <u>Direct Salaries & Wages Plus Fringe Benefits</u> \$215,000 (1): \$400,000 (3) plus \$80,000 (4) = 44.7%			
•Indirect Rate— <u>Total Direct Costs</u> \$215,000 (1): \$1,000,000 = 21.5%			

*Allowable
Indirect
Costs*

Notes

\$100,000
20,000
5,000
15,000
5,000
5,000
10,000
5,000

(A) Exclude capital expenditures; allowed depreciation.

(B) Unallowable pursuant to grant cost principles.

(C) Private, direct activities; to be included in direct costs and base to which indirect costs are allocated.

20,000
15,000
5,000
10,000

\$215,000(1)

*Other
Direct*

\$520,000

(D) Direct costs include all costs chargeable to all activities of grantee organization, whether supported by federal funds or private funds. Totals must be reconciled to accounting records and financial statements.

Nonfinancial Reports

Federal grantors generally require periodic program activity reports to permit an assessment of progress or activity of the grantee. Some reports provide statistical information, unit costs, references to predetermined milestones, changes in personnel, and other information such as problems encountered, accomplishments, and plans for the next reporting period. The format for such reports varies with the grant program.

Periodically, throughout the grant period, the grantee has to submit a report on the property furnished it by the federal grantor or property that was purchased with grant funds. Generally, this reporting is required for nonexpendable significant items.

6 Federal Cost Principles

This chapter identifies and discusses the cost principles applicable to federal grant-in-aid programs. It is imperative that public accountants auditing for or consulting with federal grantees know these principles, since they form the criteria by which costs claimed by grantees are deemed to be allowable or unallowable for reimbursement by the federal government.

Cost Accounting for Grants

As used in connection with federal grant-in-aid programs the term *cost accounting* refers to the accumulation, allocation, and reporting of the program's expenses, generally by object classification, functions, and activities within specified accounting periods. The federal government has established an extensive body of cost principles, which to a large degree determine the manner in which the cost accounting is to be done.

Responsibility for Cost Principles

The Office of Management and Budget has established the principles defining the costs allowable under federal grant programs and the types of organizations that can be reimbursed under federal grants. These cost principles have been published in three documents:

- OMB Circular A-21 (or FMC 73-8), Revised, *Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Educational Institutions.*
- OMB Circular A-87 (or FMC 74-4), *Principles for Determining Costs Applicable to Grants and Contracts with State and Local Governments.*

- OMB Proposed Circular A-*, *Grants and Contracts with Certain Nonprofit Organizations—Principles for Determining Cost.*

Most federal grantor agencies have adopted the requirements of Circular A-21, with certain modification, as the cost principles for grants and contracts with nonprofit organizations in general. It should be noted that in both A-21 and A-87, these principles are confined to the determination of cost and not to the identification of circumstances or dictation of the extent of federal participation in the financing of a particular grant program. The circumstances under which grants are awarded and costs allowed, as well as extent of federal participation, are determined by the grantor agency.

Circular A-21, originally issued in 1958 and revised over the years, defines the principles for determining the allowable costs applicable to research and development performed by educational institutions. A later attachment to this circular extended its scope to the determination of costs by educational institutions under grants for training and educational services as well.

The cost principles in Circular A-21 generally apply to grants and contracts awarded to nonprofit organizations other than educational institutions, with some modification. Additionally, these cost principles, with a few minor exceptions, have been incorporated into the Federal Procurement Regulations as Subpart 1-15.3 of Part 1-15, "Contract Cost Principles and Procedures."

Circular A-87 sets forth the principles for determining the allowable costs of grant and contract programs administered by state and local governments. These principles were designed to insure that federally assisted programs bear a fair share of the costs recognized under the principles, except where the allowability of such costs is otherwise restricted or prohibited by law. The cost principles of Circular A-87 have been incorporated into the Federal Procurement Regulations as Subpart 1-15.7 of Part 1-15.

The proposed OMB circular for nonprofits will do for nonprofit organizations what OMB Circular A-21 did for educational institutions and OMB Circular A-87 did for state and local governments. This circular provides a uniform approach to determining costs for certain nonprofit grantees.

Applicability of OMB Circulars

OMB circulars are designed to establish consistency and uniform-

* A proposed draft of OMB Circular, not issued at publication date.

ity among federal grantor agencies with respect to the allowability of costs. The circulars are applicable to all federal grant programs. On occasion, federal grantor agencies have issued implementing regulations that contain more stringent or restrictive conditions than the circulars. Generally, the grantor agencies have incorporated the principles of these circulars by reference as conditions of the grant. It should be noted that where the more stringent conditions of the agreement differ from the cost principles in the circulars, the conditions of the agreement prevail.

Cost Guides of Other Agencies

Typically, federal grantors issue administrative guidelines to grantees. These guidelines, while generally similar to the requirements of Circular A-21 or A-87, may exclude from reimbursement certain costs that are allowable under the circulars. Therefore, a careful examination must also be made of the administrative guidelines for each federal program, as well as the specific grant conditions.

Department of HEW

The Department of Health, Education, and Welfare, the largest federal grantor, has led the way in developing guidelines and instructions related to the determination of costs and procedures for allocating indirect costs to grant programs. The department has published several reference documents that should be carefully studied before beginning an audit or consulting service with any federal grantor. All these documents are available for a nominal fee from the Government Printing Office in Washington.

- *Grants Administration*—Department (of Health, Education, and Welfare) staff manual.
- *A Program for Improving the Quality of Grantee Management*—Financially dependent organizations (volume I); Financially independent organizations (volume II).
- *A Guide for Colleges & Universities*—Cost principles and procedures for establishing indirect cost rates for research grants and contracts with the Department of HEW (OASC-1).
- *A Guide for Hospitals*—Cost principles and procedures for establishing indirect cost rates for research grants and con-

tracts with the Department of HEW (OASC-3).

- *A Guide for Nonprofit Institutions*—Cost principles and procedures for establishing indirect cost rates for grants and contracts with the Department of HEW (OASC-5).
- *A Guide for State and Local Government Agencies*—Cost principles and procedures for establishing cost allocation plans, indirect cost and other rates for grants and contracts with the federal government (OASC-10). (Replaces the earlier OASC-6 [for state governments] and OASC-8 [for local governments].)

Hierarchy of Cost Principles

On occasion, questions arise concerning the hierarchy of the cost principles relating to allowable costs—that is, which cost principles apply when several are generally applicable. A basic rule is that the most specific principles or statements of allowable and unallowable costs apply. An order of priority for a grant issued by the National Institutes of Health, for example, would go like this:

- The specific conditions of the executed grant generally prevail. If a cost deemed allowable by other agencies is specifically identified in the grant agreement as unallowable, the exclusion in the grant agreement will govern.
- The National Institute of Health may prescribe certain types of costs, that are allowable under other HEW grant programs, to be inapplicable or unallowable as a charge to NIH grants. In such cases, NIH's policy would prevail.
- The Department of Health, Education, and Welfare has the authority to determine which costs, deemed generally allowable by the Office of Management and Budget, are unallowable, or allowable with certain conditions, under HEW grant programs.
- The Office of Management and Budget has established the costs that may be considered as allowable or unallowable under federal grant programs, unless illegal or otherwise deemed unallowable by the specific grantor or by a condition of the executed grant agreement.

A general rule is that the broader cost principles, established by other than the involved federal grantor, are confined to the subject of cost determination and do not attempt to identify the circumstances or dictate the extent to which a grantor must partici-

pate in the financing of a particular grant. Special heed must be given to costs defined as allowable or unallowable by specific reference in the agreement. However, a cost classed as unallowable by the Office of Management and Budget or an organization senior to the grantor may not be allowed under the grant agreement by the grantor.

Definition of General Cost Principles

Differences exist among federal agencies between the nature of the costs allowable for payment under a grant and the level of costs considered permissible as a charge to a grant. However, the general principles discussed in this section are similar for all federal grantors; exceptions are usually set forth by an agency in its administrative guidelines or in the grant agreement.

Grant costs are discussed in terms of the following aspects, which are generally applicable to the grants of most federal agencies: total costs, direct costs, indirect costs, allowable costs, and unallowable costs.

Total Costs

The total cost of a grant or contract agreement is defined as the allowable direct and allowable indirect costs, less any applicable credits. While an agency may specify the system of accounting to be used, usually any generally accepted accounting method of equitably determining or estimating costs may be used.

There is no universal rule for classifying certain costs as direct or indirect. The essential point is that each item of cost be treated consistently, as either a direct or an indirect cost, between the different governmental and nongovernmental activities of the grantees and between accounting periods.

Direct Costs

Direct costs can be identified with a specific project, grant, contract, or other cost objective. These costs must be charged directly to the activities benefited. Direct costs may also be charged to cost objectives or expense pools for later distribution to grants, contracts, or projects on a basis that is reasonable and equitable.

With slight variation, the following classifications of costs, generally referred to by the federal grantors as object classes, are the

categories or groupings of direct cost common to most federal grants:

- *Personnel compensation or salaries*—compensation of employees for the time and effort devoted specifically to the execution of the grant program.
- *Fringe benefits*—cost related to vacations, sick time, insurance, holidays, and similar employee benefits to the extent that such costs are related to the employees being charged direct to the grant and that such costs have not been claimed elsewhere.
- *Travel*—expenses incurred by grantee staff for the costs of lodging, meals, and transportation while in a travel status away from the individual's official duty station and the costs of local travel on official grant business.
- *Consultants, contracts*—payments made to specialists or experts and for services rendered by a contractor that are external to the grantee's immediate organization.
- *Materials and supplies*—costs of materials and supplies acquired, consumed, or expended specifically for the purpose of the grant.
- *Equipment*—generally includes the cost to procure or lease nonexpendable, high-value equipment necessary to the performance or completion of the grant. In the case of fully depreciated equipment, a use charge may be an alternatively acceptable charge to the grant.
- *Space*—generally includes the cost of procuring or leasing the facilities necessary to conduct grant activities. In the case of a fully depreciated building, a use charge may be an alternatively acceptable charge to the grant.
- *Other direct costs*—other costs specifically identified in the executed grant agreement which were not considered to be within the above categories.

Indirect Costs

Indirect costs are (1) incurred for a common or joint purpose benefiting more than one project, grant, contract, or cost objective and (2) not readily assignable to the cost objectives specifically benefited without an effort that is disproportionate to the results.

The term *indirect costs* could apply to costs originating in the grantee operation as well as those incurred by other departments (in the case of government agencies) in supplying goods, services,

and facilities to the grantee. Additionally, minor direct cost items may be considered to be indirect costs for reasons of practicality.

Illustrative methods of determining the indirect or overhead costs applicable to grants are discussed in chapter 5.

Bases for Distributing Indirect Costs Indirect costs must be accumulated by logical groupings, giving consideration to the reasons for incurring the costs in order to permit distribution to the various projects, grants, and contracts of the grantee.

Where an indirect cost grouping can be distributed directly to a project, grant, contract, or activity benefited, such a distribution is made. In many instances, the indirect cost grouping is more general in nature. Here the distribution must be made on the basis that will produce a cost result equitable to both the government and the grantee. Generally, any cost element could form the basis for distribution of indirect costs provided (1) that it can be expressed in terms of dollars or other quantitative measure and (2) that it is common to the cost objectives of the base time period, typically the grantee's fiscal year.

Among the more common bases for distributing indirect costs to grants are—

Total direct costs

Total direct salaries and wages

Total direct salaries and wages, plus fringe benefits costs

Man-hours applied

Square feet utilized

Hours of usage

Number of documents processed

Population served

Distribution bases, by types of services, suggested by HEW appear in exhibit 6-1, page 101.

To avoid disagreement, grantees and grantors should establish at the outset the basis that is to be used for the distribution of indirect costs. The conclusions of such discussions should be formalized as a part of the grant agreement. The later refusal of a grantor to accept the basis used by a grantee for indirect costing could cause gross inconsistencies in the cost accounting for the grantee's activities and could form the basis for significant disallowances and exceptions by other grantors.

Indirect Cost Rates A federal grantee may be reimbursed for its indirect costs by one of the following methods:

- Provisional indirect cost rate
- Predetermined/fixed indirect cost rate
- Lump sum or fixed amount

Where a provisional indirect cost rate is used in reimbursing the grantee for these costs during the grant period, the actual indirect cost will be determined by negotiation or by the grantor's final audit of the indirect costs.

To permit a grantee to recover indirect costs during the period of the grant, grantors generally negotiate a *provisional* or *interim indirect cost rate*. This is an estimate of the indirect costs that the grantee will incur and the grantor will accept any claim for reimbursement until such time as the grantee can determine its actual indirect cost rate for the period.

Once the rate has been determined and accepted by the grantor, the grantee is entitled to receive or must refund the difference between the provisional and the actual rate. If the provisional rate was higher than the actual, a refund or adjustment must be made to the grantor. If the provisional rate was lower, the grantee is entitled to claim the additional actual amount, provided that there is no other restriction on the level of indirect costs that may be charged to the grant.

A *predetermined fixed indirect cost rate* may be negotiated between the grantor and the grantee. The predetermined rate may be used when the grantee is deemed sufficiently experienced to reach an informed judgment about the probable level of indirect costs during the period to be covered by the negotiated rate and to insure that the amount actually allowable under the predetermined fixed rate will not exceed the fixed rate.

The negotiation of a *lump sum* or *fixed amount* for indirect cost might be appropriate when the benefits from an indirect service cannot be readily determined. If used, the grantor will make a determination that the lump sum will approximate the actual indirect costs that may be incurred so as to preclude a significant overrecovery of these costs by the grantee. Any lump sum must be deducted from the total of the indirect costs being allocated to other grantee activities.

Negotiated Indirect Cost The more common method of determining the amount of indirect cost that will be reimbursed under a grant is negotiation with the grantor. Typically, an overhead plan or budget must be submitted. At the outset of the grant, an overhead budget might be the basis for establishing a provisional overhead rate. At the end of the overhead period, the grantee is required to submit a statement of its actual indirect costs. This

Exhibit 6-1

SUGGESTED BASES FOR COST DISTRIBUTION

Following are suggested bases for distributing joint costs of certain central-type services to local government departments or agencies and to projects and programs utilizing these services. The suggested bases are not mandatory for use if they are not suitable for the particular services involved. Any method of distribution can be used which will produce an equitable distribution of cost. In selecting one method over another, consideration should be given to the additional effort required to achieve a greater degree of accuracy.

<u>Type of Service</u>	<u>Suggested Bases for Allocation</u>
Accounting	Total dollar volume or number of transactions processed.
Auditing	Direct audit hours.
Budgeting	Direct hours of identifiable services of employees of central budget.
Building lease management	Number of leases.
Data processing	Machine hours.
Disbursing service	Number of checks or warrants issued.
Employees' retirement system administration	Number of employees contributing.
Insurance management service	Dollar value of insurance premiums.
Legal services	Direct hours.
Mail and messenger service	Number of documents handled or employees served.
Motor pool costs including automotive management	Miles driven and/or days used.
Office machine and equipment maintenance repairs	Direct hours.
Office space use and related costs (heat, light, janitor service, etc.)	Sq. ft. of space occupied.
Organization and management services	Direct hours.
Payroll services	Number of employees.
Personnel administration	Number of employees.
Printing and reproduction	Direct hours, job basis, pages printed, etc.
Procurement service	Number of transactions processed.
Local telephone	Number of telephone instruments.
Health services	Number of employees.
Fidelity bonding program	Employees subject to bond or penalty amounts.

Source: *A Guide for Local Government Agencies—Establishing Cost Allocation Plans and Indirect Cost Proposals for Grants and Contracts With the Federal Government*, Department of HEW (Document OASC-8).

statement is examined by the grantor so as to determine the actual indirect costs to be charged to the grant. See chapter 5 for illustrations of indirect cost statements.

Fixed Rate With Carry-Forward HEW permits the use of a fixed rate with a carry-forward provision, which has characteristics of both the provisional rate and the predetermined fixed indirect cost rate. Under this method, the indirect cost rate is computed and fixed for a specified future period, based upon estimated levels of operation.

When the actual indirect costs of the period are known, the difference between the provisional rate and the actual indirect cost rate is carried forward or rolled forward as an adjustment to the indirect cost rate of a subsequent accounting period. Under HEW regulations, the adjustment cannot be made in the next fiscal period since the fixed rate for that period will already have been determined. Adjustments are generally carried forward to the second or third fiscal period following the period being adjusted.

Accurate forecasting will of course minimize the differences in rates that will have to be carried forward. However, grantees should exercise extreme caution in determining rates to be used under this method of indirect cost recovery. Should the grantee recover more than its indirect costs in the first year because its provisional rate was higher than the actual rate, the excess would be returned to the federal grantor two or three years later. However, the converse is also true. Should the grantee recover less than its indirect costs in the first year, it would not receive the remainder through the use of a higher provisional indirect cost rate until the second or third following year, possibly creating a cash flow problem for the grantee.

Audited Indirect Cost When the conditions of a grant provide that the actual indirect costs allowable under the grant will be determined by government audit, the auditor is the final determinant on the nature and level of indirect costs allowed for reimbursement. It is important to note that under these conditions, no negotiations are conducted. Thus, grantees must make the necessary effort to resolve all questions raised before the audit is concluded, or disallowances could be made without discussions.

Allowable Costs

While the Office of Management and Budget has prescribed the cost principles that govern grant-in-aid programs, many agencies

have modified or more stringently interpreted these principles. The grantee should be governed by the administrative regulations and the specific grant agreements that are issued by the grantor for the specific grant programs under its jurisdiction. As a general rule, the grant agreement is the final determinant of the costs to be allowed as a claim under a grant. The agreement is the binding instrument defining the specific conditions and terms that were negotiated by the grantor and a particular grantee.

The general definition of allowability of costs under federal grants includes direct and indirect costs allocable to the grant less applicable credits. In determining costs, any generally accepted accounting method that is equitable may be used. Factors affecting allowability of costs for HEW programs include (1) reasonableness, (2) allocability, (3) application of appropriate generally accepted accounting principles, and (4) any limitation or exclusions set forth in the HEW cost principles or in the grant as to types or amounts of cost items.

- *Reasonableness*—By nature and amount the costs do not exceed that which would be incurred by the ordinarily prudent person in the conduct of competitive business.
- *Allocability*—The cost is assignable or chargeable to a particular cost objective (grant, contract, project, activity, process, service, or whatever) in accordance with the benefits received or other equitable relationship and is incurred specifically for the grant; benefits both the grant and other work and can be distributed in reasonable proportion to the benefits received; and is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown.
- *Application of generally accepted accounting standards*—The *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations* or other comparable standards are used by the grantee for non-HEW supported activities, the grantee must use the same standards to allocate costs to HEW grants.

Many federal grantor agencies have accepted the definition of allowable costs as including the direct and indirect costs defined above insofar as such costs are necessary and related to the performance of the grant.

Unallowable Costs

As a matter of public policy, certain costs and expenses cannot be accepted as valid or allowable charges to federal grants. The fol-

lowing are the more commonly unallowed costs or expenses, although a particular federal grantor may for some reason establish that additional types of expenses would be unallowable charges to its grant program.

- *Advertising.* Promotional use of such media as newspapers, magazines, radio, television, direct mail, trade papers, and the like is unallowable unless done solely for the grant program.
- *Bad debts.* Any losses arising from uncollectable accounts and other claims and related costs are unallowable.
- *Contingencies.* Contributions to a contingency reserve or any other similar provision for unforeseen events are usually unallowable.
- *Contributions and donations.* Gifts, contributions, and donations are unallowable.
- *Entertainment.* Costs of amusements and social activities as well as incidental costs relating thereto, such as meals, beverages, lodgings, rentals, transportation, and gratuities, are unallowable.
- *Fines and penalties.* Costs resulting from violations of or failure to comply with federal, state, and local laws and regulations are unallowable.
- *Government official's expenses.* The salaries and expenses of the office of the governor of a state or the chief executive of a political subdivision are considered a general cost of the state or local government and are unallowable.
- *Interest and other financial costs.* Costs incurred on borrowing, bond discounts, cost of financing and refinancing operations, financial campaigns, endowment drives, solicitation of gifts, bequests, and other expenses, and cost of legal and professional fees paid in connection therewith are unallowable.
- *Legislation expenses.* Salaries and other expenses of the state legislature or similar local governmental body such as county supervisors, city councils, and school boards, whether incurred for purposes of legislation or executive direction, are unallowable.
- *Underrecovery of costs or losses under grant agreements.* Any excess of costs, direct or indirect, over the federal contribution under one grant agreement is unallowable as a charge under another grant agreement, either as a direct or as an indirect charge.

In the case of a nonprofit organization, the following additional costs are unallowable for inclusion in the grantee's indirect costs and must be reported as direct costs to which indirect costs must be allocated.

- Maintenance of membership rolls, subscriptions, publications, and related functions.
- Providing services and information to members, legislative or administrative bodies, or the public.
- Promotion, lobbying, and other forms of public relations.
- Meetings and conferences except those held to conduct the general administration of the institution.
- Fund raising.
- Maintenance, protection, and investment of special funds not used in the operation of the institution.
- Administration of group benefits on behalf of members or clients, including life and hospital insurance, annuity or retirement plans, and financial aid.
- Other activities performed primarily as a service to a membership, a client, or the public.

Generally, costs associated with these activities, when normal and necessary to the organization's primary mission or objective, must be accounted for as direct costs of that institution.

Allowability of Indirect Cost Plans

Federal grantors generally establish the level of the indirect costs that may be permitted as an allowable cost to a grant on the basis of an approved cost allocation plan. With respect to governmental grantees two cost allocation plans are required.

The first plan covers distribution of the cost of support services provided to a state or local government grantee agency and referred to as the consolidated governmentwide cost allocation plan. The second plan covers distribution of the costs within the individual grantee agency, including the costs allocated to it under the consolidated state or local governmentwide cost allocation plan to all activity of that grantee.

With respect to other types of grantees, the level of indirect costs allowable as a charge to the grant is generally determined by the grantor upon review of the grantee's indirect cost proposal. This proposal generally consists of a report of the indirect costs

incurred during the last complete fiscal year. Alternatively, though, a budget or forecast of indirect costs might be an acceptable and possibly a more accurate base for establishing the allowable provisional indirect cost rate. See chapter 5 for illustrations of indirect cost reports that should be submitted to federal grantors at the close of a fiscal year.

Some federal grantors consider the failure to comply with the development of an indirect cost plan of sufficient importance to disallow indirect costs previously awarded on an earlier approved provisional basis. Further, in the absence of a current provisional indirect cost rate new grant awards will not include an amount for indirect costs. If a rate is subsequently established, indirect costs on the grants may be allowed only for the period subsequent to the date when the plan is submitted. When extenuating circumstances prevent on-time submission, it is important that grantees make a formal request for an extension of the due date for the submission of an indirect cost plan.

Matching Share and In-Kind Contributions

Many federal grant programs require that grantees provide certain costs to the grant in a specified ratio or matching share. Such costs are considered to be an integral part of the project costs and are subject to audit as to allowability or unallowability in the same manner as the federally funded costs. To the extent that a matching share contribution is deemed unallowable for a particular grant program, the grantee must provide an acceptable alternative contribution. Records must be maintained for the matching share or contribution with the same care that is applied to accounting for the federal monies.

Matching Share Definition

The matching share of grant project costs represents costs that are required for the grant program, but are not borne by the federal government. Matching shares might be required for a grant program by the law establishing the program, in which case the requirement is made a part of the grant agreement conditions. Unless restricted by the grant agreement, matching shares could take one of the following forms:

- *Project costs that do not require cash outlays* but that benefit the grant project, such as depreciation and use charges incurred by the grantee for buildings and equipment, indirect costs.
- *Cash contributed or donated by grantee or others* for use in the grant program.
- *In-kind contributions* that meet the following criteria:
 1. They are identifiable in the grantee's records.
 2. They are not included as contributions for any other federal program.
 3. They are necessary and reasonable for the accomplishment of the grant project objectives.

The above criteria have been expressly promulgated by the Office of Management and Budget (in OMB Circular A-102) for application to grants to state and local governments. However, the same criteria have generally been applied by most federal agencies to other programs requiring matching share or in-kind contributions. Additionally, the agreement of a grantee to request reimbursement for less than the actual indirect costs might be considered an allowable matching cost.

It should be noted that the foregoing criteria for allowable and unallowable costs apply equally to matching or in-kind contributions.

Valuation of In-Kind Contributions

For many years, the valuation of in-kind contributions was the subject of considerable discussion between grantees and federal grantors. The Office of Management and Budget set forth the following criteria for valuing in-kind contributions by governmental grantees that will probably be adopted and used as a guide for grants to nongovernmental organizations as well.

Volunteer Services The valuation of volunteer services contributed by professional and technical personnel and by skilled and unskilled labor should be at the regular rates paid for similar work in other activities or in the labor market in which the grantee competes for services at the rate paid by an employer who donates an employee to the grant project.

Materials The valuation of materials contributed, including office supplies, maintenance, workshop, and classroom supplies should be at a reasonable amount not exceeding the cost of the

supplies to the donor or current market price, whichever is less at the time charged to the project.

Equipment, Buildings, Land, Space The valuations of donated equipment, buildings, land, and space might vary depending upon the purpose of the grant. If the purpose is to furnish such facilities, then the total value of the donation may be claimed as the matching share. If the facilities are in support of the grant project, then a depreciation charge or use charge or fair rental value (for land) may be used.

Contributions The in-kind contributions received from private organizations and individuals must be supported in the grantee's records in such a way as to show (1) the hours of services, computed in the manner used for the grantee's employees, and (2) the basis for determining charges for personal services, materials, equipment, buildings, and land.

7 Federal Audit Requirements

All operations, activities, and functions of federal agencies are subject to audit. Included among the operations that must be audited are the grantees that have been recipients of federal funds. Audits may be made by the General Accounting Office, by the federal grantor agency's own audit staff, or by organizations that are external to the grantor agency such as state and local government auditors and certified public accountants.

Since the objectives and scope of the audits made by these organizations differ, it is important that certified public accountants be aware of the purposes of such audits and the reporting responsibilities of each of these organizations. Additionally, the role of the certified public accountant has been ever enlarging, and there is every expectation that the scope of this role will continue to grow. To participate in this growth, the certified public accountant should be knowledgeable of the general policies of federal agencies and the audit requirements imposed by these agencies.

Federal Audit Policies and Responsibilities

The audit policies and responsibilities of federal agencies are established by several bodies, each of which influences the nature and scope of audits. Congress through many laws has imposed audit requirements upon federal agencies. The General Accounting Office, given broad auditing powers by Congress, has been instrumental in establishing governmentwide requirements and standards of audit for all federal agencies. Each agency is responsible for establishing an effective program of audit and review as part of its financial management. Additionally, the Office of Man-

agement and Budget has been instrumental in minimizing differences in audit requirements of the various federal grantors. Responsibility for the auditing of federal grantees rests with the head of the agency making the grant.

GAO Responsibility for Audit The Budget and Accounting Act of 1921 established the General Accounting Office as an agency independent of the executive departments with reporting responsibility to the Congress of the United States. Since that time the authority and responsibility of the General Accounting Office have been continually expanded by the Congress.

In the exercise of this responsibility the General Accounting Office has published and maintains its *General Accounting Office Policy and Procedures Manual for Guidance of Federal Agencies*. In eight sections this manual sets forth the policies, procedures, and requirements of federal accounting and auditing in considerable detail. Copies of the manual are available at nominal cost from the Government Printing Office.

In summary, several acts have provided the General Accounting Office with its broad audit authority and responsibility and have established the legal framework for the conduct of audits of federal agencies and their expenditures, including grants. Among the laws providing GAO with broad audit authority are the following:

- The Budget and Accounting Act of 1921 provided that all claims, demands, and accounts in which the government is concerned be settled by the General Accounting Office and that it investigate all matters relating to the receipt, disbursement, and application of public funds.
- The Government Corporation Control Act of 1945 expanded the General Accounting Office's audit authority to include financial transactions of wholly owned government corporations.
- The Legislative Reorganization Act of 1946 authorized the General Accounting Office to make expenditure analyses of each agency in the executive branch.
- The Property and Administrative Services Act of 1949 required that the General Accounting Office audit all property accounts and transactions.
- The Budget and Accounting Procedures Act of 1950 further emphasized the role of the General Accounting Office in government audits by providing that the financial transactions of

each executive, legislative, and judicial agency be audited by the GAO.

- The Legislative Reorganization Act of 1970 called on the comptroller general to review and analyze the results of government programs and activities as well as to make studies of the costs and benefits of the programs.
- The Congressional Budget and Impoundment Control Act of 1974 amended the act of 1970 and required the comptroller general to review and evaluate the results of government programs and activities, assist in developing legislative objectives and goals and methods for assessing and reporting actual program performance, and develop and recommend to Congress methods for review and evaluation.

The General Accounting Office has seldom made direct use of the services of other governmental audit agencies or certified public accountants. Indirectly, it attempts to benefit from the efforts of these audit organizations by reviewing earlier audits and minimizing duplicate coverage whenever it considers these audits sufficient to place reliance thereon.

OMB Responsibility for Audit In its Circular A-102 *Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments*, the Office of Management and Budget prescribes the financial management standards for grant-supported activities of state and local governments. The circular requires that audits be made by the grantee or at its direction to determine the fiscal integrity of financial transactions and reports as well as compliance with laws, regulations, and administrative requirements. Customarily the grantee should have these audits every year, but not less frequently than every other year. OMB requires that audits be made with the same frequency for institutions of higher education, hospitals, and other nonprofit organizations. The requirements for these entities are set forth in OMB Circular A-110. Another circular specifying requirements for nonprofit organizations only is currently under development.

GSA Responsibility for Audit During the period of GSA responsibility, it issued Financial Management Circular 73-2, relating to the audit of federal operations and programs by executive branch agencies. FMC 73-2 superseded the earlier OMB Circular A-73.

This circular, *Audit of Federal Operations and Programs by Executive Branch Agencies*, sought to promote improved audit practices

and achieve more efficient use of manpower through improved coordination of audits at the federal, state, and local levels. According to this circular, the audit policy of federal agencies is to rely, to the maximum extent feasible, on internal or independent audits performed at state and local levels.

Federal Grantor Responsibility for Audit By law, the head of each federal grantor agency is responsible for establishing an audit capability as an integral part of the agency's system of management controls. In addition to the performance of audits of its internal operations, each agency is responsible for audits of those external organizations, such as grantees, to which the grantor has released appropriated funds.

The specific legal requirement for audit appears in the Budget and Accounting Procedures Act of 1950, which mandates that the head of each executive agency establish and maintain systems of accounting and internal control designed to provide effective control and accountability, including appropriate internal audit.

In the execution of these responsibilities, the federal grantor establishes procedures relating to the coverage, frequency, and priority of audits. Typically, several of the following factors, published in FMC Circular 73-2, are considered:

- The newness, changed conditions, or sensitivity of the entity to be audited.
- The dollar magnitude and duration of the program.
- The extent of federal participation in terms of resources or regulatory authority.
- The management needs that must be met.
- Prior audit experience, including the adequacy of the financial management systems and controls.
- The timeliness, reliability, and coverage of audit reports prepared by others, such as state and local governments and certified public accountants.
- Results of other evaluations, inspections, reviews, and so on.
- The mandatory requirements of legislation or other congressional recommendations.
- The availability of audit resources.

In addition, the congressional acts authorizing funds for expenditure generally contain a section specifying that the agency

make audits and examine the books, documents, papers, and records of fund recipients.

Reporting Relationships

Both the General Accounting Office and federal grantor agencies conduct audits to determine the efficiency, economy, and effectiveness with which the agencies are spending congressionally appropriated funds. Additionally, grantees may have separate needs for independent audits.

The audit reports of the federal grantor are addressed to the agency management for its consideration in improving the operations of the grant program. In the case of the General Accounting Office, its reports are addressed to the Congress, with copies to the agency, to the Office of Management and Budget, and, on occasion, to the president and the Justice Department. In the case of grantees, no external reporting may be required.

Typically, certified public accountants are involved in the federal government's audit program as a supplemental or additional audit resource of the grantor agency. In this role, the reports of federal grants by public accountants could be addressed to either the audited grantee or the federal grantor, depending on the terms of audit engagement contract. Regardless of the addressee, the grantee and grantor do generally receive copies of the audit report. The General Accounting Office has working arrangements with all federal agencies to regularly or upon request receive the reports issued by certified public accountants. On occasion the accountants' reports are forwarded to the congressional committees before which the grantor agency must appear for authorizing and appropriating legislation.

Types of Grant Audits and Reviews

A public accountant might be requested to make one or a combination of several reviews and audits of a federal grantee. The more common ones can be grouped into six categories: preaward review or survey, postaward review or survey, fiscal or cost audit, periodic audit, compliance audit, and operational audit.

Preaward Review or Survey

A preaward review or survey might be required by a federal

agency prior to the award of a grant to an organization that has not previously received grants from that agency. Typically, the prospective grantee's internal and administrative controls are closely examined through observation and limited testing to determine the apparent capability for protecting the funds that would be released under the grant. The preaward review could also include a check with other agencies that might have awarded grants to the organization in the past to determine the fiscal integrity and capability of the organization prior to the release of federal monies.

For programs that come under the Community Services Act the preaward review or survey is required by law as a condition precedent to the award of the grant.

Postaward Review or Survey

A postaward review or survey might be made by a federal grantor, generally within 90 to 120 days after the award of the grant. The objective is to determine early in the grant period whether the grantee has effective administrative procedures, controls, and systems and to insure that the internal accounting controls system is operating as predicted and that the minimum acceptable grant accounting criteria are being met. Where controls are inadequate, improvements would be required as a prerequisite to continued funding.

Again, Congress has on occasion mandated a postaward review or survey as a requirement of law that has to be made by the grantor agency within a specified time after the award of the grant.

Fiscal or Cost Audits

A fiscal or cost audit would be made at the completion of the grant program and is generally limited to the cost claimed for reimbursement under the federal grant. The primary objective of this audit is to verify that the costs claimed were expended, are supported by documentary evidence, and that the amounts were within any budget limitations set forth in the agreement. An audit of cost against supporting documents and a comparison to the grant agreement conditions is the extent of the examination usually made. Such an audit would generally be performed when the total grant was nominal (possibly less than \$100,000) and there is little likelihood that the grantee will receive follow-on or additional grants. In this situation, the internal control systems that

may have been in effect during the grant period ceased to exist upon completion of the grant program.

Periodic Audits

A periodic audit is usually made of grantees having more than one grant program, all of which are likely to continue to operate in the future. Such an audit would also be made, usually annually, of a grantee with a multiyear grant program.

The periodic audit commonly consists of a financial audit and a compliance examination. The financial audit covers the costs charged to the grant, and tests are made to ascertain the adequacy of the systems of controls and accounting. The compliance examination consists of an evaluation of the grantee's adherence to the general and special conditions of the grant agreement. The areas usually included in these periodic or annual audits are the following:

- Test of selected transactions and observations of the accounting and internal control systems to ascertain that these systems continue to meet the grant requirements.
- Verification that the costs incurred under the grant are within the total approved budget or within the cost category budgets (for example, salaries, travel, supplies).
- Determination that the costs charged to the grant are in accordance with the costs budgeted in the agreement.
- Verification that the costs charged to the grant are allowable under the general and special conditions of the agreement.
- Substantiation of the local, matching, or cost-sharing contribution required of the grantee.
- Determination that the specific costs charged to the grant are reasonable in amount and supported by documentary evidence.

Periodic audits are often made of the larger or continuing grant programs of federal agencies pursuant to a previously designed audit guide.

Compliance Audits

Compliance audits or examinations are not audits in the financial sense of attesting to the reasonableness of the amounts appearing on financial statements. A compliance examination would have as its objective the determination of the extent of adherence to the

grantor's policies, regulations, and procedures. Such examinations are made on a periodic basis by all federal agencies, usually, but not necessarily, as part of the periodic audit.

The emphasis in such examinations is on whether the grantee is complying with the terms of the grant agreement and other administrative requirements of the federal grantor.

Operational Audits

In practice there are several descriptives for operational audits, such as performance auditing, management audits, effectiveness audits, and program auditing.

In recent years, considerable discussion has focused on operational audits. Some federal grantor agencies have to a limited degree performed such audits and to a lesser degree retained certified public accountants to make such audits. As mentioned earlier, the GAO regularly makes program or operational audits of federal grants-in-aid and other programs.

In contrast to other reviews and audits, the operational audit is concerned with what has been accomplished or achieved with the monies, manpower, and other assets that were expended. Additionally, the operational audit might have the objective of determining whether the grant method or program was the most effective form or approach that could have been chosen to achieve the program objectives.

Federal Standards of Audit

In 1972 the General Accounting Office published *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*. This document has a direct influence on the scope of audit, the legal responsibility, and the manner of performance by all accounting firms practicing in the public sector. While designed for application to governmental organizations, these standards are being incorporated by reference into the agency contracts issued to public accounting firms for audits of other grantees.

This section summarizes pertinent sections of the standards, but close and careful study of the *Standards for Audit* is mandatory for all firms practicing in the public sector. Copies of the *Standards* may be obtained by writing to the General Accounting Office in Washington.

Background of Federal Standards

In 1969 the president directed all federal agencies to improve, streamline, and simplify the administration of grant assistance programs. The specific areas of concern were accounting, financial reporting, and auditing. The Congress required the Office of Management and Budget, with the cooperation of the comptroller general, to develop a body of audit standards that could be used in determining the reliance that federal grantors could place on audits of federally assisted grant programs by state and local governments and certified public accountants. Under the direction of the General Accounting Office an interagency, intergovernmental work group was set up in 1969 with the objective of establishing standards of audit that could be applied in the audit of federal grant programs irrespective of the auditing organization performing the work and regardless of whether the work is done by one or several groups.

To provide some criteria for the performance of audits and have some measure of the quality of performance, until 1972, the federal agencies had relied upon the generally accepted auditing standards of the public accounting profession issued by the American Institute of Certified Public Accountants. These standards, because of the high degree of relevance to the work of federal auditors, were adopted by most major agencies, including the General Accounting Office. The accounting profession's standards (the General Standards, the Standards of Field Work, and the Standards of Reporting) were then modified where necessary to relate them more closely to the work of the auditor in specific federal agencies.

In 1973 the GSA issued FMC 73-2, which sets forth the federal policy of making maximum use of audits performed by state and local governments and by internal and independent auditors so as to avoid unnecessary duplication of audit work by the federal agencies.

Definition and Scope of Governmental Audits

The *Standards* published by the General Accounting Office define the governmental audit in significantly broader terms than do certified public accountants. Further, the *Standards* are to be applied to an audit process that places increased emphasis on the compliance and performance aspects of a grant program as compared to the public accountant's primary emphasis on financial matters.

For example, the governmental audit *Standards* provide that an audit may include not only work typically done by accountants in examining financial reports, but also work done in reviewing (1) compliance with applicable laws and regulations; (2) efficiency and economy of operations; and (3) effectiveness in achieving program results.

The *Standards* further define each of these aspects of governmental audit in the following manner:

Financial and compliance. Determinations are made of (a) whether financial operations are properly conducted, (b) whether the financial reports of an audited entity have complied with applicable laws and regulations.

Economy and efficiency. Determinations are made of whether the entity is managing or utilizing its resources (personnel, property, space, and so forth) in an economical and efficient manner and causes of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organizational structure.

Program results. Evaluations are made of whether the desired results or benefits are being achieved, whether the objectives established by the legislature or other authorizing body are being met, and whether the agency has considered alternatives that might yield desired results at a lower cost.

The *Standards* specifically state that the defined scope of audit is not intended to imply that all audits are now being conducted this way or that such an extensive scope is always desirable. A risk to the certified public accountant arises when a prospective governmental client incorporates the entire *Standards* by reference into the contract terms and conditions. Unless the accountant takes care to specify those portions of the *Standards* that are or are not applicable, there is a valid basis for the client to assume that all the *Standards* will be applied to the audit.

Absence of Criteria for Economy and Efficiency and Program Audits

Particular care must be exercised by the public accountant when undertaking an engagement to be performed in accordance with the governmental *Standards for Audit*. Unless the scope of audit or the degree to which the GAO *Standards* will apply is qualified in the engagement contract, such an audit could be difficult to complete and significantly different from the intended engagement.

Few agencies have established the criteria necessary to conduct an economy and efficiency audit. The Department of Commerce,

for example, formally recognized these limitations and placed the following preamble in its audit guide for the Office of Minority Business Enterprises (OMBE) for use in the public accountant's report:

Operating efficiency and economy are both relative terms and it is virtually impossible to report as to whether an organization has reached the maximum practical level of either. Therefore, in view of the lack of criteria to measure operating efficiency and economy, we (the CPA) are not in a position to make any representations as to the overall efficiency and economy of the operation. However, based upon our review, and the criteria established by OMBE . . . we (the CPA) have the following comments, observations and recommendations.

Probably no agency has established the criteria that would permit the conduct of an audit of effectiveness or of program results.

This expanded audit scope must be carefully examined before the certified public accountant accepts engagements to be made in full compliance with the GAO *Standards for Audit*. Such engagements often require auditing and accounting skills, a variety of management advisory service skills, and, possibly, reliance upon the work of other experts and consultants. Because of concern about the possibility that a practitioner may overextend his available resources or fail to deliver the work scope expected, the management advisory services division of AICPA has published *Government Audit Engagements to Evaluate Economy, Efficiency, and Program Results*. The objectives of this publication are—

- To give practitioners a better understanding of the expanded audits and knowledge and qualification that should be possessed or acquired prior to undertaking these audits.
- To assist practitioners in responding to government requests for proposals to perform such engagements.
- To acquaint practitioners with the techniques and constraints involved in the conduct of such engagements.
- To provide illustrations to aid practitioners in developing work programs for economy and efficiency evaluations.
- To acquaint practitioners with the developing art of evaluating program results or effectiveness.
- To assist practitioners in preparing reports of findings and recommendations.
- To interpret existing professional standards as they apply to the expanded governmental audits.

Some government officials and certified public accountants

have equated economy and efficiency reviews with the level of work required in support of management letters commonly given to clients. *This comparison is in error.* The AICPA MAS division points out that management letters are almost totally a by-product of the work required for the financial audit. GAO has clearly stated that its standards do not refer to such a by-product; instead, these audits require a separate audit program.

Thus the engagement time, skills required, and estimated costs to perform the expanded scope of audit will clearly exceed that required for just a financial audit.

It is important to remember that often federal and other governmental organizations request audit services that incorporate the *GAO Standards for Audit* without qualification or exception. The risk is on the auditor when a contract is accepted to complete such an all-encompassing effort.

GAO Standards for Audit

The *GAO Standards for Audit* in many instances parallel the generally accepted auditing standards of the accounting profession. Certified public accountants must, however, be aware that many of the governmental audit standards are much broader in scope and must be clearly understood before any engagement is undertaken in accordance with such standards. The governmental audit standards include general standards, examination and evaluation standards, and reporting standards. The more important differences between these standards and those of the public accounting profession are highlighted below.

General Standards

The governmental general standards are similar to the general standards of auditing published by the American Institute of Certified Public Accountants, since governmental auditors and public accountants use similar techniques and adhere to similar audit disciplines. These standards are concerned with the auditor's qualifications and the nature of the work performed, but there has been included a standard which would result in an audit of much broader scope than would ordinarily be contemplated in an attestation audit. This is the governmental standard:

The full scope of an audit of a governmental program, function, activity, or organization should encompass: (1) a financial examina-

tion including an evaluation of compliance with applicable laws and regulations; (2) a review of efficiency and economy in the use of resources; and (3) a review to determine whether desired results are effectively achieved.

Examination and Evaluation Standards

The governmental examination and evaluation standards apply to all the activities that an auditor performs in his examination, survey, or review, other than the preparation of the audit report. These standards describe the objective and subjective evaluations that auditors perform in order to provide financial, compliance, and operational information to report users. Again, the standards are broader and require that auditors greatly expand the scope of their work.

Of particular concern to certified public accountants are the following governmental standards, which differ from the field work standards of the public accounting profession: (italics represent a variance from AICPA standards):

- *A review is to be made of compliance with legal and regulatory requirements.*
- An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, *to ensure compliance with laws and regulations, and to provide for efficient and effective operations.*
- Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor's opinions, *judgments, conclusions, and recommendations.*

Reporting Standards

The governmental reporting standards refer to the transmittal, content, and quality of the audit report. These standards require more detail in governmental audit reports than is called for in the AICPA standards. Of particular significance is the standard relating to the distribution and release of the audit report to organizations and parties other than the organization or client arranging or requiring the audit. The governmental reporting standards include the following requirements, most of which differ from the AICPA standards:

- Written audit reports are to be submitted to the appropriate officials of the organizations requiring or arranging for the audits. Copies of the reports should be sent to other officials who may be

responsible for taking action on audit findings and recommendations and to others responsible or authorized to receive such reports. Copies should also be made available for public inspection.

- Reports are to be issued on or before the dates specified by law, regulation, or other arrangement and, in any event, as promptly as possible so as to make the information available for timely use by management and by legislative officials.

- Each report shall

Be as concise as possible but, at the same time, clear and complete enough to be understood by the users,

Present factual matter accurately, completely, and fairly, and

Present findings and conclusions objectively and in a language as clear and simple as the subject matter permits, and

Include only factual information, findings, and conclusions that are adequately supported by enough evidence in the auditor's working papers to demonstrate or prove, when called upon, the basis for the matters reported and their correctness and reasonableness. Detailed supporting information should be included in the report to the extent necessary to make a convincing presentation.

Include, when possible, the auditor's recommendations for action to effect improvements in problem areas noted in his audit and to otherwise make improvements in operations. Information on underlying causes of problems reported should be included to assist in implementing or devising corrective actions.

Place primary emphasis on improvement rather than on criticism of the past; critical comments should be presented in balanced perspective, recognizing any unusual difficulties or circumstances faced by the operating officials concerned.

Identify and explain issues and questions needing further study and consideration by the auditor or others.

Include recognition of noteworthy accomplishments, particularly when management improvements in one program or activity may be applicable elsewhere.

Include recognition of the views of responsible officials of the organization, program, functions, or activity audited on the auditor's findings, conclusions, and recommendations. Except where the possibility of fraud or other compelling reason may require different treatment, the auditor's tentative findings and conclusions should be reviewed with such officials. When possible, without undue delay, their views should be obtained in writing and objectively considered and presented in preparing the final report.

Clearly explain the scope and objectives of the audit.

State whether any significant pertinent information has been

omitted because it is deemed privileged or confidential. The nature of such information should be described, and the law or other basis under which it is withheld should be stated.

- Each audit report containing financial reports shall

Contain an expression of the auditor's opinion on whether the information contained in the financial reports is presented fairly. If the auditor cannot express an opinion, the reasons therefor should be stated in the audit report.

State whether the financial reports have been prepared in accordance with generally accepted or prescribed accounting principles applicable to the organization, program, function, or activity audited and on a consistent basis from one period to the next. Material changes in the accounting policies and procedures and their effect on the financial reports are to be explained in the audit report.

Contain appropriate supplementary explanatory information about the contents of the financial reports as may be necessary for full and informative disclosure about the financial operations of the organization, program, function, or activity audited. Violations of legal or other regulatory requirements, including instances of noncompliance, shall be explained in the audit report.

AICPA's Position on *Standards for Audit*

In 1973, the AICPA committee on relations with the General Accounting Office set forth the Institute's position on *Standards for Audit* and other information of value to accountants, in a publication titled *Auditing Standards Established by the GAO—Their Meaning and Significance for CPAs*. The Committee's conclusions and recommendations with respect to the GAO *Standards for Audit* were in part as follows:

The *Standards for Audit* define an audit that may be concerned with efficiency and economy of operations, compliance with both financial and nonfinancial laws and regulations, and with program effectiveness. This broader definition of an audit will require that agreement be reached as to criteria for evaluating economy, efficiency, and effectiveness.

Independent public accountants should be encouraged to participate in audits of the types contemplated by the GAO but should be cautioned to define carefully, in an engagement agreement, the scope of each engagement and the method of reporting.

When the scope of an audit goes beyond examination of financial

presentations, the auditor should ascertain whether criteria are available (in audit guides or other sources) for use in reviewing compliance with laws and regulations, and in evaluating efficiency and economy of operations and program effectiveness.

When nonaccounting expertise is needed, the independent auditor should determine in advance its availability and cost and how his use of the work of a nonaccounting expert will be made known in his report.

A CPA should recognize that the GAO Standards do not contemplate that he will express an opinion as to the economy and efficiency of operations or as to program effectiveness.

Audits concerned with economy, efficiency, and program effectiveness will presumably require more time than those covering only financial presentations. Care should be taken to provide for sufficient time to complete the engagement.

Obligation to Meet Governmental Engagement Responsibilities

A CPA's responsibilities with respect to government engagements are no less than those exercised for private sector clients. The AICPA professional ethics and state legislation division has specifically addressed the question as to whether an auditor must follow the requirements of the audit guide in addition to generally accepted auditing standards. The AICPA's position is:

Audit Guides Issued by Governmental Agencies

Question—A member has been asked to perform an audit for a grantee receiving funds from a governmental agency. The grantee is required to be audited, and the governmental agency overseeing the use of the funds has issued an audit guide, which states that the audit “. . . must be sufficiently comprehensive in scope to permit the expression of an opinion on the financial statements in the report and must be performed in accordance with generally accepted auditing standards and audit requirements set forth in the audit guide.” The guide further states that the auditor is to evaluate compliance with applicable grant provisions and instructions from the governmental agency and that the auditor's report should state that the audit was made in accordance with the audit guide.

Must the auditor follow the requirements of the audit guide in addition to generally accepted auditing standards?

Answer—Most agencies requiring audits of grantees request

the auditor to submit his proposal in a form that includes an agreement to follow the requirements of the agency's audit guide. If the member has agreed to follow the requirements of an agency's audit guide, he is bound by such requirements in addition to generally accepted auditing standards. Accordingly, if he does not follow the audit guide requirements, he must disclose this fact in his report and the reasons therefor.

It should be noted that there exists an AICPA program to handle allegedly substandard reports submitted to governmental agencies by certified public accountants. Under it, governmental agencies have been informed that substandard reports may be submitted to the Professional Ethics and State Legislation Division of the Institute for investigation. After full consideration, an ethics committee will decide:

- To dismiss the case without action, or
- To urge the accountant to undertake an educational program, or
- To recommend admonishment of the accountant by the Ethics Executive Committee, or
- To find a prima facie case which, with the approval of the Ethics Executive Committee, would be referred to the Trial Board.

Qualifications of Independent Auditors

With the issuance of the GAO *Standards for Audit*, the comptroller general stated that when outside auditors are employed for assignments requiring an expression of an opinion on the financial statements of a governmental organization, only certified public accountants should be employed. The qualifications deemed necessary for financial audits of governmental organizations and programs were those possessed by independent certified public accountants. In 1970, in a letter to heads of federal departments and agencies, the comptroller general stated that such audits should be conducted by independent certified public accountants or by independent licensed public accountants, licensed on or before December 31, 1970, who are certified or licensed by a regulatory authority of a state or other political subdivision of the United States.

8 Federal Use of Public Accountants

The use of public accountants by the federal government has increased significantly since the mid-1960s, and there are indications that reliance upon the profession will be even greater in the future.

Factors Affecting Use of Public Accountants

One significant factor in the profession's increased participation in federal activities was the emergence of grants as the most important vehicle for the disbursement of federal funds, surpassing contract expenditures. Grantor agencies recognized that the need for audit and financial expertise exceeded the capability of federal staff and that the intermittence of that need made the services of public accounting firms more economical. Additionally, grantor agencies did not generally possess, nor were they likely to acquire, sufficient audit staff to perform all the required audits. Many accounting firms have considerable experience with the types of organizations that are the recipients of federal grants and can therefore render independent professional services and advice with minimal orientation.

More recently, the federal government has attempted to insure compliance with the policy articulated in General Services Administration Circular FMC 73-2 to make maximum use of the state and local government audits performed by internal and independent auditors and to minimize unnecessary duplication by federal auditors.

Chapter 7 discussed the publication of governmental audit standards. While such standards are still being evaluated and ex-

perimented with, they form a basis for greater federal reliance on, and use of, the public accounting profession.

The increased trend toward decentralizing the management of federal programs to ten regions will further dilute the limited audit resources of federal grantors. To insure that there is even minimal audit coverage (which the General Services Administration has said should be not less than once every two years), increased reliance must be placed upon the public accounting profession.

These instances are not intended to be an exhaustive listing of the reasons and factors for increased involvement of the public accounting profession in the governmental audit program, but are indicative of a greater government need for the certified public accountant in the future.

Services Provided by Certified Public Accountants

The education, training, experience, and discipline of the accounting profession have been important factors in federal reliance on certified public accountants. The following discussion of audits and other services provided by public accounting firms is merely indicative of the functions performed for governmental agencies in the past. The future will probably see an increased reliance on the profession, with firms providing a growing diversity of services.

The greatest involvement of the public accounting profession has been in the audit of federally assisted grant programs. Exhibit 8-1, page 129, provides a partial listing of federal grantors, federally assisted programs, and fund recipients.

The major grantor agencies have also retained public accounting firms to render technical assistance and training to governmental grantees in such matters as accounting systems, internal controls, financial reporting, cash management, cost accounting, and budgetary and planning matters.

Federal Contracting Procedures

The federal grantor has generally retained public accounting firms to conduct grant audits under two contractual arrangements.

Exhibit 8-1
FEDERAL GRANT PROGRAMS
Using Certified Public Accounting Firms

<i>Federal Grantor</i>	<i>Federal Grant Program</i>	<i>Grantees or Fund Recipients</i>
Treasury Department	General revenue sharing—Office of Revenue Sharing	State and local units of government
Labor Department	Comprehensive Employment and Training Act	Prime sponsors—units of state and local governments with 100,000 population
Transportation Department	Capital and operating assistance projects—Urban Mass Transportation	Transit systems and authorities
ACTION	Domestic programs of agency	Nonprofit organizations
Agency for International Development	Assistance and support programs	Nonprofit organizations
Commerce Department	Office of Minority Business Enterprise; Public Works Program	Contractors and grantees
Community Services Administration	Assistance to variety of community groups and agencies	Local community action groups, nonprofit organizations, other grantees
Environmental Protection Agency	Construction grant programs	Local sanitation units
	Nonconstruction grants—research, demonstration, planning, training, etc.	State and local units of government; nonprofit grantee organizations
Health, Education, and Welfare	Medicare, Medicaid programs	Government and private health care units
	Educational assistance programs	Educational institutions
Housing and Urban Development	Various grant programs; including community development block grants	Over 30,000 audits of local governmental units annually
Law Enforcement Assistance Administration	Planning, action, and assistance grant programs	State and local government units
Small Business Administration	Technical assistance program	Nonprofit organization; contractors
Federal Aviation Administration	Airport grant program	Local airports

- The grantee is directed by the grantor to retain a public accounting firm, which must receive the approval of the federal grantor. In this instance the grantee pays the audit firm; but the firm conducts the audit in accordance with the grantor's requirements, and copies of the audit report are usually distributed to the grantee and grantor.
- The grantor enters into a contract with a public accounting firm. The contract specifies that the firm conduct an audit in accordance with the grantor's requirements and outlines the reporting procedure that will be used. In this instance the grantor pays for the audit, and the report is distributed in accord with the grantor's direction.

Because of the investment of appropriated funds, most federal grantors have designed a review or audit guide indicating the scope of work that is to be performed by the public accountant, whether the firm is retained by the grantee or by the grantor.

Selection of Firm by Grantee

Many grantor agencies have adhered to a practice of permitting the grantee to select a public accounting firm of its own choice. The federal grantor usually retains the right to disapprove the selection.

Under these conditions, the funds to meet the estimated fee of the firm are included in the amount of the executed grant agreement. The supporting grant budget also details the nature of the services to be rendered by the firm—for example, survey and reviews, assistance in establishing internal controls and accounting systems, bookkeeping and accounting advice, and consultation and audit. When the grantee selects its accounting firm, the grantor generally has administrative regulations governing the scope of reviews and audits to be conducted by the firm, the types of reports to be issued, and the recipients of the reports. In essence, the firm is retained by the grantee, but in fact the work is performed in accordance with the grantor's guidance and requirements as well as the instructions received from the grantee.

When faced with such a working relationship, the accounting firm should document to the grantee and the grantor its understanding of such matters as client relationships, scope of work, billing and payment procedures, and reporting responsibilities. Unless the conditions of the engagement are clearly understood by all parties at the outset, considerable time, effort, and money

could be expended at some future date when the parties attempt to sort out their interpretations of the arrangements.

Contract by Federal Grantor

A more formal method by which firms are retained to provide auditing and accounting-related services to the federal government is the issuance of a contract by the grantor directly to the accounting firm. Depending upon the extent of decentralization in the federal agency, these contracts could be issued from the grantor's headquarters or from any of its several regional offices.

The contractual process generally includes the following phases:

- Publication by the federal agency of an intent to contract, a description of the services desired, and an invitation to firms to submit a technical proposal to perform the services and an estimate of fees.
- The preparation and submission by each interested firm of a description of the firm's expertise in the areas for which services are desired, the qualifications and experience of the firm's staff, the work plan by which the firm believes the engagement can be completed, and an estimate of the fee.
- Review of the submitted proposals by the federal agency.
- Execution of a contract between the agency and the selected firm.

Unlike the circumstance where the firm is retained by a grantee, but must perform part or all of the services in accordance with guidelines published by the grantor, the issuance of a contract by the federal agency clearly establishes that the firm's only client is the agency.

Methods of Reimbursement

When the public accounting firm has been retained by the grantee, the specifics on billing the client and receiving payment are negotiated in the same manner as the firm's other engagements. Usually, a single billing is made at the completion of a short engagement. If the duration is extended, appropriate arrangements can usually be made to permit billing on an interim basis as the engagement progresses.

The billing and reimbursement procedures differ considerably if the firm has been retained under a contract with a federal

grantor agency and are dependent upon whether a fixed-price or a cost-plus-fixed-fee contract is involved. Under a fixed-price contract, the firm generally bills the grantor and is reimbursed at the end of a short-term engagement for the amount of the contract, regardless of the total fees incurred by the firm. For engagements of longer duration, procedures are usually negotiated that permit the firm to receive interim or progress payments at designated points or after completion of designated phases of the contract. Most fixed-price contracts provide that the federal agency withhold a portion of the total until after delivery or completion of all the contracted work by the firm and acceptance by the agency.

Cost-plus-fixed-fee contracts are usually issued for larger engagements of indefinite scope or duration. Since neither the firm nor the agency can define the work with sufficient precision to permit the negotiation of a fixed price, the federal agency will negotiate a contract under which the government will reimburse the firm for its actual cost, plus a fixed amount of fee or profit. With such a contract, the firm is required to dedicate its proposed staff, perform the negotiated engagement approach, and make its best effort to complete the work within the estimated time period and dollar budget.

Cost-plus-fixed-fee contracts generally permit the firm to make monthly billings to the agency for the costs incurred, plus a portion of the fee or profit. The cost reimbursement limits a firm to recovery of labor costs and other direct costs in addition to an allocation of overhead costs. The fixed fee is the only factor paid to the firm over and above cost and constitutes the profit permitted under this type of contract.

Areas of Concern in Governmental Auditing

Public accounting firms may find that audits or other services performed for a governmental grantee are similar to the services rendered to nongovernmental clients. But there are several areas about which a word of caution is in order and which should be clearly delineated before the firm begins the engagement. In most instances, these areas cause no problem. For example, suppose the grantee does not perform in the manner negotiated with the federal grantor or the grantor should take exception to certain

policies, procedures, or practices of the grantee. In that event the firm may, through no effort on its part, find itself in the role of being both an investigator and arbitrator of how, why, and for what purposes grant monies were expended.

Questions could arise about the scope of the work expected of the firm, the reporting responsibility, the type of report to be issued, who has access to the firm's workpapers, and the fee arrangements and conditions under which the firm is to be paid for its services. The early resolution of these matters is in the best interest of any firm undertaking an engagement with a governmental grantee.

Definition of Scope of Work

An area of past concern and often an area of dispute involving the accounting firm, grantee, and grantor is the scope of work agreed to by the accountant. An accounting firm proposes to make a financial audit, and the grantee, not fully aware of the audit requirements of the federal agency, accepts the proposal for such an audit. Subsequently the audit is performed and accepted by the grantee, but it is rejected by the grantor as unsatisfactory because it is not of the kind contemplated or required under the grant agreement.

In such a condition, the firm has a valid claim for services rendered to the grantee, but the grantee's only source of funds to pay for the audit may be the federal grant. The firm then finds itself in the position of having to perform a second audit in accordance with the federal grantor's requirements in order to salvage some fee for the engagement.

Alternatively, a firm that is aware of the grantor's requirement and has even reviewed the audit guide may fail to fully explore the implications of some of the audit requirements included in the audit guide only by reference. Examples might be the incorporation, by reference, of adherence to the GAO *Standards for Audit* (discussed in chapter 7). Such standards may not apply or may apply only in part. Unless the liability for *all* references is clarified and understood by all parties, an accounting firm could be liable for the performance of an engagement of far greater scope than it anticipated or proposed.

In most instances, the accounting firm would be better protected if it took the initiative for determining the precise audit requirements imposed by the grantor, rather than rely on the grantee. This would enable the firm to advise the grantee of its responsibilities and the type of performance and accounting that the federal grantor is expecting. Further, the firm would have a

more accurate view of the type of audit required and could estimate its fees and expenses more realistically.

Reporting Responsibility

A dispute could arise over the reporting responsibility. This could become an issue when problems exist between the grantee and the grantor or when the grantor is expecting the accounting firm to examine and report on certain matters. The grantee could take the position that the privity of contract is between the grantee and the firm and that no reports should be released to other parties. On the other hand, one of the grant agreement conditions might be that the audits be performed in accordance with the grantor's requirements and that copies of all audit reports be issued concurrently to grantee and grantor.

The grantee should be fully cognizant of the grant requirements for audit, the type of audit that must be performed, and where the audit report must be sent. Again, for its own protection, before accepting the engagement the accounting firm should assume the responsibility for determining the specifics of the federal requirement, whether the grantee intends that the firm meet these requirements or some other criteria, and to whom the report will be submitted.

Types of Audit Reports

When contracting for engagements for federally supported grantees the audit or engagement report should be defined as early as possible with both the grantee and the grantor. With few exceptions, the accountant's standard short form report will not be satisfactory to the federal agency.

The federal grantor may require a simple schedule of the cost incurred under a grant. Or it may design a pro forma report for which the firm can merely provide the correct data and accompanying schedules. On the other hand, the agency may require an extensive descriptive report, paralleling a comprehensive management letter, which contains positive and negative comments on each of the areas covered during the examination.

This is another matter which the grantee may not fully comprehend, but it would be in the firm's interest to assume the burden of determining what reports meet the grant agreement terms. For governmental program audits and reviews, the cost of report preparation could vary significantly. Of course, the firm's more

important concern should be the avoidance of a report that meets neither the grantee's nor the grantor's needs.

Access to Working Papers

The question of who has access to the audit work papers is similar to the earlier concerns over the scope of work and reporting responsibility. The problem arises because the firm contracts with a grantee organization, and that organization is expected to pay the fee for services rendered. However, money for the firm's fees is provided by a federal agency that wants the firm to be retained to perform a specific engagement in accordance with certain criteria.

The federal grantor may request that its auditors be given access to the working papers of the firm in order to assess the adequacy of the examination. While it is proper for the accounting firm to notify the grantee when such a request is received, in almost all instances a condition precedent to the award of the grant was the acceptance of a grant term giving the federal agency such access. Thus while the grantee might legally be the client, the specific grant conditions may require that the firm cooperate or take direction from the grantor.

Fee Arrangements

Prior statements of the grantee notwithstanding, the firm that insures that its examination meets *both* the grantee's and the grantor's needs will have less difficulty in collecting its fees. When federal requirements have not been met despite full compliance with the audit requirements expressed by the grantee, firms have found that the federal agency will not pay for audit services and that the grantee probably does not have the money to pay for the services.

Another subject the accounting firm should clarify is the method of billing and the procedure for payment. Where possible the firm should ascertain, or ask the grantee to ascertain, the conditions under which the agency will release funds for audit services to the grantee. In many instances, if the federal agency does not release the funds, no payment will be made to the firm.

It is acknowledged that many of the foregoing areas of concern are more properly within the province of the grantee organization to determine and to relate to the accounting firm. However, many grantees go on the assumption that the accounting firm accepting the engagement knows exactly what kind of examina-

tion or audit must be performed to meet its needs as well as the needs of the agency to which the grantee is responsible.

Government Survey of Use of Public Accountants

Public accountants should be aware that the profession's standards must also prevail in engagements in the public sector. Governments have turned to the profession for assistance because of its high standards, ethics, and independence. Whenever these qualities are lacking, all accountants are affected.

Within the past few years the General Accounting Office has highlighted inadequacies in auditing and reporting of grant programs that must be avoided by all public accounting firms. In a report on the need for more effective audits, GAO stated:

About 60 percent of over 1,000 audits of grantee operations reported no major accounting or internal control systems deficiencies.

Ten of some 27 reports examined disclosed that the public accountants were performing services which could affect their independence.

Some public accountants needed additional guidance and training to fully understand and comply with the federal agency's auditing requirements.

Accountants expressed the view that their allegiance and responsibility was to the grantee rather than the federal agency, but the General Accounting Office believed that the agency should strengthen the contractual arrangements under which (1) the auditors' services are obtained and (2) the auditors are held responsible for their work by emphasizing the auditor's concurrent role to the federal agency.

More recently, in 1976, GAO examined another grantor department's use of independent public accountants to supplement its own audit staff. In this instance, during a four-year period the grantor approved some 4,100 public accountant audit contracts. GAO reviewed some 15 audit reports in detail, made limited reviews of another 21 reports, and sent a questionnaire to 75 practitioners. On the basis of this examination, GAO concluded that none of the 15 practitioners whose reports were checked in detail adequately reviewed all applicable compliance areas.

For the 15 audits, 215 separate reviews should have been made for compliance. GAO found that 170 reviews, or 79 percent, were

not made or were made inadequately. Some of the work performed by two public accountants in support of their opinions may not have always met AICPA's generally accepted auditing standards. The grantor reviews revealed that five audits by practitioners appeared to be below the profession's standards. Among the factors causing these conditions were the following:

- The grantor's audit guide does not clearly explain how public accountants should perform compliance reviews.
- Public accountants cannot always confirm financial information and do not always have access to the grantor's handbooks needed for compliance with the grantor's regulations.
- Public accountants are not sufficiently familiar with the grantor's audit requirements and accounting and program regulations, which differ from those applicable to commercial audit engagements.

The above observations stemmed from an examination in which the General Accounting Office made its own audit of the grantee's operations, examined the contents of the public accountant's audit report, reviewed the files of audit working papers, and asked the public accountants themselves why certain conditions were reported and others were omitted which the General Accounting Office felt should have been reported.

AICPA's Program for Substandard Reports

As described in more detail in chapter 7, an AICPA program is directed toward handling allegedly substandard accountants' reports submitted to governmental agencies by certified public accountants. The auditor should be aware of the program and his responsibilities to provide the same high standards of performance in public sector engagements as are provided in the private sector.

9 Conducting Audits of Federal Grantees

To a large degree, the approach undertaken for an audit of a federal grantee is similar to the preparation and execution of the steps performed in an audit of a private organization's financial statements. Like any industry, the government has certain procedures, practices, and unique characteristics. To deal with these, the auditor has to make a specific orientation and survey effort to obtain a background of the entity that is to be audited and then tailor his audit program accordingly. A bank audit necessarily differs from an audit of a manufacturing concern or a marketing organization. In much the same way, auditing of governmental programs calls for similar orientation and survey effort, and tailoring of the audit program.

This chapter discusses and illustrates several pertinent aspects of an audit of a federal grantee's operation:

- The prescription of the scope of audit.
- The nature of the orientation required before the audit begins.
- The auditing of governmental grantees.
- The acceptable standards of supporting documentation.
- The nature of opinions that are required of auditors of government programs.
- An audit work plan.

While the specific requirements or policy on these matters varies from agency to agency, there is broad commonality of thought among the various federal audit organizations on what might be considered a generally acceptable audit.

Prescription of Scope of Audit

A public accounting firm may on occasion be asked to make an audit of a federal grantee without the benefit of a specific scope of

audit outlined in advance by the federal agency. But these instances are rare.

In the typical contractual agreement executed with the accounting firm, the federal agency outlines the scope of the audit to be made of a federal grantee. In most situations, the agency or the grantee incorporates in the contract a reference to specific agency audit guides that detail the scope and nature of the audit.

It is important that the public accountant identify, review, and understand the nature and depth of the audit under consideration. This is particularly so if the contractual agreement between the accounting firm and the client calls for an audit that is to be in accordance with another document. As mentioned earlier, the grantee may itself be unaware of the implications of the federal agency audit guides that have been incorporated by reference in a contract for an audit engagement.

As described in greater detail in chapter 8, failure to understand the implications of the audit criteria that appear in many governmental requests for proposals may result in the practitioner's agreeing to undertake an engagement that is impossible to perform or that will generate costs far in excess of what can be collected from the governmental client.

Of particular significance is the fact that few grantors or grantees have established the criteria or definitions of the previously described GAO's *Standards for Audit* relating to economy, efficiency, and program results, which would permit any firm to perform an adequate audit. Nevertheless, these standards are often incorporated as part of the scope of the desired audit.

Orientation for Governmental Audits

When the accounting firm is to make its initial audit of a particular program, or when the specific audit team is not experienced with the program to be examined, an orientation review should be made of the following types of information related to the particular grant program: congressional legislation and history; agency policies, rules, and regulations; specific grant conditions; general cost principles; and referenced or published audit guides.

This information generally exists in some format for all federal grant programs. The data should be obtained and made a part of the permanent files of the firm.

Congressional Legislation and History

The record of congressional hearings that result in the authorization of a new federal grant program will contain considerable

information and provide valuable insights into the intent of the program and the views of the agency that is to manage it. When the program has been in existence for a time and the public record is adequately documented on its general purpose, significant information can be obtained from the congressional record on the program's objectives, problems, issues, and concerns for a particular fiscal year.

This information is available to the public from the grantor at little or no cost.

Agency Policies, Rules, and Regulations

Without exception, federal agencies have prescribed policies, rules, and regulations that affect the grantees receiving funds for operations. On occasion, staffing limitations or the exigencies of the moment compel the federal grantor to "borrow" or reference the publications of a similar program as applicable to its program. More often, federal agencies have issued policies, rules, and regulations on a specific program basis. These documents address such matters as the legal, operational, property, funding, financial, and audit requirements of the grant program.

With respect to a federal grantee, these pronouncements have the effect of law and have probably been incorporated by reference in the executed grant agreement under which the grantee is to receive financial assistance. In most instances, these same agency pronouncements have been referred to in the audit guidelines applicable to the grant program and form the basis for the criteria of a compliance audit.

This information should be available at the grantee's place of business. The information is also available upon request, at no cost, from the responsible federal agency.

Specific Grant Conditions

The foregoing information governs all grantees receiving funds under a federal grant program. As important or in some cases more important are the specific conditions of the grant executed by the grantee. It is the grant agreement that outlines the specific terms under which the grantee has accepted the government grant. A grant agreement may contain a waiver of a certain programwide policy, rule, or regulation. Similarly, the grantee may for some reason have agreed that particular costs, although otherwise allowable, would not be charged to the grant and are to be considered unallowable.

The importance of examining the grant agreement cannot be overemphasized. The auditor must assure himself that he has in his possession the original grant agreement as well as all modifications and supplements to it. As a precautionary measure, the auditor should obtain a written confirmation from the federal agency of *all* changes executed with the grantee, thus insuring that no modification or supplement can exist without the auditor's knowing about it. Should the auditor find that the grantee does not possess each of the changes, the grantee should be requested to obtain copies of each from the grantor.

General Cost Principles

A copy of the applicable cost principles must be examined by the auditor before the audit begins. Chapter 6 describes the government's general cost principles. It is possible that one federal agency or program might make the cost principles of another grant program applicable by reference. Regardless of the source of the principles, the auditor must understand the pertinent rules and regulations governing the acceptability of costs for the specific grant program.

As discussed in chapter 6, the policies, rules, or regulations of the federal grantor might limit or modify the applicability of the general governmentwide cost principles. Further, the terms of the grant agreement, as mentioned above, could constitute a waiver of governmentwide cost principles or of the federal grantor's policies, rules, or regulations concerning the allowability of specific costs.

Referenced or Published Audit Guides

The referenced or published audit guide must be carefully examined, for this document generally constitutes the minimum scope of tests that must be made to satisfactorily complete the audit engagement. The suggested table of contents for audit guides published by the American Institute of Certified Public Accountants summarized the general nature or content of a federal audit guide as including the following:

- Introduction
- Program background
- Definition of terms
- Audit objectives
- Audit programs

- Specifics
 - Compliance
 - Other services
- Auditor's report
 - General discussion
 - Format
- Exit conference
- Appendixes
 - References
 - List of regional offices

Any documents referenced in the audit guide should be examined by the auditor to determine the impact that the contents might have upon the scope of audit or nature of tests to be conducted. While the government audit guides do conform closely with the suggested content, a grantor or a grantee may not desire the entire audit to be performed. After review, the auditor should meet with representatives of the grantor, grantee, or both to definitively establish the scope of audit to be performed in the specific instance. Often, the audit guide will contain numerous references, more for comprehensiveness than applicability, that are not required reading for every audit. Similarly, the specific tests outlined in the guide may not be appropriate for many grantees. In other instances, depending upon the timing of the audit, not all tests may be conducted, particularly if the grantee was not refunded by the agency.

Auditing of Governmental Grantees

Depending on the prescribed scope of audit, the auditor could be required to make a survey of the accounting and internal control systems, the costs incurred by the grantee, and the extent of grantee compliance with several financial and nonfinancial requirements, restrictions, or conditions.

Accounting Systems and Internal Controls

It is important to note that the survey of the grantee's accounting system and system of internal controls might require more detailed examination than is generally performed to meet the second standard of field work of the accounting profession relating to the evaluation of internal control, as spelled out in AICPA's

Codification of Auditing Standards and Procedures. That standard requires a proper study and evaluation of the existing internal control as a basis for reliance thereon and for determining the resultant extent of the tests to which auditing procedures are to be restricted.

Prior to undertaking an audit whose report must contain an opinion as to the adequacy of the grantee's accounting system and internal controls, public accountants are cautioned to review the appropriate statements on auditing standards issued by the American Institute of Certified Public Accountants.

A careful analysis must be made of the requirements and criteria set forth in the federal agency's audit guide relating to the internal control system, including the accounting system, personnel practices, property procurement and custody, issuance of contracts, and control over the grantee's expenditures.

A federal grantor agency may require that the public accountant express an opinion on the adequacy of the internal control system. Such an expression of opinion could involve considerably more testing than is needed to determine the extent to which generally accepted auditing procedures are to be restricted.

Audit of Cost Incurred

An important segment—and in some cases the entire audit—of a governmental grantee may be concerned with the audit of costs incurred. The term *audit of costs*, however, is defined in a manner that differs significantly from its use in the more common financial statement audit. For example, any cost reported as applicable to a governmental grant must be audited or examined from the following several viewpoints:

- *Allowability.* Is the cost claimed under the grant allowable in accordance with governmentwide costing criteria, the cost guidelines of the agency, and the specific conditions of the grant agreement?
- *Supportability.* Is the cost supported by acceptable documentary evidence establishing the nature, purpose, and cost of the expenditure?
- *Reasonableness.* Is the cost, otherwise allowable, reasonable or not in excess of the amount that would have been incurred in the same circumstances by the reasonably prudent man?
- *Compliance.* Is the cost incurred in accordance with the specific terms of the agreement and only for purposes authorized by the agreement?

Most audit guides require that the public accountant identify and report all instances of grant expenditures that do not meet these criteria. Once reported, the ultimate allowability of a cost that does not meet these criteria must be negotiated or justified to the grantor agency. Should the grantee be unsuccessful, the expenditure is disallowed and the grantee is liable for refunding to the grantor the amount so expended. As might be expected, a disallowance and subsequent demand for payment by a federal agency can have severe financial consequences for a grantee, particularly a nonprofit organization.

Standards for Supporting Documentation

Considerable time can be devoted to discussions between the auditor and the grantee and between the grantee and the grantor over the acceptability or adequacy of the documents that the grantee has on file in support of the costs charged to a governmental grant. In some instances the supporting documentation is less than complete because the grantor provided minimal advance guidance. In other instances, the grantee personnel may not have closely examined or understood the documents required to validate the expenditure and relate it to the specific grant. On occasion, an auditor establishes his own definition of acceptable documentation or may not examine other types of evidential matter when primary documentation is nonexistent.

Public accountants can render an invaluable service by advising governmental grantees at the outset of the grant as to what constitutes acceptable documentation. It is by no means unusual for a grantee to sustain formal disallowances of otherwise valid costs because it is unable to document the expenditure at some later time. Among the grounds for questioning the adequacy of documentation are these:

- The grantee failed to maintain time and attendance records for its employees.
- The grantee did not retain copies of paid invoices to validate the amounts paid for services, equipment, and supplies.
- The grantee did not authorize in advance the expenditure of monies for travel.
- The supporting documentation did not contain evidence that the purchased item was received.

Most of these exceptions can probably be attributed to the limited time allotted for the audit as well as to concern over the time it might take to establish the reasonableness and validity of other evidence that might corroborate the expenditure. Most agencies will not accept a questioned cost until the grantee has occupied significant time in assembling alternative evidence. This effort also entails considerable expenditure of time by the accountant who originally questioned the adequacy of the documentation.

As an alternative, the accountant would probably consume less time and prepare a better report if he were to advise the grantee at the time of the audit what records were missing and thus give the grantee a chance to present other documentation and evidence. Under these circumstances, the auditor could report that while the primary support documents do not exist, other acceptable evidence does.

When the accountant has been retained by the grantor, or is performing the audit for the dual benefit of grantee and grantor, a greater service would be to seek and examine alternative corroborating evidence when primary evidence does not exist. For example:

- When time and attendance records do not exist, the auditor might look at payrolls, canceled checks, meeting schedules, grantee progress reports, trip reports, work sheets, and other data indicating that the employees performed the services.
- Paid and mutilated invoices evidencing receipt might be considered as primary audit evidence. But in their absence, consideration should be given to physical inspection, determining whether the purchased items are being used in the program, and possibly confirming the cost and quantities with the vendors.
- Advance authorization of travel is required under most circumstances, but many grantors would be satisfied to read in the audit report that a test of expense vouchers, trip reports, agenda, and minutes all confirmed, that the most economical method of travel was used, that the trip was for grant purposes, that the travel budget was not exceeded, and that the proper employees made the trip.
- A properly executed receiving report would be evidence for property control purposes. However, lacking the documentation, the auditor could make a physical verification that the purchased item exists, was authorized by the grant, and is being used in the grant program.

As we shall see, the profession's auditing standards relating to the competency and sufficiency of evidential matter identify many alternatives that would be acceptable in the absence of particular types of documentation.

Sufficient and Competent Documentation

The AICPA's third standard of field work provides that:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Section 330 of the AICPA's Statements on Auditing Standards also defines evidential matter as consisting of the underlying accounting data and all corroborating information available to the auditor. Assuming that proper consideration is given to the propriety and accuracy of the data, the following examples of supporting evidence should be considered in each grant audit:

- Books of original entry, general and subsidiary ledgers, accounting manuals, informal and memorandum records such as work sheets, supporting allocations, computations, and reconciliations.
- Documentary materials such as checks, invoices, contracts, minutes of meetings, confirmations, other written representations by knowledgeable people; information obtained by the auditor by inquiry, observation, inspection, and physical examination; and information developed by, or available to the auditor which permits the auditor to reach conclusions through valid reasoning.
- Tests by the auditor, including analysis and review, retracing procedural steps in the accounting process, recalculations, and reconciliations could provide evidence of the overall soundness and integrity of the accounting system and controls.
- Both within and outside the organization are knowledgeable people to whom inquiries can be directed. Assets having physical existence can be inspected; activities of organization personnel can be observed. Based on certain conditions as observed by the auditor, the auditor can reason to conclusions with respect to the validity of representations in the financial statements.

When other documentation or corroborating evidence is examined and accepted, the auditor should mention the fact in the grant audit report even if such a statement is not specifically required by a federal grantor. This would give the grantor sufficient information to approve expenditures which might otherwise be classed as unsupported and therefore unallowable.

Opinions Required of Certified Public Accountants

When accepting engagements to audit or provide services for a grantor or a grantee, the accountant should insure that all parties clearly understand the scope of the engagement and the nature of the opinion that must be provided to both grantor and grantee. Many audits of governmental grantees must be conducted in accordance with an audit guide prepared by a federal agency.

In the audit report, the public accountant may be legally required, under the terms of his engagement, to express formal opinions on matters such as these:

- The continued adequacy of the accounting and internal control systems.
- The allowability of costs incurred and charged to the governmental grant.
- The grantee's compliance with the financial as well as non-financial terms of the grant agreement.
- The usual expression of an opinion with regard to the financial statements.

Adequacy of Systems

As discussed above, the public accountant may be required to express a formal opinion in the audit report with respect to his appraisal of the grantee's accounting and internal control systems. On occasion a grantor will set forth in its audit guide the precise wording that must be included in the report in order to be acceptable to the agency. An auditor may be requested to state:

The accounting system and internal controls of the grantee (and delegate agencies, if any) are considered (adequate, inadequate) to safeguard the assets of the grantee, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed management policies.

The public accountant may also be held liable for the expression of an opinion on the continuing adequacy of the accounting and internal control systems of the delegate agency or subgrantees, if any exist. The accountant must seek to have this requirement modified since the continued adequacy of the systems is beyond his control.

It can be expected that future governmental auditing contracts will increasingly incorporate, by reference, the GAO's *Standards for Audit of Governmental Organizations, Programs, Activities and Functions*. These standards also differ from the profession's with respect to the evaluation and examination of internal controls. The comptroller general of the United States has established the standard for governmental auditing which states:

An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, to ensure compliance with laws and regulations, and to provide for efficient and effective operations.

The extent of audit work required to adequately review the internal controls in accordance with these *Standards* varies considerably depending upon the nature of the examination. The *Standards* provide the following examples of varying scope:

- *Financial and compliance examinations.* The review must be sufficient to permit the determination of how much reliance must be placed upon the accounting records and reports to accurately portray the financial condition and safeguard the grantee's resources.
- *Efficiency and economy.* The review must include a review of policies, procedures, practices, and internal controls applicable to any aspect of the activities to make a judgment as to whether the existing practices can be made significantly more efficient or economical.
- *Program results.* The review must include those policies, procedures, practices, and controls having a specific bearing on the attainment of goals and objectives specified by law or regulation.

Thus it can be seen that in governmental audits, tests of internal accounting control systems differ in purpose and depth from inquiries typical of a financial statement audit. In addition, historically the auditor has not been required to render an opinion on the adequacy of these systems.

Allowability of Costs

Most guides for the audit of governmental grantees require that the auditor express an opinion as to the acceptability of the costs charged and claimed under the grant. To render such an opinion, sufficient tests must be conducted to determine the allowability, supportability, reasonableness, and compliance of the costs to the general and specific cost guidelines.

When the auditor questions the acceptability of a cost, this must be clearly identified in the governmental audit report. While the designation of a cost as questionable does not necessarily mean that the cost will ultimately be disallowed, the auditor must be particularly cognizant of his responsibility and role. The questioning of cost is specified in most governmental audit guides, and such a classification is the first in a series of procedural steps that could lead to the formal disallowance of a cost as a charge to the grant.

Should a cost be disallowed, the grantee might be required to make a cash refund or other restitution to the federal agency. Thus the basis for questioned costs should be carefully examined and all facts and circumstances related to these costs should be detailed in the audit report.

Compliance With Terms of Grant Agreement

On occasion, the public accountant is asked to report on the grantee's compliance with the nonfinancial as well as the financial terms of the grant agreement. Requirements for reports on nonfinancial matters should be fully clarified prior to the acceptance of a governmental audit. Specifically, the scope of work expected of the auditor should be spelled out and understood by all parties involved.

As in the case of financial compliance, reports relating to nonfinancial compliance might require myriad examinations of records and technical program reports as well as field trips, physical observations, and other efforts. Where such a report must be provided the auditor must ascertain that the appropriate skills are employed to render it. The comptroller general's *Standards* require that—

The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required.

If statistical techniques, computer sciences skills, and engineering background are needed, staff members or consultants to the audit staff must have these skills. Accountants must also consider

the manner in which nonaccountant expert opinions are reported.

Opinions on Financial Statements

In most governmental audits, the public accountant is required to express an opinion as to the fairness of the grantee's financial statements. Typically, the financial examination leading to such an opinion—or a disclaimer—must be in accordance with generally accepted auditing standards.

With the publication of the comptroller general's audit standards, it can be expected that federal grantors will increasingly require that the scope paragraph of the opinion contain a statement that the audit was performed in accordance with such financial and compliance standards. These *Standards for Audit* are discussed in greater detail in chapter 7.

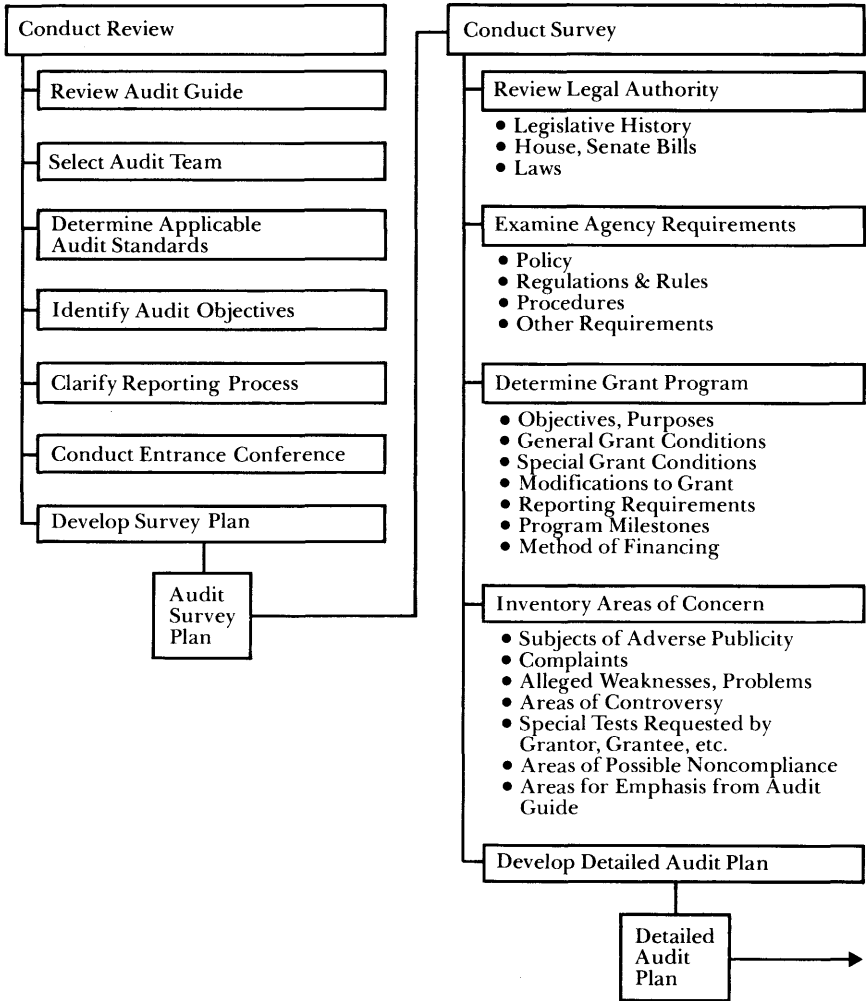
The Audit Work Plan

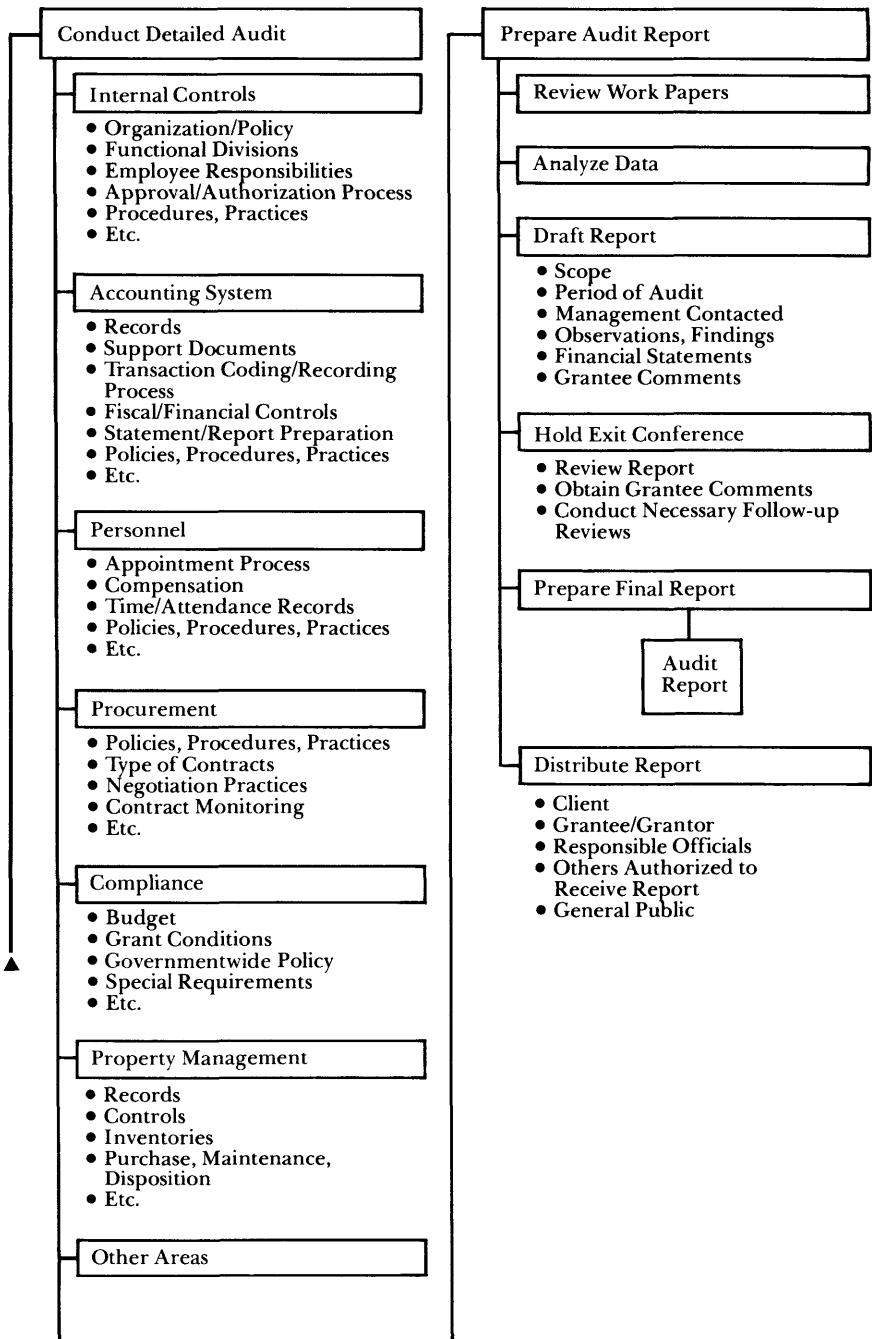
While specific tasks and areas to be examined will vary by the governmental program being audited, there exists a generalized work plan or approach that will conceptually apply in most instances. Grantor audit guides will vary in completeness and detail. Regardless of the completeness of the guide, the audit contract will generally contain a statement that the requirements of the guide are intended to be the minimal criteria for auditing the grant and are not intended to inhibit or restrict the scope of the examination deemed necessary by the auditor to achieve the objectives of the guide and reach a conclusion concerning the information that must be reported.

Exhibit 9-1, page 152–153, illustrates a generalized audit work plan. While the audit guide will identify the specific areas of emphasis, the development of such a plan is recommended to provide assurance that all requirements of the guide are being addressed. Further, the early development of a plan will reduce the duplication of effort that often results when only part of the multiple objectives of the government audit are examined initially and reaudit is necessary to meet other objectives. With few exceptions, grantor audit guides are concerned with the following areas: internal controls, accounting systems, management systems, procurement, personnel, property management, in-kind contributions, and valuations. Additionally, the guide will, as mentioned earlier, identify several areas for which a compliance examination must be made.

Exhibit 9-1

ILLUSTRATION OF GENERALIZED AUDIT WORK PLAN





10 The Grant Audit Report

The audit report of a governmental grantee is the product for which the public accountant is engaged. However, in the governmental sector the audit report is viewed from a perspective and used in a manner different from the private sector. To the grantee, the audit report is an accounting of its stewardship of federal monies and, more often than not, an evaluation of the management and its accomplishments. To the federal grantor, the audit report is an important management tool used in assessing the performance of the grantee. The audit report may be the only grass roots or on-site inspection made of the grantee. The report is given a heavy weighting in decisions on the feasibility of grant renewal, the practicality of increased funding of the grant, and perhaps even the continuation or termination of the grant program.

Thus it can be seen that the auditor's role is critical to both the grantee and the grantor in federal activities.

This chapter explores four aspects of the grant audit report prepared by a certified public accountant: (1) the varying, perhaps concurrent, reporting standards; (2) the variety in form and content of grant audit reports; (3) the reporting and distribution procedures to the grantee, the federal grantor, and the general public; and (4) the use of the report by the federal grantor.

Standards of Reporting

There are at least three groups of reporting standards or requirements that have an impact on the public accountant in the public sector. In his engagement agreement the certified public accountant has to resolve the manner in which he will meet the following minimal reporting standards or requirements:

- The standards of reporting as set forth in the AICPA codifications of auditing standards and procedures.
- The reporting standards identified in the *Standards for Audit of Governmental Organizations, Programs, Activities and Functions* published by the comptroller general.
- The reporting requirements set forth in the audit guide that constitute the scope of the work to be performed by the public accountant for a specific grant program.

In addition, the engagement contract for services that might be issued by the grantee under some federal grant programs could contain other reporting requirements.

It is not unusual to find a reference to all the foregoing reporting standards and requirements in a single audit engagement contract. Usually the profession's standards are incorporated by reference; the comptroller general's *Standards for Audit* will no doubt be referenced by most governmental organizations seeking audit assistance; and, in addition, the audit guide of the federal grantor can be expected to contain specific requirements on reports. The grantee that has contracted for the audit services may itself impose other reporting criteria. In some instances the various reporting criteria could be in conflict. It is important that these conflicts or differences be resolved before the audit agreement is signed.

AICPA Standards of Reporting

The generally accepted reporting standards of the public accounting profession are sometimes incorporated by reference into the audit guides describing the scope of work and reporting responsibilities of public accountants for auditing specific grant programs. The four reporting standards would appear to have direct applicability to the opinion that might be required in the audit of the grantee's financial statements. These standards, in summary, require that the report state:

- Whether the financial statements are presented in accordance with generally accepted accounting principles.
- Whether such principles have been consistently observed in the current period in relation to the preceding period.
- That informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- An expression of opinion regarding the financial statements,

taken as a whole, or an assertion to the effect that an opinion cannot be expressed.

The audit opinion relating to the grantee's financial statements, which is set forth in the federal grantor's audit guide, may require the public accountant's statement that the examination was made in accordance with generally accepted auditing standards.

Governmental Audit Standards—Reporting

Chapter 7 sets forth the reporting standards published by the comptroller general of the United States, which will probably be incorporated by reference and without qualification in most audit guides for governmental programs. These reporting standards vary considerably in depth and applicability from the AICPA's standards and should be carefully examined by all certified public accountants engaged in governmental reviews and audits. The *Standards for Audit* do not merely apply to the financial statements of the grantee, but address considerably broadened scopes of governmental reviews.

By and large, it is the certified public accountant's responsibility to resolve reporting conflicts before agreeing to conduct the engagement. This is important since not all governmental standards may be applicable to the specific engagement. Further, in many instances neither the grantor nor the grantee may desire compliance with all of the reporting standards.

Federal Grantor Reporting Requirements

In addition to the aforementioned reporting standards, the certified public accountant must also be responsible for determining and adhering to the reporting requirements set forth by the federal grantors in audit guides that might be applicable to the grantee's program. These requirements may be quite specific, even prescribing the wording of the reports that the agency will consider acceptable with respect to accounting systems, internal controls, compliance with grant terms and conditions, and financial statements.

Prior to the engagement and at the conclusion of his field work, the auditor is cautioned to make a critical examination of the precise nature of the reports called for in the audit guide to determine that sufficient information can be and has been obtained to satisfy the reporting requirements. Many auditors find that they must extend the scope of their work in order to satisfactorily

appraise grantee performance and stewardship and to render their reports thereon.

Form and Content of Grant Audit Reports

The form and content of audit reports covering federal grant programs is not standardized. Each grantor agency has prescribed a report form and content that best meets its management needs. Because a grantee that retains a public accountant to make the required annual audit may not know what kind of report is required, the accountant must take the initiative in making such a determination, since the profession's typical short form report will not always suffice.

Generally, though, reports can be grouped into two categories: (1) a variation of a short form report and (2) a prescribed narrative report. Both differ from the reports issued in the commercial sector and warrant additional comment.

Short Form Reporting

There are instances when grantee or grantor considers the typical short form public accountant's audit report to be an adequate reporting of the results of the audit. However, this reporting requirement should be confirmed before accepting the engagement.

Even when a short form is acceptable, variations may have to be considered. The auditor may be required merely to issue a short form opinion as to the reasonableness of the data appearing in the grantee's attached basic financial statements, certifying that the examination was in accordance with generally accepted or other auditing standards or guides. Other grant programs require that the opinion be attached to particular types of financial or information schedules. Care should be taken to determine that the short form opinion continues to be applicable for such financial or information schedules.

Under a federal grant, the grantee will request and receive operating funds on the basis of the costs incurred or claimed. Almost always, funds are paid to a grantee on the condition precedent that the ultimate claim to such funds will be determined by audit.

For costs questioned within governmental auditing, a procedure exists whereby the auditor examines the cost charged or

claimed under a grant and determines its allowability in accordance with the cost principles outlined in chapter 6 or other criteria. Should the auditor conclude that a particular cost is not in accordance with the cost principles, other criteria, or grant conditions, he is instructed to question its allowability as a cost that should be paid by the agency. Thus most governmental audit guides require that the auditor complete a summary schedule of costs, including costs questioned under a grant. Such a schedule may be structured in a manner similar to the following:

Summary of Results of Audit
 Grant no. _____
 For the Grant Period _____ to _____

<i>Category of Cost Claimed</i>	<i>Cost Claimed or Charged</i>	<i>Total Cost</i>	<i>Recommended Adjustments or Cost Questioned</i>	<i>Notes</i>
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The required explanatory description of each questioned cost usually identifies the type of expenditure questioned, the amount, and the reason for questioning the allowability.

Criteria for Questioning Cost

Numerous criteria must be met before a federal grantor may finally release its claim to federal monies. The criteria vary by agency; many of the criteria are imposed by Congress at the time the program is authorized and funds are provided. Examples of the reasons why costs might be questioned are likely to be included in the grantor's audit guide. These criteria state that costs questioned are normally in the following categories:

- Costs that are specifically unallowable under the general and special grant conditions or agency instructions (including pregrant and postgrant costs, travel or per diem costs in excess of federal rates, and other expenditures in excess of budget).
- Costs that were not supported by adequate documentation, and the auditor could not satisfy himself by any other evidential means that the costs were proper charges to the agency grant.
- Costs that were not in the approved budget.
- Costs that were unreasonable, including those not considered to reflect the action that a prudent person would have taken

under the circumstances; and also an unreasonably high valuation assigned to in-kind contributions.

While the costs questioned will vary with the grant program and the specific conditions of the grant agreement, Federal grantors often have a history of the types of questioned costs. For example, the following listing generally describes the questioned costs experienced by the Environmental Protection Agency in the audit of its grant programs.

- *Unallowable costs.* Costs which are specifically unallowable under the terms of the grant or other cost principles cited in the grant or applicable EPA regulations.
- *Unreasonable costs.* In determining the reasonableness of a given cost, consideration shall be given to
 - Whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the grantee's (contractor's) business or the performance of the contract;
 - The restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, federal and state laws and regulations, and grant/contract terms and specifications;
 - The action that a prudent businessman would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the government, and the public at large; and,
 - Significant deviations from the established practices of the grantee/contractor which may unjustifiably increase the grant/contract costs.
- *Unallocable costs.* In reviewing the allocability of costs, the auditor will be guided by the following criteria:
 - A cost is allocable to a particular grant/contract to the extent of benefits received.
 - Any cost allocable to a particular project or function may not be shifted to a federal grant/contract to overcome fund deficiencies, avoid restrictions imposed by law or grant/contract agreements or for other reasons.
 - Where an allocation of joint cost will ultimately result in charges to a grant/contract, an indirect cost rate proposal will have to be prepared to justify the equitability of the charge.
- *Undocumented costs.* Costs for which detailed documentation is

not available to show that the costs claimed were in fact incurred under the EPA grant/contract.

- *Unapproved costs.* Costs for which grant/contract provisions or applicable cost principles require awarding agency approval, but for which the auditor finds no evidence of approval.

The designation of a cost as questionable by the auditor does not necessarily mean that the federal grantor will disallow the cost. Grantor agencies have an appeal and adjudication procedure for the consideration of costs questioned. The questioning of costs does, however, draw attention to the fact that there is a matter of concern which the federal agency will focus on. For its part, the grantee is on notice that an additional defense will have to be made if it is to be reimbursed for the questioned cost.

Narrative Reports

In governmental programs, a narrative report often must be submitted by the auditor in conjunction with the financial examination. The auditor could be asked to report instances of the grantee's noncompliance with grant terms. Additionally, the report may have to address the level of program performance during the period audited, the nature of the services rendered, the number of persons served, or the services provided to a certain constituency.

While the form of the narrative report will vary, the content could include the following topics:

- *Introduction or background.* Identifies the grantee organization, the grant(s) audited, the period of audit, the purpose of the audit.
- *Scope of audit.* Sets forth the type of audit performed, the auditing standards adhered to, and the specific work performed (reviews, observations, analyses, tests, interviews, field trips, etc.).
- *Personnel contacted.* Lists, where required, the grantee personnel and others contacted about matters concerning the grant undergoing audit.
- *Auditor's observations and recommendations.* Includes a complete, clear, and fair discussion of all the facts, circumstances, conditions, issues, and lines of responsibility for all reported observations and recommendations.

This section should contain a complete summary of all matters affecting the audited organization, whether or not required by the grantee or the federal grantor. Typically, this section is concerned with the discussion of compliance with conditions or terms of the grant and the auditor's questioning of certain costs charged to or claimed under the grant.

Compliance With Grant Conditions

A usual requirement of a governmental audit is that the auditor report the extent of grantee compliance with the terms and conditions of the grant. These compliance opinions might be required for nonfinancial or financial areas or both.

With respect to compliance reporting, a word of caution is in order. Two committees of the American Institute of Certified Public Accountants have taken the following positions:

- The AICPA's committee on relations with the federal government noted that its activity had revealed a rapid buildup in compliance work, often as an adjunct to audits, but that the criteria applied to compliance work may differ fundamentally from those involved in auditing. With this in mind, the committee reaffirmed its position that compliance work should be encouraged, as long as the accountant's area of responsibility is clearly defined and the accountant's skills equip him for the task.
- The AICPA's committee on auditing for federal agencies (1970–1971) stated that audit guides should establish two basic points with respect to compliance reporting:
 1. Compliance audit work is a proper function of the independent auditor provided that his responsibility is clearly defined and his skill equips him for the task.
 2. The guide should clarify whether the compliance work is to be pursued only incidental to the financial audit or whether the financial audit procedures are to be extended to cover some specific compliance matters.

The audit guide usually requires that the compliance section of the report discuss each instance of noncompliance separately. A complete discussion of an observed area of noncompliance should include the following information:

- Clear identification of the instance of noncompliance.

- An accurate determination, wherever possible, of the significance or dollar effect that might be related to the noncompliance observation.
- A discussion of all relevant circumstances that might have had an impact on the reason for noncompliance.
- Any conclusions or recommendations appropriate under the circumstances.

As mentioned earlier, the use to which an audit report might be put by a federal agency imposes a great responsibility upon the auditor. No effort should be spared in reporting in as complete and objective a manner as possible. The level of funding of a grant program or whether a program should be funded at all could be decided on the basis of the information contained in an audit report.

Report Distribution

Requirements unique to each federal grant program dictate the procedures for discussing the content of the audit report, addressing it, and distributing it. The only general guidance that can be provided is that the accountant must determine what procedures are to be adhered to in each of these circumstances. If the grantee has retained the auditor to make the audit in accordance with a federal grantor's requirements, guidance should be obtained from the grantor.

Discussion of Audit Report Contents

Federal agencies encourage the auditor to fully discuss all audit observations with the grantee management, thus insuring that the report contains all the relevant facts and that the grantee has ample opportunity to resolve as many audit observations as possible before publication in an audit report.

Wherever the opportunity is present, the auditor will find it beneficial to discuss potential audit observations with the grantee as the points are noted throughout the audit. Additionally, most audit guides direct the auditor to hold an exit conference with the grantee.

The exit conference between the auditor and the grantee's management is held when the site audit work is completed. Based

on his review of preliminary findings, a representative of the federal grantor agency may express a desire to attend. The conference provides the grantee with an insight into the open or unresolved audit observations that the auditor believes must be put in the audit report. The conference also allows the auditor to obtain additional information that might have a bearing on the conditions to be covered in the audit report. Some agencies try to have the auditor obtain the grantee's concurrence to the observations in the audit report. But a concurrence is not always possible, and the auditor may have to be content with providing the grantee management with all the facts upon which the reported observations were made. Further, some agencies require that the grantee's comments on reported matters be incorporated into the audit report.

Reporting and Distribution Procedures

No governmentwide procedure exists for addressing and reporting of audit observations. Alternatives encompass the full range of reporting, including addressing the report to the grantee, to the federal agency's audit official, or to a program management official of the agency.

The alternatives of the distribution differ in the same way; the distribution is according to the ultimate client's requests.

When the grantee or grantor is the client, the alternatives include the following:

- The audit report is issued to the client and the client is then responsible for distribution of the audit report.
- The auditor is authorized to concurrently release a copy of the audit report to others at the time the report is issued to the client.

When the grantor is the client, the alternatives include the following:

- The report is submitted to the federal grantor's audit officials for review and release by the agency to the grantee.
- The audit report might be submitted to the federal agency's program manager for later release to both the agency's audit official and the grantee.
- The audit report might be released to the grantee and others.

It is natural for a grantee to request a copy of the audit report when it is issued by the auditor. When the grantor agency con-

tracts for the audit, no release of the report should be made by the auditor without specific permission from the client. Federal grantor agencies sometimes specifically prohibit the release of an audit report except by the responsible federal official.

Some federal grantors believe that an important reason for not providing the grantee with a copy of the audit report directly is that the observations of the auditor are tentative and unofficial until reviewed and approved by the grantor. The grantors, having ultimate responsibility for the grant program, may want to evaluate any corrective action that might be recommended by the auditor before implementation by a grantee.

Use of Audit Reports of Federal Grant Programs

The audit report of a federal grant program is used in making several critical decisions affecting the present or continued status of the program. In many cases, the audit represents the federal grantor's only on-site inspection. For this reason, the auditor is often required to review not only the financial matters of a grant program, but also the personnel and organizational structure, property controls, program activities, and overall compliance with the executed grant conditions. On the basis of the reported results, the federal grantor will make decisions concerning the requests for refunds when unallowable costs are charged or claimed under the grant, the level of funding in the next program period, or the feasibility of continuing the grant program.

Because of their importance, the auditor must be extremely careful in reporting audit observations. Governmental grantees should respond in a timely and complete manner to all grantor requests for additional information concerning the reported audit observations. It is to everyone's benefit to resolve open audit exceptions or other audit questions within the minimum time possible.

Grantor Report Review Procedures

While many agencies have not formalized the procedures to be used in resolving audit questions, grantees are generally given an opportunity to present additional facts about the circumstances that gave rise to the observations in the audit report. These procedures often consist of the following phases:

- The receipt and review of the audit report by the grantor agency, development of an agency position, and notification to the grantee of any appeal procedure.
- The development of a response or rebuttal by the grantee, which will permit the submission of additional evidence and possibly the negotiation of costs questioned or disallowed.
- An agency position either waiving the audit exceptions or demanding grantee restitution of funds.

As discussed earlier, the exceptions, conclusions, and recommendations appearing in an audit report are tentative and do not represent the position of the federal grantor until the report has been received and reviewed and the grantee has been notified of any corrective actions required.

Assistance to Grantees

Throughout this entire proceeding, the auditor can play a valuable role. It must be recognized that at the time of reporting, the auditor must reach conclusions as to the conditions or facts available to him during the audit. If the reported observation includes instances such as weaknesses in internal controls, accounting systems, documentation, or property controls or systems, the auditor can provide guidance and assistance to the grantee to overcome the weaknesses. Such assistance is generally welcomed by both the grantee and the grantor agency. If evidence is not available or cannot be obtained within the audit period, the auditor can provide advice to the grantee about other alternatives that might be pursued in order to verify that certain costs claimed under the grant were incurred for purposes benefiting the grant program.

Thus, while the auditor has the responsibility for making a complete reporting of the grant program, there is no prohibition against helping to correct any weaknesses or gather additional evidence that would help both the grantee and the grantor to resolve the audit report matters.

It is common for grantor agencies to give the grantee a chance to present additional information or justification that might have a bearing on the final decisions on allowability of costs questioned or future funding matters. It is imperative that grantees respond promptly and completely to all requests by the federal grantor.

Review by Grantor's Audit Staff

The grantor's audit staff might examine the report submitted by the public accountant to determine that the prescribed audit

guide had been followed in the conduct of the site examination and that the audit report addresses the matters of concern to the grantor agency and contains the required opinions.

The audit staff could ask the accountant to submit additional details or explanation of certain reported observations. In some instances, depending upon the nature of the report and the past performance of the grantee, the agency's auditors might deem it necessary to review the accountant's working papers prior to accepting the observations set forth in the audit report.

Once the audit report is accepted, the grantor's audit staff will forward the report, with comments, to the grantor's program manager.

Review by Grantor Program Manager

The program manager makes a review and analysis to assess the extent of the grantee's compliance with the executed grant agreement and program goals. The outcome of this review is a notification to the grantee of the grantor's position with respect to the reported matters and, generally, a request that the grantee provide certain additional information or evidence to permit the resolution of any remaining open matters. The grantee usually is given the opportunity to present its point of view, a specific time period being established for the submission of data or evidence. During this period, there could be considerable discussion between grantor and grantee staff and management.

Because the ultimate decision with respect to some of the audit report matters could have an adverse effect upon the grantee, the grantee would be well advised to place a high priority on the resolution of any issues raised by the grantor's program manager. To insure that a comprehensive submission is prepared for review by the program manager, the grantee should make a systematic reexamination of the unresolved audit matters.

Responding to, or Rebutting, Audit Findings

For many reasons the grantee may not agree with the auditor's interpretation of certain facts or circumstances. However, if the grantee cannot or will not provide the proper evidence to the auditor, a response or rebuttal to the audit report will almost always be required by the grantor. From the grantee's view, the

timely presentation of data to an auditor would require the least effort and permit on-site evaluation, thereby possibly avoiding inclusion of the exception in the audit report.

If the request by the grantor relates to the submission of additional documentary evidence or other records, the grantee might find it easier to gather the information and request that the auditor make a follow-up visit to the site so as to evaluate the adequacy of the additional data. The auditor can then merely report to the grantor on the acceptability of the information or actions taken.

An orderly process of response by a grantee should include these steps:

- Make a detailed review of the grant condition or requirements and the circumstances surrounding the reported audit observations.
- Gather and present the additional evidence necessary to support the rationality of the grantee's actions.
- Adhere to a schedule for the timely development and presentation of the information to the grantor.
- Negotiate any costs questioned or disallowed.

It must be remembered that the federal grantor must make an accounting to the Congress and that many of the requirements imposed upon the grantee are directly related to the legislation authorizing the grant program. Therefore, the grantor must have factual, and preferably documented, evidence of the performance of grantees.

Many grantees fail to comprehend this reality and waste considerable time and money in partially successful efforts to prevail upon the grantor to accept oral testimony or statements from officials and others.

Review of Grant Conditions and Requirements

The grantee should make a detailed review of the grant conditions or regulations to ascertain the precise requirements that were to have been met. A close examination should then be made by the grantee of the precise nature of the exception or observation set forth in the audit report.

Before any data gathering begins the grantee should insure that the grantor has communicated a clear definition of the evidence, actions, or other desires that the grantee is being asked to respond to. It is valuable for the grantee to communicate with the auditor in order to learn the exact causes of the matter to be

reported. This exchange could also identify other evidence or information that would be acceptable to the auditor and would satisfy the condition or regulation that was not initially documented as completely as required.

Gathering Evidence to Support Compliance With Grant Conditions

Typically, the federal grantor will give the grantee a chance to provide other data to evidence compliance with grant conditions. The grantee should determine precisely what documentation or other information was provided by its own staff at the time of the audit. Often, despite many requests, not all the needed information is made available to the auditor. This is because the liaison assigned by the grantee to work with the auditor has limited knowledge or limited understanding as to what information is required.

There are many alternative types of information and evidence that might be available to support a particular grantee action. Because of the potential for disallowance or a more severe action by the grantor, care should be exercised to insure that responsible grantee management personnel are involved in this data-gathering effort. The detailed grant files may not contain the precise document required to settle an exception, for example, but other members of management may have corroborating information that would support the rationality of an action or the allowability of a cost charged to the grant program.

Timely Presentation

Grantees should be advised that when a grantor agency requests information to permit the resolution of an audit exception, such a request should be given a high priority. Grantor agencies have been known to extend the period for submission of additional data if convinced of the sincerity of grantee efforts to resolve any deficiencies.

For several reasons, the timely resolution of audit issues generally benefits the grantee:

- Immediate attention to the audit issues limits the grantee's exposure and potential liability.
- The continuation of poor accounting procedures or weak internal controls could constitute a risk to the grantee's operations.

- Audit trails may be lost if settlement is prolonged—staff members transfer, records become misplaced or lost, memories fade, identical circumstances are difficult to reconstruct.
- Delays may be viewed by the federal grantor as attempts to improperly retain and use federal monies.

Some federal grant programs do require that audit exceptions be resolved before any refunding determinations are reached. Other grantors might be required to suspend grant activities temporarily until grantees show a positive effort in resolving audit exceptions. These adverse actions might well be avoided and the grantor might be willing to accept the result of any substantive, even though not completely successful, effort to provide a reconstruction of events and facts relating to the reported audit exception.

Negotiation of Costs Questioned

After the submission of the additional data requested by the grantor or the reevaluation by the auditor at the grantee's site, the next step in the appeal process involves determining the revised questioned costs and deciding what costs, if any, will be disallowed by the grantor.

While some costs may not have been properly budgeted in the grant agreement, they may be necessary for the grant program. Other costs may not have been properly documented, even though facts and records show that the costs did benefit the program. These are bases for an attempt to negotiate a reduction in the amount of the costs that the grantor ultimately determines to be unallowable.

For the most part, grantors will accept reasonable evidence that supports the nature of a cost or the reason for a decision. Where there is truly a difference of opinion and the grantor is satisfied with the grantee's attempt to resolve the issue, a lower final disallowance might be negotiated or the question could be waived in its entirety by the grantor.

Formal Disallowance Action and Method of Refund

After the termination of the appeal period, the grantor will reach a final decision with respect to the disposition of the matters appearing in the audit report.

Nature of Decision Appeal

The grantor official who has the authority to make and enforce the grants of a particular program is charged with the responsibility for the final disposition of the matters in the audit report.

Upon evaluation of the additional information and justifications submitted by the grantee, the grantor generally has the authority to either (1) waive the reported matter and consider it satisfactorily resolved or (2) reach a conclusion that the reported matter was not within the letter or intent of the grant agreement and take a formal exception against the grantee.

In the latter instance, the grantee is formally notified of the adverse decision and requested to make restitution for any money or grant property that might have been misused, misspent, or otherwise involved in the reported matter. The grantee is then provided a time within which the restitution of funds or property must be made.

Methods of Restitution

When the federal grantor takes formal exception to an action of a grantee, the restitution of any money or property must be made within a specified time and could be accomplished by one of the following methods:

- A cash refund or the equivalent type of property could be provided to the grant program or to the grantor agency, depending upon the instructions received from the grantor.
- A credit could be given by the grantee through the reduction of the next billing submitted to the grantor for reimbursement.
- An offset in an amount equal to the amount of the disallowance could be taken by the grantor and agreed to by the grantee in the next refunding of the grant, thereby increasing the grantee's share of the cash expenditures of the program.

Cash is always an acceptable form of settlement of a disallowance. When property is involved, the replacement property must be of equal quality and condition, if not better than the original property. When the disallowance relates to the required nonfederal share or contribution, the grantee is directed to obtain and account for the required type of nonfederal contribution.

Significance of Disallowance Actions

With few exceptions, federal grants are awarded to nonprofit organizations. These organizations typically have no continuing source of unrestricted funds, income, or revenues from which a federal disallowance action can be paid. Thus a disallowance action has a serious impact upon the grantee's financial status.

If the amount of the dollar disallowance is considerable, the grantee could be faced with dissolution. Should the grantee refuse to make restitution of the disallowed amount, and should the resources of the organization be insufficient to meet the amount of the disallowance, the grantor could take immediate action to terminate all federal support of the grantee's programs. Further, the grantee would in all likelihood not be eligible for refunding until the disallowance had been settled to the satisfaction of the grantor.

Role of the Accountant

The certified public accountant can be invaluable to a federal grantee by providing advice and assistance throughout the grant period, which should help to minimize the number of audit exceptions and disallowance actions.

At the inception of the grant program, the accountant should make a close evaluation of the costs allowed under the program, the accounting and internal control systems that must be maintained, the supporting documentation, and the conditions of the agreement with which the grantee must comply. Should it appear that the grantee might be undertaking an action that is not in accordance with the grant, management should be informed at that time and made aware of the cost consequences should such action be disallowed.

Throughout the period of the grant, the certified public accountant could provide valuable assistance to a grantee by, for example:

- Periodically examining the currency and timeliness of billings or advance withdrawals to insure that the grantee is realizing the maximum cash flow allowable.
- Testing the adequacy of supporting documentation for costs claimed or charged to the grant.
- Monitoring indirect costs and periodically comparing them to any negotiated ceilings, since the consequences of an overrun might be viewed as the grantee's responsibility.

- Reviewing the procedures for controlling costs and making periodic comparisons to the executed grant budget categories, particularly if overruns in certain budget categories could be viewed as costs to be absorbed by the grantee.
- Checking to determine that the grantee is complying with all reporting requirements set forth in the grant agreement.

At the end of the grant program, or the end of the fiscal year in the case of a multiyear program, the public accountant should assist the grantee in resolving any questions that might have arisen during the audit. The overall objective of assistance in this area is to insure that the grantee makes the most complete case possible for its action and that the maximum effort is made to present all relevant corroborating evidence to justify the validity of the grantee's action and the benefits to the program.

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Index

- Accountability of grantor for grant, 10
- Accountants. *See* Public accountants
- Accounting
 - for construction grants, 77
 - and controls, grant programs, 46
 - for depreciation on grantee equipment, 74–75
 - by fund, grantor, 37
 - GAO interpretation, 45–46, 59
 - generally accepted standards in determining allowability of costs, 103
 - by grantor, 50–53; illustrative entries, 53–54
 - in grantor financial management, 11
 - and internal control, grantee responsibility for, 60–64
 - for property, 77–79
 - required of grantee by grantor, 57–58
 - see also* Accounting for federal funds; Accounting system; Audit; Grant audit; Grantee audit
- Accounting for federal funds
 - allotments, 41–42
 - and Anti-Deficiency Act, 42–43
 - apportionments, 41
 - appropriation and expenditure process, 39–40
 - appropriation warrants, 40–41
 - budget process, 39
 - classification of obligations, 44–45
 - and Supplemental Appropriation Act, 43–44
 - value of obligations, 45
 - see also* Accounting; Accounting system; Audit; Grant audit; Grantee audit
- Accounting system
 - GAO definition of, 59
 - grantee, 64–70
 - in grantee audit, 143–144
- Account structure, grantor, 36
- Accrual reporting, in grantee accounting system, 66–67
- Accrued expenditures, 67
- Accrued income, 67
- Administrative requirements, grant programs, 45–49
- Advance
 - by check, 28, 48–49
 - in financing grantee, 18
 - by letter of credit, 49–50
 - request for, 33
- Advance receivable, establishment of, 51
- Advance understandings, grants, 24
- Advertising, as unallowable cost, 104
- Agencies. *See* Grantor
- Agreement, grant
 - public accountant’s opinion on compliance with terms of, 150–151
 - purpose of, 47–48
- Air Pollution Control Program, Sassafras County, Md.*, 6
- Allocability, in determining allowability of costs, 103

- Allotments
 - accounting for, 41–42
 - of apportioned funds, 16
- Allottee or program, in fund
 - accounting, 37
- Allowability
 - of grantee costs, public
 - accountant's opinion on, 150
 - of costs incurred, in grantee
 - audit, 144
 - of indirect cost plans, 105–106
- Allowable costs, defined, 102–103
- American Institute of Certified Public Accountants
 - audit standards, vs. GAO, 120–123
 - and federal audit standards, 117, 119
 - and grantee audit standards, 143–144
 - position on GAO audit standards, 123–124
 - position on reporting
 - compliance with grant conditions, 162–163
 - professional ethics and state legislation division, 125
 - program on substandard reports, 137
 - reporting standards, grant audit, 156–157
- Anti-Deficiency Act (1870), 42–43
- Application for grant, 21–26
- Apportionments, accounting for, 41
- Appropriation
 - and apportioned status, in fund
 - accounting, 37
 - and expenditure, in accounting
 - for federal funds, 39–40
 - federal budget procedure, 15
- Appropriation warrants, in
 - accounting for federal funds, 40–41
- Assets, liabilities, investment, and net worth, in grantee
 - accounting system, 64–66
- Audit
 - AICPA position on GAO
 - standards, 123–124
 - compliance, 115–116
 - federal standards, 116–120
 - federal policies and
 - responsibilities, 109–113
 - GAO vs. AICPA standards, 120–123
 - and reviews, grants, 113–116
 - see also* Accounting; Accounting system; Grant audit; Grantee audit
 - Audited indirect costs, 102
 - Auditing, areas of concern in, 132–136
 - Auditors, independent,
 - qualifications of, 125
 - Auditors—Agents for Good Government*, 6
 - Audit report
 - discussion of contents, 164–165
 - in governmental auditing, 134–135
 - Audit staff, grantor, review of
 - grant audit, 166–167
 - Authorization procedure, federal budget, 15
 - Bad debts, as unallowable cost, 104
 - Balance sheet
 - of governmental units, 82
 - of voluntary health and welfare organizations, 82
 - Balance sheet accounts, grantor, 36
 - Block grants, 2
 - Budget and Accounting Act (1921), 39, 110, 112
 - Budget and Accounting Procedures Act (1950), 9, 110–111
 - Budgetary accounts, grantor, 37
 - The Budget of the United States Government*, 13
 - Budgeting
 - in accounting for federal funds, 39

- in grantor financial management, 11
- see also* Federal budget
- Buildings, valuation of
 - contribution of, 107–108
- Capital or current operations, in fund accounting, 39
- Carry-forward, fixed rate with, 102
- Cash transactions, report on, 32–33
- Categorical grants, 2
- Check
 - advance by, 28, 48–49, 52
 - payment by, 52
- Claims of grantee, recording, 51–52
- Closeout requirements, grant, 26
- Codification of Auditing Standards and Procedures*, 144
- Commitment, of funds, 50
- Commitment form, grant, 17
- Community Services Act, 114
- Compensation, personnel, 73, 100
- Competitive grants, 2
- Compliance
 - cost incurred in, 144
 - CPA's opinion on, 150–151
 - federal audit standards, 118
 - gathering evidence to support, 169
 - reporting in grant audit, 162–163
- Compliance audits, grants, 115–116
- Comptroller General, position on unused funds at grant termination, 23
- Congress
 - authorization and appropriation phase, federal budget, 14–15
 - and budget process, 39
- Congressional Budget and Impoundment Control Act (1974), 12, 14, 39, 111
- Construction, grantee accounting for, 75–76
- Construction grants, 2
 - grantee accounting for, 77
- Construction programs, request for reimbursement for, 33
- Consultants, as direct cost, 98
- Contingencies, as unallowable cost, 104
- Contracts
 - as direct cost, 98
 - grantee accounting for, 75
- Contributions
 - in-kind, 107–108
 - valuations of, 108
- Control
 - and accounting, grant programs, 46
 - grantee system criteria, 62–64
- Cost
 - accountant's opinion on allowability of, 150
 - criteria for questioning, 159–161
 - incurred by grantee, audit of, 144–145
 - suggested bases for distribution, 100
 - see also* Cost principles
- Cost accounting, grants, 93–95, 114–115
- Cost-plus-fixed-fee contract, reimbursement method, 132
- Cost principles
 - agency guides, 95–96
 - allowability of indirect cost plans, 105–106
 - definitions, 97–105
 - and grantee audit, 142
 - hierarchy of, 96–97
 - in-kind contributions, 107–108
 - matching share, 106–107
 - responsibility for, 93–94
 - see also* Cost
- Cost reimbursement basis, grant, 17, 18, 28

- Contributions, as unallowable cost, 104
- Current operations or capital, in fund accounting, 39
- Depreciation on grantee
 - equipment, accounting for, 74–75
- Direct allocation rate reports, grantee, 82, 89
- Direct costs, 97–98
- Disallowance action
 - formal, and refund method, 170–172
 - significance of, 172
- Disbursements to grantee, 52
- Discussion of report contents, grant audit, 163–164
- Distribution procedures, grant audit, 164–165
- Documentation
 - in grantee audit, 145–148
 - of grant expenditure, 47
 - for grant resources and expenditures by grantee, 70–77
- Donations, as unallowable cost, 104
- Economy, federal audit standards of, 118–120
- Efficiency, federal audit standards of, 118–120
- Eligibility criteria, grants, 21–22
- Entertainment, as unallowable cost, 104
- Equipment
 - as direct cost, 98
 - grantee accounting for expenditures for, 74–75
 - valuation of contribution of, 107–108
- Examination and evaluation, GAO standards, 121
- Examples of Findings from Governmental Audits*, 6
- Execution of grant, 50–51
- Executive Order 11717, 8
- Expenditures
 - documentation of, 47, 70–77
 - and receipts, in grantee accounting system, 66–70
 - functional, voluntary health and welfare organizations, 43
 - program, accounting for, 71–77
- Expenses, unallowable
 - of government official, 104
 - legislation, 104
- Federal agencies. *See* Grantor
- Federal budget, 12–13
 - Congressional authorization and appropriation phase, 14–15
 - implementation and monitoring phase, 16
 - preparation phase, 13–14
 - review and audit phase, 16–17
- Federal funds, obligation of, 42
 - see also* Accounting for federal funds
- Federal receipts, grantee accounting for, 70
- Federal Register*, 21
- Federal standard form 1034, 84
- Fee arrangements, in governmental auditing, 135–136
- Financial activities, summaries, voluntary health and welfare organizations, 83
- Financial costs, as unallowable cost, 104
- Financial Management Circulars. *See* Office of Management and Budget Circulars
- Financial management implementation, grant programs, 10–11
- Financial process, grantor agency, 17
- Financial statements
 - of governmental units, 81–82
 - for grants, 83
 - from grantees, 84–88, 89; CPA opinion on, 151

- of voluntary health and welfare organizations, 82–83
- Financial status report, grant, 32
- Financing
 - of grant, 26–33
 - of grantees, 18
 - and payment documents, grant, 48–49
 - reimbursement basis of, 49
- Fines, as unallowable costs, 104
- Fiscal audits, grants, 114–115
- Fiscal Requirements Manual for Guidance of Departments and Agencies*, 8
- Fixed amount, reimbursement of indirect costs, 101
- Fixed-price contract reimbursement method, 131–132
- Fixed rate with carry-forward, indirect costs, 102
- Format, short form reporting, grant audit, 158–159
- Formula grants, 2
- Fringe benefits, as direct costs, 98
- Functional accounting, grantor, 37, 39
- Functional expenditures analysis, voluntary health and welfare organizations, 43
- Fund accounting
 - grantor, 35–36
 - integrated, 36
 - uniqueness of federal system, 37–39
- Funding, grant programs, 11–21
- Funds, commitment of, 50
- General Accounting Office
 - audit responsibility, 110–111
 - audit standards, 120–123; AICPA position on, 123–124
 - and budget process, 39
 - examination and evaluation standards, 121
 - and federal standards of audit, 116–120
 - general audit standards, 120–121
 - internal control criteria, 62–64
 - position on acceptance of grant, 23
 - reporting standards, 121–123
 - report on need for more effective audits, 136–137
 - requirements from grantee, 58–59
 - responsibility for grant programs, 5–6
- General fund appropriation expenditure accounts, 40
- General Services Administration
 - audit responsibilities, 111–112
 - requirements from grantee, 59–60
 - responsibility for grant programs, 8–9
- Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*, 81
- Governmental engagements, obligation to meet responsibilities of, 124–125
- Governmental units, financial statements of, 81–82
- Government Audit Engagements to Evaluate Economy, Efficiency, and Program Results*, 119
- Government Corporation Control Act (1945), 110
- Government official, expenses as unallowable cost, 104
- Grant
 - accountant's role in, 172–173
 - applying for, 21–26
 - audits and reviews, 113–116
 - award of, 17
 - central financial control agencies, 5–9
 - closeout requirements, 26
 - conditions and requirements, review of, 168–169
 - cost accounting for, 93–95
 - eligibility criteria for, 21–22
 - execution of, 50–51

- execution of advance
 - understandings, 24
 - financial management
 - implementation, 10–11
 - financial statements for, 83
 - financing, 26–33; and payment
 - documents, 48–49
 - grantor accountability for, 10
 - grantor accounting for, 50–54
 - grantor responsibilities for, 9–10
 - grantor review of, 24–25
 - incremental funding, 27
 - preparation of application, 23–24
 - reporting requirements, 32–33
 - revenue-sharing programs, 2–3
 - submission requirements, 22–23
 - types, 1–2
 - see also* Grant audit; Grantee; Grantee audit; Grantor
- Grant audit**
- AICPA reporting standards, 156–157
 - assistance to grantees, 166
 - criteria for questioning cost, 159–161
 - decision appeal, disallowance
 - action, 171
 - discussion of report contents, 163–164
 - formal disallowance action and
 - refund method, 170–172
 - form and content of reports, 158–163
 - gathering evidence to support
 - compliance, 169
 - governmental reporting
 - standards, 157
 - grantor reporting requirements, 157–158
 - narrative reports, 160–161
 - negotiation of costs questioned, 170
 - reporting and distribution
 - procedures, 163–165
 - reporting and distribution
 - standards, 164–165
 - reporting compliance with grant
 - conditions in, 162–163
 - reporting standards, 155–158
 - report review procedures,
 - grantor, 165–166
 - responding to or rebutting
 - findings, 167–170
 - restitution methods, 171
 - review by grantor audit staff, 166–167
 - review by grantor program
 - manager, 167
 - review of grant conditions and
 - requirements, 168–169
 - timely presentation, 169–170
 - short form reporting, 158–159
 - use of reports, 165–167
 - see also* Audit; Grantee audit
- Grantee**
- accounting and internal control
 - responsibility, 60–64
 - accounting for construction
 - grants, 77
 - accounting for program
 - expenditures, 71–77
 - accounting for program
 - resources, 70–71
 - accounting for property, 77–79
 - accounting required by grantor, 57–58
 - accounting system structure, 64–70
 - assistance to, grant audit, 166
 - disbursements to, 52
 - documentation for grant
 - resources and
 - expenditures, 70–77
 - financial statements from, 84–88, 89
 - financing methods, 18
 - GAO requirements from, 58–59
 - GSA requirements from, 59–60
 - nonfinancial reports, 92
 - OMB requirements from, 59–60
 - payment of federal money to, 27–30
 - recording claims of, 51–52
 - record retention period, 79–80

- responsibilities, 25
- selection of accounting firm by, 130–131
- see also* Grant; Grant audit; Grantee audit; Grantor
- Grantee audit
 - accounting systems and internal controls, 143–144
 - and audit guides, 142–143
 - and cost principles, 142
 - costs incurred, 144–145
 - CPA opinions required in, 148–151
 - documentation standards, 145–148
 - grantor policies, rules, and regulations on, 141
 - orientation for, 140–143
 - prescription of scope, 139–140
 - reporting frequency, 46–47
 - reporting purpose, 46
 - work plan, 151
 - see also* Accounting; Audit; Grant audit
- Grantor
 - accounting for federal funds, 39–45
 - accounting for grants, 50–54
 - accounting required of grantee, 57–58
 - administrative requirements for grant programs, 45–49
 - audit responsibilities, 112–113
 - audit staff review of grant audit, 166–167
 - CPA firm contractual procedures, 128, 130–132
 - financial process, 17
 - fund accounting, 35–39
 - GAO internal control criteria for, 62–64
 - policies, rules, and regulations on grantee audits, 141
 - prepayment review, 54–55
 - reporting requirements, grant audit, 157–158
 - report review procedures, grant audit, 165–166
 - responsibilities for grant programs, 8–9
 - review of grant, 24–25
 - review of grant audit by program manager, 167
 - see also* Grant; Grant audit; Grantee; Grantee audit
- Grant program
 - accounting for expenditures, 71–77
 - administrative requirements, 45–49
 - funding, 11–21
 - grantor responsibilities, 8–9
 - use of audit reports of, 165–167
 - using CPA firms, 129
- Grants Administration*, 95
- A Guide for Colleges and Universities* (OASC-1), 87, 95
- A Guide for Hospitals* (OASC-3), 87, 95
- A Guide for Nonprofit Institutions* (OASC-5), 87, 89, 95–96
- A Guide for State and Local Government Agencies* (OASC-10), 87, 96
- Health and welfare organizations, voluntary, financial statements of, 82–83
- Health, Education, and Welfare Department
 - Departmental Federal Assistance Financing System (DFAFS), 28, 30
 - guides for cost accounting for grants, 95–96
 - and hierarchy of cost principles, 96
 - procedures for preparing indirect cost proposals, 87
- Illinois *Use of Public Accountants for Auditing State Activities*, 6
- Implementation of federal budget, 16
- Income and expense accounts, grantor, 36

- Incremental funding of grant, 27
- Independent auditors,
 - qualifications of, 125
- Indirect charges, grantee
 - accounting for, 76
- Indirect cost(s)
 - defined, 98–102
 - distribution basis, 99
 - grantee statements illustrated, 87
- Indirect cost plans, allowability of, 105–106
- Indirect cost proposal
 - nongovernmental grantee, 89, 92
 - preparation of, 87
 - submission of, 85
- Indirect cost rates, 99–101
 - grantee statement of, 85
- In-kind contributions, valuation
 - of, 107–108
- In-kind matching contributions,
 - grantee accounting for, 76–77
- Integrated federal fund
 - accounting, 36
- Interest, as unallowable cost, 104
- Interim indirect cost rate, 101
- Internal audits, in grantor
 - financial management, 11
- Internal control
 - criteria for, 60–64
 - in grantee audit, 143–144
 - in grantor financial management, 11
- Investment, in grantee accounting
 - system, 64, 66
- Land, valuation of contribution of, 107–108
- Legislation expense, as
 - unallowable cost, 104
- Legislative Reorganization Act
 - 1946, 110
 - 1970, 111
- Letter of credit, 17
 - advance financing by, 49–50
 - conditions, 30, 32
 - in financing grantee, 18
 - in paying grantees, 29–30, 52
- Liabilities, in grantee accounting
 - system, 64, 66
- Losses, underrecovery, as
 - unallowable cost, 104
- Lump sum reimbursement of
 - indirect costs, 101
- Management information, in
 - grantor financial management, 11
- Matching contributions, grantee
 - accounting for, 71
- Matching share, defined, 106–107
- Materials
 - and supplies, as direct cost, 98
 - valuation of contributions of, 107
- Monitoring of federal budget, 16
- Multiple rate cost report, grantee, 88
- Municipal Financial Officers
 - Association, 81
- Narrative reports, grant audits, 161–162
- National Health Council, 82
- National Institute of Health, 96
- National Social Welfare Assembly, 82
- Negotiated indirect cost, defined, 101–102
- Negotiation of cost questioned,
 - grant audit, 170
- Net worth, in grantee accounting
 - system, 64–66
- Noncash matching contributions,
 - grantee accounting for, 76–77
- Noncompetitive grants, 2
- Nonfederal receipts, grantee
 - accounting for, 70–71
- Nonfinancial reports, grantee, 92
- Nongovernmental grantee,
 - indirect cost proposal, 89, 92

- Nonprofit organization, unallowable costs, 105
- Obligation(s)
 - classification of, 44–45
 - of federal funds, 42
 - in grantee accounting system, 67
 - value of, 45
- Obligation reporting, in grantee accounting system, 67, 70
- Office of Management and Budget
 - allotments, 16
 - and appropriation process, 40
 - and apportionments, 41
 - audit responsibility, 111
 - and budget process, 39
 - and federal budget preparation, 13
 - and hierarchy of cost principles, 96
 - requirements from grantee, 59–60
 - responsibility for grant programs, 6–7
- Office of Management and Budget Circulars
 - applicability to cost accounting for grants, 94–95
 - proposed, *Grants and Contracts with Certain Nonprofit Organizations—Principles for Determining Cost*, 93
- A-11, 44
- A-21 (FMC 73-8), *Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Educational Institutions*, 8, 93, 94
- A-73 (FMC 73-2), 9, 111–112, 117
- A-87 (FMC 74-4), *Principles for Determining Costs Applicable to Grants and Contracts with State and Local Governments*, 8, 93, 94
- A-88 (FMC 73-6), 8
- A-100 (FMC 73-3), 8
- A-102 (FMC 74-7), *Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments*, 9, 22, 32, 47, 48, 59, 60, 76, 78, 83, 107, 111; summary of, 61
- A-110, 9, 22, 32, 111
- Office of Minority Business Enterprises (OMBE), 119
- Operating statements
 - of governmental units, 82
 - of voluntary health and welfare organizations, 82–83
- Operational audits, grants, 116
- Organizational coordination, grantor's responsibility for, 10
- Other direct charges, grantee accounting for, 76
- Outlays
 - in grantee accounting system, 67
 - report, 33
- Payment, of federal money to grantee, 27–30
 - by letter-of-credit withdrawals, 52
 - by Treasury check, 52
- Payment documents, and financing, grant, 48–49
- Penalties, as unallowable costs, 104
- Periodic audits, grants, 115
- Personnel
 - compensation or salaries, as direct cost, 98
 - grantee accounting for expenditures for, 73
- Policy and Procedures Manual for Guidance of Federal Agencies*, 6, 110
- Postaward review or survey, grant, 114
- Preaward form, grant, 17
- Preaward review or survey, grant, 113–114
- Predetermined fixed indirect cost rate, 101

- Prepayment review, grantor, 54–55
- Procurement, in grantor financial management, 11
- Program, or allottee, in fund accounting, 37
- A Program for Improving the Quality of Grantee Management*, 95
- Program manager, grantor, review of grant audit, 167
- Program results, federal audit standards, 118–120
- Project grants, 2
- Property
 - grantee accounting for, 77–79
 - in grantor financial management, 11
 - valuation of contribution of buildings, 107–108
- Property and Administrative Services Act (1949), 110
- Provisional indirect cost rate, 101
- Public accountants
 - AICPA program on substandard reports, 137
 - areas of concern in governmental auditing, 132–136
 - contract by grantor, 131
 - factors affecting use of, 127–128
 - federal contracting procedures, 128, 130–132
 - government survey of use of, 136–137
 - grant programs using firms of, 129
 - grant role, 172–173
 - opinion on adequacy of grantee system, 148–149
 - opinion on allowability of grantee costs, 150
 - opinion on compliance with terms of grant agreement, 150–151
 - opinion on grantee financial statements, 151
 - reimbursement methods, 131–132
 - role in grant audit, 172–173
 - selection by grantee, 130–131
 - services provided by, 128
- Qualifications of independent auditors, 125
- Questioning of costs, criteria for, 159–161
- Questions and Answers in Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, 6
- Reasonableness
 - of cost incurred, grantee audit, 144
 - in determining allowability of costs, 103
- Rebuttal of grant audit findings, 167–170
- Receipts and expenditures
 - sample classifications, 72
 - in grantee accounting system, 66–70
- Record retention period, grantee, 79–80
- Reimbursement
 - of CPA firm, 131–132
 - grantee periodic invoices for, 84
 - request for, 33
- Reimbursement basis of financing, 49
- Reorganization Plan 2 (1970), 6
- Replenishment of advances, grantee periodic invoices for, 84
- Reporting
 - GAO standards, 121–123
 - grantor requirements, 157–158
 - grant requirements, 32–33
 - procedures, 164–165
 - responsibility in governmental auditing, 134
 - short form, 158–159
- Reporting standards, grant audit, 155–158
 - AICPA, 156–157
 - government, 157
- Request for payment, 33
 - on letter of credit, 30
- Resources and expenditures
 - grantee statement of, 84–85

- grantee documentation for, 70–77
- Responding to grant audit findings, 167–170
- Restitution methods, 171
- Review
 - of federal budget, 16–17
 - of grant audit report, 165–169
 - of grant by grantor, 24–25
- Scope of work, definition, in governmental auditing, 133–134
- Signature card, for letter of credit, 30
- Space
 - as direct cost, 98
 - valuation of contribution of, 107
- Special Analyses, Budget of the United States Government*, 12
- Special fund accounts, grantor, 40
- Standards, reporting and distribution, grant audit, 164–165
- Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, 6, 116, 117–118, 156
 - AICPA position on, 123–124
- Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, 82, 89, 103
- Statement on Auditing Standards, 149
- Submission requirements, grants, 22–23
- Suggested State Auditing Acts and Constitutional Amendments*, 6
- Supplemental Appropriation Act (1955), 43–44
- Supplies
 - grantee accounting for, 75
 - and materials, as direct cost, 98
- Supportability of cost incurred, in grantee audit, 144
- Timely presentation, grant audit, 169–170
- Total costs, defined, 97
- Transfer appropriation account, 40
- Travel
 - as direct cost, 98
 - grantee accounting for expenditures for, 73–74
- Treasury Circulars, 1075, 28, 49
- Treasury Department
 - and appropriation process, 40
 - appropriation warrants, 40–41
 - and budget process, 39
 - disbursement function, 16
 - responsibility for grant programs, 7–8
- Trust fund accounts, grantor, 40
- Unallocable cost, in grant audit, 160
- Unallowable costs
 - defined, 103–105
 - in grant audit, 160
- Underrecovery of costs or losses, as unallowable cost, 104
- Undocumented cost, 160–161
- Unapproved cost, 161
- The United States Budget in Brief*, 12
- Unobligated balance, in grantee accounting system, 67
- Unpaid obligations, 67
- Unreasonable cost, in grant audit, 160
- Valuation of in-kind contributions, 106–107
- Value of obligations, 45
- Voluntary health and welfare organizations, financial statements of, 82–83
- Volunteer services, valuations of contribution of, 107
- What GAO Is Doing to Improve Governmental Auditing Standards*, 6
- Working papers, access to, in governmental auditing, 135
- Work plan, grantee audit, 151

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65