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## Federal financial management : accounting and auditing practices

Cornelius E. Tierney

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# Federal Financial Management: Accounting and Auditing Practices

Cornelius E. Tierney, CPA  
Robert D. Hoffman, CPA

**AICPA**

American Institute of  
Certified Public Accountants

Federal Financial  
Management:  
Accounting and  
Auditing Practices

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**Cornelius E. Tierney, CPA  
Robert D. Hoffman, CPA**

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

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# Director's Preface

The extent of the federal government's involvement in the financial affairs of the nation has become so great that today nearly every individual is affected by the federal government's revenue producing and expenditure policies. Until now, however, no single publication has been devoted to describing and explaining the financial policies and practices followed by the federal government. In fact, other publications have attempted only to describe these policies and practices as variations of the traditional accounting practices followed by state and local governmental units. Now, information on how the federal government accounts for and audits congressional appropriations and related expenditures has been distilled into a single volume. Previously, such information could be obtained only by reference to the myriad federal statutes, policy statements, and the procedures and practices of numerous federal agencies.

This publication, authored by Cornelius E. Tierney, CPA, and Robert D. Hoffman, CPA, is based on their years of personal experience as federal auditors, accountants, systems analysts, and financial managers.

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.

Mr. Hoffman is presently the Director of Corporate Audits for the Federal Deposit Insurance Corporation. Prior to this he held positions with the Army Audit Agency and the National Aeronautics and Space Administration and headed his own public accounting firm. In addition, he has been a partner with a national public accounting firm where he was responsible for financial consulting operations and audit clientele.

In attempting to make this study as readable as possible, the authors have refrained from including footnote references to various sources of information. However, these sources are listed in the bibliography.

As with any work of this nature, the resulting product is the culmination of the efforts and contributions of many individuals; thus, to mention all those who have made significant contributions would be impossible. However, the authors wish to thank all of those in the federal government and the accounting profession whose assistance has made this publication possible.

Thomas R. Hanley, Director  
Federal Government Division

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# Introduction

For many years, there has existed a common body of knowledge of federal financial requirements, procedures, and practices. However, this knowledge was not in one reference work, but in countless statutes, policy statements, procedures, and practices that were expressed or mandated by individual federal agencies, the four central financial agencies of the government, and Congress. On occasion, no formal promulgations were made; an operating practice was merely adopted.

Until recently, the publication of such information would have had little purpose since few people outside the federal financial management community would have been interested. During the last decade, however, the government's role and involvement has extended to all sectors of American society—business, state and local governments, even the individual and his family. In the process, the public accounting profession, perhaps more than any other profession, has been increasingly involved. Many firms and many individual practitioners have been retained to assist in the establishment of government agency systems and procedures and to perform audits of grantees, contractors, and other recipients of federal funds.

This study combines in a single reference source information on how the government budgets, accounts for, and audits federal monies. For the practicing accountant, this will provide a broader background and better perspective for advising clients who do business with the government. This information will aid in assessing the reasons for a particular agency's actions or its requests for information from a recipient of funds.

While the study has been limited to federal promulgations, many government sources have been tapped. Congressional statutes have been the basis for many of the financial, accounting, and reporting requirements imposed by federal agencies. Additionally, the central financial agencies (Office of Management and Budget, Treasury Department, General Accounting Office, and, more recently, General Services Administration) have specified what is required of an agency financial function, when certain financial activities must be per-

formed, and what must be reported. Each agency also is responsible for the design, development, and implementation of the system and controls that will insure compliance with congressional and central agency requirements.

As indicated throughout, this study is the result of its authors' reviews of central agency issuances, statutory requirements having financial implications, and examinations and personal knowledge of written systems and procedures. The materials in these pages have been grouped, as chapters, into the subject areas briefly summarized below.

*Federal Financial Management* Responsibility for financial management in the federal government is interwoven among all organizational segments. However, the focus of responsibility rests with four central financial agencies and their respective responsibilities to the executive, legislative, and judicial branches. These four agencies jointly exercise their authority over other agencies of government with a high degree of cooperation and communication.

Each of the four agencies has separate and distinct duties. The Office of Management and Budget focuses on planning and budgeting. The General Accounting Office is concerned with the prescription and promulgation of financial management and accounting matters and the review of agency financial systems and practices. The Treasury Department is responsible for the fiscal aspects of government, particularly the disbursement function and the maintenance of central accounts. The General Services Administration provides guidance to executive branch agencies for the development of financial systems and policies.

*Organization of Agency Financial Management Functions* Each agency has to develop an organizational structure that will meet the requirements it is chartered to fulfill. This is why there is no typical or standardized organizational structure for all agencies, small or large.

Nevertheless, smaller agencies tend to have a financial management structure that encompasses functions such as control over program commitments and obligations. In larger agencies and departments such control is somewhat decentralized.

*The Federal Budget* Understanding the federal budget is basic to understanding how a federal agency receives and spends the funds appropriated by Congress and how the funds ultimately become available to states, local governments, grantees, contractors, borrowers, and others. For the most part, no funds are spent until approval has been obtained from Congress through the budgetary

process. In the federal government, budgeting is a continuing process. A single cycle begins some 16 months before the fiscal year commences and ends, from the agency's standpoint, some two years after the appropriation expires. In all, many years of accounting, reporting, and auditing are involved for each cycle.

*Overview of Federal Accounting System* Federal accounting differs markedly from commercial accounting. The accounting cycle includes actions of Congress, the central agencies, specific agencies, and the program centers of the specific agencies.

This chapter focuses on types of funds, accounting systems used for fund accounting, object classifications, and other accounting structures required for agency accounting.

*Accounting for Federal Agency Funds* This chapter provides an understanding of the terminology used in the full federal accounting cycle and the methods of recording, accounting for, and reporting information relative to appropriations.

*Federal Contracts* The dollar volume of contracts for supplies and services makes contracts a significant vehicle by which the government disburses funds. The amount of money and the number of contracts issued create an audit and accountability need that can be met by few agency audit staffs. To supplement these staff resources, the agencies have turned to the public accounting profession to conduct preaward pricing reviews, audits of costs incurred, and closeout examinations of contractor activities. Knowledge of the federal contracting process, its controls and restrictions, and the manner in which the agency accounts for contracts throughout the life of the instrument will help the public accountant to comprehend the system, provide more informed consultation to clients, and accept opportunities to audit government contracts.

This chapter outlines the process by which contracts are issued and the several organizations within an agency that are required to participate in the award and monitoring activities. Pertinent portions of the federal procurement regulations are discussed, including types of contracts, contract cost principles, and allowable and unallowable costs. The federal agency's internal accounting process is also presented, along with the interrelationship of the contractor's reporting and the agency's system.

*Federal Grants* Grants-in-aid represent one vehicle by which the government, under a variety of programs, annually disburses billions of dollars to industry, nonprofit and educational organizations, state and local governments, and individuals. In recent years, the auditing



of grant programs has been a primary area in which the government has turned to the public accounting profession for assistance. Firms have provided such services as financial management technical assistance, preaward surveys, systems reviews, compliance audits, financial statement audits, and grant closeout examinations.

This chapter outlines the needs of the agency and the importance of full and timely reporting by grantees. It shows the interrelationships between the records of the grantee and the accounting being done within the federal agency in discharging its responsibility to Congress, discusses the responsibilities of federal grantors, outlines the records and controls of grant-in-aid programs, and defines generally allowable and unallowable costs, including matching share considerations.

*Audits of Federal Funds* All operations, activities, and functions of federal agencies must be subjected to audit, either by federal auditors or by other audit organizations. Historically, the internal activities of an agency were audited by federal audit staffs: the external activities, such as contractors, grantees, and borrowers, may have been audited by other organizations such as state and local government auditors and by public accountants.

During the 1960s, federal agencies used the public accounting profession extensively for external audits of grantees and contractors. In the 1970s, agencies have used the profession to make internal audits of the agencies themselves.

This chapter outlines the agencies responsible for auditing in the government and the interrelationships of the various audits of federal monies. Also discussed are the types and standards of audit and the manner in which the typical agency audit is conducted.

# I Federal Financial Management

By law, congressional direction, and presidential delegation, the responsibilities for prescribing federal financial policy, defining and promulgating accounting, fiscal, and reporting requirements to all federal agencies, and providing specific guidance in the planning, budgeting, and auditing of federal programs and activities have historically centered in three agencies, often referred to as the central financial agencies: the Treasury Department, the General Accounting Office, and the Office of Management and Budget.

Additionally, the Civil Service Commission, with its responsibilities for maintaining the quality of the federal civil service and training, has increasingly participated in activities relating to the development of financial management and the design of formal training programs. In July 1973 the General Services Administration was assigned a broader role in developing and promulgating federal financial management policy.

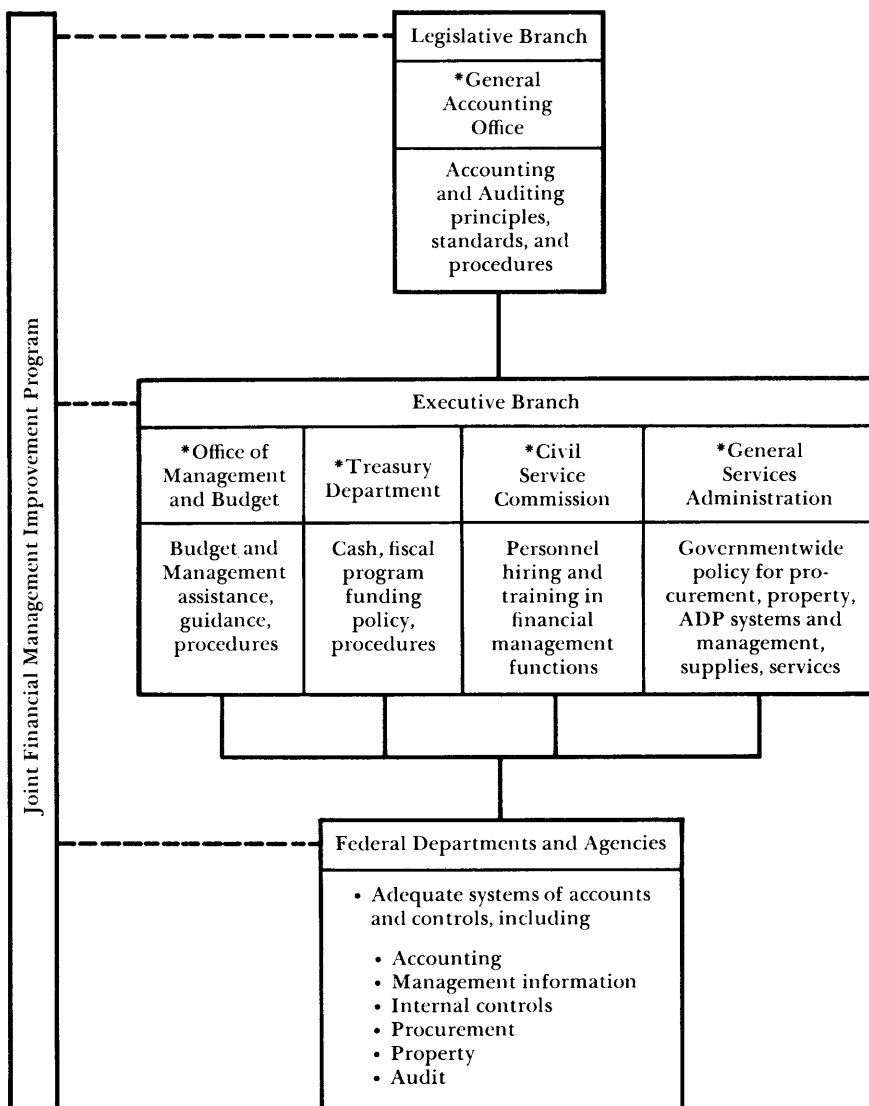
With the support of these agencies, the ongoing efforts to improve the government's financial management are coordinated under the Joint Financial Management Improvement Program, and the results are published annually.

However, it is the responsibility of each federal agency to develop its own systems of financial management, including accounting, information, control, and auditing. The latitude and criteria for these systems are set forth in the various regulations and issuances of the five agencies mentioned earlier.

As shown in Exhibit 1-1, page 6, the development of the federal financial management function is the coordinated responsibility of five central agencies that directly influence the financial, fiscal, and

## Exhibit I-1

### COORDINATION FOR FINANCIAL MANAGEMENT IN THE FEDERAL GOVERNMENT



\*Heads of these agencies serve as principals of the Joint Financial Management Improvement Program

audit activities of federal agencies and are also the principal members of the Joint Financial Management Improvement Program: the General Accounting Office, the Office of Management and Budget, the Treasury Department, the Civil Service Commission, and the General Services Administration.

## 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 provides accounting and auditing guidance to all agencies and makes independent reviews and audits of the manner in which the federal departments and agencies disburse and apply the funds appropriated by the Congress.

This agency was established by the Budget and Accounting Act of 1921 as an agency independent of the executive branch. As an additional assurance of independence, the comptroller general and the deputy comptroller general of the United States are appointed by the President with the advice and consent of the Senate. Both officers serve for 15 years, subject to removal only by a joint resolution of the Congress for specific causes or impeachment.

Several additional laws form the basis for the broad range of review, evaluation, adjudication, and reporting responsibilities of the General Accounting Office. Three principal responsibilities directly affect the many federal agencies and their contract and grant programs.

1. Recommending ways and means for improving financial management, prescribing accounting principles and standards, and assisting agencies in improving financial management systems.
2. Auditing or reviewing agency financial and management systems, the efficiency of management use of resources, and the effectiveness of agency programs in achieving the objectives of the Congress.
3. Assisting the Congress and its committees by conducting special audits, surveys, and investigations of governmental programs and providing financial and technical advice on matters considered to be within the competence of the General Accounting Office.

Additionally, the comptroller general renders legal opinions and provides legal advice to the agencies of government. When requested,

or at its discretion, the General Accounting Office must determine the legality or propriety of payments of public funds that have been made in accordance with federal agency certifications. On request, the comptroller general provides advance decisions on the legality of proposed or actual contract or grant awards. Any bidder may ask for a ruling on the legality of an actual or proposed award that adversely affects him. These decisions are not binding on the Congress or the courts, but they are legally binding on executive agencies.

Another GAO responsibility is to settle claims and collect debts on behalf of the United States, whether they involve individuals, business entities, or foreign, state, and municipal governments as claimants or debtors. The agency must settle claims against the United States as required by law or where doubt of legal entitlement exists; and it must settle claims by the United States if there are questions about the amount or propriety of the debt or the liability of the debtor, or if the administrative agency has not been able to collect the debt. Settlement of these claims by GAO is binding on executive branch agencies.

Much of the policy and procedural guidance of the General Accounting Office is available to the general public and provides a detailed description of the requirements relating to the accounting and auditing activities of federal departments and agencies. In addition, the General Accounting Office has published information of considerable value relating to contracts and grants issued by federal departments and agencies. Illustrative of the GAO guidance 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 departments and agencies.
- *The Decisions of the Comptroller General of the United States* sets forth the official GAO position with respect to specific financial and legal transactions affecting the government.
- *The Standards for Audit of Governmental Organizations, Programs, Activities & Functions* and several documents related to grants set forth the requirements and suggestions to improve the character and quality of auditing and evaluating federally assisted programs.
- *The Government Contract Principles* and other documents related to government contracts set forth the general policy and procedures by which federal departments and agencies contract for services and supplies.

- The various reports of GAO audits, surveys, and investigations of government activities set forth the GAO position with respect to the activities examined and recommendations for corrective action, where deemed necessary.

This information is available from the General Accounting Office or the Government Printing Office in Washington, D.C.

## Office of Management and Budget

The Office of Management and Budget (OMB) was established in the Executive Office of the President pursuant to Reorganization Plan 2 of 1970. By Executive Order 11541 of July 1, 1970, functions transferred to the President of the United States by Part I of the reorganization plan were delegated to the director of the Office of Management and Budget.

Under this plan, OMB was created by renaming the Bureau of the Budget. A key function of the new office continued to be assisting the President in the preparation of the federal budget and overseeing its execution, but greater emphasis was placed on management and fiscal analysis.

Some OMB responsibilities affect the financial management function of federal agencies—for example, assisting the President in preparing the budget and formulating the fiscal program; 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 and practices; considering, clearing, and, where necessary, preparing proposed executive orders and proclamations; planning and promoting the development, improvement, and coordination of federal and other statistical services; planning and developing information systems to provide program performance data; and planning, conducting, and promoting evaluation efforts to assess agency program objectives, performance, and efficiency.

As will be described in later chapters, the Office of Management and Budget exerts considerable influence on the activities of a federal agency through procedures for apportionment of funds and the exercise of its budget review responsibilities. All executive agencies must have advance OMB approval to obligate and spend funds. This is done by having the Office of Management and Budget approve an apportionment of an agency's appropriated funds before the agency incurs any obligation.

The Office of Management and Budget makes known its policy and procedural requirements in the form of bulletins and circulars, which are generally issued directly to the federal departments and agencies and relate to specific subjects of interest to the government. Included in these publications is guidance relating to department and agency accounting, budgeting, and financial management as well as to grants and contracts.

## Treasury Department

The oldest of the central agencies, the Treasury Department, was organized in 1789. Although its roles and responsibilities have changed and increased significantly since then, the Treasury Department continues to exercise control over the fiscal and financial management practices of federal agencies because of its duty to control and obtain an accounting for funds disbursed by the government.

Today, the Department of the Treasury acts as the financial policy adviser to the President, the financial and fiscal agent of the government, an important law enforcement and security organization, and an overseer of other financial and monetary activities. The following illustrates the functions that most directly affect the financial management activities of a federal agency.

- Formulating and recommending domestic and international financial policy; formulating and recommending tax policy; participating in the formulation of broad fiscal policies that have general significance for the economy; and managing the public debt.
- Performing several functions of fiscal service operations, including accounting for public monies; issuing and processing federal checks; issuing and promoting the sale of savings bonds and other securities; collecting tax revenues and customs duties; supervising national banks; and manufacturing coins, currency, and postage stamps.
- Maintaining the government's uniform central accounts for disbursing monies for most civilian agencies, and designating federal depositories for receiving, holding, and paying out public funds.

The policies and procedures relating to the fiscal and accounting requirements are made known to the many federal departments and agencies by a series of Treasury notices and circulars issued on spe-

cific subjects to each of the governmental organizations. In addition, more permanent or continuing guidance is formalized in the Department of the Treasury's *Fiscal Requirements Manual for the Guidance of Departments and Agencies*.

## Civil Service Commission

In addition to its policy responsibilities related to the recruitment, classification, and payment of civilian federal personnel, the Civil Service Commission exercises considerable responsibility in the area of training and maintaining the quality and competence of civil service employees. This is particularly true with respect to financial and administrative management. Many continual programs provide training in federal accounting, budgeting, planning, grants management, and contracts.

## General Services Administration

The General Services Administration (GSA), created by the Federal Property and Administrative Services Act of 1949, is the most recent member of the Joint Financial Management Improvement Program. It became a member in 1973, when, in addition to its responsibilities for buildings, property, vehicles, and records, it was delegated several former OMB functions: financial management systems development, procurement, contracting, property management, and automatic data processing management.

Through its circulars and other directives, the General Services Administration is increasingly active in prescribing financial management policy and procedures for federal agencies.

## Joint Financial Management Improvement Program

The Joint Financial Management Improvement Program was launched in 1948 as a cooperative effort of all federal agencies under the original leadership of three central agencies—the General Accounting Office, the Treasury Department, and the Office of Management and Budget—with the purpose of updating and modernizing



financial management practices and systems throughout the government, including budgeting, accounting, reporting, and auditing systems.

More recently, two additional agencies have joined the central agency leadership. The Civil Service Commission was invited to participate because of problems in the recruitment, classification, and training of financial management personnel. The General Services Administration joined when it assumed responsibility for governmentwide financial management functions which were reassigned from OMB under Executive Order 11717.

The heads of the five central agencies, who constitute the principals of the program, meet periodically to review progress, plans, and problems. Each principal has designated one high-ranking official to serve on the executive council, which gives policy guidance to the program; one representative to serve on the steering committee, which is responsible for the general direction of the program, for providing advice and assistance to individual agencies, and for undertaking projects that generally have governmentwide implications; and one representative to serve as liaison for his agency. The liaison representative is a point of contact in his agency on joint program matters and helps the steering committee in dealing with problems related to individual agencies.

The following are some of the more significant joint program objectives in improving financial systems.

- Strengthening agency organization.
- Establishing responsibility-oriented accounting systems on an accrual basis to serve fund and cost control needs.
- Integrating the planning, programming, and budgeting practices with accounts to support budgets and cost-based appropriation requests.
- Developing and using responsibility-centered cost-based budgets and financial reports.
- Simplifying agency appropriation and allotment structures.
- Using consistent classifications for more effective coordination of agency financial practices.
- Establishing suitable internal controls, including internal audits.
- Integrating agency accounting and reporting to satisfy requirements of the budget process, management needs, and the central accounting and reporting of the Treasury Department.
- Developing accurate and useful governmentwide reports on fiscal status, results of operations, and cost of agency performance.

- Educating personnel in the effective utilization of management tools to achieve more efficient operations.

The results and accomplishments of this coordinated effort are published annually to the Congress and made available to the public.

## Agency Responsibilities for Financial Management

By law, it is the responsibility of each department and agency to develop an adequate system of financial management, including planning, budgeting, accounting, property control, and internal control. The statutory requirements have been supplemented by numerous regulations and promulgations issued by the central financial agencies in the execution of their own legal responsibilities.

### **Budget and Accounting Act of 1921**

The Budget and Accounting Act of 1921, as amended, makes the head of each federal department and agency responsible for, and required to comply in, four areas of financial management.

1. Preparing requests for regular, supplemental, or deficiency appropriations and submitting such requests to the Office of Management and Budget.
2. Using cost-based budgets for purposes of administration and operation and for the subdivision of appropriations.
3. Taking action to achieve consistency in accounting and budget classifications, synchronization between these classifications and organizational structures, and budget justification by information on performance and program costs for each organizational unit.
4. Furnishing to the comptroller general information regarding the powers, duties, activities, organizations, financial transactions, and methods of business as he may require from time to time.

Section 113 of the act specifically requires the head of each executive agency to establish and maintain systems of accounting and internal control designed to provide full disclosure of the financial results of the agency's activities; adequate financial information for the agency's management; effective control over and accountability for all funds, property, and other assets for which the agency is re-

sponsible, including appropriate internal audit; and reliable accounting results to serve as the basis for preparation and support of the agency's budget requests. Additionally, the head of each agency is responsible for controlling the execution of its budget, for providing financial information required by the Office of Management and Budget, and for suitable integration of the accounting of the agency with the Treasury Department in connection with the central accounting and reporting responsibilities imposed on the Secretary of the Treasury.

A later amendment to the act states that the head of each executive agency

. . . shall, in accordance with principles and standards prescribed by the Comptroller General, cause the accounts of such agency to be maintained on an accrual basis to show the resources, liabilities, and costs of operations of such agency with a view of facilitating the preparation of cost-based budgets. . . . The accounting system . . . shall include adequate monetary property accounting records as an integral part of the system.

### **Other Legislative Requirements**

In addition to the above-mentioned governmentwide requirements, the authorization and appropriation laws of the individual executive departments and agencies contain provisions relating specifically to the management of their financial affairs. Some of the provisions, for example, relate to expenditure limitations, ceilings on the rate of obligations, financial reporting, average or unit costs of operating various programs, auditing requirements, and special evaluations. Each of these requirements must be considered when the agency designs or modifies its systems of accounting and internal controls.

### **Implementation by Federal Departments and Agencies**

To meet their responsibility to establish and maintain an adequate system of financial management, federal organizations must design systems that will provide fiscal and accounting information for planning, budgeting, monitoring, and controlling funds appropriated by the Congress. These systems must concurrently meet all the central agency criteria and provide for full accounting on all funds transferred or disbursed to other agencies, contractors, and grantees. The financial management system of a department or agency will consist of such subsystems as these.

- *Accounting*, including the recording, summarizing, and reporting of all fiscal transactions of the agency by such formats as

type of appropriation, programs, organizations, and object classifications of expenses.

- *Management information*, including the statistical and other data evidencing the activity level or accomplishments of the organization.
- *Budgeting*, including the annual preparation, monitoring, and controlling of funds requested from and appropriated by the Congress.
- *Procurement*, including the method of contracting for, receiving, and paying for supplies and services required by the organization 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 records to account for the receipt, inventory, and disposal of property in possession of the organization, other government agencies, contractors, and grantees.
- *Internal controls and audits*, including the procedures for monitoring, reviewing, and otherwise safeguarding the organization's funds and assets.

As is evident from this listing, the responsibilities for financial management of a governmental department or agency extend to contractors, grantees, and other organizations with which a financial relationship exists. To discharge these responsibilities, departments and agencies issue policies and procedures to the various recipients of federal funds. Noncompliance with these policies and procedures could result in the severance of relations with the governmental organization. In the case of contractors and grantees, many departments and agencies prescribe the accounting systems, internal controls, and audits that must exist as a condition to receiving federal funds.

Of necessity, the specific requirements vary with the individual department or agency. Familiarization with the regulations of each of the agreements under which a contractor or grantee receives funds is extremely important.



# 2 Organization of Agency Financial Management Functions

Financial management in a federal agency, for the purposes of this chapter, encompasses planning and program review, budgeting, financial systems, accounting, and financial reporting. The auditing function is covered in a later chapter.

## Financial Management Structure

All federal agencies must perform essentially the same financial management function, but their organizational structure will vary according to departmental requirements. Each agency may establish its own structure to handle its financial management requirements; there is no standardized structure for federal agencies. However, two distinct structures appear frequently in the large cabinet-level departments and in smaller agencies or offices within a larger department.

A distinguishing characteristic of the larger federal departments or agencies is that the planning, programming, and evaluation functions are generally independent of the financial or accounting functions. This has been characteristic since 1965, with the introduction of the planning, programming, and budgeting systems (PPBS) throughout the government. In these departments, the PPBS role was normally exercised by a staff organization or office reporting directly to the department head. In smaller agencies or offices, financial management normally includes overall administrative responsibility, accounting, and other financial functions within the same organization structure. Since financial management structures do vary, it is suggested that reference be made to the *United States Government Manual*, which is updated annually and is available through the Government Print-

ing Office. The manual summarizes organizational structures and other information concerning federal departments and agencies.

## **Responsibilities of Financial Management Personnel**

However the agency is structured, federal financial managers must insure prudent, economical, efficient, and effective performance. To plan, monitor, and report on such performance, the managers are expected to make full use of sophisticated analytic techniques, responsive program information systems, and integrated financial systems.

Financial management must be in strict conformity with prescribed principles, standards, and procedures in order that the agency can fully account for the public funds with which it is entrusted. All aspects of financial management, including accounting, planning, programming, and budgeting, are expected to comply fully with the promulgations of the Office of Management and Budget, the Treasury Department, the General Accounting Office, the General Services Administration, and the intent and purposes authorized by Congress.

### **Retention of Qualified Staff**

Competent people are essential to any successful organization; the need is no less in the federal financial management function. Experienced personnel with a sound background in accounting, the federal budget and fiscal process, as well as management and economics are a prerequisite to the fulfillment of any agency's financial management function. Once these financial personnel are employed, an agency must install a program of professional development through regular refresher courses and supportive formal training to increase the contribution of the personnel to the agency.

### **Adviser to Management**

To fulfill its highest purpose the financial management should provide timely advice and consultation on available alternatives and monitor the implementation of management decisions. To perform this dual role, federal financial managers must be knowledgeable of the program decisions that are made by management, the problems management faces, the feasible alternatives, and the data required for complete statistical and financial accounting of program activities.

In the capacity of adviser, the financial managers perform an invaluable service by anticipating the informational needs of management and providing plans of action, reporting mechanisms, and statements of accountability. By performing such a role, they can help the agency to steer clear of pitfalls and avoid cumbersome financial and reporting arrangements that would result from a less orderly and anticipatory approach.

### **Continual Evaluation of Data**

Statistical or financial program data, which form the basic building blocks of information, are generated by all organizations of an agency. While all organizations must cooperate to maintain the data systems, the primary responsibility in the federal agency for the resultant records and reports usually lies with the financial manager. This means that the financial manager monitors the completeness and accuracy of the information being recorded in the statistical and financial systems. Up to a point, this can be accomplished through the regular analysis of reported data. However, on-site audits and inspection are often the only way to find out how the reporting instructions are being interpreted and implemented.

## **Federal Financial Management Organizations**

There is a similarity between the financial management function in a small federal agency and the operating administration or program offices of a large department or agency. At small agencies and at lower organizational levels in large departments, financial management has fewer specialties. In the small agency, this function is usually the responsibility of the administrative office headed by an assistant director for administration or a comptroller.

In the large organization financial management may require the close coordination of the staff and organizations of at least two offices within the office of the secretary, such as the office of a deputy under-secretary and an assistant secretary for administration (and possibly others). Other agencies might split the function between an assistant director for research, planning, and evaluation, an assistant director for budgets, and an assistant director for administration. The titles of the organizations sharing financial management responsibilities can vary; where the financial management is split between two offices,



usually planning and budgeting is separated from accounting and reporting.

### **Administrative and Financial Management Functions**

Centralization of several functions into single organizations and more limited reliance on specialties are the pattern in smaller agencies. This should not be construed to mean that the responsibilities are in any way diminished. In fact, the financial management personnel of small agencies must be more conversant with the full range of the agency's financial responsibilities.

The general financial and administrative functions of federal organizations include planning and program review, budget and finance, personnel, financial systems, investigations and security, installation and logistics function, and auditing.

*Planning and Program Review* To accomplish its organizational mission and fulfill its assigned responsibilities, an office of planning and program review could develop and manage a cyclical program planning and evaluation system for a department in coordination with other secretarial offices, which may be responsive to the secretary and undersecretary, OMB, the White House, and Congress. In consonance with departmental policy, the office may assist in the development and identification of departmental program goals and objectives and may recommend program priorities among those goals in the development of the department's budget, programs, and legislative proposals.

It is the task of planning and review to identify and define major planning and program issues and possible alternatives, as well as to help assure their orderly and timely resolution. Further, this function might coordinate and help analyze the comprehensive program plans of the operating administrations, check their relationship to departmental or national goals, and help identify areas where such plans are inconsistent, incomplete, or overlapping.

Other planning and program review functions might include evaluating ongoing departmental programs periodically to assess results and effectiveness related to stated objectives or conducting short-term responsive analyses of program matters or issues that arise daily. Analytical studies of total program costs (including federal budget costs as well as costs to the economy and society) versus total benefits will be made, including studies of cost-effectiveness, cost-benefit, and cost constraints and will assist in analyzing and determining the cost, benefits, and effects of program modifications that would result from the adoption of new policies or legislative proposals.

*Budget and Finance* Financial management in a small agency or program office generally combines budget and finance, which could be assigned to the director of a budget and finance division who would report to the agency's assistant or associate director for administration. This division director might bear the title of controller.

The extent to which such a division performs any or all budget and finance responsibilities depends on several personnel and organizational factors. In some organizations, the level of experience, academic background, and technical competence is such that the director not only performs budget and finance functions but is also expected to play a key role in presenting the agency's budget to OMB and before Congress.

Further, there are instances where an agency's budget and finance division director is entrusted with all its planning, budgeting, and financial management. In other agencies the organizational structure of the budget and finance division is limited, particularly in the larger and more decentralized agencies.

In many federal agencies, the financial function is performed almost entirely within a budget and finance division or similar organization, whose primary focus is on stewardship and accountability. This division must provide competent and timely guidance and technical support to insure that the funds appropriated by Congress or received from other sources are controlled, accounted for, and reported in accordance with the appropriate regulations.

The data retrieved by a budget and finance division in its stewardship and accounting role also must be usable for decision making by the agency's planning functions and program offices. Additionally, the director of a budget and finance division normally can be expected to assume certain externally imposed responsibilities as an accountable officer, acting as an agent of the Treasury Department and having primary and personal responsibility for certifying to the authenticity of the agency's scheduled disbursements, its year-end obligations, and the designation of agency imprest and petty cash fund cashiers.

The following are several responsibilities that a federal agency could require the budget and finance functions to meet.

- Develop, administer, and monitor the agency's accounting system to conform to accounting practices, principles, and standards established by the comptroller general and provide the accounting information required for effective program planning and budgeting, revolving fund management, contracts and grants-in-aid administration, cost budgeting, program evaluation, and decision making.

- Provide professional leadership and technical direction for accounting systems and financial management programs.
- Represent the agency in conferences and negotiations with other federal agencies and other groups concerning the agency's accounting and financial management programs.
- Determine methods and procedures under which accounting (including cost and asset accounting for property, inventories, and other resources), vouchering, payroll, and disbursing are to be carried out.
- Furnish employee compensation services and perform voucher examinations of, and make certifications for, payment of employees' travel claims and claims for goods and services rendered to the agency.
- Develop and conduct a continuing evaluation of the financial management practices of, and provide technical advice and assistance to, the agency's program managers.
- Exercise leadership in the cooperative development and improvement of state and local government financial management and provide staff assistance to these officials and other professional groups with objectives and interests that coincide with or are supportive of agency goals and objectives in financial management improvement.
- Plan and conduct programs to provide agency management at all levels with up-to-date information on the status of apportionments and allocations of program funds, with interpretations and evaluations of program progress and pertinent data needed in the planning, execution, administration, and control of agency funds.
- Insure compliance with applicable congressional, Treasury, and OMB reporting requirements.
- Maintain continuing surveillance of imprest fund operations through periodic counts and examinations of practices, documents, and procedures.
- Certify, as accountable officer, to the transactions scheduled for disbursement and the periodic statement of obligations of the agency.

*Organizational Considerations* Budget and finance may be organizationally within the same division or office, but most agencies assign different people to the two functions.

Generally, the *budget function* is the smaller of the two offices in total staff and more specialized in its support services. Budget per-

sonnel are primarily concerned with compiling, presenting, defending, and executing the agency's budget or financial plan. Budgeting is an ongoing process, and at any one time, budget personnel are concerned with the events of at least three program years. Usually an agency's budget function is structured along program lines, permitting a degree of specialization that has the advantage of letting budget staffs acquire more in-depth knowledge of the agency's activities than would be possible with a more general organization.

The *finance function* encompasses several fiscal specialties. Its structuring must provide for internal control to insure that all finance, accounting, and related operations are carried out with accuracy, efficiency, and economy and that the agency's operations are within the limits of applicable laws and regulations as well as agency policies and directives. The finance function should be designed to provide for assurances that assets are safeguarded against waste, loss, or improper use, that revenues are collected and accounted for, and that financial reports are accurate and reliable.

The division of the following financial activities is not uniform throughout the government, although they must be performed by all agencies, large and small. The *accounting section* is responsible for maintenance of the general ledger accounts and subsidiary records; financial analyses of program accomplishments as related to expenditures, costs, and obligations; and preparation of all financial reports required inside as well as outside the agency. The *fiscal section* reviews and approves all proposed disbursements for legality and propriety of payment; it schedules all disbursements for transmittal to the Department of the Treasury for check preparation; and it maintains a payroll system to process pay, leave, and benefits as well as retirement records.

*Personnel Function* The primary mission of an office of personnel and training is to provide leadership and professional guidance of sufficient depth and scope to assure the continued attraction, retention, motivation, training, and development of managerial and employee talent capable of meeting departmental responsibilities.

To accomplish its organizational mission and fulfill its responsibilities, a personnel office must provide personnel and training leadership; serve as the principal adviser for the development and coordination of policies, standards, and guidelines for full personnel management and training programs; administer an executive personnel program; plan and conduct research in the several areas of training and personnel management; plan and conduct departmentwide manpower planning programs; plan and develop policies and design programs to implement and maintain a system for the evaluation of

personnel management and training; and plan and develop policies and programs for labor relations and employee relations and services.

A personnel office must also plan and develop wage and salary administration policies within the limits of statutory and regulatory authority; plan and develop policies and direct position management programs; and plan and develop policy, programs, and procedures to promote equal employment opportunity in the department's personnel.

*Financial Systems* The financial systems section might formulate financial policy for control over and reporting of funds, property, and personnel utilization; it could design, develop, implement, and monitor an integrated financial system that meets statutory as well as program requirements; and it maintains liaison with OMB, the Treasury, and the GAO on all systems and other matters having reporting and financial implications.

To accomplish its responsibilities, the financial systems function often performs the following:

- Develop and administer a departmental organization system, including concepts, plans, standards, documentation, and control governing organizational structure, assignment of responsibility, delegation of authority, and operational relationships.
- Develop and administer an accounting system that not only conforms to the accounting practices, principles, and standards established by the comptroller general but also provide comprehensive accounting information which may include program planning and budgeting, revolving fund management, grants-in-aid administration, cost budgeting, program evaluation, and decision making.
- Guide in developing and providing overall leadership in administering a comprehensive internal departmental data handling system covering the financial ADP requirements, resources, and applications.

*Investigations and Security* In any federal department or agency, the investigations and security function insures that the investigations and security programs are responsive to departmental or agency needs, applicable laws, executive orders, and federal regulations.

Fulfilling its mission and responsibility could entail ascertaining the need for formulating and recommending policies, plans, and programs for all aspects of investigations and security; developing and recommending policy and guidelines for the prevention, detection, and investigation of actual or suspected violations of law or regu-

lations; and developing and recommending policies, standards, and procedures for the protection of facilities, installations, equipment, records, and property.

*Installation and Logistics* The installation and logistics function generally includes procurement, facilities, properties, and grants management policies, practices, and systems. It is often organized by three general areas of responsibilities.

*Procurement management* encompasses policy and systems development, professional assistance and guidance, development of compliance standards, and evaluation of such activities as contracting, contract compliance, grant management and compliance, purchasing, small business policies, and interagency agreements.

*Facilities management* covers comprehensive planning and programming for facilities as well as development of policies governing the acquisition, design, construction, maintenance, utilization, and disposal of facilities.

*Property management* includes policy and systems development, assistance and guidance, development of compliance standards, and evaluation of such areas as supply systems, personal property management, inventory management and control, shipping and traffic management (including household effects), transportation, equipment management, vehicle management, disposal activities, and so forth.

*Auditing* Generally, the audit function is charged with providing services to insure that resources are protected and utilized within the department or agency and by its grantees and contractors in a manner that conforms with all applicable laws, regulations, and directives as well as prudent management.

In the discharge of assigned responsibilities, the audit function will develop and implement a program of audit services and administer audit policies and standards; represent the organization in audit matters with other federal agencies, local government, and industrial, educational, and professional groups; examine documents and certifications of vouchers prior to payment to insure compliance with laws, regulations, agreements, purchase orders, or other authorizations and insure that all administrative determinations and conditions have been met.



# 3 The Federal Budget

An understanding of the budget is basic to a comprehension of how the government spends the funds appropriated by the Congress of the United States and how the funds ultimately become available to states, local governments, grantees, and contractors.

With few exceptions, any outlay by a federal agency must have the prior approval of Congress through the budgetary process.

## The Federal Budget Defined

In a technical context the federal budget may be defined as the summary totals of appropriations, receipts, expenditures (excluding net lending), expenditure accounts surplus or deficit, gross and net lending, total expenditures, and total budget surplus or deficit.

In a nontechnical sense, the budget is the spending plan on which the President bases his annual message to the people and to Congress. If approved by the Congress, the budget historically took effect the following July 1 in the form of appropriations. With the passage of the Congressional Budget and Impoundment Control Act of 1974, the federal fiscal year was changed. Beginning with 1976, the fiscal year extends from October 1 to September 30.

## Format of the Budget

Both the format and the content of the federal budget have been modified and changed over the years. The budget is the volume containing the budget message of the President and the summary information being presented to the Congress. However, in its broadest sense the federal budget is a group of five documents.

1. *The U.S. Budget in Brief* is a pamphlet containing a concise presentation that is less technical than other budget documents.



2. *Special Analyses, Budget of the United States Government* contains special analyses designed to highlight specific programs and other significant presentations of the federal budget data.
3. *The Budget of the United States Government* is a compact volume containing the President's budget message and summary information on budgetary recommendations. This volume contains the facts and figures most widely used in and out of the government.
4. *The Budget of the United States Government—Appendix* is the text of the appropriation estimates proposed by the President for each federal agency and program; specific supporting information on various appropriations and funds; and supplementary schedules required by past legislation.
5. *The Budget of the United States Government—District of Columbia* consists of estimates for the support of the municipal government of the District of Columbia.

As indicated, these documents describe the federal budget in varying detail. All are available annually from the Government Printing Office and are valuable sources of background information on federal programs. Specifically, these documents contain, on an agency-by-agency basis, such details as a summary description of all programs to be operated during the budget year, the level of funding that is available from past years, the number and grade level of agency staffing, and dollars of proposed cost (and actual costs in the case of past years) of the agency programs analyzed by types of expenditures.

Before 1969, the budget of primary concern to the public and to federal personnel was the one known as the administrative budget. It was this budget that represented the President's proposed programs and funding levels. At that time confusion abounded, since there were three forms of budget presentations: the administrative budget, the consolidated budget, and the national income and product accounts budget. A unified budget was adopted as a result of the recommendations of the President's Commission on Budget Concepts.

### **The Unified Budget**

In 1967 the President's Commission on Budget Concepts published its report, containing many recommendations that were implemented in later years. The commission called for a single unified, comprehensive budget showing the whole financial plan in a single

statement, since the emphasis was generally on whether the budget had a surplus or a deficit; and the way in which any deficit would be financed was presented in a separate table removed from the proposed receipt and expenditure transactions.

Other recommendations proposed were to give more prominence to the actions being requested of the Congress in any one year, since only part of the budget requires Congressional action in each fiscal year; to include all programs of the government and its agencies in the comprehensive budget, with the exception of government-sponsored but privately owned enterprises; to divide the budget totals between loan accounts and receipt-expenditure accounts, since the identification of the surplus or deficit of the receipt-expenditure accounts is significant for fiscal planning and for assessing the economic impact of the budget; to continue to reflect the federal insurance or guarantee of private loans outside of the budget, since these guarantees represent neither expenditures nor borrowings; and to explicitly present the method of financing the budget deficit or disposing of the surplus.

The commission further recommended that the deduction of receipts from gross expenditures should be based on the nature of the transaction rather than the nature of the fund; receipts other than taxes which were enterprise- or market-oriented should be offset to related expenditures; loan accounts should offset principal repayments and sales against loan disbursements.

The commission took a stand against a capital budget that would provide separate financing of capital or investment expenditures as distinguished from current or operating expenditures; and it recommended that the accrual basis of accounting eventually be adopted for reporting budget expenditures and receipts in lieu of the checks-issued and the collections-received basis of accounting. This last recommendation has never been implemented.

The unified budget, implemented in fiscal year 1969, combined the receipts and outlays for federal and trust funds. The federal funds are derived mainly from taxes and borrowing; trust funds are collected and used as specified by the Congress, for example as in the payment of social security and unemployment insurance benefits. Thus the unified budget measures the totality of the government's transactions.

The federal or government-owned funds are made up of four types.

*General funds* are credited with receipts or borrowings not earmarked by law and are charged with the payments or expenditures from such receipts.

*Special funds* contain federal receipts earmarked for specific purposes, other than carrying out a cycle of an agency's operations. For example, the Federal Highway Trust Fund's receipts are generated by gasoline sales to the public; these receipts may be used only for the purposes specified by law, such as highway construction.

*Public enterprise funds or revolving funds* are used to finance a cycle of operations in which the outlays of goods or services generate receipts primarily from the public. The Tennessee Valley Authority is a case in point; it wholesales power to 160 local municipal and cooperative electrical systems serving 2 million customers in seven states.

*Intragovernmental revolving and management funds* facilitate the financing of agency operations within and between government agencies, when one agency produces goods or renders services to other agencies under a reimbursable agreement. For example, the General Services Administration manages more than 10,000 buildings that are federally owned or leased and is responsible for operations, maintenance, repair, improvements, safety, and so on.

The unified budget covers all agencies and programs administered by the government, regardless of the type of funding. Mixed-ownership (government-private) and nonstock government corporations are included as trust revolving funds. The quasi-government corporations, such as the Federal Home Loan banks, and the board of governors of the Federal Reserve System are excluded from the budget totals since these type of organizations are self-sustaining and presented as annexed budgets to the unified budget.

A distinction is maintained in the unified budget to show the differing impact of an expenditure and a loan. Federal expenditures add directly to the income of the recipient and are an outflow of cash from the government for which repayment is seldom anticipated. In contrast, when the government grants a loan, it expects the borrower to repay; and the government treats the loan as an asset or a receivable until it is paid in full or the indebtedness is forgiven.

## The Budget Process

When dealing with programs financed by federal funds, it is soon evident that there is more than one budget year to consider. The budget cycle for a federal agency starts at least 16 months before the fiscal year to which it is applicable. During a fiscal year the

agency will be concerned with the budgets for at least three fiscal years. It is still accounting for the budgets of the current and the last two completed fiscal years.

In recent years the accounting profession has become increasingly involved in the final phase of the budget cycle, helping to review and audit grantees, contractors, and government agencies themselves, in an attempt to assess how well a budget has been executed.

In practice, we talk about the budget cycle, although "process" is probably more descriptive of the various phases of the federal budget. The budget cycle is a continuous process with four identifiable phases: (1) preparation and submission of the budget by the executive branch, (2) congressional authorization and appropriation reviews, (3) implementation and monitoring of the congressionally approved budget, and (4) review and audit of the manner in which the budgeted resources were applied or expended.

While each budget phase is discernible, there is no sharp line of demarcation between one phase and the next. Historically, the beginning of the fiscal year marked the end of the first two phases for most agencies and the beginning of the budget execution phase. In recent years, however, congressional authorization and appropriation has been extended so far into the new fiscal year that it is no longer unusual for federal agencies to not know the current year's appropriation until eight or nine months of the fiscal year have passed.

In the face of such an emergency, some kind of legislation must be enacted to permit the government to operate. This legislation, which must be passed by both houses of Congress, is referred to as continuing resolutions. These resolutions are temporary funding authorizations or vehicles to maintain an agency's expenditures at the level of the preceding fiscal year.

The general rule is that, under a continuing resolution, an agency cannot exceed the prior year's spending rate. However, if only the House has passed the agency's appropriation bill, the spending rate must be maintained at the lower of the last year's rate or the House's appropriation. If both the Senate and the House have passed appropriation bills, the spending rate must not exceed the lower of the rates in the two bills. Should an agency's appropriation not become law before a continuing resolution expires, Congress must pass another resolution. If it should fail to do so, any agency that continues to obligate funds would be violating the Constitution as well as assorted laws prohibiting the obligation of funds before they have been appropriated by the Congress.

## Phases of the Budget Cycle

There is no period in the year when an agency is free of budget activity. The phases of a budget cycle are important to all financial personnel, since it is the budget to which the Congress will react in the form of an appropriation, and it is the appropriation that becomes the fund that must be obligated, spent, and reported on by the agency.

### **Budget Preparation Phase**

The President's transmittal of his budget proposals to the Congress each year climaxes many months of planning and analysis throughout the executive branch. For example, the formulation of the 1976 budget, covering the fiscal year July 1, 1975, to June 30, 1976, began in the agencies in the spring of 1974. About ten months later, in February 1975, the budget was formally transmitted to Congress.

Some 16 months before the start of the fiscal year, each agency evaluates its programs, identifies policy issues, and makes budgetary projections, giving attention both to important modifications and innovations in its programs, and to alternative long-range program plans. After review by the Office of Management and Budget, preliminary plans are presented to the President for his consideration. Following a review and after considering the economic projections and revenue estimates prepared by the Treasury Department, the Council of Economic Advisers, the Office of Management and Budget, and others, the President establishes the general budget and fiscal policy guidelines. Individual budgets are then formulated by each agency, reviewed in some detail by the Office of Management and Budget.

The Congressional Budget and Impoundment Act of 1974, which changed the start of the fiscal year from July 1 to October 1, has altered the time-phasing of these activities, for fiscal years beginning October 1, 1976.

### **Congressional Authorization and Appropriation Phase**

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

Under the traditional *authorization procedures* the Congress first enacts legislation through authorization committees. This legislation

authorizes an agency to carry out a particular program and may also set a limit on the amount that can subsequently be appropriated by other congressional committees for the program. Some federal programs require annual authorizing legislation, some are authorized for a specified number of years, and some go on indefinitely.

The *appropriation procedure* is more complex. The granting of budget authority—which permits an agency to enter into obligations requiring immediate or future payment of money—is a separate action subsequent to the authorization phase. Most budget authority is enacted by Congress in the form of appropriations, which may not exceed the limit established in the legislation authorizing the program. The appropriation becomes available each year only as voted by the Congress. In some cases, permanent budget authority has been voted, under which funds become available annually without further congressional action. Most trust fund appropriations are permanent, as is the appropriation to pay interest on the public debt.

Once approved by the Senate and House of Representatives, the appropriation measure is forwarded to the President for his approval or veto. If this appropriation of funds is approved and is apportioned by the Office of Management and Budget to a federal agency, it becomes that agency's authority to obligate and later expend funds on behalf of the government. An appropriation has a term of availability for obligation which is defined (1) as the fiscal time period or (2) by the 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 an agency for obligation and expenditure until the designated purpose is accomplished or until the funds are spent. If an appropriation is not obligated, and in some cases not expended, within a specific time period, the appropriation has expired or lapsed and no further obligations can be made against that appropriation.

## **Execution of the Budget**

*Apportionments of Appropriations* After approval by the Congress and the President, the appropriated funds are available for use in accordance with the agency's operating plan. The operating plan for obligating and expending the appropriated funds must be in conformity with the agency's authority and the appropriation act. Further, the obligation of funds must be in accord with administrative actions known as *apportionments*. Following is a summary of the budgetary and fiscal responsibilities of involved organizations for federal funds.

## Responsibility for Federal Funds

<u>Organization</u>	<u>Actions</u>
Congress	Authorizes programs and funding limits; appropriates funds for expenditure by the executive branch
General Accounting Office and Treasury Department	Executes appropriation warrant
Office of Management and Budget	Apportions the congressionally appropriated funds to the individual federal agencies, generally on a quarterly basis
Federal agency	Establishes program allotments of the funds apportioned by the Office of Management and Budget
Delegated agency, program, and office heads	Obligates allotted funds for expenditure, such as employee salaries and expenses, services from other agencies, federal grants, federal contracts
Treasury Department	Disburses checks to recipients who are authorized or identified by individual federal agencies

The objective of the apportionment system is to plan the effective and orderly use of available obligational authority and, in the case of annual appropriations, to forestall the need for an agency to ask Congress for supplemental spending authority. The director of the Office of Management and Budget distributes or apportions appropriations and other budget authority to each agency by time periods—usually quarterly—or by activities. Technically, the agency submits a request for apportionment to the Office of Management and Budget. Once funds are apportioned, obligations may be incurred by an agency up to the apportioned amounts. The Office of Management and Budget, acting for the President, may withhold an apportionment in the form of a reserve until the need for the apportionment is demonstrated.

*Allotment of Apportionments* Within the agency, the funds apportioned by the Office of Management and Budget are distributed to the various program offices by an administrative procedure known as allotments. The heads of the program offices are generally the allottees and as such are the officials responsible for insuring that the obligations and expenditures do not exceed the apportioned and allotted funds. It is generally at the allottee level that the decision is made to fund a grantee or enter into a contract. It is at this

level that needs for services originate and the alternative of using federal staffing or outside sources is determined.

*Obligation of Allotments* Once funds have been allotted, usually on a quarterly basis, each allottee is authorized to incur obligations on behalf of the agency. The obligation procedure is a financial control that reserves or restricts portions of the allotted funds as goods and services are ordered or procured by the agency's program offices. The amount obligated must not exceed the total of allotted funds.

*Expenditure of Obligated Funds* As services are rendered, goods received, or performance completed, obligations established for these services, goods, or performance are converted to liabilities of the department or agency and must be paid. While the Treasury Department actually disburses funds, the checks are issued only upon written requests from the federal departments and agencies. No disbursement is made unless a valid obligation has been established.

### **Review and Audit Phase**

Review and audit constitute the final step in the budget process. The individual agencies 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 appropriating legislation, as well as the apportionments. Most reviews take the form of audits performed by agency audit staffs or by state and local government auditors and public accountants. The types and scope of these audits are discussed in detail later.

The Office of Management and Budget also reviews substantive and financial reports and keeps abreast of each agency's progress in attaining program objectives. Similarly, the General Accounting Office carries on a continuing program of examination and evaluation of government agencies. Its findings and recommendations for any corrective action are made to the Congress and to the agencies themselves.

## **Congressional Appropriations**

In general, an appropriation is an act of the Congress authorizing an agency to incur obligations and to make payments out of the Treasury for specified purposes. The authorizing legislation merely



authorizes an appropriation; it does not authorize incurring obligations or making expenditures. An appropriation act must be passed before obligations and expenditures can be made.

Generally an appropriation act of the Congress is an agency's authority to incur obligations and make expenditures out of the general fund. However, an appropriation act may also permit an agency to use receipts that have been collected for specified purposes. An appropriation for a particular purpose confers the authority to incur expenses that are necessary or incidental to the proper execution of the purpose.

Congressional appropriations are known by several terms, of which the following paragraphs set forth the more common ones. It should be noted that the terms are not mutually exclusive. For example, a no-year, one-year, or multiple-year appropriation could at the same time be an unexpired and a current appropriation. The following GAO definitions have found general acceptability in practice. Yet Congress could build certain limitations into an appropriation that would keep it from being clearly classified in any of the following categories.

*Time Availability for Obligation* The time period for which an appropriation is available for obligation may be specified in the appropriation act, as shown in the following examples.

*A one-year appropriation* is available for obligation only during a specific fiscal year. This is the kind of appropriation Congress might make for the payment of an agency's annual operating costs, such as salaries and expenses.

*A multiple-year appropriation* is available for obligation for a definite period that is in excess of one fiscal year and could extend for several years into the future. Some military projects have received appropriations for a multiple-year period, after which the authority to obligate ceases.

*A no-year appropriation* is available for obligation for an indefinite period. The obligational authority under such an appropriation remains available until the agency achieves the goal for which the funds were provided or until all funds are expended.

*A permanent appropriation*, by virtue of standing legislation, becomes automatically available for obligation and expenditure by the proper agency acting in accordance with the purposes of the original appropriation act.

*Types or Status of Appropriations* In practice, the following descriptions are also applied to the types or status of appropriational

authority held by various federal agencies. Again, these terms are not exclusive of the preceding appropriation definitions.

*A definite appropriation* is for a specific amount of money.

*An indefinite appropriation* is for an unspecified sum, such as all or part of the receipts from certain sources, the amount of which is not determinable until some future date.

*A current appropriation* is made by the Congress in, or immediately prior to, the fiscal year during which it is available for obligation.

*A permanent appropriation*, by virtue of standing legislation, becomes available automatically.

*An unexpired appropriation* is available for obligation.

*An expired or lapsed appropriation* is no longer available for new obligations but is available for payment of existing obligations.

Other Congressional obligational authority, in addition to the various types of appropriations, could include a statutory authorization to incur obligations and make payments for specified purposes out of money derived from the sale of public debt securities of the government and corporate debt securities; a statutory authorization, or contract authority, to enter into contracts or obligations before appropriations are made for the payment of such obligations; and a joint resolution of the Congress authorizing an agency to continue operations between the expiration of the previous fiscal year's appropriation and the enactment of a regular appropriation for the current fiscal year—that is, a continuing resolution.

## Federal Budget and Accounting Periods

The budget is prepared and submitted for one fiscal year, and the Congress addresses itself to the requests of the executive branch year by year, but the accounting period for which appropriated funds must be controlled could extend for several years.

During the budget process, the budget staffs of an agency are concerned with financial data for a three-year period. The budget year is the fiscal year for which estimates are being prepared and the budget will be submitted many months later to the Congress. The current year is the fiscal year immediately preceding the budget year. The past year is the fiscal year immediately preceding the current year.

At the inception of the budget cycle, there is little factual information on which to base the initial budget request. For example, the current year in relation to a given budget year will commence some

three to four months in the future. As the budget cycle progresses, facts replace the estimates of the earlier budget requests and formulations.

The accounting staffs are also concerned with a three-year period, but the years differ. A federal agency's accounting records are maintained for the current year and the two immediate past years. As a general rule, only the current year's appropriation is available for obligations. However, once the funds are obligated the agency must account for their expenditures until all obligations have been liquidated or until two years have passed since the close of the fiscal year in which the funds were obligated. After the two-year period, the unliquidated and unexpended account balances are merged, even though the agency is still ultimately responsible for accounting and settlement.

## **Program Control Concepts for Better Budgeting**

During the 1960s, agency budgeting was intended to be structured into specific phases so as to examine alternatives to existing operating programs for the most advantageous way to achieve objectives and execute the will of Congress. This control system has been known by many names, and even now the formal titles may vary from one agency to another.

Program evaluation tied into a system of financial controls remains an objective, as is monitoring of the federally appropriated funds entrusted to the agency. All federal obligations and ultimate cash disbursements stem from agency decisions made pursuant to a program evaluation such as the planning, programming, and budgeting system or management by objectives. What is particularly significant is that the control systems, cost audits, and program reviews have a common purpose: to account for and monitor federal monies to insure that the funds are spent in a manner consistent with the plans made by the President, the Congress, and the agency.

### **Planning, Programming, and Budgeting System**

A three-phase management planning, programming, and budgeting system (PPBS) was introduced into the civilian agencies of the executive branch by the President in 1965. The three phases, in summary, are as follows.

*Planning* entails the study of objectives and ways to achieve them as well as of future environments and of contingencies and ways to respond to them.

*Programming* is a way of describing activities according to objectives (outputs) and of relating the objectives to the costs (inputs) needed to achieve the desired level of effectiveness.

*Budgeting* is the activity through which funds are requested, appropriated, apportioned, and accounted for.

Few other concepts or changes in the *modus operandi* of the government have ever been implemented with the speed of PPBS. The initial Office of Management and Budget announcement of October 12, 1965 (OMB Bulletin 66-3) made the system mandatory for many agencies, and many others appeared willing to test the concept. Each agency adopting the system was required to develop a series of output-oriented measures, commonly referred to as *program structures*, which defined the operations of the agency. Also required was the development of (1) a comprehensive multiyear program and financial plan and (2) analyses including program memoranda and special studies.

The new system was not uniformly successful. Among the problems observed in the implementation of PPBS was the difficulty of achieving workable program measurement techniques in such large, complex, and diverse organizations as federal departments and agencies. Nevertheless, output had to be developed and used by decision makers. In addition, for some government programs it was doubtful that benefits would ever exceed expected costs; though it appeared reasonable to assume that the least costly alternatives for meeting such program objectives should be identified. Furthermore, program managers were not held to strict performance accountability once money was committed to a budget program; day-to-day time-cost/performance measures were missing.

In 1967, the Senate Subcommittee on Economy in Government of the Joint Economic Committee made known certain caveats concerning the potential of PPBS in the government. The subcommittee stated: (1) measurements of benefits and costs were significantly more difficult when marketplace prices, values, or equivalents are not available; (2) the role of PPBS in the federal decision process would always be less than certain; although it could provide data for rational, cohesive judgments, there are many problems for which quantitative analysis is of little assistance; and (3) PPBS was not much help in deciding on the ultimate goals of public policy or the optimum balance among programs; these were political decisions arrived at through political processes of open discussion and negotiation.

There have been problems in the acceptance and implementation of PPBS, and its ultimate objective may never be attainable in the federal financial arena. Yet two conclusions are clear: PPBS was superior to earlier financial decision processes, and federal agencies are not likely to opt for a return to the pre-PPBS budget era. A number of beneficial effects of PPBS on the federal financial process have been identified.

- Many agencies underwent a reappraisal of functions and missions, with a resultant increase in the understanding of programs and in the awareness of alternatives and limitations that might not otherwise have been evident.
- More solid information now exists on agency inputs and outputs.
- Decision makers have used the results of systems analyses and studies more and more in resolving major policy issues.
- The amount of program evaluation has increased considerably in many agencies.
- The need to tie broad program decisions into specific resource allocations has increased the involvement of top agency officials over the whole span of agency planning, budgeting, and performance.
- There has been increased recognition of the value of systematic analysis in providing government officials with a better understanding of outputs, benefits, and costs of the various courses of action available to management.
- PPBS has permitted a better display of related programs in several agencies. For example, at one time 24 manpower programs were found in six agencies; 21 education programs in five agencies.
- The federal experience has encouraged officials at the state and local levels to design planning and programming components for their own budgetary process. The inherent characteristics of a PPBS system, with appropriate modifications, would have relevance not only at other governmental levels but also in major grantee and contractor organizations.

### **Management by Objectives**

Many agencies are utilizing major parts of the PPBS conceptual framework in their planning and budgeting activities, but PPBS has been somewhat replaced by program planning and evaluation, which requires closer integration of planning and budgeting.

More recently, the Office of Management and Budget has placed

emphasis on a management by objectives approach to planning and budgeting. However, MBO, as it is known, is more limited and less structured than its predecessors. An agency may, of its own volition or at OMB urging, establish program or activity objectives that are to be achieved in a specified time; then, the actual performance is compared to the stated objectives. Unlike earlier monitoring systems, there is no governmentwide reporting system or categorization of activities. The concept can be applied to some or all of the programs for which an agency is responsible.



# 4 Overview of the Federal Accounting System

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

Basic to the design and development of an adequate and responsible accounting system is a clear understanding of financial needs and objectives. When the data requirements of agency management and external organizations are identified, a system can be structured to provide needed information with a minimum of analysis and duplication of effort.

## Fund Accounting

Although federal activities such as government corporations, operating authorities, and revolving funds utilize accounting systems patterned after commercial corporate practices, the predominant system among the executive agencies is fund accounting related to individual congressional appropriations. In an accounting sense, each appropriation is a legally earmarked fund of money or resources 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.

Federal fund accounts can be classified as those derived from the general taxing and revenue powers of the government and from the business operations of an agency as well as those held by federal agencies in the capacity of custodian or trustee.



## **Funds From General Taxing and Revenue Powers**

*General Fund Accounts* General fund receipt accounts are records of general revenue collections that are not dedicated to specific purposes by the Congress. The income tax collections of the Internal Revenue Service and the duties collected by the Bureau of Customs are in this category. Also included in this fund grouping are the general fund expenditure accounts, which are maintained to record the obligations and expenditures of an agency pursuant to congressional appropriation.

*Special Fund Accounts* Special fund accounts are separate records of receipts and expenditures that have been reserved by law for a specific purpose. Congressional authorization is required to make the receipts available for expenditure by an agency.

*Revolving Fund Accounts* A revolving fund contains receipt and expenditure accounts used to finance a continuing cycle of operations. The receipts derived from operations, unlike special funds, are available in their entirety for expenditure without further congressional action.

*Management Fund Accounts* These funds combine receipt and expenditure accounts to control the accounting for and administration of certain interagency operations.

## **Custodial or Trustee Funds**

*Trust Fund Accounts* Trust fund receipt and expenditure accounts are records of funds held for a federal agency (trustee) by the Treasury Department, as the trust custodian, to carry out a legal or statutory objective. The assets of trust funds may be held for years, and the administration of the funds may include periodic investment as well as accounting for any income earned. For a trust fund dedicated to a business operation—called a trust revolving fund—receipt and expenditure accounts are combined.

*Deposit Fund Account* A deposit fund must have receipt and expenditure accounts to record receipts held in suspense and later paid or refunded to the depositor or to another fund of the government. A deposit fund could also include receipts, held by the government as a banker or agent, to be paid out as directed by the depositor. Monies in a deposit fund are not available for paying salaries and expenses, for making grants, or for other agency expenditures.

## Account Structure

An account structure consists of the transaction classification system and the accounting records associated with a specific fund. The accounts—usually double entry—reflect transactions relating to assets, liabilities, revenues, and expenditures of the specific fund. Only accounts appropriate to a particular type of undertaking need be maintained.

Depending upon the nature of the fund to be accounted for, an agency maintains certain groupings of accounts, except where a fund would obviously not warrant a separate group of accounts 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 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), must provide additional details about the unapportioned appropriation, apportionments, unobligated allotments, and unliquidated obligations. Further, the account structure must permit the recording of expenditures in organizational units, functions, and object classes. The account structure must also provide for distinguishing transactions of a nonbusiness nature—fees, user charges, rents, fines, penalties, and interest, which are to be under Treasury Department control.

## Integrated Federal Fund Accounting

An agency accounting system must be designed to accommodate the integrated and multidimensional accounting and reporting requirements of the federal government. It is not sufficient to establish a system that accounts for appropriations or other resources received and for the expenditure of these resources. 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 such needs as the following:

- Financial statement and reporting requirements for each organization and suborganization by such bases as obligations, accrued expenditures, and disbursements.

- Budgetary control and accounting, required by law to prevent an overobligation or overexpenditure of appropriated, apportioned funds and with sufficient specificity to fix responsibilities.
- Accrual basis of accounting, essential to the development of the legally required cost-based budget and showing obligations and expenditures incurred.
- Cost accounting, that is, the full accounting of costs incurred to perform an activity, conduct a program, or provide a service, with the provision for obtaining a unit of measurement and, where necessary, distinguishing between direct materials, direct labor, and overhead costs.
- Property accounting, with respect to nonexpendable supplies and materials and fixed assets, such as land, buildings, machinery, equipment, and furniture.

Exhibit 4-1, opposite, shows, in simplified form, the integrated financial requirements of the single accounting system of a federal agency. Not to be overlooked in appropriation accounting is the requirement to account for three years' transactions (the current and two immediate past years) during any given fiscal year. The balances of obligated appropriations for all earlier years are merged or transferred to accounts maintained by the Treasury Department ("M" or merged accounts).

## Uniqueness of Federal Systems

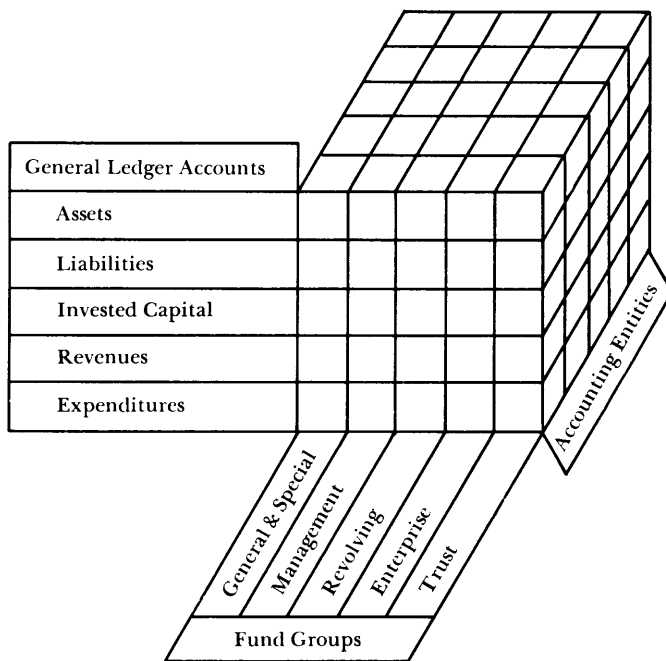
The unique characteristic that sets a federal agency's accounting system apart from commercial systems is the incorporation of fund and budgetary accounts into the more common asset, liability, net worth, revenue, and expense accounts.

*Budgetary Accounts* The insertion or integration of budgetary accounts into an agency's account structure is mandated by the continual vigilance that must be employed to insure that appropriation and other fund balances are neither overobligated nor overexpended. Either action would be a statutory violation for which an accounting would have to be made immediately and directly to both the President and the Congress.

The legislation and regulations concerned with the authorization, appropriation, and expenditure of public monies emphasize, almost to the exclusion of efficiency and economy, the importance of safeguarding public funds. In attempting to provide safeguards, many

## Exhibit 4-1

### MULTI-DIMENSIONAL VIEW OF FEDERAL FINANCIAL ACCOUNTING SYSTEM REQUIREMENTS



A Unified System of Government Accounts  
(All Funds and Accounting Entities)

Source: "Transaction Concept for Governmental Accounting," by E. Reece Harrill, *The Federal Accountant*, March 1969.

legislative, executive, and administrative controls have been enacted into law. Thus an agency's system of accounts is governed as much by regulation as by sound accounting principles.

*Accounting by Fund* Like all organizations, 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 fund for which the agency is accountable. In this respect, each fund is an accounting entity.

## Changing Emphasis of Federal Systems

*Accounting for Appropriations* Historically, federal accounting has focused on disclosing the source, application, and status of appropriated funds. Included in an identification of the source was whether the funds were derived from congressional enactment, from reimbursement for goods and services furnished to other agencies, from transfer appropriations, or from other sources. Accounting for the application of funds entailed recording the amount of orders placed and personnel expenses.

These accounting procedures helped officials responsible for the administrative control of appropriations to avoid violations of the Anti-Deficiency Act. But they ignored the cost of resources actually used and the period when the resources were used; and the procedures did not relate the funds expended to the work accomplished.

*Redirection of Federal Accounting* In the 1960s the agencies tried to move away from the government's traditional control-oriented accounting systems to improved, integrated accounting and reporting with program and budgeting data. The basic change was to introduce cost accounting, with the emphasis on charging organizational units with expenses or costs. Among the primary changes were the following:

- Identifying costs with the programs, activities, or units.
- Purifying appropriations to ensure that expense items were associated with operating appropriations and investment items were associated with capital appropriations.
- Extending the use of working capital or the management fund concept that charged an expense when and where the expense

was incurred or the cost was consumed; a distinction was made between the time of purchase and the time of use or consumption.

- Collecting financial data under a uniform expense structure that was consistent with the programming, budgeting, and funding categories of agency organizational units. Account structures were provided to report costs by program element (who used the resources) and functional category (why the resources were used).

*Pyramiding Concept in Financial Systems Design* The pyramidal concept of information needs is particularly applicable to federal accounting systems because the accounting task of even the smaller agencies dwarfs the financial requirements of all but the largest corporations.

Under this concept, the closer to the operating level, the greater the need for detailed information; the higher the organizational level, the greater the need for broad information. Basic to the structuring of an integrated accounting system is the individual transaction. How transactions are coded when they enter the system data bank is of critical importance. If the proper coding and summary are lacking, an agency's personnel will spend considerable time in analyzing accounts and preparing special reports.

## Account and Transaction Coding for Federal Systems

Key to full accounting, controlling, and timely reporting of federal funds are the care and specificity devoted to the transaction code structure at the time of the system design. Consideration should be given to the following elements.

*Single System* The General Accounting Office prefers an agency account structure that incorporates into a single integrated system the accounts relating to all sources of funds to finance authorized activities as well as all resources used.

*Identification by Fund* Because most fund sources have legal limitations when established by the Congress, the fund is the accounting entity or classification upon which management must render a report of its stewardship. The system must therefore be capable of identifying all expenditures and all resources received on a fund-by-fund basis.

*General Ledger Accounts* The General Accounting Office has prescribed that a federal agency operation must account for assets, liabilities, government investments, revenues, and costs. The inclusion of specific accounts within these general groupings has been left to the discretion of each agency; the objective of any system, however, must be to provide adequate accounting for all resources, liabilities, obligations, expenditures, revenues, and costs.

*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 a fund in relation to the apportionments made by OMB.

*Program or Allottee* Within the accounting system the agency must maintain the financial status of each program office. In the budgetary process, the head of each program office is usually designated as an allottee who is responsible to the agency head for the proper, effective, and economical use of federal monies. At any given time, the system must be able to provide the status of funds of an agency's allottees, individually as well as collectively for a whole appropriation.

*Functional Accounting* Depending on the size and geographical 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. The accounting for funds used at this level shows why and for what purpose the funds were used.

*Capital or Current Operations* Every agency must make a distinction between capital expenditures and current operational expenditures. Capital expenditures are those benefiting more than the current fiscal year, whereas current operational expenditures are made each fiscal year to carry out the program mandated by the Congress. This distinction between capital and current operational expenditures may be required in accounting for transactions throughout the obligation, expenditure, and disbursement phases.

### **Assignment of Account Symbols**

The account classification and symbols are critical in an agency's endeavor to provide a system that will fully account for fund balances. While the classifications and specific terminology vary, agencies

are required to comply with certain governmentwide fund symbols and classifications as required by the Treasury Department, GAO, and OMB. There is no limit to the number of digits that an agency may use. Specific details are left to the agencies in order that there be sufficient flexibility to permit the accounting required by agency management.

*Appropriation Symbols* The Treasury Department assigns appropriation symbols to all appropriations passed by the Congress. The assigned numbers are published annually and must be used by the agencies in their reports to the Treasury and OMB. The uniformity is made necessary by the Treasury Department's responsibility to maintain the central accounts by appropriation and agency.

The symbols assigned by the Treasury Department identify the department or agency, the fiscal year, and the appropriation number. Essentially the same numbering scheme is used for both receipts and expenditures.

*Appropriation Numbering System* The Treasury Department has established a several-digit numbering scheme to identify appropriations, receipts, and expenditures which agencies must use in communicating financial data to the Treasury. Additional numbering schemes may be required within each agency, although care must be taken to account for funds in such a way that they can be readily summarized by the Treasury Department to avoid repetitive account analysis.

*Agency and Department Identification Number* The Treasury Department has assigned numerical prefixes to federal departments and agencies. These prefixes must be used each time a receipt or expenditure is reported, for it is by these codes that fiscal responsibility is fixed. Generally, an agency identification number is limited to two digits. However, when a portion of an appropriation is transferred from one agency to another for obligation and expenditure, a four-digit agency coding could be used. If the Veterans Administration (code 13) transferred a portion of its appropriation to the Department of Commerce (code 36), the reporting would be shown with the compounded agency designation 13-36. This permits relating the expenditure to the original appropriation and to the agency having the primary accounting responsibility.

*Coding of Agency Receipts* The coding of receipts must be in accord with the fund group of receipts established by the Treasury Department. Exhibit 4-2, page 52, illustrates the major types of fund



receipts and some 20 master subsidiary receipt classifications of the general fund.

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**Exhibit 4-2**

**RECEIPT ACCOUNT SYMBOLS AND TITLES  
MAJOR CLASSES OF RECEIPTS BY FUND**

**General Fund**

**Governmental Receipts**

Taxes	0100
Customs Duties	0300
Receipts from monetary power	0600
Fees for regulatory and judicial services	0800
Fines, penalties, and forfeitures	1000
War reparations and recoveries under military occupation	1100
Gifts and contributions	1200
Clearing accounts	3800

**Proprietary Receipts**

Interest	1400
Dividends and other earnings	1600
Rent	1800
Royalties	2000
Sale of products	2200
Fees and other charges for services and special benefits	2400
Sale of government property	2600
Realization upon loans and investments	2800-2900
Recoveries and refunds	3000

**Special Fund**

5000-5999

**Trust Fund**

Department and Agencies (exclusive of District of Columbia)	7000-8999
District of Columbia	9000-9999

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Source: U.S. Department of Treasury. *Receipts, Appropriation, and Other Fund Account Symbols and Titles*, as of January 1971.

In total, more than a thousand separate receipt accounts are prescribed by the Treasury, only a few of which are applicable to the activities of any particular agency.

*Governmental receipts* arise from the taxing and regulatory powers unique to the federal government. Additional receipts could ac-

crue from fees charged for agency services rendered or from debt-management and loan operations. This category would include the net increase or decrease in the clearing accounts for the undistributed agency collections.

*Proprietary receipts* include receipts that are market-oriented or derived from activities operated as business enterprises.

*Coding of Expenditures* Like the receipt accounts, a four-digit coding identifies expenditures of an agency with certain fund categories. Exhibit 4-3, below, illustrates the major groupings of appropriation expenditure accounts in use.

### Exhibit 4-3

#### APPROPRIATION AND OTHER FUND ACCOUNT SYMBOLS— Expenditure Account Symbols by Fund

<b>Fund</b>	
General Fund	0000-3899
Management, including consolidated working fund	3900-3999
Revolving Fund	
Public Enterprises	4000-4499
Intragovernmental	4500-4999
Special Fund	5000-5999
Deposit Fund	6000-6999
Trust Fund	
Departments and Agencies (exclusive of District of Columbia)	7000-8999
District of Columbia	9000-9999

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Source: *Receipts, Appropriation, and Other Fund Account Symbols and Titles.*

The four-digit expenditure code identifies the specific fund (including appropriations) and its purpose and may identify the organization within the department or agency responsible for the fund, such as the Navy Department within the Department of Defense.

*Coding of Fiscal Year* The availability of an appropriation for obligation and expenditure is indicated in the Treasury Department number in the following manner.

A *one-year appropriation* is indicated by a single digit to identify the year for which an appropriation is available for obligation. The digit is the last digit of the fiscal year; 6 is for fiscal year 1976, 7 for 1977, and zero for 1970 or 1980, as the case may be.

A *multiple-year appropriation* would be indicated by a slash separating digits signifying the first and last years of obligational authority for that particular appropriation. For example, a designation 5/9 would indicate an appropriation that was available for obligation for the five-year period 1975 through 1979.

A *no-year appropriation* is available until fully obligated without time limitations. Such an appropriation would contain an X in lieu of a fiscal year digit.

A *merged or M account* is an expired appropriation. That is, the obligational authority of the appropriation expired at least two fiscal years earlier and the unliquidated balances were transferred to and merged into the Treasury Department's central accounts. To identify an expenditure with an expired or successor account, the digit M would be inserted in place of a fiscal year digit by the agency.

## **Object Classification of Expenditures**

*Uniform Classification of Expenses* All federal agencies are required to establish a system of coding financial transactions in accordance with the uniform classification of expenses by object. The object classes specified by OMB are based on the services, articles, or other items involved, not on the purpose for which the expenditure may have been made. These same object classes apply equally to the agency's accounting for obligations. Thus salaries paid to federal employees must be recorded and reported as personnel services even though the payments may have been made for repairing equipment or constructing a building.

*Application of Object Classification* In submitting budget estimates to OMB the federal agency must utilize the object classification of expenditures for all obligations, applied costs, accrued expenditures, and disbursements. Federal accounting systems must be designed so as to provide this information in accordance with Section 113 (a) of the Budget and Accounting Procedures Act of 1950. However, an agency is permitted to subdivide the object classes prescribed by OMB as deemed necessary for a full accounting for its

activities and operations. Any subdivision must be subsidiary to, and must conform in total with, the summary object classes prescribed for governmentwide use.

*Identification of Object Classification* The Office of Management and Budget has established object classifications for the identification, accumulation, and reporting of financial transactions in the federal government. (See Exhibit 4-4, page 56.) The degree to which an agency subdivides the object classifications for financial transactions is dependent upon factors and considerations such as the nature of the agency's activities and programs; the requirements mandated by external organizations (Congress, Treasury Department, OMB); the agency's expressed desires and need for refined or detailed accounting for obligations, accrued expenditures, applied costs, and cash disbursements; and the appropriation structure and fund accounting responsibilities of the agency. Also considered are the level of allotment control established within the agency, the financial responsibility and authority delegated by the head of the agency to other subordinate management, and the budgetary system of the agency.

## Structuring of General Ledger Accounts

*Input Versus Output System Considerations* Federal financial systems are structured on both an output and an input basis. One way of designing or modifying an accounting system is to emphasize the reports that will be required of the financial system—that is, make the system output-oriented. Such an emphasis is contingent on an identification of the agency's financial data needs, whether internally or externally imposed. Once the reports or outputs of the system are established, the general ledger accounts are coded so as to produce summary data that will satisfy the needs with a minimum of analyses and duplicate effort.

Often federal organizations give primary consideration to the types of expenses and costs that will be accounted for. This is generally referred to as an input-oriented system; its account structure accumulates financial data by the type of documents or inputs supporting the financial transactions. In this approach, the summarization or aggregation of data usually requires continued analyses of account balances, to identify costs by organization, function, or other classifications.

## Exhibit 4-4

### ACCOUNTING AND BUDGET OBJECT CLASSIFICATION

<u>Entry No.</u>	<u>Object Classification</u>
11.0	<b>Personnel Compensation</b>
11.1	Permanent Positions
11.3	Positions Other Than Permanent
11.5	Other Personnel Compensation
11.7	Military Personnel
11.8	Special Personal Service Payments
12.0	<b>Personnel Benefits</b>
12.1	Civilian Employees
12.2	Military Employees
13.0	<b>Benefits for Former Personnel</b>
21.0	<b>Travel and Transportation of Persons</b>
22.0	<b>Transportation of Things</b>
23.0	<b>Rent, Communications, and Utilities</b>
24.0	<b>Printing and Reproduction</b>
25.0	<b>Other Services</b>
26.0	<b>Supplies and Materials</b>
31.0	<b>Equipment</b>
32.0	<b>Lands and Structures</b>
33.0	<b>Investments and Loans</b>
41.0	<b>Grants, Subsidies, and Contributions</b>
42.0	<b>Insurance Claims and Indemnities</b>
43.0	<b>Interest and Dividends</b>
44.0	<b>Refunds</b>
56	

<u>Entry No.</u>	<u>Object Classification</u>
91.0	<b>Unvouchered</b> (This object classification would be used for those financial transactions lawfully incurred for confidential purposes, not subject to detailed vouchering or reporting by an agency.)
92.0	<b>Undistributed</b> (This object classification is used for those financial transactions that cannot be distributed to any of the specifically identified object classes. This class may only be used with the prior approval of the Office of Management and Budget.)
93.0	<b>Administrative Expenses for Revolving and Trust Funds</b> Administrative Expenses Nonadministrative Expenses (Used only for revolving and trust funds which have annual limitations on administrative or other expenses.)
94.0	<b>Changes in Selected Resources</b> (This object classification is used as an adjusting entry account to make the bridge between the sum of the detail and total obligations, when the detail is on the basis of accrued expenditures or applied costs.)
95.0	<b>Quarters and Subsistence</b> (This object classification is used for amounts charged to employees for quarters and subsistence provided in kind by the agency.)

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Source: Department of Transportation, National Highway Safety Bureau. *Instruction DOT 1100.23*. July 17, 1970.



# 5 Accounting for Agency Funds

Accounting for federal agency appropriations and receipts includes recording and reporting on obligations, expenditures, and disbursements. This chapter is concerned with accounting for the appropriations or obligational authority received by a federal agency, utilization, commitment, obligation, and expenditure of these funds.

## Accounting for Resources

Generally, the fund resources to support the operations of a federal agency are provided by one or more of the following sources.

*Direct Appropriations* The principal programs of a federal agency are usually financed by direct congressional appropriation. This permits the agency to enter into contracts, award grants, pay salaries and administrative expenses, and enter into other obligations. Each of these actions must be in accord with congressional authorizing and appropriating legislation.

*Appropriation Transfers* When one agency performs work for another agency, it is financed by an appropriation of the agency for which the work is being performed. This obligation is settled by transfer of a portion of the appropriation. A transfer is generally based on the authority of Section 601 of the Economy Act, as amended (31 U.S.C. 686). In many instances the Congress has provided specific appropriation transfer authority in the appropriation legislation of individual agencies.

Reimbursable work and services performed for other agencies may also be accomplished in accordance with a reimbursable agree-



ment. Under such arrangements, the work is financed from appropriations available to the agency performing the work or the services after establishing a reimbursable obligation. The agency receiving the work or services settles the obligation by reimbursing the performing agency for the cost of the goods and services.

*Trust Fund Accounts* Some agencies are trustees of funds for which Congress has prescribed a use. One example is the Highway Trust Fund. Work and services performed for nonfederal organizations such as states, counties, or municipalities could be financed from trust fund accounts established to record receipts deposited with a federal agency and held in trust by that agency for specific projects and programs in accordance with the trust agreement or statute.

*Appropriation* The government defines an appropriation as “a statutory authorization to make payments out of the Treasury for specified purposes.”

The statutory authority is an appropriation act by the Congress. It authorizes federal agencies to obligate and expend funds for the purposes specified in the act and pursuant to proper obligations established by the individual agencies. Generally the Treasury Department is authorized to disburse the funds, but other departments or agencies sometimes perform a disbursing function.

*Types of Appropriation* There are several types of appropriation, each established by Congress to meet a particular objective or purpose. The more common types are defined in chapter 3. It should be noted that these defined appropriations apply not only to monies directly appropriated by Congress, but also to any revolving funds, trust funds, and the like.

*Apportionment* An apportionment of funds is a distribution made by OMB of amounts available for obligation or expenditure under an agency’s appropriation or other fund account into amounts available for specified time periods, functions, projects, objects, and so on. Congress appropriates; but, unless OMB apportions, an agency is precluded from obligating any of the appropriated funds. The amounts apportioned limit the obligations to be incurred or, if specified, the expenditures to be accrued.

*Allocation* An allocation of funds is an amount set aside by an agency in a separate appropriation or fund account for the use of another agency in carrying out the purpose of an appropriation act.

The term *allocation* also applies to amounts set aside by an agency in a transfer appropriation account.

*Transfer Appropriation Account* One agency establishes a transfer appropriation account to receive and later disburse funds provided by another agency. The transfers are treated and referred to as nonexpenditure transactions at the time the allocations are made. In accounting for transfer appropriations, the account numbers are identified by the symbols appearing with the original appropriation.

*Transfers Between Appropriation Accounts* A transfer between appropriation accounts is a nonexpenditure transaction, which, pursuant to a law, withdraws from one appropriation an amount available for obligation and expenditure, then credits it to another. It should be noted that payments to other accounts or appropriations for goods or services received or to be received are not transfers; they are expenditure transactions.

*Allotments* An allotment is an authorization, usually by the head of an agency, to incur obligations within a specified amount and for a definite purpose pursuant to an appropriation or other statutory provision. The person authorized to obligate and expend appropriated funds is called an allottee. The specific allotment form is generally referred to as an advice of allotment.

*Appropriation Receipts* Appropriation receipts are collections made by an agency pursuant to law, deposited in the Treasury as receipts, and available for expenditure in accordance with congressional legislation for specific purposes. These receipts generally relate only to special or trust fund accounts. For example, the federal Highway Trust Fund includes receipts generated by gasoline sales to the public.

*Refunds* Refunds are defined as recoveries of funds disbursed in error or recoveries of advances which are to be credited to an appropriation account. If the appropriation has not expired, such refunds are available to the agency for obligation and expenditure. A refund is not accounted for as a reimbursement to the appropriation; rather, it is a reduction in an agency's disbursements. Refunds also include credits to an appropriation resulting from accounting adjustments to obligations and expenditures.

*Reimbursements to Appropriations* Reimbursements to an appropriation are amounts collected for commodities, work, or services

furnished to another appropriation, individual, firm, or corporation which may be credited to an appropriation or fund account. These reimbursements include accounts receivable; amounts earned but not billed; amounts anticipated for the remainder of the year; and interagency orders accepted and on hand for which a valid obligation is supported by constructive receipt for delivery of goods or services. Reimbursements to appropriations exclude appropriation refunds, as noted earlier.

*Other Obligational Authority* While appropriated funds account for the larger amounts of obligations and expenditures, there are other sources of funds from which obligational authority may be derived. For example, a congressional statute could permit an agency to incur obligations and make payments for specific purposes out of money available from the sale of government and corporate debt securities or to enter into contracts or other obligations before money is appropriated for the payment of such obligations.

A joint resolution of the Congress could also continue agency operations during the period between the expiration of the prior year's appropriation act and the enactment of the new appropriation. This authority to incur obligations and make expenditures, generally known as a continuing resolution, usually permits an agency to obligate and spend at the same rate, but makes no provision for new programs or increased expenditures.

## Accounting for Federal Funds

The present appropriation process of the federal government is of relatively recent origin. Prior to 1921, appropriations were made directly to the departments and agencies, the only coordinating organization being the office of the secretary of the Treasury. Treasury's function consisted of little more than printing and transmitting the financial requests of the several agencies to Congress. There was no responsibility in the executive branch for analyzing whether sufficient funds could be raised to meet the proposed expenditures. Further, there was no centralized control over the preparation of the annual budget estimates, no fixed responsibility for matching projected income with expenditures, and no fixed accountability for the outcome of the appropriation process.

Legislation to centralize responsibility for financial matters was enacted in 1921 with the Budget and Accounting Act, generally rec-

ognized 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, among other structures, its own Office of Budget.

### **Budget Process**

As described in more detail in Chapter 3, the appropriation requests ultimately presented by each agency to Congress are the end result of months of planning, debate, and assessment of revenue levels, the economy, and expenditure priorities for each agency as well as for the country as a whole. The appropriation requests are elements of the budget submitted annually by the President.

Most authority to incur obligations and make expenditures is enacted by Congress in the form of appropriations, which cannot exceed any dollar limits established in earlier authorizing legislation for the particular program.

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. Most trust funds are permanent appropriations, as is the appropriation to pay interest on the public debt.

### **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 agency officials.

5. The agency's program officials obligate funds, incur expenditures, and monitor the validity of funds to be disbursed.
6. The agency's fiscal officer certifies to the availability of funds to be disbursed.
7. The Treasury Department makes the cash disbursements that settle federal obligations and debts.

Exhibit 5-1, opposite, is a general outline of the organizational responsibilities and actions required in accounting for an appropriation. Each appropriation must be accounted for by some agency as a separate fund. Obligations, refunds, receipts, expenditures, and disbursements must continually be related to the specific congressional appropriation, and the fiscal integrity of each separate fund is maintained throughout the life of the appropriation. At any one time, an agency may be responsible for several appropriations. The following are examples of appropriation fund accounts.

- *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* consist of separate receipt and appropriation expenditure accounts established for recording the receipt and disbursement of government funds earmarked under the law for specific purposes. Each account carries its own distinguishing account number.
- *Trust fund accounts* must be established by the responsible agencies for recording the fund receipts held in trust for use in meeting the costs of specific programs in accordance with an agreement or statute. An agency may have to account for a trust fund's long-term assets and income producing investments as well as for revenue collection. As a general rule, trust fund receipt and expenditure accounts are kept separate.

However, a trust that supports a business activity is referred to as a trust revolving fund, and accounting for receipts and expenditures is combined.

- *Transfer appropriation accounts*, as defined earlier, are established by one agency to receive allocations of funds and later to disburse these funds for another agency. The transfer is considered a nonexpenditure transaction at the time of transfer or allocation between agencies. When accounting for the allocated funds, the receiving agency must use the identification symbols that appear in the appropriation of the transferring agency.

**Exhibit 5-1**  
**FEDERAL AGENCY ACCOUNTING PROCESS**

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

## Special Appropriation Transactions

Each agency must insure that all payments are identified with the applicable appropriation. Withdrawals from one appropriation for credit to another may be in the nature of an adjustment. In such cases, the amounts are not considered to be payments made by the providing agency, but must be accounted for as expenditures from or adjustments to appropriations. In reporting expenditures made pursuant to any transfer appropriation accounts, both agencies establish an appropriation account carrying the number of the parent appropriation symbol with an appropriate prefix to identify the receiving agency.

Following are several examples in which the use of a transfer appropriation account is proper.

- All movements of money between appropriations accounts.
- Transfers authorized by law where another agency is to administer the appropriation and the funds are not to be merged with the appropriations of the receiving agency.
- Advances for construction, major procurement, or major contractual services for the advancing agency.
- Advances for goods and services furnished by a performing agency using its own facilities beyond the fiscal year when the advance is made.

A transfer appropriation is considered to be a nonexpenditure transaction between agencies. However, payments to other appropriations, revolving funds, and consolidated working funds are reported by the paying agency as obligations and disbursements of the paying accounts and as reimbursements to the receiving account. Except for advances to consolidated working funds, advance payments to other appropriations are reported as disbursements by the paying agency. An obligation must be established at the time by the paying agency for an amount equal to the funds advanced. In the following examples, such an accounting treatment must be made.

- Orders for goods, services, or equipment are placed with other agencies; and in the same fiscal year payment is made after delivery, or advances are made for services to be rendered that same year by the performing agency, using its own facilities.
- Payments or adjustments are made to appropriation accounts in different main fund accounts; for example, from a general or special fund appropriation to a trust fund.

Under certain conditions, federal agencies must transfer sums between appropriations to adjust the amounts appropriated by Congress. Permissible transfers include the following transactions.

- Adjustments resulting from reorganizations where one agency's functions and related appropriations or balances are transferred to different agencies or bureaus.
- Transfers granted by law for the distribution or interchange of money between appropriations where the amount is deducted from one agency's appropriation for one purpose and added to another agency's appropriation for a different purpose, up to the limits established by law.
- Changes in an appropriation pattern consisting of transfers that consolidate and merge appropriations, functions, titles, and so on.
- Transfers to conform with the law that makes money in one account available for another purpose in another appropriation or fund account. Such a transfer of funds might be made in lieu of granting a supplemental appropriation.

## Appropriation Warrants

Regardless of the appropriation made by Congress, no agency has any authority to obligate and spend money until an appropriation warrant has been issued by the Treasury Department and countersigned by the comptroller general of the United States. Once the warrant is issued and signed, the funds appropriated to agencies are made available in the proper disbursing record on the books of the Treasury.

The appropriation warrant forms the basis for recording the appropriation in the central accounts of the Treasury Department and in the accounting records of the agency. The Treasury Department provides each agency with authenticated copies of the appropriation warrants for every agency appropriation.

Upon receipt of the appropriation warrant, the agency makes an accounting entry equal in amount to the entry appearing in the central accounts. An entry is made for each appropriation or fund; and subsequent obligations, expenditures, and disbursements are referenced to the proper appropriation. The agency's entry establishes the obligational authority 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 OMB apportions them. An apportionment is a distribution of money from an appropriation or fund account that can be used for specified time periods; for designated activities, projects, functions, or objectives; and for fixed amounts.

Amounts that are apportioned limit the obligations or expenditures that can be made by an agency. The process of apportionment has several purposes. The apportionment or reservation of funds prevents obligation or expenditure of an appropriation or fund account in such a way as to make a deficiency or supplemental appropriation necessary. The system of apportionment is dependent upon the manner in which funds are made available by Congress. Since apportionments are intended to prevent the overobligation or overexpenditure of appropriated funds, the apportionment actions must be consistent with the intent of Congress in making the appropriation. Where funds have been made available on an obligation basis, and where obligations may not be incurred in excess of the appropriated amounts, the apportionments are made on an obligation basis. The obligational basis of apportionment is applicable to most agency appropriations.

The accounting structure of an agency must permit the disclosure and reporting of data by apportionment as well as by appropriation, obligation, and programs. Fortunately, the apportionment is likely to be consistent with the agency's appropriation and with its organizational and accounting structure. The apportionment is generally made at the level of the appropriation or fund—that is, the apportionment limit is the same as the appropriation limit. Also, since an appropriation is generally the responsibility of the agency head, the responsibility for apportionment compliance generally rests with this level of an agency.

*Time Period for Apportionments* Depending on the purpose or nature of the appropriation, an apportionment may be for calendar quarters, for the year as a whole, or for other time periods when such periods are pertinent to program activities. An apportionment is made for the year as a whole when the money is for a nonrecurring purpose without time limit and is normally apportioned below the appropriation level.

Whether funds may be obligated beyond the period of the apportionment depends upon the time of year and the terms of the appropriation act. When apportionments are for less than a year, any un-

obligated balances at the end of the period are carried forward within the current fiscal year without reapportionment. When appropriated funds remain available for obligation beyond the fiscal year, the balances of apportionments remain available until a new apportionment is made. Any new apportionment supersedes prior apportionments and covers transactions from the beginning of the fiscal year. Remaining apportioned balances may not be used to initiate or enlarge new programs provided for in the current year's appropriations. New programs must await a new apportionment.

With few exceptions, the apportionment process applies to all funds for which a federal agency is responsible. Certain funds are exempted by OMB under discretionary statutory authority, such as trust funds, including deposit funds; working funds; payment of claims, judgments, refunds, and drawbacks; payment under relief acts and other laws requiring payment to specific payees in the total amount provided by such acts; interest on or retirement of the public debt; and items determined by the President to be confidential.

## Accounting for Receipts and Collections

Most agency accounting is concerned primarily with obligations and expenditures arising from activities authorized and funded by Congress. The receipt and collection of funds are incidental activities and generally involve nominal amounts.

Two exceptions are the Bureau of Customs and the Internal Revenue Service, which receive monies under specific laws and regulations. Before the United States Postal Service was incorporated, the Post Office Department was another agency responsible for significant collections.

Agency receipts are deposited with the Treasury Department and reported in the monthly accounts, supported by certificates of deposit or schedules of collections referring to certificates of deposit. The officials responsible for the receipt, deposit, accounting, and reporting of these funds are known as collectors, whose "account" or term of stewardship must be settled or audited by GAO. Among other collection sources are receipts for use of government facilities, proceeds from sale of government property, and fees remitted by federal employees who serve as jurors or government witnesses. Outside collections that are properly accounted for as credits to an appropriation are available for obligation by an agency. Obligating and expending any other outside collections would constitute an expenditure of unappropriated federal funds, which would be a violation of the Constitution.

## Accounting for Allotments

The General Accounting Office requires that an agency's accounting procedures provide for the recognition of apportionments of appropriations as well as for the subdivision of funding authorizations to facilitate the management of funds and to insure compliance with any applicable funding limitations.

GAO defines an allotment as . . . "an authorization by the head or other authorized officer of an agency to the responsible heads of organizational units or activities to incur obligations within a specified amount pursuant to an appropriation or other statutory provision."

The Anti-Deficiency Act, 3679 of the Revised Statutes (31 USC), contains this requirement:

In order to have a simplified system for the administrative subdivision of appropriations or funds, each agency shall work toward the objective of financing each operating unit at the highest practical level, from not more than one administrative subdivision for each appropriation or fund affecting such unit.

In meeting the objectives of this act, GAO recommends that an appropriation and an apportionment be subdivided at the highest level, consistent with assignments of responsibility, and be limited in number. The objective is to avoid the prescription of detailed line item or object expenditure budgets that tend to focus the attention of management on too many precise category limitations and to direct efforts toward staying within the spending levels of each category.

An agency official is responsible for an agency program and he is formally provided with the funds to support an approved budget level. This approved budget level is an allotment. The agency official receiving the allotment, referred to as the allottee, is charged with the management of a program within the level of funding provided. Most agencies try to hold the allottee to specific limitations within the allotment. An agency notifies allottees of the funds available to their programs or offices by an *advice of allotment*. While most agencies have prescribed forms that are formally executed by the head of the agency or an authorized official, the advice of allotment could take the form of a memorandum or a letter issued at the beginning of a fiscal year to set forth the allotted amount of an apportioned appropriation.

Advices of allotments, issued for each quarter or for the entire fiscal year, cannot exceed the funding authority provided by the apportionment received from OMB. The number of allottees is the agency's prerogative. Most allottees are responsible for sub-

stantial agency programs or offices, and many agencies have 20 or more allottees. For example, an agency may establish an allotment of apportioned funds for the office of the director, the office of administration, and each of the program offices at the headquarters level. Additionally, each regional director may receive an allotment to support his functions and activities.

### **Reservation of Funds**

Allottees usually have a written designation of the officials authorized to make reservations of funds against allotments and establish monetary limits on such authorizations, often called allowances. Because of the size and dispersion of some agencies, recipients of allowances may in turn authorize other subordinate officials to incur reservations against allowances.

A request or authorization to incur an obligation, referred to as a reservation of funds, must be in writing and signed by only the authorized official. A copy of each reservation form may be furnished daily to the office or employee responsible for maintaining the reservation record. Reservations are generally estimates of the amount of the intended obligations. The obligations are in turn further adjusted when liquidated.

### **Common Reservation Actions**

Of the reservations or commitments made by agency officials, the following are among the more common and significant in number as well as in dollar amounts.

*Contracts and Purchases* A request for the issuance of a purchase order or contract, usually called a procurement request, must precede the award of a purchase order or contract. This request must be signed by the person authorized by the allottee to reserve funds. The signature certifies to the procurement office that funds are available and that the intended procurement is consistent with the appropriation and apportionment limitations. Procurement offices are directed not to issue contracting instruments in the absence of, or in excess of the amount of funds cited on a properly executed procurement request or similar form.

*Grants* Each allottee names the points or offices in his agency at which prospective grants can be considered as a commitment of the agency and a reservation of the allotted funds. The allottee may delegate authority to approve the reservation of funds for grants and to

decide on the forms and procedures for processing and recording the grant amounts. A form similar to the procurement request is executed at a designated time to reserve an amount equal to the grant to be funded.

Neither the procurement request, in the case of a contract, nor the reservation form for a grant is a document of obligation. An accounting entry may or may not be used to record the reservation of funds.

*Travel* Without exception, the travel of federal employees is authorized with a travel order before the trip begins. The cost is estimated by the initiating office or official, and the amount becomes a reservation against the allotment funds at the time the travel order is issued.

*Salaries* As an accounting convenience, the salaries and related costs of personnel on an agency's roster at the beginning of a month are considered a reservation against the allotment or allowance funds in an amount equal to the estimated costs for the remainder of the allotment or allowance. This procedure constitutes a reservation of funds in advance.

*Interagency Actions* Agencies are careful to insure that reservations of funds issued to other agencies to perform services or provide supplies are covered by procurement requests or similar forms.

### **Reporting Required for Appropriated Funds**

The reports required from an agency can be divided into two general categories: those for internal agency management and those for use by others.

An agency's management must have internal reports with current information on financial condition and program progress to permit comparison with budgetary plans, cost performance, and activity accomplishments. These reports must provide management with review data on operations, including the effect of program decisions, the relationship between costs and accomplishments, and an indication of the work to be accomplished with the remaining resources.

Agencies must also publish financial reports on varying aspects of the appropriated funds in their possession in accordance with laws or regulations or with requirements imposed by GAO, Treasury, or OMB. The format, content, and frequency of these reports are uniform throughout the government. Exhibit 5-2, opposite, is a

## Exhibit 5-2

### SUMMARY OF REQUIRED AGENCY REPORTS ON APPROPRIATION BALANCES, OBLIGATIONS, AND EXPENDITURES

<u>Description of Report</u>	<u>Content</u>	<u>Frequency</u>
Trial Balance	Summary of general ledger accounts	Monthly
Statement of Transactions	Statement of cash receipts and disbursements submitted to Treasury Department—data segregated by appropriation	Monthly
Report on Budget Status	Budget status—obligation basis of funds appropriated and other authorizations, apportionments, obligations incurred, expenditures, and available balances—submitted to OMB	Monthly
Statement of Financial Condition	Required by Treasury Department Circular No. 966—purpose to show in condensed form the assets, liabilities, and investment of U.S. in agency	Annual
Statement of Transactions	Summary of accomplished payment vouchers on Letters of Credit to Treasury Department, if Letters of Credit used by agency	Monthly
Fiscal Year Section 1311 Report	Statement of unexpended appropriations and funds, requests for transfers and restorations, and analysis of appropriation and fund balances	Annually at year end
Report on Obligations	Cumulative obligations by object class for current year's appropriation—report for each appropriation	Monthly
Report Stating Budget Results on Accrual	Report reconciling accrued expenditures to net cash disbursements for each appropriation—submitted to Treasury Department	Monthly

Source: OEO *Financial Accounting and Reports Manual*  
CAB *Accounting Manual*

summary of the external reports that must be prepared by an agency as well as the contents and the submission frequency for each report.

## Obligation of Funds

The term *obligation* has both financial and legal meaning within the government. From the financial viewpoint, an obligation must be recorded in order to restrict appropriated funds for future expenditure. The obligation and expenditure 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 very precise; it prescribes specific obligation instruments, along with the consequences of overobligating and thus overspending an agency's appropriated funds. Section 3679 of the Anti-Deficiency Act and Section 1311 of the Supplemental Appropriation Act relate to the specifics of obligation.

Agencies having appropriations authorized and apportioned for their program responsibility must respond to the requirements of the Department of the Treasury, the Office of Management and Budget, and the General Accounting Office. These central agencies prescribe forms and procedures for incurring, accounting for, reporting on, and liquidating government obligations. However, each agency has to design and implement its own controls and procedures for insuring that central agency directives as well as other statutory limitations and requirements are being complied with. The statutory limitations referred to here are those set forth in the enabling legislation or otherwise invoked.

In federal accounting, *obligation* has been defined in these words:

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.

An agency must include in its reported obligations the value of goods and services accepted and other liabilities arising and chargeable against the agency's appropriation, whether or not a formal order exists. For every disbursement an agency must previously or subsequently record and report an obligation for the amount of the disbursement. These obligations also include adjustments for the differences between obligations previously recorded and actual disbursements in payment of the earlier obligations.

The significance of an obligation and the formal act of obligating funds relate to the agency's legal responsibility to manage the funds appropriated by Congress and comply with the legal prohibitions against the overobligation and overexpenditure of appropriated funds.

The obligation basis of accounting should not be construed as a method of costing an agency's performance. As a general rule, obligations are not satisfactory monitors or measures of performance because they are incurred well in advance of resource utilization or program completion. Obligation accounting has been supplemented by cost accounting as a measure with performance. An agency must obligate funds before purchases are made or work commences; therefore, the obligated amounts are not directly related to work progress or completion. Further, the fact that funds are obligated is no guarantee that the purchases will be made within the amounts obligated or that the work will progress according to plan.

The importance of obligational data is that it provides relevant information for the control of funds.

Because funds are normally obligated well in advance of expenditures, they are not available for other purposes. That is, the obligation of funds serves to prevent the later overexpenditure of the fund authority.

The obligational process is also a valuable tool for monitoring the utilization of appropriated funds. When an appropriation lapses at the end of a particular fiscal year, the agency no longer has the authority to obligate funds. Any funds that remain unobligated at year end must revert to the Treasury and may be lost forever to the agency. It is therefore incumbent upon the agency to insure that its rate of obligation is at a level desired by Congress when it appropriated the funds.

## Control Over Expenditures

The Constitution itself sets forth the requirement for a system of control over appropriated funds in Article I, Section 9, which states: "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law. . . ."

Without fund control, such as the present system of obligating funds, federal agencies would be unable to measure compliance with this constitutional requirement until disbursements were made. Control over disbursements would be minimal protection if the agencies had already incurred debts and liabilities in excess of the



appropriations. Disbursements in excess of the appropriated funds to satisfy unrecorded obligations would violate the prohibition against withdrawing funds before they have been appropriated.

An old act, but one of considerable significance to a federal financial manager, is the Anti-Deficiency Act of 1870 (31 USC 665). This act increased the control over the expenditure of appropriated funds and reaffirmed that no funds could be expended before they had been appropriated.

The act was developed to control the use and expenditure of appropriated funds and to prevent deficiencies, with the consequent need for supplemental appropriations.

The following provisions of the Anti-Deficiency Act directly affect the obligation and expenditure of appropriated funds by an official or employee of the government.

- 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 reappportionment, or (B) in excess of the amount permitted by regulations.
- In addition to any penalty or liability under other law, any officer or employee of the United States who shall violate subsections . . . shall be subjected to appropriate administrative discipline, including, when circumstances warrant, suspension from duty without pay or removal from office; and any officer or employee of the United States who shall knowingly and willfully violate subsections . . . shall, upon conviction, be fined not more than \$5,000 or be imprisoned for not more than two years, or both.
- In the case of violation of subsections . . . by an officer or employee of an agency, or of the District of Columbia, the head of the agency concerned, or the Commissioners of the District of Columbia, shall immediately report to the President, through the director of the Bureau of the Budget [now the Office of Management and Budget], and to the Congress all pertinent facts together with a statement of the action taken. . . .

The prohibitions in the Anti-Deficiency Act are generally known

as Section 3679 statutes, and violations are referred to as 3679 violations.

For an obligation to be valid and legally binding on an agency of 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 an action of an agency to be deemed an obligation. Section 1311 provides that no funds with a limited time for obligation shall be spent after that time, except in satisfying obligations validly made during the period of the appropriation. According to Section 1311, the following documents constitute valid supporting evidence of an obligation of the 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 while the appropriation or fund is available for obligation 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, 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.
- A grant or subsidy that must be repaid in fixed amounts or according to a prescribed formula, 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 an authorized law.
- A liability which may result from pending litigation brought under authority of law, or
- Employment or services of persons or expenses of travel in accordance with law, and services performed by public utilities.
- Any other legal liability of the United States against an appropriation of fund.

Violations of the aforementioned provisions are generally referred to as 1311 violations.

Even though a contemplated obligation could be supported as required by Section 1311 of the Supplemental Appropriation Act of 1955, before obligating the government an agency must determine (1) that a valid need exists, (2) that the obligation is in accord with the intent of Congress as expressed in the authorizing and appropriation legislation, (3) that appropriated and unobligated funds are available, and (4) that the contractor, grantee, borrower, or other recipient of federal monies intends to commence services or performance without unnecessary delay (31 USC 200).

Although the document required by Section 1311 may exist, generally no amount is entered in the agency records as an obligation until the document has been signed by the prospective recipient of the funds (except for small purchases of \$10,000 or less) and by the person having obligational authority for the agency. Further, the document must contain all the administrative approvals required by legislation or agency policy, and a copy must have been delivered to the performing party.

One agency has defined delivery as placing a document in official postal service channels or with a publicly recognized messenger service, or handing it to the recipient. Placing a document in an agency's own administrative services mail channels is not considered sufficient for delivery. For recording purposes, except at the end of the fiscal year, delivery is assumed to have occurred on the date of the last required signature. At year end, only documents actually mailed or otherwise delivered before the last day of the year would be included as a valid obligation in the agency's year-end reports.

When obligations that are incurred by an agency are not supported by precisely the documentation described in Section 1311, a written administrative determination may constitute the substantiating documentation. This administrative determination must include a description of the transaction, a reference to the document initially authorizing the transaction, an approval by an official authorized to make the determination, and, where known, an estimate of the cost to be incurred. An administrative determination might be required for an obligation relating to payment for personal services, travel and transportation, a grant, public utility services, or amounts due periodically under a rental or lease agreement or a similar transaction where the document supporting the obligation provides for a series of payments. Supply operations may utilize data-processing equipment or punch-card accounting machines where the purchase order is automatically prepared and no authorizing signature is required. The recording of the obligation may be based on a signed summary of a computer print-out supported by a detailed machine

listing of the documents. The listing must be backed up by documents maintained in auditable form, verified for correctness, and containing approval by an authorized official.

## Accounting for Obligations

*Types of Obligations* The reporting required of an agency by the Treasury and OMB provides for a consistent classification of an agency's obligations, costs, and cash disbursements. The standard object classification includes the following categories, not all of which apply to every agency.

- Personnel compensation for temporary and permanent positions, military personnel, and special personal service payments

- Personnel benefits for civilian and military employees

- Benefits for former personnel

- Travel and transportation of persons

- Transportation of things

- Rent, communications, and utilities

- Printing and reproduction

- Supplies and materials

- Equipment

- Lands and structures

- Investments and loans

- Grants, subsidies, and contributions

- Insurance claims and indemnities

- Interest and dividends

- Refunds

- Unvouchered obligations, which are lawful but confidential and not subject to detailed vouchering or reporting

- Undistributed obligations, which can be used only with the prior approval of the Office of Management and Budget

- Administrative expenses

- Changes in selected resources, which entails adjusting the entry account to make a bridge between the sum of the detail and total obligations when the detail is on the basis of accrued expenditures or applied costs

- Quarters and subsistence charges to employees

*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 appear to be routine because the dollar amount on the obligating document is the correct amount. However, the dollar amount cited on the supporting documents may not be the amount that an agency obligates.

Following are examples of amounts for various types of obligations.

### **Personal Services**

An obligation for personal services or salaries and related costs should be evidenced by the payroll or other written administrative determination. The obligation for personal services must be based on the personnel records and be recorded in the month the services are performed. When a payroll period covers portions of two calendar months, the proportionate amount accruing each month is recorded as an obligation applicable to that month.

*Personal service contracts*, the obligation recorded in each month, should be the estimated amount earned during that month under the provisions of the contract.

*Civilian employees' salaries*, the obligation recorded in each month, should be the gross amount earned by the employees during that month.

*Accrued annual leave* should be recorded as an obligation when an employee terminates his employment.

*Contributions for federal employees' life insurance, federal employees' health benefits, FICA taxes, and civil service retirement*, the obligation recorded for each of these items in each month, should be the estimated liability incurred during the month.

*Severance pay*, the obligation recorded each month, should be the gross amount due the former employees for that month (31 USC 200).

### **Personnel on a Reimbursable Basis**

Many agencies are required to support personnel of another agency who are providing services on a reimbursable basis. Under such an arrangement, the agency receiving the services must reimburse the other agency for the costs of the personnel who are on loan. The obligation recorded in each month for military personnel on a reimbursable basis should be the amount earned and reimbursable to the Department of Defense based on the standard rate published by that department for reimbursable details, plus travel and other

costs. The obligation recorded in each month for civilian personnel on a reimbursable basis should be based on the salary earned and related fringe benefit contributions, which are reimbursable to the other agency, plus travel and other costs.

### **Travel and Transportation**

An obligation for travel and transportation should be documented in a travel authorization with an estimate of the costs, including transportation and per diem allowance as well as transportation of household goods and other reimbursable expenses.

*Payment of Mileage* In general, mileage is charged to the appropriation for the year in which the travel is performed. If travel begins at such a time as to enable the traveler to complete a journey before the close of the fiscal year, it is charged entirely to the appropriation for that year. If the travel begins so late in one fiscal year that the major portion of it is performed in the next fiscal year, it is charged to the appropriation for the succeeding year (31 USC 200).

*Per Diem* Per diem and other authorized expenses, such as taxi hire, official telegrams, and transportation and baggage charges paid by the traveler, should be charged to the funds current at the time the costs are incurred (31 USC 200).

The obligations for permanent-change-of-station travel reimbursed on a commuted basis are charged to the appropriation current on the date the traveler actually pays the costs incurred under permanent-change-of-station orders. These costs should include all expenses in connection with the travel, such as transportation of dependents and household goods, packing, and storage.

*Transportation of Things* An obligation incurred for transportation of government property and supplies should be evidenced by a government bill of lading issued to a commercial carrier, a contract for commercial transportation or rental of a truck, or an intragovernmental order for specific transportation.

### **Rent, Communications, and Utilities**

*Rental Agreements and Leases* The amount recorded as an obligation should be based on the specific conditions of the lease or agreement or on a written administrative determination of the amount due. Following are various considerations that are given to the agreement conditions before obligating an amount for rental costs.

- Under a rental agreement that may be terminated by the government at any time without notice and without incurring any obligation to pay termination costs, the obligation is recorded each month in the amount of the rent for that month.
- Under a rental agreement providing for termination without cost after giving a specified number of days' notice, when the agreement is executed an obligation is recorded in the amount of rent payable for the number of days' notice called for in the agreement. In addition, an obligation is recorded each month in the amount of that month's rent. When the number of days remaining under the lease equals the number of days of advance notice required under it, no additional amount is recorded.
- Under a rental agreement providing for a specified dollar payment in the event of termination, an obligation is recorded upon execution of the agreement in the amount of the specified minimum dollar payment. In addition, an obligation is recorded each month in the amount of the rent payable for that month. When the remaining rent is equal to the obligation recorded for payment in the event of termination, no additional monthly obligation is recorded.
- Under a rental agreement which does not contain a termination clause, an obligation is recorded at the time of its execution in the total amount of rent specified in the agreement.

*Communications and Utilities* The obligation for recurring charges for utility services and communications is evidenced by a written administrative determination of the cost of the service furnished during the accounting period. The obligation is adjusted on receipt of a voucher or other documentary evidence that an adjustment is needed. An obligation for utility services or communications for which a specific contract is issued at a specified cost should be recorded in accordance with the terms of the contract.

### **Interagency Orders and Services**

The obligation to be recorded by an agency for goods or services to be delivered or performed by another agency is carefully considered since the amounts could be significant. An obligation will unnecessarily restrict the funds appropriated and an over-obligation could put the agency in the position of jeopardizing the appropriation limitations of Congress (31 USC 686). The following paragraphs are indicative of the amounts that would be obligated under varying conditions.

*Interagency Orders on a Reimbursable Basis* A definite and complete order for goods or services placed on a reimbursable basis by one agency with another is obligated in the amount of the order when accepted in writing by the performing agency, with one exception. Orders chargeable to the administration appropriation placed under the authority of the Economy Act should be deobligated at the end of the fiscal year to the extent that the agency receiving the order has not incurred a valid obligation.

*Agency Orders Required to Be Placed With Other Agencies* Various laws require that orders be placed with certain government agencies and not with contractors. These agencies include the Federal Prison Industries (18 USC 4124), the Government Printing Office (44 USC 111), and the General Services Administration (GSA Regulations).

The amounts of these orders are recorded as obligations when the orders are issued, and obligations recorded against a one-year appropriation or fund need not be decreased at the end of the fiscal year even though the performing agency may not have incurred supporting obligations under the order. All such orders must authorize the performing agency to proceed with a particular job. When requests are in a form that represents nothing more than an inquiry as to the probable cost of a given job, no obligation is incurred.

*Orders Requiring Delivery by Another Agency* When an order is placed with another government agency out of choice and not because the action is required by law, and when the order is for items procured and normally carried in stock by that agency or installation, the record date of the obligation depends largely on the supplying organization's capacity with respect to the particular transaction. For example:

- If the order involves common-use standard stock items that the supplying organization has on hand or on order for prompt delivery at published prices, the obligation is incurred at the time the order is placed by the requisitioning activity.
- If the order involves stock items other than those just referred to, the obligation is incurred by the requisitioning organization when the supplier issues a formal notification that the items are on hand or on order and will be released for prompt delivery.
- If the order requires that the supplier execute a specific contract, the obligation is incurred when the contract is entered into.



*Orders Placed by Another Government Agency* An order placed by one government agency chargeable to funds of a benefiting agency is recorded as an obligation by the benefiting agency when the contract is entered into.

*Payment to Be Made by Appropriation Transfers* A transfer of funds to another agency for obligation and disbursement does not constitute an obligation at the time of the transfer. The agency administering the transfer appropriation account is required by the Office of Management and Budget to furnish monthly status reports, including obligations incurred under such account, to the agency administering the parent account. This agency in turn uses the information as the basis for its own reports. The final report at the close of the fiscal year must be certified as to the validity of any unliquidated obligations.

### **Grants, Subsidies, and Contributions**

The amount of a grant, subsidy, or contribution is recorded as an obligation only when supported by documentary evidence. A grant requiring the performance of some service or delivery of some item is recorded when consummated by mutual agreement. Usually, a grant is signed by an agency official and mailed to the grantee for acceptance. The obligation is incurred when the grantee accepts the offer by signing the document and mailing or otherwise delivering it to the agency.

A grant, subsidy, or contribution not preceded by a contract or agreement is recorded as an obligation when payment is made. A cash grant or award is recorded as an obligation in the accounting period in which the award is approved by the authorized official. A copy of the approval document, or a copy of the document informing the recipient of the award, is used to support the obligation.

### **Legal Liabilities and Other Actions**

The estimated amount of a legal liability is recorded as an obligation when it is established that a liability exists for the payment of money from an available appropriation and litigation is pending to determine the amount of the liability.

The estimated cost of land acquisition under condemnation proceedings is recorded as an obligation at the time the attorney general is requested to institute the proceedings. The obligation record should be supported by a written administrative determination of the estimated liability that could result from litigation.

## **Loan Agreements**

A loan agreement is recorded as an obligation in the amount of the loan. A commercial loan to a contractor which is guaranteed by an agency should be recorded as an obligation when a written demand is received from the financing institution that the agency purchase the guaranteed portion of the loan in the stated amount, including accrued interest if applicable.

## **Postage**

An obligation should be recorded each month based on an estimate of the billing to be received from the postal service. The obligation should be adjusted when the actual bill is received. In the event that advance payment for penalty mail is required, the obligation is based on the billing for the advance. Stamps purchased are obligated when payment is made.

## **Contracts**

The amount obligated for a contract issued by an agency depends on the terms of the contract, which may obligate the government for less than the full amount—or could result in an even greater liability than initially recognized. The following paragraphs highlight several conditions that could affect the amount obligated for a particular contract.

A contract or agreement may include more than one pertinent provision. In such instances, funds should be obligated in accordance with each separate provision and not for the aggregate total of the contract. For example, one element of a contract or agreement may be recordable immediately as an obligation, whereas another may require further action or processing before it can be obligated.

*Firm Fixed-Price Contracts* An obligation for the total amount, is recorded when the contract is executed.

*Fixed-Price Redeterminable Contracts* When the contract is executed an obligation is recorded for the stated fixed price—or for the target price if the contract includes an incentive clause—even though the contract contains a higher ceiling price. The recorded amount should be increased or decreased as provided in amendments to the contract.

*Cost Contracts* Cost-reimbursement and time-and-material contracts include cost-plus-fixed-fee, cost-sharing, cost-plus-incentive-fee, cost-plus-award-fee, and labor-hour contracts. An obligation is recorded when the contract is executed for the total estimated cost or payment, but not in excess of the stated maximum liability, including the fixed fee in a cost-plus-fixed-fee contract. The target fee in a cost-plus-incentive-fee contract is the base fee plus an amount for the award fee not in excess of the maximum stated in a cost-plus-award-fee contract.

The recorded amount should be increased or decreased as provided by any amendment to the contract or by a unilateral revision of an award fee estimate made by the contracting office. Any award in excess of the target fee in a cost-plus-incentive-fee contract should be recorded as an obligation when the administrative determination to award the larger fee is sent to the contractor. A cost-plus-award-fee contract obligation is adjusted at the time the actual award is determined and the contractor notified. If any of these contracts is incrementally funded, the amount obligated should be the funded increment.

*Indefinite Contracts* Indefinite delivery contracts include definite and indefinite quantity contracts, requirements contracts, and basic ordering agreements. Where the quantity required under a contract or agreement is indefinite, the ultimate obligation is determined by subsequent orders. Any specified minimum order should be recorded as an obligation when the contract is executed.

An order in excess of the minimum not requiring acceptance by the contractor under the terms of the agreement and placed within the time period specified should be recorded as an obligation when issued in the stated amount. Such an order is recorded as an obligation upon acceptance of the order at the agreed price. In the case of services, the written evidence may be a consolidated listing of work orders issued to the contractor at least monthly and showing the estimated dollar amount of each.

Regardless of the variation permitted, an obligation should be recorded when the contract is executed for the price of the quantity specified for delivery. The amount so recorded should be increased or decreased to reflect the price of the quantity actually delivered and accepted.

*Letter Contracts* For the most part, letter contracts are limited to unusual circumstances and require advance approval from the highest level of agency management. If authorized, the letter con-

tract is signed by the contracting officer and then mailed to the contractor for acceptance. The obligation is incurred when the contractor accepts the offer by signing the contract and returning it to the agency. The obligation should state the maximum amount for which the government will be liable.

*Purchase Orders* A purchase order issued in accordance with agency procedures could constitute an obligation when issued if the purchaser accepts a binding written offer made by a vendor to sell specific goods or to furnish specific services at a specific price. If the purchase order requires vendor acceptance, it is recorded as an obligation at the time of such acceptance, evidence of which must be retained in the files. If written acceptance is not received, delivery in accordance with the purchase order constitutes evidence of acceptance, but only to the extent of the delivery and provided that the delivery is accomplished while the appropriation or fund is available for obligation.

If written acceptance is not received but delivery is nevertheless accepted after the time cited in the purchase order, a new and current funding citation must be provided for the processing of an amended purchase order. If payment to the vendor should inadvertently be made from expired funds, charges should be transferred to the proper fiscal year by means of a correction voucher.

*Notice of Contract Award* A notice of contract award may be used when time does not permit an agency to prepare and execute a definitive contract before contract performance begins. A notice of award is merely an acceptance of an offer. If the terms of the offer and of any other document specifically incorporated in it include all the terms that would be required in a formal contract, it may be accepted by a notice of award. If the acceptance is clear and unqualified, a binding agreement between the parties results. In such event, an obligation goes into effect when the notice of award is issued; and the offer, coupled with the notice of award, constitutes the documentary evidence supporting the obligation.

*Incrementally Funded Contracts* An incrementally funded contract provides for performance within an estimated total cost and fee. It limits the government's liability to the amount of funds allotted to the contract, and provides initial funding that is less than the total estimated cost and fee of the contract. An agency might resort to this type of funding to conserve the agency's appropriation or control performance of a contractor. Thus the incremental funding

clause serves as a limit on the amount to be recorded as an obligation under the contract. Allotting additional funds to the contract raises that limit and increases the obligation up to, but not exceeding, the amount that would be recordable if such a clause were not in the contract.

*Termination of Contracts and Agreements* When the government terminates a contract or agreement in whole or in part by a notice of termination to the other party, the obligation is decreased to an amount sufficient to cover the settlement costs. But the obligation should not be decreased below the contracting officer's estimate of the amount due as a result of the termination. As the proceedings go on, the termination contracting officer should make periodic examinations to redetermine the government's probable liability; and, based on appropriate documentation, the amount of the obligation should be adjusted accordingly.

## Control and Liquidation of Obligations

Once an obligation has been incurred and recorded, the agency's system must provide adequate controls to insure appropriation limitations are not violated. Additionally, the agency is responsible for the periodic review as well as the proper and timely reduction or liquidation of obligated balances as expenditures are incurred.

The Office of Management and Budget must approve the system of administrative control designed to restrict obligations or expenditures against each appropriation to the amount of the apportionments or reappportionments. The OMB system must also enable the head of an agency to fix responsibility for any obligation in excess of an apportionment or reappportionment (31 USC 665[9]). It is the responsibility of each agency to implement and adhere to the administrative controls.

The agency has to prescribe procedures and design controls to meet the following criteria:

- That they will restrict obligations or expenditures against appropriations or funds to the amounts apportioned or reappportioned, or to amounts that will actually be realized, whichever are smaller.
- That they are not inconsistent with any accounting procedures prescribed by or pursuant to law.

- That they will enable the head of the agency or any administrative subdivision to fix responsibility for any obligations or expenditures in excess of an apportionment or reapportionment.
- That they provide for prompt and adequate reporting of violations of the law.
- That the system of subdividing funds be made at the highest level compatible with assignments of program responsibilities that will make for effective and efficient management and also provide the controls necessary for carrying out the intent of Congress.

An agency's obligations may be liquidated or reduced by complete or partial cancellation or termination of the order or contract; by delivery of the required goods or services under the order or contract; or by accrual of salaries or other expenditures, thereby recognizing the actual cost of the earlier obligation.

It should be noted that recognition of actual expenditures replaces or liquidates earlier obligations. Any obligations for which no accrual has been recognized are referred to as unliquidated.

As has been said, the Constitution allows only funds appropriated by Congress to be expended. Congress is inclined to monitor the financial system by limiting the periods for which appropriated funds may remain available for obligation. This keeps agencies from creating new obligations from expired appropriations. However, appropriations sometimes require payment of monies many years after expiration. Agencies use a merged or "M" accounts procedure to combine the expired appropriations of past years. An appropriation by Congress remains available for obligation for the period provided by law. After that time the authority to obligate funds is withdrawn and the appropriation is said to have lapsed. The authority to obligate funds may also be withdrawn if for some reason no disbursement has been made against an appropriation for two fiscal years.

An agency will continue to account for an appropriation for two full years after the applicable fiscal year. Then the account is closed on the agency's books; the obligated balance is reported to the Treasury Department; and the balance of that account is merged with all previously lapsed balances of appropriations for the same general purpose in an M or merged account in the agency's records.

The M accounts remain open indefinitely for the settlement of the obligated balances. If subsequent liquidations exceed the amount originally obligated and transferred to the M account, the overliquidation or negative balance does not necessarily constitute an

overexpenditure unless the total of all such overliquidations exceeds the total of the appropriation withdrawals.

## Accrual Accounting for Expenditures and Costs

Probably no financial concept has received more analysis, discussion, and thought than accrual accounting, as adopted throughout the federal government. Since 1955 and the Second Hoover Commission, Congress has enacted a public law, three Presidents have issued directives, and the central accounting agencies of the General Accounting Office, the Office of Management and Budget, and the Treasury have published innumerable statements, instructions, and regulations on this subject.

Complicating the lag in implementing a concept of accounting that has been accepted in principle by the private sector is the varying definitions and interpretations of the concepts inherent in accrual accounting.

In the government, accrual accounting could refer to accrued expenditures or accrued costs—and a distinction is not always maintained. Accrued expenditures have to do with services received or performance accepted; accrued costs have to do with the consumption of goods or the use of services in the operation of a program. Accrued expenditures are singularly important to outside economists and planners. Accrued costs are critical for managers who bear primary responsibility for program performance and achievement.

### Background of Accrual Accounting

Accrued expenditures must be distinguished from costs or accrued costs and the concepts kept clearly separated. Accrued expenditures are liabilities for goods and services received, assets acquired, performance accepted, and so on. Costs, accrued costs, or applied costs are the costs of resources (plant, property, or personnel) consumed, work put in place, or, in the case of a procurement program, items procured or produced.

There are a number of steps or timing differences in the flow of funds through the life of a federal transaction: appropriation, obligations, accrued expenditures, costs, and checks issued. An agency's system must be sufficiently comprehensive and integrated to record and account for each phase.

Generally, there is no significant difference between the obliga-

tion, accrued expenditure, costs, and checks issued when the transaction is incurred and settled immediately. For example, the time difference between incurring an obligation for employee salaries and benefits and paying this obligation could be relatively short and be of little consequence in an agency's accounting or reporting.

However, the time lag is material in many projects, particularly those of long duration. In the past, when an accounting was made for only the obligation and the check issued, years could pass between an obligation and a cash disbursement. Without an accounting such as accrued expenditures and accrued costs, agency management had no measure of the work performed or the interim liability.

This definition of accrued expenditures requires that consideration be given to performance, the point of time when money is first owed, the identification of contractor or grantee performance, and the fact that advance payments are not considered as expenditures.

### **Methods of Determining Accrued Expenditures**

There are at least three ways to determine a federal agency's accrued expenditures, not all of which provide the same degree of accuracy or the same information for management.

*The Forecast Method* Under the forecast method, entries are made at the beginning of the accounting period for the total estimated liability to be incurred. During the period, cash payments are made against this amount. The portion of the estimate that remains unpaid is recognized as the accrued expenditure. The forecast method does not meet the criteria or the intent of the accrued expenditure concept of accounting and provides management with no performance data throughout the period. The estimated liability is assumed, perhaps erroneously, to be accruing at the same rate during each quarter or interim of the accounting period. The method does not provide continual, systematic reporting of performance received, nor does it provide information to monitor for timeliness of delivery.

*The Inventory Method* Under the inventory method, transactions are recorded by the agency on a cash basis during the month, with receivables, advances, liabilities, and expenditures being inventoried at the end of each reporting period. The entries that record the accrued or inventoried transactions and events are reversed at the beginning of the next accounting period, thereby returning the accounting records to a cash basis.



The inventory method, as the name implies, requires that the agency take an inventory of its unpaid bills, open obligating documents, receipts of goods for which no invoices have been received, and performance reports at the end of each accounting period, preferably monthly. An alternative to making an adjustment entry for the accruals and reversing that entry at the beginning of the next accounting period is to account for only the increase or decrease between one month's accrual and the next month's accrual.

The comptroller general, in prescribing the accounting principles and standards for federal agencies, illustrated the inventory method in the manner outlined in Exhibit 5-3, opposite. The total cash disbursements (item 1 in Exhibit 5-3) would be obtained from the cash disbursement record. Under the inventory method, of course, such a record would not have a column for debiting the accounts payable since the accounts payable and liabilities are determined by taking an inventory at the end of the month. At that time, the appropriate asset and expense accounts are posted.

As mentioned earlier, accruals may be accounted for in two ways under the inventory method. One approach is to post the end-of-month accruals in total or gross. The same entries would be reversed in total at the beginning of the next month, and the procedure would be repeated for each month of the fiscal year.

An alternative is to post only the net changes in the accruals from one month to the next. For example (item 2 in Exhibit 5-3), the increase or decrease in the accounts payable and other liabilities is the difference between the month's beginning and end totals of unpaid invoices, receiving reports, and other documents evidencing liabilities for goods and services. Increases are added to and decreases are subtracted from the cash disbursements to arrive at the total accrued expenditures for the period.

If an agency were on the inventory basis, it would have to apply the same method to its obligations. The increase or decrease in the unliquidated obligations (item 4 in Exhibit 5-3) is determined by checking the undelivered orders, other outstanding obligations, and other obligating documents that were inventoried at the beginning of the month and comparing them to the inventoried totals at the end of the month. Increases in the unliquidated obligations must be added to the accrued expenditures and decreases in the unliquidated obligations must be subtracted from them in order to arrive at the total obligations incurred.

The inventory method is not designed for and should not be used in the maintenance of detailed cost accounts. Nor is it adequate for keeping detailed stock record cards to support a general ledger con-

**Exhibit 5-3**

**INVENTORY METHOD OF DETERMINING  
ACCRUED EXPENDITURES AND OBLIGATIONS INCURRED**

<u>Item</u>	<u>Month of July</u>	<u>Last 11 Months of Fiscal Year</u>	<u>Total for Fiscal Year</u>
(1) <i>Total Cash Disbursements</i> During Current Period .....	\$41,250	\$787,750	\$829,000
(2) Increase or Decrease* of Ending Over Beginning Balance of Accounts Payable, Determined by Inventories of Unpaid Invoices and Other Liability Documents:			
(a) <i>Accounts Payable</i> , per ending inventory .....	\$ 350	\$ 1,000	\$ 1,000
(b) <i>Accounts Payable</i> , per beginning inventory .....	—	350	—
(c) Increase (or Decrease*) .....	\$ 350	\$ 650	\$ 1,000
(3) <i>Accrued Expenditures</i> , or Liabilities Incurred During the Current Period for Assets and Expenses (See Journal Entries Nos. 2 and 3 Below) .....	\$41,600	\$788,400	\$830,000
(4) Increase or Decrease* of Ending Over Beginning Balance of Unliquidated Obligations, Determined by Inventories of Purchase Orders, Contracts, and Other Obligor Documents:			
(a) Unliquidated Obligations, per ending inventory .....	\$35,000	\$110,000	\$110,000
(b) Unliquidated Obligations, per beginning inventory .....	—	35,000	—
(c) Increase (or Decrease*) .....	\$35,000	\$ 75,000	\$110,000
(5) <i>Obligations Incurred</i> , or Purchase Orders and Contracts Placed, and Other Obligor Documents Issued During the Current Period (See Journal Entry No. 1 Below) .....	\$76,600	\$863,400	\$940,000

(continued)

**Exhibit 5-3 (continued)**

	<u>July</u>		<u>Last 11 Months</u>	
	<u>Debit</u>	<u>Credit</u>	<u>Debit</u>	<u>Credit</u>
<i>Journal Entries:</i>				
(1) Unobligated Allotments . . .	\$76,600		\$863,400	
Unliquidated Obligations		\$76,600		\$863,400
(See Item No. 5 Above)				
(2) Unliquidated Obligations . .	41,600		788,400	
Expended Appropriations		41,600		788,400
(See Item No. 3 Above)				
(3) Assets and Expenses . . . . .	41,600		788,400	
Fund Balances with U.S.				
Treasury . . . . .		41,250		787,750
Accounts Payable . . . . .		350		650
(See Item Nos. 3, 1, and				
2c Above)				

Source: U.S. General Accounting Office, *Policy and Procedures Manual for Guidance of Federal Agencies*

trol account for materials. Such cards should be posted from receiving reports and materials issuance cards.

In some agencies an obligation, accrued expenditure, cost data, and disbursement are almost simultaneous because the timing difference of a transaction in moving through these various stages is minimal.

Accruals may not always produce data of greatly increased usefulness to the management of an agency. For example, if most of an agency's costs are incurred for the payment of personal services to employees or for travel, other controls and limitations reduce the risks of overexpending or require alternative types of monitoring. In these circumstances a conversion to the accrual method might be required only for reporting purposes, and the inventory method would be most practical.

*The Continuity Method* As the name implies, the continuity method of accounting for accrued expenditures, as well as obligations, relies on continual processing, recording, and accounting for transactions and events throughout the fiscal period. With the advent of computers, necessitated by the requirement that each agency maintain an integrated accounting system and report capability,

most agencies adhere to the continuity method of accounting. By this method, receivables, payables, and changes in other assets and liabilities and accrued expenditures are processed, recorded, and accounted for all through the year. Offsetting income and cost entries are made on the same basis, thus providing agency management with interim financial data on operations. The continual accounting for receivables and payables also permits the current reflection of the amounts owed by or to the agency.

The continuity method relies on the recognition of each event affecting an agency's fund status. Basic to a sound system of accounting for, monitoring, and reporting on expenditures is a disciplined procedure for the approval, flow, central control, and safekeeping of supporting documents. Another prerequisite of the continuity method is prompt and accurate coding of a transaction throughout the period when it is active—from the time of obligation to the ultimate settlement by disbursement or total liquidation of an advance, if one was made.

### **Support for Accrued Expenditures**

A separate file is generally established for each transaction when an obligation is incurred. This file is kept current, with accounting entries being made as appropriate, throughout the life of the transaction. The support that should be in each transaction file includes such documents as the approval of fund availability in the form of a procurement request, purchase order, request for grant funds, or similar form; the contract, grant, or other agreement or obligating document; the report of expenditures or performance; receiving reports; claims for payment; and evidence of disbursement and payment.

### **Estimating End-of-Month Accrued Expenditures**

As discussed, the accrued expenditure concept requires that agency management recognize not only the liability which is evidenced by invoices and other documents received, but also those accrued expenditures for which no bills have been received or for which payment has not been made at the end of a month.

It is permissible to estimate such accrued end-of-month expenditures on the basis of available information and prior agency experience. Among the alternatives in federal accounting for estimating or determining accrued expenditures are the following:

- Unpaid invoices from vendors covering shipments received.

- Receiving reports showing quantities received and whether a given shipment is complete or partial when the invoice has not been received.
- Payroll, travel, and other supporting vouchers prepared but not yet paid.
- Estimates of personal services for the days between the close of the latest payroll period and the end of the month based on experience and factors such as overtime.
- Where an obligation is recorded covering the expenditure accrued in an accounting period, the obligated amount may be the best estimate of the expenditure.
- For fixed-price contracts extending beyond one month and covering goods manufactured to the government's specifications, a statement from the contractor estimating the percentage of completion, including work performed by subcontractors.
- For cost contracts, monthly reports from the contractors showing the unbilled portion of performance to month end, including work performed by subcontractors.
- Similar monthly performance reports from grantees for accrued expenditures under grants.
- Estimates from project managers or operating officials familiar with progress under the contract or grant.
- Sampling or statistical methods where there are a large number of small dollar-value transactions or where sound correlations can be made.
- For utilities, an estimate of the liability for services for the interval between the date of last billing and the end of the accounting period.

## Accrued Expenditure Reporting Requirements

For reporting purposes, with respect to apportionments and data on an agency's budget status, OMB requires that such data be reported on the accrued expenditure basis, defined as consisting of the following:

. . . liabilities incurred for goods and services received, other assets acquired and performance accepted, and other liabilities incurred not involving the furnishing of goods and services, whether or not payment has been made and whether or not invoices have been received.

Where the precise amount of accrued expenditures is not known, the best estimate is used for the amount which will subsequently be paid. OMB has recognized that absolute precision is not attainable, nor is it economically feasible.

The following reports must be submitted to OMB by each federal agency to show the status of the apportioned balance of its appropriation.

- *Reports on applied costs and accrued expenditures* contain total agency program cost by activity and the necessary adjustment to reflect accrued expenditures.
- *Apportionment and reapportionment schedules—accrual basis* sets forth on an accrual basis the amounts available to the agency for apportionment, the amounts apportioned and unapportioned, and the undisbursed balances of various funds.
- *Reports on budget status—accrual basis* are prepared each quarter for revolving funds and for some funds not apportioned, as specified by OMB.

## Accounting for Accrued Costs

The terms *accrued costs* and *applied costs* are synonyms that refer to the amount, measured in dollars, of goods and services used or consumed in carrying out an operation or function.

Accounting for costs on an accrual basis is seen by GAO to be merely an extension of accounting for accrued expenditures. These expenditures, as described earlier, are recognized as earned or received. The cost or consumption of accrued expenditures is recognized when an operation, function, activity, or whatever, makes use of the assets or expense.

According to the General Accounting Office, cost-based budgeting is budgeting whose activity levels are estimated in terms of the value of resources to be consumed in carrying out the activity, rather than in terms of the dollar amount of the obligations incurred or cash payments made. Cost-based budgets are used by some operating managements of federal agencies.

### Considerations of a Cost System

In its principles, the GAO has identified a number of considerations for an agency's system and its reporting of costs.

- The accounting system must provide for the systematic accumulation of cost by major organizational segments, budget activi-

ties, and the program structure adopted under the agency's planning-programming-budgeting system.

- Where appropriate, the cost accounting system should provide quantitative data on performance or output in order to relate cost to achievement and permit the computation of unit costs.
- Any unqualified representation as to costs is construed to include all the significant cost elements—financial, property, personnel—of an activity or program.
- Differences in financing, reimbursement methods, and administrative policies of budgeting, accounting, and reporting are not grounds for excluding costs that should otherwise be included.
- Cost systems should provide for the accumulation of all significant costs. Where this is not done, the basis for estimating costs or the nature and effect of omissions must be identified so as not to mislead users.
- Cost data provided to agency management and to external users must be sufficiently accurate to be valid in making evaluations and decisions.
- Cost reports for internal management must disclose information that is consistent with the assignment of responsibility.
- Costs assigned to a program, activity, or function must not be limited to those financed by an agency but should encompass funds from all sources.

### **Classification of Costs**

Agency systems must classify costs for programs, activities, functions, or other cost centers into two general groupings.

1. The *acquisition of assets or capital expenditures*—the procurement of resources, plant, and equipment that will not be consumed in the operations of an activity in the near future, but will benefit operations for several future periods.
2. The *incurrence of current expenses*—the consumption or use of resources in a period, including a proper allocation of any capital expenditures initially recorded as an asset.

The degree of detail of the cost accounting is a responsibility of the individual agency managements and must be sufficient to permit the proper planning, control, and evaluation of operations.

## **Relating Costs to Appropriations**

Accrued costs and cost-based budgets are used by some agency managements for operating purposes and decisions on future funding needs. Accounting for obligations by appropriation status is required to meet external reporting needs and requests for data, particularly from the OMB and the Congress. Nevertheless, the cost basis is the single best way to insure that all resources are considered in planning and operating an activity and in accounting for the full cost of work done and accomplishments. However, when accounting on a cost basis, federal agencies need to reconcile these costs to appropriations, obligations, and accrued expenditures. Exhibit 5-4, page 100, illustrates the relationship of the cost basis and cost budget to these other bases.

## **Accounting for Disbursements**

For many years the government equated expenditures with disbursements and checks issued. Today, there is a clear distinction between the accrual of an expenditure and the disbursement of cash. The disbursement is the final phase of accounting for financial transactions in the federal government.

### **Role of Treasury Department**

Although it is commonplace to speak of a federal agency's paying bills or making disbursements, this is not generally the case. The usual procedure is for the agency to prepare a schedule or request for payments and submit this list to the Treasury Department, which then issues the checks.

The present central accounting system is fully integrated; it embraces all federal cash operations and is maintained by the Treasury Department. The system links the Treasury, as the financial center, to all operating agencies through transactions common to all agencies: appropriations enacted, monies received, and monies disbursed. The undisbursed or credit balance of each appropriation and fund on the central books of the Treasury Department is a reciprocal balance to the asset or debit balance for each appropriation and fund on every agency's books and represents the agency's cash authority to draw on the Treasury. Withdrawals are made by federal agencies upon presentation of properly certified vouchers and voucher sched-



Exhibit 5-4

PLANNING AND EXECUTING A PROGRAM FOR COST TYPE BUDGETS

All programs are based on the work or service to be accomplished and what that work will COST

THE TERMS USED (Measured in Dollars)	HOW THE PROGRAM IS SET UP	PROGRAM CONTROLS
<p>Transactions for Control Purposes</p>		
<p><b>OBLIGATIONS</b>— Goods and services <i>ORDERED</i> regardless of when received, paid or used.</p>	<p>1st COST OF THE WORK + OR — Changes in Inventories + OR — Changes in other available resources</p>	<p><b>ESTIMATES AND OPERATING BUDGETS</b> Control the <i>SCOPE</i> of the activity.</p>
<p><b>ACCRUED EXPENDITURES</b>— Goods and services <i>RECEIVED</i> regardless of when ordered, paid or used.</p>	<p>Goods and Services received without charge ↓ ↓ ↓ ↓</p>	<p><b>CONGRESS</b> Through <i>APPROPRIATIONS</i> controls the maximum <i>AMOUNT</i> of <i>ALLOTMENTS</i> that can be made (on an obligation basis)</p>
<p><b>COSTS</b>— Goods and services <i>USED</i> regardless of when ordered, received, or paid.</p>	<p>2nd <b>ACCRUED EXPENDITURES</b> +</p>	<p><b>APPORTIONMENTS</b> Control maximum amount of <i>ALLOTMENTS</i> that can be made and the <i>RATE</i> at which <i>OBLIGATIONS</i> can be incurred</p>
<p><b>DISBURSEMENTS</b>— Bills <i>PAID</i>, regardless of when ordered, received, or used.</p>	<p>Increases in Undelivered Orders Decreases in Undelivered Orders ↓ ↓ ↓ ↓</p>	<p><b>ALLOTMENTS</b> <i>AT BROAD LEVELS</i> control the <i>AMOUNT</i> of <i>OBLIGATIONS</i> that can be incurred</p>
<p>Available Resources</p>	<p>3rd <b>OBLIGATIONS</b> Reimbursements and funds contributed by others — Unobligated funds on hand ↓ ↓ ↓ ↓</p>	<p><b>OPERATING BUDGETS</b> Control the <i>COSTS</i> that can be incurred.</p>
<p><b>APPROPRIATIONS</b> Funds made available by Congress</p>	<p>4th <b>NEW APPROPRIATION REQUIRED</b></p>	<p><b>REPORTS</b> Of results reflect variations in the <i>ESTIMATES</i> and furnish a basis for control of <i>OPERATING BUDGETS</i></p>
<p><b>INVENTORIES</b>— Goods in stock and available for future use.</p>		
<p><b>OTHER AVAILABLE RESOURCES</b>— Things for future use, such as items in process for use, cost in suspense, and other undistributed expenditures.</p>		

Source: U.S. General Accounting Office. *Policy and Procedures Manual for Guidance of Federal Agencies, Title 2—Accounting*

ules. The actual withdrawals are generally in the form of checks issued by the treasurer of the United States.

### **Role of the Federal Agency**

With few exceptions, notably the Internal Revenue Service and the Bureau of Customs, the concern of federal agencies is to disburse and not collect funds. The agency's disbursement system is essentially a series of approvals and certifications as to the propriety of a disbursement to settle a claim and the preparation of a schedule and voucher of payments which are transmitted to the Treasury Department.

After the check is drawn, the agency's concern is with providing the required periodic reports to the Treasury.

### **Accountable Officers in Federal Agencies**

Basic to the government's system of disbursements is the designated accountable officers of a federal agency. An accountable officer could be a collecting officer, disbursing officer, or certifying officer. In the role as accountable officer, this individual is charged with a personal responsibility and liability for the *account*—in other words, the officer's record of funds received, disbursed, certified, or retained during his term of office.

Periodically, these accounts are "settled" or audited. That is, an examination is made of all transactions processed or approved by the certifying officer. The objective of such audits is to determine the accuracy of the accounts and any amounts that may be due the government.

*Collecting Officers* Designated collecting officers of the government are principally those of the revenue collecting agencies. The district directors of the Internal Revenue Service and the collectors of customs of the Bureau of Customs are the collecting officers having the largest accounts.

*Disbursing Officers* Disbursing officers are generally not employees of the agency for which funds are being disbursed. When agency personnel do perform disbursing functions, they must act in strict accord with Treasury Department requirements. Directors of disbursing centers and regional disbursing officers in the Treasury Department are employees of this department, not of the agency, and each disburses funds on behalf of many agencies.

By law, disbursing officers must (1) disburse money in strict accordance with vouchers duly certified by the head of the agency or

another properly designated individual; (2) make an examination of vouchers to ascertain whether every voucher is in proper form, duly certified and approved, and correctly computed; and (3) be held personally accountable.

*Certifying Officers* Each voucher, voucher schedule, invoice, or bill must be approved or certified for payment by an agency official who knows the facts surrounding the payment. By law the certifying officer is responsible for (1) the existence and correctness of the facts recited in the certificate and (2) the legality of the proposed payment under the appropriation involved. The disbursing officer is not responsible for the correctness of the facts or the computations appearing on a voucher proposed for payment. Unlike the disbursing officer, the certifying officer is always an employee of the agency for which the certificate is being rendered.

### **Reporting of Accountable Officer Transactions**

Federal agencies are required to make monthly reports to the Treasury Department. One such report is the statement of accountability, which records the transactions that occurred during the reporting period for each accountable officer. In addition, each agency must submit a statement of transactions, a summary required by the Treasury which classifies collections and disbursements according to appropriation, receipt, and fund accounts. When a consolidated statement of transactions is prepared, there must be an audit trail from the consolidated statement to the individual accountable officer's statement of transactions.

The statements of accountability and of transactions must be supported by paid vouchers, voucher deduction documents, certificates of deposit, debit vouchers, and all other documents previously approved and certified by agency personnel as accurate and proper receipts or disbursements of funds.

All vouchers, contracts, grants, schedules, invoices, and payroll vouchers necessary to establish the legality, authenticity, accuracy, and propriety of the transactions represented in the amounts appearing on the statement of accountability and statement of transactions must be maintained and available for audit by the GAO.

# 6 Federal Contracts

On the basis of dollar volume, government contracts for supplies and services constitute one of the most important vehicles for the disbursement of federal funds. Many agencies disburse an amount of appropriated funds through or under contracts that dwarf the dollar amount of appropriated funds required for the agencies' own support.

Knowledge of the process by which the government awards and controls federal contracts, contract procurement in general, and contract accounting is important to all organizations doing business with the government. Further, an understanding of contracting procedures and basic governmental policies will minimize apprehensions about accepting opportunities to audit government contracts.

The federal government considers a contract to be a binding legal relationship obligating the seller to furnish personal property or nonpersonal services (including construction) and the buyer to pay for it.

Contracts are commitments, generally in writing, that obligate the government to an expenditure of funds. In addition to two-signature documents the term *contract* includes all transactions resulting from acceptance of offers by awards or notices of awards; agreements and job orders or task letters issued thereunder; letter contracts; letters of intent; and orders, such as purchase orders, under which the contracts become effective by written acceptance or performance.

## Responsible Federal Organizations

In government contracting, seldom does a single office or individual have total responsibility for a contracted procurement. Many persons are responsible for the contracts of an agency.

## **Agency Responsibilities**

As illustrated in Exhibit 6-1, opposite, the efficient and prudent procurement of services and supplies under a contract requires the coordinated execution of procedures by several functional organizations.

For example, the program office or other functional organization determines that a need exists which can be met only by an outside organization under contract to the agency. Once a justifiable need is identified and funds are certified to be available, the agency's contracts office actually procures the services or supplies at the most reasonable prices, consistent with the agency's desire for quality and delivery schedule.

After the services or supplies are received, the agency must document the receipt and the acceptability of the contractor's performance. Paying the contractor and accounting for the contract costs are then the primary responsibility of the agency's finance office. A condition of federal contracts is that the agency, through its cognizant audit division, also has the right of audit for a period of three years after final payment has been made under the contract.

## **GAO Responsibilities**

Every major federal agency has a General Accounting Office staff resident at its headquarters who conducts a continuing review of the agency. These GAO staff members are knowledgeable about internal procurement, contract monitoring, and contract settlement procedures.

The General Accounting Office also conducts many contract audits and reviews at contractors' plants, most of which are made under the general authority of several laws.

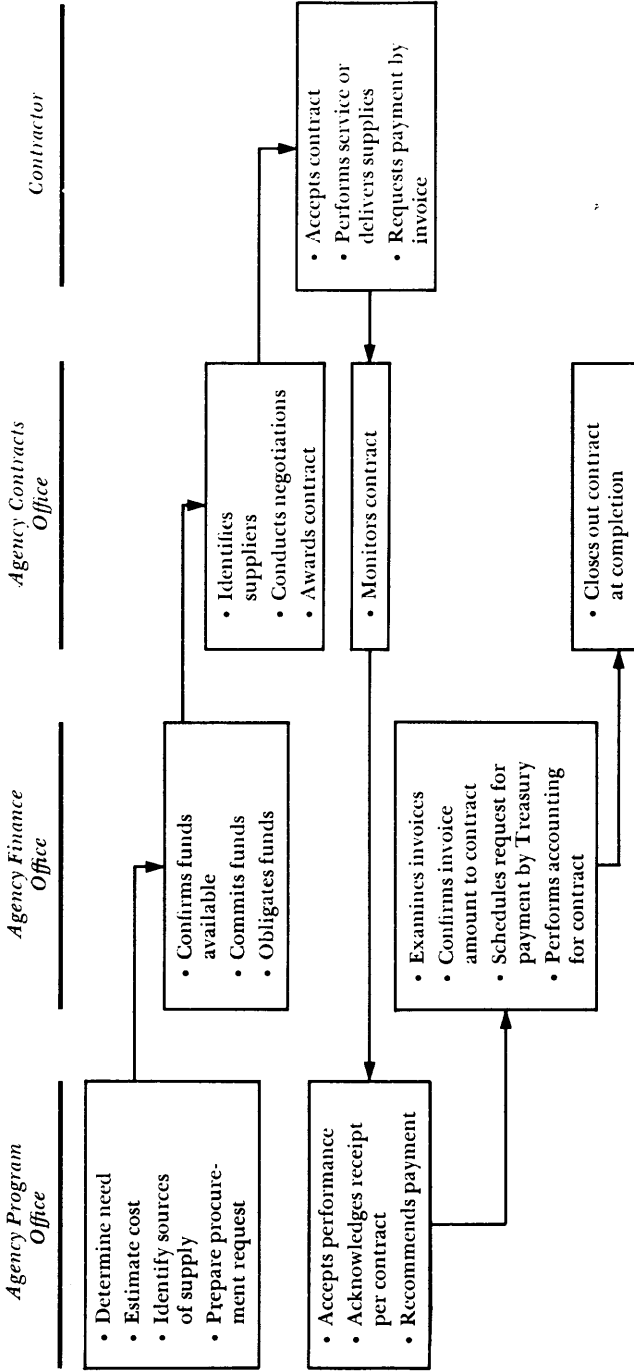
The Armed Services Procurement Act, the Federal Procurement Regulations Act, the Federal Property and Administrative Services Act, and the Atomic Energy Act require that contracts negotiated without formal advertising include a clause to the effect that within three years after the final payment the comptroller general of the United States and his representatives are entitled to examine books, documents, papers, and records of the contractor or any subcontractors that directly pertain to, and involve transactions relating to, the contracts or subcontracts.

## **GSA Responsibilities**

The General Services Administration established the federal procurement regulations system (FPR) to codify and publish uniform policies and procedures applicable to federal agencies in the pro-

**Exhibit 6-1**

**ORGANIZATIONAL RELATIONSHIPS REQUIRED TO CONTRACT IN A FEDERAL AGENCY**



Overview of functions performed by various organizations within a federal agency in the award and monitoring of a government contract

curement of personal property and nonpersonal services (including construction) as well as the procurement of real property by lease. The system includes regulations prescribed by the GSA administrator called the Federal Procurement Regulations, as well as individual agency regulations which implement and supplement the federal regulations.

The federal procurement regulations system is prescribed by the GSA administrator under the Federal Property and Administrative Services Act of 1949, as amended. The regulations are developed by the General Services Administration in cooperation with other federal agencies and are issued by the administrator.

These regulations apply to all federal agencies to the extent specified in the 1949 act, as amended, or in other law. Except for standard government forms and clauses, federal specifications and standards, and directions from the President, Congress, or other authority, these regulations are not made mandatory for the Department of Defense, which determines the extent of its own implementation of, and participation in, the system. The Department of Defense has its own body of procurement regulations—the Armed Services Procurement Regulations (ASPR). In many areas the FPR's and the ASPR's are similar, if not identical.

### **OMB Responsibilities**

The Office of Management and Budget, formerly the Bureau of the Budget, also plays a vital part in the field of federal contracts. With Circulars A-21 and A-87, this agency established uniform principles for the determination of costs applicable to contracts awarded to particular institutions and organizations. Both these circulars have now been incorporated in the Armed Services Procurement Regulations and the Federal Procurement Regulations.

OMB Circular A-21 (now FMC 73-8) sets forth the principles for determining costs applicable to research and development activities conducted under contracts with educational institutions.

By its Circular A-87 (now FMC 74-4), the Office of Management and Budget prescribed the principles for determining costs applicable to contracts with state and local governments. This circular attempted to provide the principles for determining the allowable costs of programs administered by state and local governments under contract to the federal government. This circular has been incorporated in both the armed services procurement regulations and the federal procurement regulations.

## Legislative Actions That Will Affect Federal Contracts

Actions by the Congress during 1969 and 1970 have had a direct impact on the contracting procedures and the costing of federal contracts. During this period, hearings were held and legislation was passed which established a temporary, bipartisan Commission on Government Procurement. In an unrelated action, the Congress also provided for the permanent Cost Accounting Standards Board, in the legislative branch, for the purpose of promulgating cost accounting standards to achieve uniform cost principles for defense contractors and subcontractors under federal contracts.

### **Commission on Government Procurement**

The bipartisan 12-member Commission on Government Procurement was established by Public Law 91-129 to promote efficiency, economy, and effectiveness in the procurement of goods, services, and facilities by and for the executive branch. The commission conducted numerous studies and investigations and held extensive public hearings on the existing procurement statutes, policies, rules, regulations, and practices. The results of these efforts are set forth in a multivolume report. Among the numerous recommendations affecting the government's contractual procedures is one calling for the establishment of an independent procurement agency.

### **Cost Accounting Standards Board**

Congress established the Cost Accounting Standards Board by Public Law 91-379 (Defense Production Act, as amended). The board was made an agency of the Congress, independent of the executive departments, under the chairmanship of the comptroller general.

The board issues cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles used by defense contractors. Such standards must be used by all contractors and subcontractors for all procurements in excess of \$100,000, with two exceptions: contract prices based on established catalog or market prices and prices set by law or regulation.

The law requires that the board make, promulgate, and rescind rules and regulations to implement cost accounting standards. Further, a defense contractor and subcontractor must disclose its cost accounting principles in writing and agree to a contract price ad-



justment, with interest, if any increased cost paid by the government stems from the contractor's failure to comply with its own disclosed cost accounting practice or with a standard of the board. The General Services Administration has since made the standards applicable to contracts issued by departments and agencies of the government unrelated to defense.

Notice of any actions taken or proposed by the Cost Accounting Standards Board is published in the *Federal Register*. The number of standards will increase with time. These standards and other study subjects relate to the following areas of compliance by contractors: consistency in estimating, accumulating, and reporting in connection with pricing, administration, and settlement for covered prime contracts and subcontracts; consistency in allocating costs incurred for the same purpose and in like circumstances; allocation of home office expenses to segments of the contractor's organization (applicable, initially, to contractors holding negotiated prime defense contracts awarded during fiscal 1971 and totaling more than \$30 million); capitalization of tangible assets applicable to all prime contractors and subcontractors who receive negotiated contracts in excess of \$100,000; accounting for unallowable costs; cost accounting period; use of standard cost for direct materials and direct labor; accounting for costs of compensated personal absence.

Other accounting matters being examined for possible incorporation into cost accounting standards are allocation of materials costs, pension cost, cost of capital, independent research and development, bid and proposal costs, standard costs for service centers and overhead, and current value or price level accounting.

This listing is illustrative, not comprehensive. Care should be taken to remain current on the continuing issuances of the Board. A standard that has been published for the second time in the *Federal Register* has the full force and effect of law. The standards automatically become effective unless Congress passes a concurrent resolution within 60 days of continuous session against the proposed standard.

## Contracting by a Federal Agency

Organizations under contract to or involved with other organizations under government contract should be cognizant of the procurement regulations, the methods of procurement, the variety of contracts, and the conditions under which each is used. Also important are the applicable contract cost principles that will be used in later federal audits. These matters are summarized in this chapter.

## Other Procurement Regulations

As noted, the Department of Defense has established its own body of procurement regulations—the Armed Services Procurement Regulations. Each of the constituent armed services in the Department of Defense operates under its own procurement instructions. In addition, the National Aeronautics and Space Administration and the Atomic Energy Commission have elected to establish separate regulations.

While the following paragraphs discuss several areas using the Federal Procurement Regulations as a frame of reference, in the main, the procurement regulations of the several agencies differ in form, detailed procedures, and specific administrative limitations more than in content or substance.

The primary body of knowledge for contract procurement used by the nondefense or civil agencies is the Federal Procurement Regulations, which are issued in the Code of Federal Regulations as Chapter I of Title 41, Public Contracts. Succeeding chapters of Title 41 are devoted to implementing and supplementing material developed and issued by particular agencies to govern their procurement activities. In the development of the regulations, views are solicited from interested agencies and, where appropriate and feasible, from interested business and professional organizations. The regulations are coordinated with the Small Business Administration to assure adequate consideration of small business interests.

Changes to the Federal Procurement Regulations are published in the daily issue of the *Federal Register*, in cumulative form in the Code of Federal Regulations (Title 41), and in separate loose-leaf form. As new material is added to the regulations, agencies publish in the *Federal Register* any implementing regulations deemed necessary to clarify, for business concerns and for other interested parties, the basic and significant agency procurement policies and procedures.

## Federal Procurement Methods

As a matter of government policy, most purchases and contracts are made on a competitive basis, whether by formal advertising or by negotiation. Plans to issue contracts for property and services are announced by formal advertising whenever feasible and practicable, given the existing conditions and circumstances. If formal advertis-

ing is not feasible, purchases and contracts for property and services may be negotiated.

A federal agency is usually concerned with competition of two types: price competition and technical competition. In any procurement, the agency may consider both aspects individually or in combination, depending upon the service or supplies being purchased. Competition may be present under either a formally advertised or a negotiated procurement.

*Formal Advertising* Contracts that result from formal advertising are awarded directly to the most responsive and responsible party who submitted the lowest bid to a formal invitation for bid (IFB) issued earlier by a federal agency. The contract's conditions, delivery terms, scope of work, and price are identical to those cited in the successful bid.

A formally advertised procurement has four distinct steps: (1) The procurement is initiated by an agency issuing an invitation for bid containing specifications describing the government's minimal needs; (2) sealed bids are submitted by all qualified bidders; (3) sealed bids are opened in public at a prearranged time and place; and (4) the contract is awarded to the one whose bid meets all material requirements of the invitation for bid.

*Negotiated Procurements* A negotiated contract is awarded by a federal agency after a review of responses to its request for proposals (RFP) or after a review of an unsolicited proposal from a prospective contractor.

Under a negotiated procurement, the federal agency reviews and evaluates price, technical competence, and delivery capabilities before deciding on the most acceptable proposal. Even after a choice is made, negotiations may continue for the purpose of determining or modifying the price, delivery schedule, technical approach, method of contract performance, or type of contract.

## Types of Federal Contracts

The contracts available to a federal agency range from those that place a minimal risk on the agency to those that call for it to assume the maximum risk. The following is a list of many of the factors considered by an agency before deciding on the contract for a particular procurement.

- Type and complexity of item; the greater the complexity, the greater the tendency to use a cost-plus-fixed-fee contract
- Urgency of requirements
- Period of contract and length of production; production items usually indicate a fixed-price contract, possibly with escalation clauses for labor and materials
- Degree of competition
- Absence of reliable specification, little experience (tendency to use cost contract)
- Existence of comparative cost data or lack of market price or uncertainty of wage levels (tendency to use incentive contract)
- Prior experience with contractor (performance and cost history)
- Extent and nature of subcontracting contemplated
- Willingness of government or contractor to assume business risks; lack of willingness favors cost contract rather than fixed-price contract
- Technical capabilities and financial resources of contractor
- Cost to government and contractor of administering the contract
- Proprietary data or rights position of government and contractor
- Potential for follow-on contracts.

Exhibit 6-2, page 112, illustrates the relative risk of the various contracts.

### **Uses of Cost-Reimbursable Contracts**

A cost-reimbursable contract is generally used when an agency cannot establish a price that is reasonable to both parties. Such a contract would also be used when there is no valid basis for predicting results or performance, such as in technical studies or in research and development activities. Under cost-reimbursable contracts, the contractor is usually reimbursed for allowable costs and a fixed fee or incentive fee. The maximum risk for total cost and performance is absorbed by the agency.

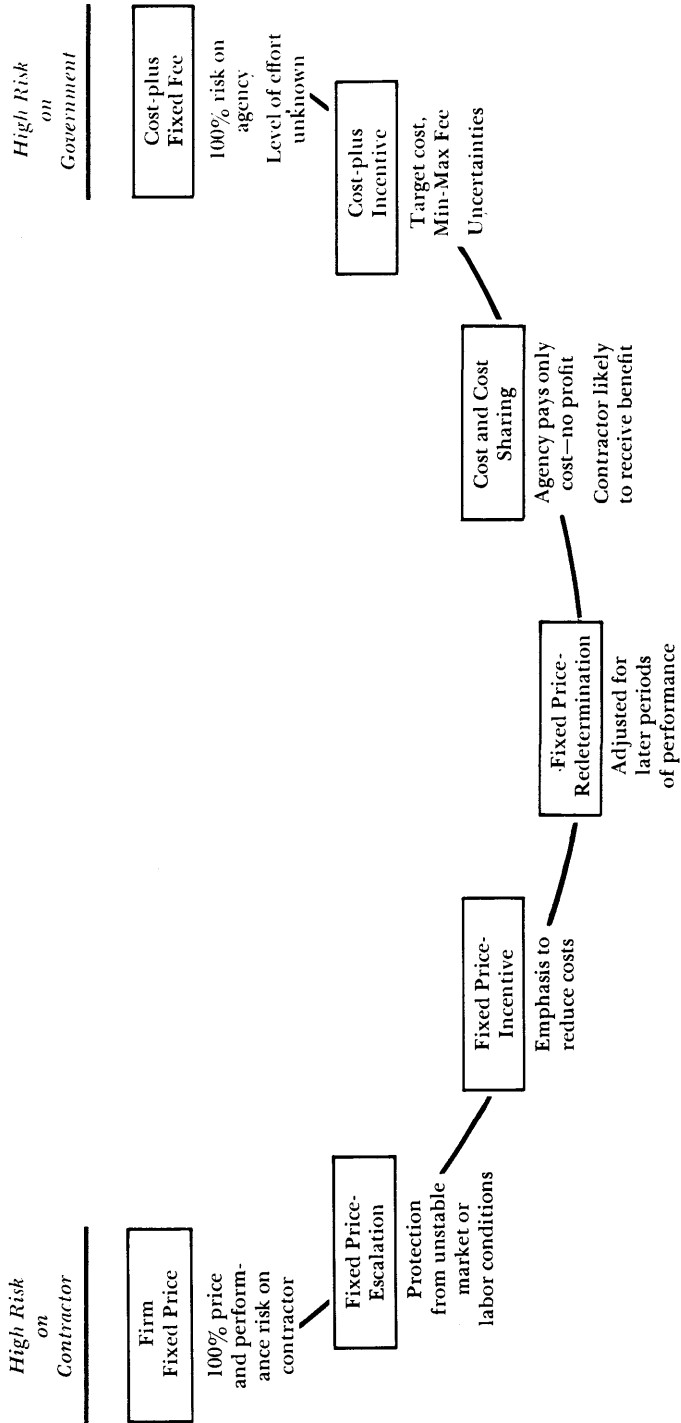
### **Types of Cost-Reimbursable Contracts**

Among the more common cost-reimbursable contracts are the following.

*Cost-plus-fixed-fee contracts* reimburse contractors for the total allowable costs incurred, plus the fee decided on when the contract was negotiated.

**Exhibit 6-2**

**RELATIVE RISKS ON GOVERNMENT AND CONTRACTORS  
BY TYPE OF CONTRACTS**



*Cost-plus-incentive-fee contracts* generally reward a contractor with a higher fee than the cost-plus-fixed-fee arrangement when the job is completed at a cost lower than the original target cost. Conversely, if the desired performance is not achieved, a lower actual fee may be realized by the contractor. Under this type of contract, the parties must agree to an estimated target and the minimum and maximum fee to be earned for performing within certain cost levels.

*Cost/no-fee and cost-sharing contracts* offer a contractor no fee or profit. Under the cost/no-fee arrangement the contractor is entitled to all the allowable costs incurred in accordance with the contract terms. Cost-sharing contracts require that the costs be divided in accordance with some predetermined formula. These contractual arrangements are for the most part restricted to educational institutions and nonprofit organizations, primarily because of the absence of a fee or profit element. Such an arrangement might, however, be negotiated with a profit-making organization that believed the commercial or other benefits were enough to justify the loss.

### **Uses of Fixed-Price Contracts**

In contrast, under a fixed-price contract the contractor must perform the work regardless of the resultant costs. Such a contract is used when the desired results or performance can be predicted and when a price can be set that is reasonable to both the agency and the prospective contractor. Costs in excess of the contract price must be borne by the contractor. However, if performance is delivered at less than the contract price, the contractor is entitled to the full amount.

### **Types of Fixed-Price Contracts**

As with cost-reimbursable contracts, a variety of fixed-price contracts are used by federal agencies. The more common types are the following.

A *firm-fixed-price contract* is an agreement to pay a contractor a specified price upon delivery and acceptance of a service or item. Unless the contract is changed, the contractor is required to perform regardless of the level of costs being incurred. The profit rate depends on the contractor's ability to control costs since the full contract price will be collected upon delivery. The lower the cost, the higher the profit.

A *fixed-price incentive contract* might be used when all conditions appear to indicate that a firm-fixed-price contract would be proper, but the parties cannot agree on a specific price. The incentive provision is designed to motivate the contractor to maximum perfor-

mance at the minimum cost. The contractor and the government share in any cost savings or underruns in accordance with a predetermined formula, which has the effect of increasing the contractor's realized profit. Conversely, in the event of a cost overrun the contractor's share will have the effect of reducing the realized contract profit.

A *fixed-price escalation contract* is favored when contract performance is extended over a long period and when recognition must be given to known contingencies, although the dollar effect of the contingencies is not known at the time of negotiation. The most common escalation clauses are related to materials and labor costs. A condition of an escalation contract is that the price increase or decrease be based on actual cost changes of the contingency factor or on a predetermined price index.

A *fixed-price redeterminable contract* places certain risks or contingencies on the agency in lieu of having the contractor assume the risks at a higher contract price. Such a contract provides an agency with the option to adjust price based on certain risks or contingencies identified in the contract. The redetermination aspect can be retroactive or prospective, as in the case of an extended contract period.

### **Other Contracts**

Agencies have found other types of contracts appropriate for specific needs. Either a time-and-materials contract or a labor-hour contract might be used when the level of effort or quality of labor or materials is known, but the duration or total cost to satisfy the agency's need is not known.

A *time-and-materials contract*, as the name implies, provides that the contractor be paid for the labor and the cost of materials used in the performance of the contract. The contract will contain a negotiated rate for each hour of labor, including the direct cost of labor, overhead, and profit.

A *labor-hour contract*, like a time-and-materials contract, is based on a fixed rate negotiated for each hour of labor. The rate includes a factor for the cost of labor, overhead, and profit to the contractor; the only variable is the number of hours to be expended by the contractor.

*Purchase orders* issued by the federal government generally have to do with supplies or services procured from commercial sources for a fixed price in amounts of \$10,000 or less. (Prior to fiscal 1975, the limit was \$2,500.) Each purchase order is executed by a federal agency and is made effective by the vendor's or supplier's written ac-

ceptance or performance. Simplified procedures have been established for such procurements when four conditions exist: (1) the transaction is not in excess of \$10,000, (2) the supplies or services are immediately available from the local trade area, (3) one delivery and one payment will be made, and (4) this form of procurement is more economical and efficient than other methods.

The General Accounting Office has consistently held that the purchase order amount cannot be construed to permit or authorize a succession of small purchases amounting in the aggregate to a sum larger than this limitation merely to avoid competition or advertising.

## Contract Cost Principles

The procurement regulations of the various agencies contain a section which prescribes the cost principles and procedures for the determination and allowance of costs in connection with the negotiation, award, and administration of federal contracts. Generally the cost principles appear in Section 15 of these agency regulations.

## Applicable Regulations

Section 1-15 of the Federal Procurement Regulations describes the cost principles and procedures for cost-reimbursement contracts, supply and research contracts with other than educational institutions, construction and architect-engineer contracts, facilities contracts, and fixed-price contracts, among others. This section contains the general cost principles and procedures for the determination and allowance of costs in connection with the negotiation award as well as for the administration of cost-reimbursement contracts, negotiated fixed-price contracts, and contracts terminated for the convenience of the government.

## Types of Contract Costs

According to the Federal Procurement Regulations, the total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits. In ascertaining what constitutes costs, any generally accepted method of determining or estimating costs that is equitable



under the circumstances may be used, including standard costs properly adjusted for applicable variances. This definition would be modified by any promulgations of the Cost Accounting Standards Board. In addition, the costs charged to the contract must be directly related or allocable to the contract and reasonable for both amount and nature. Following are important definitions related to the allowability of costs.

### **Criteria for Classifying Direct and Indirect Costs**

There is no universal rule or principle for classifying certain costs as either direct or indirect in accounting for costs under a federal contract. To one contractor or cost center a particular cost may be direct, but it may be indirect to another contractor or center. A federal agency must require that an individual contractor treat a cost consistently as direct or indirect, thereby achieving a uniformity of classification with respect to the same kinds of cost incurred by the same contractor in more than one accounting period or under more than one contract.

### **Direct Contract Costs**

A direct cost is any cost that can be identified specifically with a particular service, product, or cost objective. Direct costs are not limited to items incorporated in the end product as materials or labor. Costs identified specifically with a contract are direct costs of the contract and are to be charged directly to it. Costs identified specifically with other work of the contractor are direct costs of that work only and are not to be charged to other contracts, directly or indirectly. When items ordinarily chargeable as indirect costs are charged to government work as direct costs, the cost of like items applicable to other work of the same contractor must not be included with the indirect costs allocated to government work.

This definition of direct costs is applied to all significant cost items unless a contractor demonstrates that the application of any different current practice achieves substantially the same results. Direct cost items of minor amount may be distributed as indirect costs.

### **Indirect Contract Costs**

An indirect cost is a cost incurred for common or joint objectives. However, minor direct cost items may be considered to be indirect

costs for reasons of practicality. After direct costs have been determined and charged directly to the contract or other work as appropriate, indirect costs remain to be allocated to the several classes of work.

Indirect costs are accumulated by logical cost groupings, with due consideration for the reasons for incurring the costs. Each grouping should be determined so as to permit its distribution on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses, and general and administrative expenses are grouped separately. The number and composition of the groupings should be governed by practical considerations and should not unduly complicate the allocation where substantially the same results are achieved through less precise methods. The definition and allocation of indirect costs are of major concern to the Cost Accounting Standards Board, which has issued regulations that must be adhered to by federal agencies and their contractors.

*Distributing Indirect Costs* Each indirect cost grouping is distributed to the appropriate cost objectives. This necessitates the selection of a distribution base common to all cost objectives to which the grouping is to be allocated. The method should be in accord with applicable generally accepted accounting principles. The contractor's established practices are generally acceptable unless the Cost Accounting Standards Board has elected to prescribe an alternative method that must be complied with.

*The Base Period* The base accounting period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. Normally, the base period is the contractor's fiscal year; however, a shorter period may be appropriate for contracts whose performance involves only a minor portion of the fiscal year, or for industries that generally use a shorter period. When the contract is performed over an extended time, more than one base period is required to represent the period of contract performance.

## Allowability of Contract Costs

Costs incurred by a contractor, while necessary and proper for the ordinary conduct of business, must be examined for allowability under a government contract.

## Allowable Contract Costs

There are several factors that enter into the classification or definition of allowable or unallowable costs under a contract. For example, each of the following is a determinant in assessing the ultimate allowability of the costs charged to a government contract.

- The Federal Procurement Regulations state that factors such as reasonableness, allocability, and the application of generally accepted accounting principles must be considered.
- Section 15 of the various cost principles (the armed services or federal procurement regulations) identifies costs that are considered to be allowable and unallowable on a governmentwide basis, unless otherwise classified.
- The terms of the particular contract may identify certain costs as allowable or unallowable as a charge to the contract.
- General administrative or implementing regulations of an agency may restrict the definition of the costs that will be accepted as allowable under contracts awarded by that agency.
- Decisions by the various boards of contract appeals and the courts define the types of costs that are allowable as charges to a government contract.
- Cost Accounting Standards Board issuances are a governing factor in determining the allowability of individual cost items.
- Recommendations of governmental audit staffs affect the decision of contracting personnel with respect to the allowability of costs.

## Unallowable Contract Costs

The Federal Procurement Regulations identify some types of expenses that cannot be accepted as allowable costs, whether direct or indirect, under any federal contract. The following are the more commonly unallowable expenses, although a particular agency may classify additional expenses as unallowable under its particular contracts.

*Advertising Costs* The only advertising costs allowable under a federal contract are for (1) the recruitment of personnel required for the performance of obligations arising under the contract, when considered in conjunction with all other recruitment costs; (2) the procurement of scarce items for the performance of the contract; or

(3) the disposal of scrap or surplus materials acquired in the performance of the contract.

*Bad Debts* Bad debts are unallowable including actual or estimated losses from uncollectible customers' accounts and other claims, related collection costs, and related legal costs arising from other business of the contractor.

*Contingencies* Provisions for contingencies are unallowable as a claimed cost because cost contracts normally provide for the reimbursement of actual cost, whereas a contingent cost may not have arisen by the time of the claim or may never arise. In some instances such cost would be acceptable as a part of a contractor's indirect or normal overhead costs, such as a warranty expense. A contractor's history may conclusively demonstrate that a cost for warranty work on a product will arise in the future, and an allowable provision can be made during the current accounting period.

*Contributions and Donations* Contributions and donations are unallowable.

*Entertainment Costs* Costs of amusement, diversion, and social activities, as well as incidental costs relating thereto such as meals, lodging, rentals, transportation, and gratuities, are unallowable.

*Fines and Penalties* Cost of fines and penalties resulting from violations of or failure to comply with federal, state, and local laws and regulations are unallowable except when incurred as a result of compliance with specific contract provisions or written instructions from the agency's contracting officer.

*Dividends* Dividend provisions or payments and, in the case of sole proprietors and partners, distributions of profit are unallowable.

*Interest and Other Financial Costs* Interest on borrowings (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of prospectuses, costs of preparation and issuance of stock rights, and costs related thereto are unallowable.

*Losses on Other Contracts* An excess of costs over income under any other contract, including the contractor's contributed portion under cost-sharing contracts, is unallowable.

*Organization Costs* Expenditures such as incorporation fees, attorneys' fees, accountants' fees, brokers' fees, or fees to promoters and organizers in connection with (1) organization or reorganization of a business or (2) raising capital are unallowable.

*Professional Service Costs* Costs of legal, accounting, and consulting services and related costs incurred in connection with organization and reorganization, defense of antitrust suits, and the prosecution of claims against the government are unallowable. Costs of legal, accounting, and consulting services and related costs incurred in connection with patent infringement litigation are unallowable unless otherwise provided for in the contract.

*Taxes* Taxes are allowable, except for federal income and excess profits taxes; taxes in connection with financing, refinancing, or refunding operations; and taxes from which exemptions are available to the contractor directly or based on an exemption afforded the government, except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the government. Also unallowable are special assessments on land which represent capital improvements, and taxes on any category of property that is used solely on work other than government contracts.

## Reasonableness of Contract Costs

A cost is reasonable if, in nature or amount, it does not exceed what an ordinarily prudent person would incur in the conduct of a competitive business. Specific costs must be scrutinized for reasonableness with particular care in dealing with firms or their divisions that are not subject to competitive restraints. What is reasonable depends on a variety of factors having to do with the nature and amount of the cost. In determining the reasonableness of a cost, these questions must be considered.

- Is the cost of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract?
- What restraints or requirements are imposed by such factors as generally accepted sound business practices, arm's length bargaining, federal and state laws and regulations, and contract terms and specifications?

- What action would a prudent businessman take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the government, and the public at large?
- Are there any significant deviations from the contractor's established practices which may unjustifiably increase the contract costs?

## Allocability of Contract Costs

A cost is allocable if it can be assigned or charged to a particular cost objective, such as a contract, product, product line, process, or class of customer or activity, in accordance with the relative benefits received or some other equitable relationship. Subject to the foregoing, a cost is allocable to a government contract if it is incurred specifically for the contract; it benefits both the contract and other work, or both government work and other work, and can be distributed to them in reasonable proportion to the benefits received; or it is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

## Methods of Financing Federal Contracts

The term *contract financing*, when it refers to federal contracts, includes a variety of payment methods that could be used by an agency under its contracts. The following forms of financing are in the order of preference observed by all federal agencies: (1) private financing by the contractor on reasonable terms, with no governmental guarantee; (2) progress payments by the government; (3) partial payments by the government; (4) guaranteed loans; and (5) advance payments.

### Private Financing

The method of contract financing most preferred by federal agencies is the one whereby the contractor elects to provide financial support for the performance under the government contract, utilizing the contractor's own or privately obtained resources. The agencies prefer not to provide any guarantee if the contractor can obtain private financing at reasonable interest rates. It should be recognized how-

ever, that the interest is an unallowable cost. It is a well-established condition of contracting that the government does business with responsive contractors who are also financially responsible.

### **Progress Payments**

According to the Federal Procurement Regulations, progress payments are payments made by an agency as work proceeds under a contract, on the basis of costs incurred, percentage of completion, or stage of completion. As used in federal contracts, this term does not include payments for partial deliveries accepted by an agency under a contract or partial payments on contract termination claims.

### **Partial Payments**

In federal parlance, partial payments are payments made under a contract, on submission of proper invoices or vouchers, for supplies delivered and accepted or services rendered and accepted, where such supplies or services are only a part of the total contract requirement.

### **Guaranteed Loans**

Guaranteed loans are essentially the same as other loans made by financing institutions without guarantee, except that the guaranteeing agency is obligated on demand of the lender to purchase a stated percentage of the loan and to share losses in the amount of the guaranteed percentage. Guaranteed loans afford an especially convenient medium for financing borrowers who hold subcontracts or a number of prime contracts with one agency or prime contracts with several agencies. Funds are disbursed and collected by the lending institution, and its personnel administer the loan. Government funds are not involved except for purchasing the guaranteed portions of loans or settling losses.

### **Advance Payments**

*Purpose* Advance payments are money advances made by a federal agency to a contractor prior to and in anticipation of complete performance under a contract. Advance payments are made only to prime contractors. It is expected that the advance will be liquidated from payments due the contractor incident to performance of contracts. Since advances are not measured by performance, they differ

from partial, progress, or other payments that are based on performance. Advance payments may be made so that prime contractors can in turn make advances to subcontractors.

The letter of credit is one form of advance payment that is available to contractors; another is a Treasury check. When required by the contractor, and in accordance with the pertinent section of the applicable procurement regulations, advance payments may be authorized in addition to any progress or partial payments permitted under the same contract.

*Prerequisite for Advance Payments* Advance payments are used sparingly, and care is taken to insure that they are sufficient for, but do not exceed, the actual reasonable requirements of the contract. The amount of an advance payment is generally based on an analysis of the cash flow required under the contract, and as a rule it will not exceed the interim cash needs arising during the reimbursement cycle.

Except for (1) nonprofit contracts with nonprofit educational or research institutions for experimental research and development work and (2) contracts solely for the management and operation of government-owned, contractor-operated facilities, advance payments are not authorized unless no other source of adequate or acceptable financing is available to the contractor. Loans or credit at excessive interest rates or other exorbitant charges, or funds from other agencies of government are not acceptable.

## Administrative Requirements for Contracts

Each federal agency is responsible for establishing and maintaining adequate systems of accounting and internal controls over its contracts and the funds expended thereunder. Accounting for contracts includes all aspects of the cycle, from the award of the contract to the final payment and audit by the agency.

The following paragraphs outline the various controls and decision points in a federal agency, each of which must be consulted and each of which can delay the award of a contract or dictate the circumstances under which the contract will be issued.

Each agency establishes procedures to describe the method by which its needs can be met through contracting. The procedures itemize minimum documentation and identify members of management who must assent to the contract. The orderly flow of funds requires close monitoring of contractors. Contractor invoices must



be submitted for prepayment audit or review; the contractor must make a full accounting to the agency; and later, the agency must make a full accounting to the Treasury, Office of Management and Budget, and Congress. The controls also provide for the preservation and retention of records to meet government audit requirements.

As illustrated in Exhibit 6-1, efficient and prudent procurement, monitoring, and accounting for contracts requires the cooperation and coordination of several functional organizations within a federal agency. Generally, every action of the agency is reflected in its accounting records. For example, a separate entry is made for the intent to commit funds for a contract, the execution of the agreement and the award of the contract, the recording of all expense claims or invoices submitted by the contractor for payment, the establishment of an account receivable for any advance funding provided to the contractor, and the disbursement of funds to the contractor throughout the period of the contract.

The nature of the agency's accounting is outlined in the following paragraphs.

### **Precommitment of Funds**

Many agencies, particularly those with extensive contracting programs, use a precommitment or commitment document which requires certification by a designated official as to the availability of funds. This control has the effect of reserving funds before the contract negotiations commence. However, it is the executed contract document itself that establishes the legally binding obligation of funds and, assuming timely performance or delivery, the authority to disburse funds.

An agency program office that wants to have a contract or purchase order issued will make known its desires on a form called a procurement request. The execution of this form is the first step. The second is to have this document, or a similar form, signed by an agency allottee or his designee, thus representing a certification to the contracting officer that funds are available for the desired procurement. At the same time, the proper execution of the procurement request is viewed by the finance personnel as a precommitment of that organization's allotted funds. If the contract office cannot procure the desired property or services within the limits of the procurement request, an amendment increasing the amount must be obtained before any contract is executed.

Whether the program office or finance office maintains the register of commitments varies from one agency to another. Whatever the case, the amounts on this record will be reconciled periodically with

the amounts ultimately obligated in the agency's accounting records for each contract, since the award might differ from the earlier commitment. No formal entry is usually made to the agency's official records to reflect this reservation of funds.

### **Execution of the Contract**

The execution of the contract document, evidencing the binding legal relationship obligating the contractor to furnish property or services and the government to pay, marks the commencement of the accounting cycle for each procurement.

The contract document contains the dollar amount and purposes for which the contract was issued, the period of performance, the obligations of both parties, and other special and general conditions.

The first formal entry relating to the contract is generally made to the agency's accounting records at the time of the award, when the agency restricts a fund balance in an amount equal to the amount of the contract. This accounting action has two objectives: (1) it reduces the unobligated appropriated funds of the agency, and (2) it restricts these previously unobligated funds to meet the claims contemplated under the awarded contract.

In most instances the total on the face of the document is the basis for the accounting entry to record an obligation of the agency's appropriated funds. Generally, the obligated amount is then equal to the funds that must be committed from the current year's appropriation. If the contract is for a period in excess of a year, and the contract figure is significant, an amount less than the contract total could be obligated on the agency's records. In such instances the contract is said to be incrementally funded.

An incrementally funded contract usually states that the terms are firm, conditional only upon the continued or future availability of funds from Congress. The liability of the agency, in the event that the money runs out, is limited to the amount already obligated.

### **Recording Contractor Performance**

*Accruing the Expenditures* Under the recent definition of accrued expenditures, a federal agency must record expenditures as accrued—that is, as goods are received or performance is rendered. Entries must be made to record the accruing of an expenditure by a contractor (1) for the goods received or performance rendered by establishing an asset or charging an expense account and (2) to reduce or liquidate the applicable amount of any earlier obligation of funds relating to the contract.

*Basis for Accrual Amounts* The amounts of the accrued expenditures could be determined or supported by one of the following methods.

- Unpaid invoices from vendors covering shipments received should be used for accrual estimates when available.
- Receiving reports showing quantities received and whether a given shipment is complete or partial are useful in determining the amount of the accrual when the invoice has not been received.
- Where an obligation is recorded covering the expenditure that accrued within an accounting period, the obligation figure may be the best estimate of the expenditure incurred.
- In the case of fixed-price contracts that extend beyond one month and cover goods manufactured to the government's specifications, a statement from the contractor at the end of each month estimating the percentage of completion, including work performed by subcontractors, could be used to estimate the accrued expenditure.
- For cost contracts, monthly reports from the contractors showing the unbilled portion of performance to month end, including work performed by subcontractors, could be used to accrue the expenditure.
- If reports from contractors are not available or are not feasible, estimates could be obtained from project managers or other operating officials who are familiar with progress under the contract or grant.
- Independent of or in combination with the foregoing ways, sampling and other statistical methods that are susceptible to verification could be used, especially where amounts are relatively small and the number of transactions is large.

### **Recording the Contractor's Claim**

Claims for payment, in the form of invoices or on public vouchers, are submitted by the contractor in accordance with the terms of the contract. These documents form the support for recording on the agency records the current liability due the contractor or the immediate disbursement of cash to settle the claims. If the liability had been estimated on the basis of accrued performance, the agency would adjust the accrual to reflect the amount actually owed.

If a contractor is in possession of an advance, any claim must be reduced by the amount of the advance, in accordance with the contract.

Claims for payments must be rendered by the contractor in accordance with the terms of the specific contract but need not be made in the standard form commonly used throughout the government. A federal agency may approve for payment any invoice or billing from the contractor. Such invoices or bills may be used as basic vouchers and claims for payment. The governmentwide standard form on which claims are usually submitted bears the title of Public Voucher for Purchases and Services Other Than Personal (Standard Form 1034).

At the time of contract award, contractors are usually instructed as to the acceptable format for submitting claims. If the standard form is to be used, the contractor is issued a supply or instructed on the procedure for obtaining one. The frequency of billings is a specific condition of each contract. Additionally, many agencies require that supporting details accompany the contractor's invoice and be shown on a continuation sheet to a billing.

### **Payments to the Contractor**

*By Treasury Check* The actual disbursement of funds to a contractor for claimed expenses is supported by a schedule, prepared by the agency's finance office and submitted to the Treasury Department, for the issuance of checks to the payees listed on the schedule. The entry on this schedule is in turn supported by the contractor's invoice, claim, public voucher, or request for advance.

The entry records the disbursement of cash; any amounts still due to the contractor are adjusted to the extent of any outstanding advances.

*By Letter of Credit* Where a contractor obtains funds by withdrawals under a letter of credit, an entry is made to record (1) each drawdown as a disbursement of agency cash and (2) the opening of an account receivable due from the contractor. The entry amount is supported by the amount of the withdrawals appearing on the copies of the vouchers evidencing payments made by the Treasury Department under the letter of credit.

This receivable is reduced and the asset or expenses recorded once the contractor submits a claim, invoice, or public voucher evidencing an application or use of the funds advanced by the withdrawals made under the letter of credit.

### **Advance Funding for Contractors**

A choice of methods is available to a federal agency for providing advance funding to its contractors. While this is not the preferred

method of financing the procurement of property or services under a government contract, circumstances and equity do often warrant a financial advance. The selection of an advance is based on factors such as the dollar significance, the time period over which the contract will be performed, the significance of the contractor's investment, the financial resources and independence of the contractor, and whether the organization receiving the contract is profit-oriented or nonprofit.

When an agency has determined that a contractor warrants an advance of funds, provision of the initial advance, subsequent monitoring, and liquidation at the conclusion of the contract in accordance with the contract conditions are generally the responsibility of the agency's finance office.

The two general types are letter of credit and direct advance. The *letter of credit* is an advance funding method utilizing the Treasury Department's facilities and having the objective of minimizing the funds advanced to contractors at any one time. When the *direct advance* method is used, funds are provided to the contractor in the form of a check, and subsequent payments of billings to the contractor are considered to be replenishments of the advance.

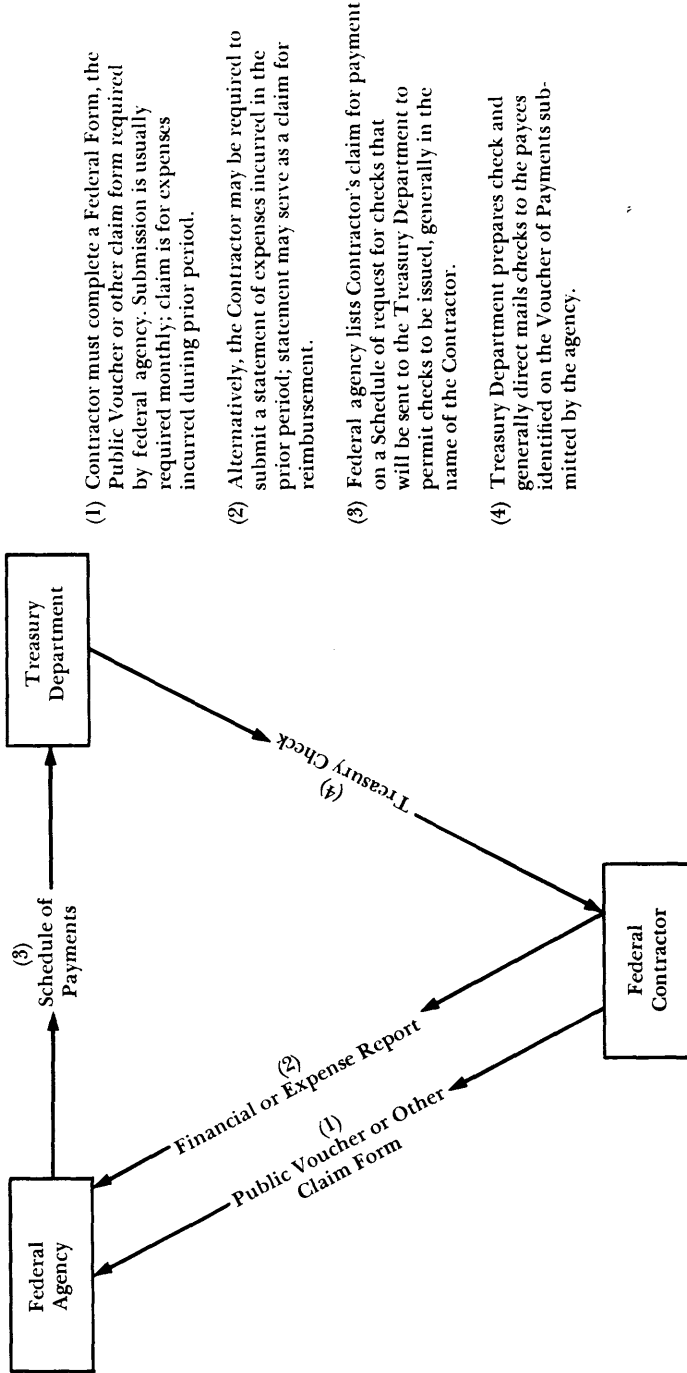
When an advance is to be provided by check, the agency generally requires the contractor to prepare and submit a claim or a public voucher. This form is prominently marked as an advance of funds. The transaction is entered on the agency's records as an account receivable from the contractor and a reduction in the agency's cash balance. The agency must then record the amount of the requested advance on a voucher and schedule of payments form. This form is submitted to the Treasury Department, which issues a check to the contractor. Exhibit 6-3, opposite, illustrates the process by which a check is issued.

Advance payments to a contractor are conditioned on certain prerequisites in the contract that must be adhered to prior to the advance and throughout the period of the contract. The following conditions are part of the Federal Procurement Regulations for protecting the funds in the possession of contractors whose services have yet to be received.

- A special bank account must be established, and wherever possible, it should be with a member bank of the Federal Reserve System or an insured bank within the meaning of the act creating the Federal Deposit Insurance Corporation.
- All payments, including advance payments under the contract, can be made by check payable to the contractor and marked for

**Exhibit 6-3**

**ILLUSTRATIONS OF CHECK ISSUANCE PROCESS**



deposit in a special account of the bank designated in the agreement.

- Funds in the special bank account may be withdrawn by a contractor solely to pay for direct materials, direct labor, and administrative and overhead expenses required for the purposes of the contract.
- When requested in writing by the agency, the contractor must repay the unliquidated balance of all advances which in the opinion of the agency are in excess of current requirements.
- Every advance must be liquidated by the contractor in strict accord with the terms of the contract.
- The contractor may be required to pay interest to the agency on the daily unliquidated balance of advance payments made under the contract.

### **Withdrawals by Letter of Credit**

After the agency establishes the letter of credit and the contractor executes the required signature card, all the contractor has to do in order to receive contract funds is to present payment vouchers to the designated treasury disbursing office.

### **Advances by Letter of Credit**

The Treasury Department's Circular 1075 has directed all federal agencies administering contract programs to make payment by letters of credit to the maximum extent possible. This is a technique for conserving funds and interest that has the objective of minimizing the federal monies in the hands of contractors, thus reducing the interest payment period and the cost of money to the government.

The following paragraphs describe the documents required to initiate, operate, and control funding by letters of credit.

- The letter of credit form, properly executed by the agency, establishes a line of credit with the Treasury Department of a specific amount that is available for withdrawal by the contractor.
- The authorized signature card contains the signatures of individuals in the contractor's organization authorized to sign payment vouchers that are presented to the Treasury Department's disbursing office.
- The payment vouchers on the letter of credit, sequentially numbered, are presented to the Treasury Department's disbursing office during the period of the letter of credit. The amount re-

quested cannot exceed the current disbursement needs of the contractor or the amount authorized by the agency for withdrawal in a particular calendar period.

### **Payment of Federal Contractors**

The payment procedures described in this section are used by an agency that avails itself of the disbursing facilities of the Treasury Department in addition to permitting the withdrawal of funds under a letter of credit.

*Payments by Treasury Department* The voucher and schedule of payments is prepared by a federal agency's finance office to summarize contractors' claims for funds and request payment by the Treasury Department. The individual entries are supported by documents such as the basic contract authorization for advances of funds, invoices, or contractor claims.

The individual entries constitute requests to the Treasury Department for the issue of checks to the organizations in the amounts designated. Once certified by the agency's certifying officer, the voucher and schedule of payments is transmitted to the Treasury Department's disbursing office. After payment, the disbursing office records the payment data and returns the voucher and schedule of payments to the agency.

*Payment by Letter of Credit Withdrawals* Once the letter of credit is established, the contractor merely presents payment vouchers to the designated disbursing office. When the agency receives its copy of the payment voucher from the contractor, it records the receivable due from the contractor as a result of the advance of funds under the letter of credit. The Treasury Department daily notifies the agency of the payment vouchers it has honored. The agency in turn insures that the payment voucher data received from these two sources are in agreement.

### **Prepayment Audit or Review**

The nature of the audits made of a federal contract is discussed in the final chapter of this book. However, in addition to these audits, it is the practice of many agencies to make a prepayment audit or review of a contractor's claim for reimbursement or of the expenditure reports submitted in support of an earlier advance or letter of credit withdrawal.



A federal agency must insure that personnel are charged with making a prepayment audit or review of the contract document, invoices, or vouchers before funds are advanced or reimbursed to contractors. This function is performed by finance personnel because it is critical to the certification made by the agency's finance officer that the imminent release of funds be proper.

### **Objectives of Prepayment Audits**

The principal objective of a prepayment review of impending disbursements to contractors is to insure that all disbursements, whether in the form of advances or reimbursements, are legal, proper, and correct. Further, all disbursements must be fully documented, properly approved, and accurately reported and recorded.

Each agency's system of internal control over, and related procedures for, disbursements must be based on the operating needs of that particular agency and must conform with the related principles and standards for internal management control prescribed by the General Accounting Office as well as with the regulations of the Treasury Department.

### **Nature of Prepayment Audit**

The agency's prepayment audit or review is designed to insure that each request for the release of federal funds is critically examined before a disbursement is made. As a minimum, the audit is directed to a determination of the following:

- Whether the required administrative authorizations for the procurement and approvals for the payment were obtained.
- Whether the payment is permitted by law and is in accordance with the terms of the contract agreement.
- Whether the amount of the payment and the name of the payee are correct.
- Whether the payment duplicates an earlier claim or payment made under a letter of credit withdrawal.
- Whether the goods received or the services performed were in accordance with the contract.
- Whether the quantities, prices, and amounts are accurate.
- Whether all cash, trade, quantity, or other discounts have been taken and, if not, whether the reason was shown on the appropriate document.

- Whether all applicable deductions were made and credited to the proper account in the correct amount.
- Whether the appropriation or fund from which the payment is to be made is available for that purpose.
- Whether proper forms or documents were used.
- Whether special certificates were furnished, if required.
- Whether the claim for payment should more properly be a reduction of funds previously advanced.
- Whether any agency audit reports have questioned the propriety of claims by the contractor for which payment should be withheld pending final resolution.

### **Prevention of Duplicate Payments**

Agencies have also established procedures to prevent duplicate payments. Vouchers, voucher schedules, invoices, and other supporting documents must be marked to prevent repetitive processing for payment. Each agency is particularly alert to the possibility of duplicating payments whenever one or more of the following situations exist.

- Contract payments have been delayed for extended periods after the due date and duplicate copies of invoices are received from vendors as follow-up claims.
- Invoices or bills may have been submitted to more than one agency location for payment.
- Adjusted invoices are received from contractors after payments have been made, particularly if advances are involved, either direct or through a letter of credit.



# 7 Federal Grants

For the past several years federal grant-in-aid programs have been a primary activity of concern to the public accounting profession. Public accounting firms have been retained by the government and by grantees to provide preaward surveys, systems reviews, compliance audits, financial statement audits, and grant closeout examinations.

Annually, billions of dollars are expended by federal agencies under grant-in-aid programs—more than 1000 grant programs are administered by some 50 federal departments, agencies, commissions, and councils.

Historically, grants were viewed almost as gifts to the recipient organizations. Commonly, the period of performance was open; only minimal accounting was required for expenditures under the grant; and little monitoring was done by the granting agency to ascertain the quality of performance or the achievement of milestones or objectives. Today, the services and purposes for which grants are issued make it difficult to distinguish between a contract and a grant. Both grants and contracts are now viewed as legally binding instruments between the federal agency and the recipients. Probably the only clear difference is that a contractor performing in accordance with the terms of a contract generally is entitled to a fee or profit, whereas grants generally do not provide remuneration to the grantee in excess of the costs incurred.

The Office of Management and Budget 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. Excluded from this definition are technical assistance programs, revenue sharing, loans, loan guarantees, and insurance.

Grants are payments made in cash or in kind to provide assistance for specified purposes, ranging from studies and research to operat-

ing and construction programs. Grants can be awarded to private enterprise for exploration, research, or development.

There are several classifications of grants; among the more common are the following.

*Formula grants* are issued in an amount specified in a law passed by Congress. There is little or no discretion to be exercised by the grantor agency.

*Project grants* closely resemble contracts in the objectives of the awards because each grantor agency agrees to pay or provide funds for a particular service. In many instances, there is competition among applicants for the award of the grant. The services might consist of research, demonstration, or pilot programs; planning or action programs; and training.

*Construction grants* are awarded specifically for the construction of buildings and other permanent facilities, such 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 the federal grantor. These grants generally are made to states, with minimum restrictions on the use of funds.

## Responsible Federal Organizations

The authorization, award, administration, and closeout of a federal grant require the coordinated action of several functional organizations within an agency as well as the guidance and assistance of other agencies such as the Office of Management and Budget, the Treasury, the General Accounting Office, and the General Services Administration.

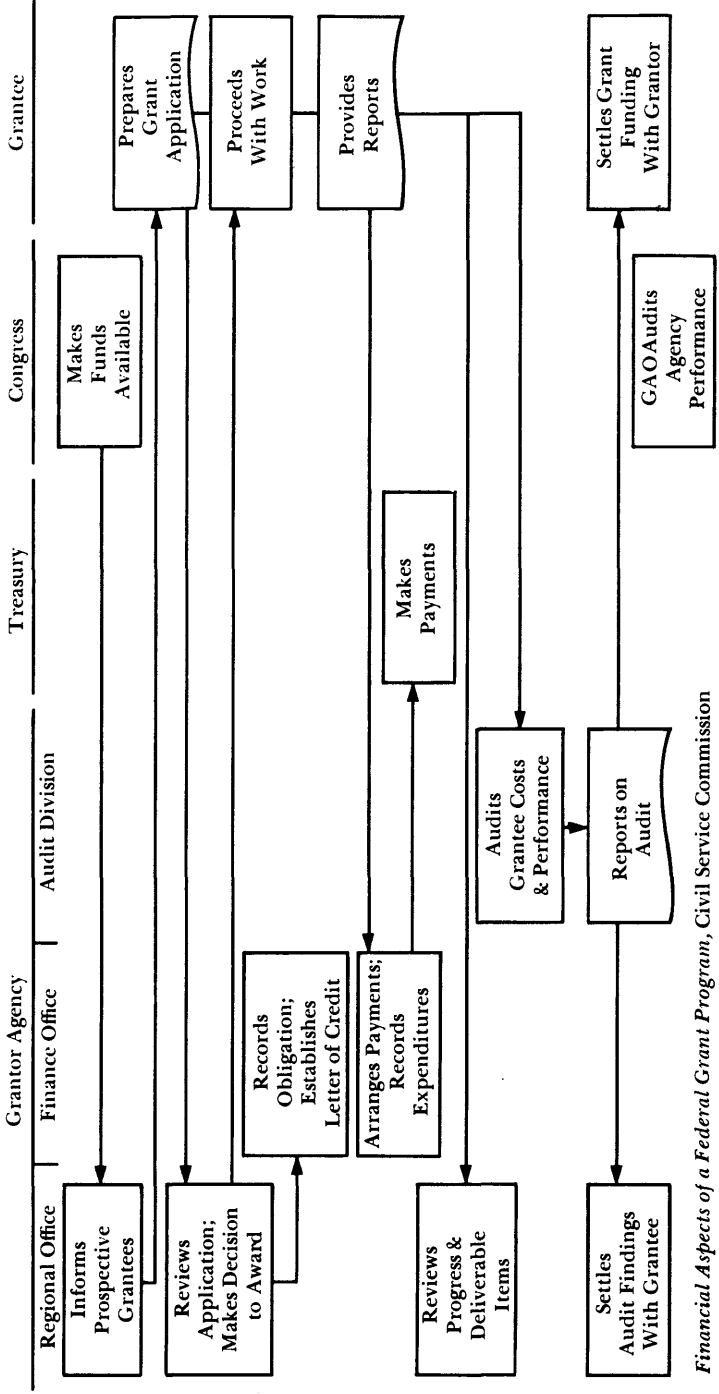
A familiarity with these interrelationships is important for a public accountant involved with federal grant programs. Exhibit 7-1, opposite, is an overview of the typical grant cycle, showing the interrelationships and functions of many organizations and agencies.

### Responsibilities of Grantor Agencies

*Accountability for Grants* The grantor department or agency is responsible for assuring that the purpose or objective of the grant is achieved; grant funds are applied solely in accordance with the conditions of the grants; and 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

Exhibit 7-1

OVERVIEW OF THE GRANT PROCESS



Financial Aspects of a Federal Grant Program, Civil Service Commission

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 grantees under the terms of the grants 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 determination to award, to monitor, and to terminate a grant when required may be the prerogatives of the agency's operating regional or program offices.

Reviews are conducted by the agency's investigating office as well as its auditors 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. This responsibility includes insuring that the grantees have adequate funding if advances are provided and that the funding is the minimum needed for effective and efficient grant operation.

### **Role of Central Agencies**

*General Accounting Office* Like all other agency programs and activities, operations conducted under grants are subject to examination and review by the General Accounting Office.

In addition to the considerable effort expended in the audit of grant recipients' operations, the General Accounting Office is concerned with the federal agency's grant accounting and reporting procedures. In carrying out its responsibility to Congress under the Budget and Accounting Act of 1950, the General Accounting Office not only conducts procedural reviews and examinations of practices, but is also responsible for determining whether an agency's accounting and internal control systems are adequate for its grant programs.

*Office of Management and Budget* The Office of Management and Budget has established uniform principles for determining the costs allowable under federal grant-in-aid programs, and it has also devoted considerable effort to streamlining and making uniform the administrative procedures for these programs.

*Treasury Department* As the disbursing office of the federal government, the Treasury Department plays a vital role in agency grant

programs. It prescribes the procedure and method to be utilized by federal agencies in providing funds to grantees in the form of checks or under the letter of credit funding procedure.

*General Services Administration* In May 1973 the General Services Administration took over 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 extends to federal grants-in-aid.<sup>1</sup>

The series of OMB circulars spelling out governmentwide regulations were reissued in 1973 and 1974 under the GSA imprint, with a different numbering sequence but essentially the same contents as the OMB circulars. Both references may be used by government personnel; the comparable circulars are itemized in the following list.

<u>General Content of Circulars</u>	<u>OMB Circular</u>	<u>GSA Financial Management Circular</u>
Cost principles for 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
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
Uniform administrative requirements for grants to state and local governments	OMB A-102	FMC 74-7

Until government agencies and grantee organizations become familiar with the more recent FMC series, the OMB circular numbers will continue to be widely used; both will be cited in these pages.

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<sup>1</sup> In January 1976 some of these functions reverted back to the OMB.



## Administrative Requirements for Grant Programs

Agency internal records and procedures for accounting for grants are rather uniform. The reports required of federal grantees help furnish the supporting or authorizing documentation for the accounting entries made in the agency's own records. The term *accounting for grants* has been interpreted by the General Accounting Office as including all aspects of grant transactions from the approval of a grant to the final closeout action by the grantee and the agency.

### Systems of Accounting and Controls

Each agency is expected to establish and maintain 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 and final settlements are made. The agency's system must also provide adequate funding for all grantees. There must be a full accounting for all funds, and supporting documentation must be preserved to meet 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 unexpended 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, state and local government grantees have been reporting the status of grant funds in a standard, government-wide 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 30 days after the specified reporting period, and final reports are required within 90 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 to support the program on an annual basis. In such cases, the grant docu-

ment 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 grantee 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 Funding 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 funding 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 Funding by Check* Some agencies have a procedure whereby grants awarded for minor amounts (for example, less than \$25,000) or for short periods (in some cases three months or less) are funded in total by check when the grant agreement is executed by both parties.

In other instances, the grantees are provided with an advance, the remaining funds being disbursed in accordance with some predetermined plan.

The following chart illustrates one method of advance funding by Treasury check.

<u>Period of grant action</u>	<u>Initial payment</u>	<u>Second payment (at end of 3 months after grant action)</u>	<u>Third payment (at end of 6 months after grant action)</u>	<u>Fourth payment (at end of 9 months after grant action)</u>
Over 9 and up to 12 months	40%	20%	20%	20%
Over 6 and up to 9 months	40%	40%	20%	
Over 3 and up to 6 months	60%	40%		
Up to 3 months	100%			

Whether a total or partial advance has been made, the program offices must prepare a form which advises an agency's finance personnel of those grantees entitled to an advance. The amount as well as a record of the payments received by a particular grantee is also provided.

Where a grantee has received an advance of funds 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 non-government grantees. Additionally, when the request for advance provides adequate information for the grantor's purposes, the requirement to submit a financial status report may be waived.

*Advance Funding by Letter of Credit* Like advance funding of contracts, advance funding of grants must be by letter of credit where possible so as to conserve funds and minimize the amount of federal money in the possession of grantees. The criteria and procedures for using letters 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. As in the

case of contract awards, letter of credit funding requires that the grantor or the grantee complete and submit the following forms at designated times during the life of the grant (see chapter 6): authorized signature cards, letter of credit, payment voucher on letter of credit, and report of federal cash transactions.

State and local governments that receive grants are permitted to use letter of credit funding when the following conditions are met.

- A continuing relationship exists between the grantee and the federal grantor agency for at least 12 months and the advances to be received in this period total \$250,000 or more, as prescribed by Treasury Circular 1075.
- The grantee has established procedures to minimize the elapsed time between the transfer of funds from the federal government and the disbursement by the grantee.
- The grantee has met the financial management system standards for fund control and accountability set forth in OMB Circular A-102 (FMC 74-7).

Advances to grantees are by check when the annual funding need is less than \$250,000 and the other two requirements are met. Where a letter of credit is not used, federal grantor agencies are required to adopt the standard form as the authorizing document for obtaining the advance.

*Reimbursement Basis of Funding* Many agencies still adhere to a cost-reimbursement basis of funding grantees under which the 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 reimbursement basis of funding is similar to the advance funding 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 a direct advance, the reimbursement replenishes the original advance. If no advance has been received, the reimbursement replenishes the funds spent by the grantee.

## Agency Accounting for Grants

A federal agency must take many specific actions and obtain many approvals before and during the grant period. The timeliness 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 its accounting records. For example, a separate accounting entry is made for the intent to commit funds for a grant; the execution of the grant agreement and final award of the grant; the establishment of an account receivable for any advance funding provided to the grantee; the recording of all expense claims under the grant agreement; and the disbursement of funds to the grantee throughout the grant period.

The nature of the accounting made by a federal grantor is outlined in the following paragraphs. Exhibit 7-1 provides an overview of the grant process for which an agency must provide an accounting.

### **Commitment of Funds**

In many agencies, 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 ultimate grant award could differ from the earlier commitment.

### **Execution of the Grant**

The first formal 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 fund balance equal to the amount of the grant. 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 of 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 any agency deems it to be in the interest of the government to provide an advance of funds at the time of grant award, this would be recorded by reducing the agency's cash balances and establishing an account receivable when the advance is issued. The receivable would be reduced by offsetting the amounts reported or claimed later 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 the Public Voucher for Purchases and Services Other Than Personal, prepared by the grantee, or the grant agreement—showing the agency has approved an advance and presented a check at the time of grant award. The procedure varies slightly for a letter of credit.

The receivable is recorded and supported by the agency 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 funding, the agency generally requires that the grantee prepare and submit the public voucher (Standard Form 1034), which is the claim for payment used by all agencies. This form is prominently labeled an advance of funds and is entered on the agency'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 agency, which releases it to the grantee when all documents and agreements have been completed. This has the advantage of immediately providing the funds 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 either case 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 agency. These documents support the entries necessary to (1) record the agency'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 funds, 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 6. The nature of 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 of funds to a grantee for expenses is supported by the schedule and voucher of payments prepared by the agency'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, 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 is supported by 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.



## Grant Cost Principles

The grant cost principles, set forth in the OMB series of circulars (OMB A-21, A-87, and A-100), are the basis for determining the costs to be allowed under grants to nonprofit, educational, or governmental recipients.

Federal grantors have issued individual implementing regulations which have the effect of further restricting the costs that are allowable under a particular program. The general principles are similar for the various federal grantors.

### **OMB Circular A-21 (Now FMC 73-8)**

Office of Management and Budget's Circular A-21, originally issued in 1958 and revised over the years, provides the principles for determining the costs applicable to research and development work performed by educational institutions under federal grants and contracts. These principles are confined to cost determination and make no attempt to identify the circumstances or dictate the extent of agency and institutional participation in the financing of a particular research or development project. The principles are designed to recognize the full allocation costs of such research under generally accepted accounting principles. A later attachment extended the scope of this circular to the determination of costs by educational institutions under grants for training and educational services.

### **OMB Circular A-87 (Now FMC 74-4)**

Another OMB Circular, A-87, sets forth the principles for determining costs applicable to federal grants to state and local governments. These principles are designed to provide that federally assisted programs bear a fair share of indirect costs of other governments recognized under these principles except where the charging of such costs is restricted or prohibited by law. Additionally, this circular defines the types of allowable and unallowable costs for federal grants-in-aid to state and local governments.

### **OMB Circular A-100 (Now FMC 73-3)**

OMB Circular A-100 also has an impact on the determination of the costs to be charged under a federal grant. This circular provides guidance with respect to participation of grant recipients in the cost of research supported by federal agencies. All agencies were

directed to consider the need for or the desirability of obtaining cost-sharing agreements from participating grantee organizations, regardless of whether or not required by law.

### **Types of Grant Costs**

Federal grant programs differ in the nature of costs that are allowable for payment and the level of costs that are permissible charges to a grant. However, most differences relate to form and definition rather than to substance. The total cost of a grant program is defined as the allowable direct cost incident to its performance, plus its allocable portion of allowable indirect costs, less applicable credits. There is no universal rule for classifying certain costs as direct or indirect under every accounting system. The essential point is that each item be treated consistently as either a direct or an indirect cost.

*Direct costs* are those that can be identified specifically with a particular project, grant, or cost objective. They may be charged directly to the grants, contracts, or other programs against which costs are finally recorded, or they may be charged to cost objectives used for the accumulation of costs pending later distribution to grants and other ultimate cost objectives.

*Indirect costs* are incurred for a purpose benefiting more than one project, grant, or cost objective and are not readily assignable to the cost objectives specifically benefited, without disproportionate effort. The term could apply to costs originating in the grantee operation as well as those incurred by other departments in supplying goods, services, and facilities to the grantee.

To facilitate equitable distribution of indirect expenses to the cost objectives served, a number of pools of indirect cost may have to be set up within a grantee or in other agencies providing services to it. Indirect cost pools should be distributed to benefiting cost objectives so as to produce an equitable result in consideration of relative benefits derived.

### **Reporting of Grant Costs**

With slight variations, the following classification of costs, generally called object class, are the categories or groupings of expenses on which grant-in-aid budgets are based and which must generally be reported to the granting agency.

*Personnel compensation* is compensation of employees for the time and effort devoted specifically to the execution of grant programs.

*Fringe benefits* are vacations, sick time, insurances, holidays, and similar benefits for employees whose services are being charged directly to the grant. These costs must not have been claimed elsewhere as either a direct or indirect cost.

*Travel* covers expenses incurred by grantee staff for lodging, meals, and transportation while in a travel status away from the official duty station as well as the costs of local travel on official grant business.

*Consultants, contracts* covers payments to specialists and for services rendered by organizations outside the grantee's immediate organization.

*Construction* covers costs related to building or improving the physical facilities of the grant program or a related effort, to the extent that such expenditures have been approved in the grant budget.

*Materials and supplies* refers to the cost of materials acquired, consumed, or expended specifically for the grant.

*Equipment* is generally defined to include the costs of procuring or leasing nonexpendable, high-value equipment necessary to the performance or completion of the grant.

*Space* includes the costs of procuring or leasing the facilities for 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* are costs specifically identified in the executed grant agreement, but not considered to be within the aforementioned categories.

*Indirect costs* are generally included in accordance with the definition above, although grants may contain a ceiling on the amount of indirect costs that are allowable because of congressional or administrative determinations.

## **Allowable and Unallowable Costs**

Grants are issued in accordance with agency administrative regulations which specify what direct costs are deemed allowable. Most agency definitions of allowable costs include all the direct and indirect costs defined above.

As a matter of public policy, certain costs cannot be considered valid or allowable. The following are the more commonly unallowed expenses, although a particular agency may identify others as unallowable charges to its grant programs.

*Advertising* in newspapers, magazines, radio and television programs, direct mail, trade papers, and the like is unallowable except for specific purposes. The allowable costs are solely for (1) recruitment of personnel for the grant program, (2) solicitation of bids for

required goods and services, (3) disposal of scrap or surplus materials acquired in the performance of the grant agreement, and (4) other purposes specifically provided for in the grant agreement.

*Bad debts*, including any losses arising from uncollectible accounts and other claims as well as related costs, are unallowable.

*Contingencies* are unallowable, whether in the form of contributions to a contingency reserve or any similar provision for unforeseen events.

*Contributions and donations*, as well as gifts, are unallowable.

*Entertainment* costs for amusements, social activities, and incidentals such as meals, beverages, lodgings, rentals, transportation, and gratuities are unallowable.

*Fines and penalties* for violations of or failure to comply with federal, state, and local laws and regulations are unallowable.

*Governor's expenses* and expenses of 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* on borrowings (however represented), bond discounts, and financing and refinancing operations, as well as legal and professional fees paid in connection therewith, are unallowable except when authorized by federal legislation.

*Legislative expenses* including salaries, for state legislatures or local governmental bodies such as county supervisors, city councils, and school boards, whether for legislation or executive direction, are unallowable.

*Underrecovery of costs under one grant agreement* is unallowable under other grant agreements.

### **Matching Share and In-Kind Contributions**

Many federal grants require that grantees provide certain costs in a specified ratio to the funded grant. Such costs are considered an integral part of the project costs, subject to audit as to the allowability or unallowability of the contributed 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 matching costs in the same manner and with the same care as is applied to accounting for federal monies.

The *matching share* of the project costs represents those costs not borne by the government. If matching shares are required by the law establishing a grant program, the requirement is made a part of the grant conditions. Unless restricted by a grant condition, matching shares might include the following:

- Project costs that do not require cash outlays, but benefit the grant project, such as depreciation and use charges incurred by the grantee for buildings and equipment.
- Cash contributed or donated to the grantee by other public agencies, institutions, organizations, and individuals for use in the grant program.
- All in-kind contributions that are identifiable in the grantee's records, are not included as contributions for any other federal program and are necessary and reasonable for the accomplishment of the grant project objectives.

These criteria have been expressly promulgated by the Office of Management and Budget for application to grants to state and local governments. However, the same criteria have generally been applied by most federal grantor agencies in requiring matching share contributions for grants to nongovernmental organizations.

*Valuation of In-Kind Contributions* In past years, the valuation of in-kind contributions has been the subject of considerable dispute between grantees and federal agencies. Effective January 1, 1973, the Office of Management and Budget set forth a number of criteria for governmental grantees valuing in-kind contributions. These criteria are also used as a guide by nongovernmental grantees.

*Volunteer services* by professional and technical personnel as well as by skilled and unskilled labor should be valued at regular rates paid for similar work in other activities or in the labor market in which the grantee competes for services, or at the rate paid by an employer who donates an employee to the grant project.

*Materials contributions* including office supplies, maintenance, workshop, and classroom supplies should be valued at a reasonable amount not exceeding the cost of the supplies to the donor or current market prices.

*Equipment, buildings, land, and space* valuations might vary with the grant; if the purpose is to furnish such facilities, the total value of the donation may be claimed as the matching share. If the facilities are in support of the grant project, a depreciation charge or use charge or fair rental value (for land) may be used.

*Contributions from private sources* must be supported in the grantee's records that show (1) the hours of services provided, computed in the same manner as used for the grantee's employees and (2) the basis for determining charges for personal services, materials, equipment, buildings, and land.

## Prepayment Audit or Review

It is the practice of many agencies to make a prepayment audit or review of grantees' claims for reimbursement or of the expenditure reports submitted subsequent to an advance or letter of credit withdrawal. Federal agencies usually insure that a function has been established and personnel charged with making a prepayment audit or review. In many agencies, this function is performed by finance personnel because it is critical to the certification made by the agency's finance officer that the release of funds for the claimed purpose is proper.

*Objectives of Prepayment Review* The principle 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 disbursements are fully documented, properly approved, and accurately reported and recorded.

Each agency's system of internal control and related procedures for disbursements must be based on the operating needs of that particular agency 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 review is designed so as to insure that each request for the release of federal funds is critically examined before disbursements are made. The following are typical of the inquiries that are made prior to the release of funds to grantees.

- Have all the required authorizations and the approvals of agency 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 accordance 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 it is the questions raised during this prepayment audit that cause the payment of a grantee's claim or invoice to be delayed.

# 8 Auditing of Federal Funds

With few exceptions, the activities, operations, and functions of a federal agency are subject to audit. Included in the areas that must be audited are internal activities as well as grantees', contractors', and borrowers' activities and other recipients of federal monies. These audits are made by the agency's own audit staff and by organizations such as state and local government auditors and public accounting firms.

During the 1960s, federal agencies increasingly turned to the public accounting profession for external audits, primarily of grant programs or activities. In the 1970s the agencies are using public accounting firms to make internal audits of the activities and operations managed by federal employees.

There are few public accounting firms whose clients are not recipients of federal funds under a grant, contract, or loan, or as beneficiaries of a federal guaranty of a loan. Further, public accounting firms are being increasingly relied upon by government in the audit of public monies.

While the objectives, scope, and techniques of these audits may be similar, there are significant differences in the nature of the examinations or audits and in the reporting responsibilities of the audit organizations. This chapter provides background information that will help public accountants to anticipate the purpose, scope, and methods of audit that may be required by federal agencies.

## Federal Audit Responsibility

Within the federal government, the overall responsibility for audits rests with two officials: (1) the head of each federal agency and (2) the comptroller general of the United States, who heads the General Accounting Office.



## **Agency Audit Responsibilities**

The specific legal requirement for audit of an executive agency is set forth in Section 113, Part II of the Budget and Accounting Procedures Act of 1950:

The head of each executive agency shall establish and maintain systems of accounting and internal control designed to provide . . . effective control over and accountability over all funds, property, and other assets for which the agency is responsible, including appropriate internal audit.

Thus the head of the agency has the authority and responsibility for establishing an audit capability as part of the agency's system of internal control. In addition to the agency's own employee operations and activities, the head of the executive agency must also audit outside organizations to which the agency has awarded contracts, made grants, lent money, or otherwise released federal funds. This responsibility has been exercised with the help of federal, state, and local government auditors and public accounting firms.

## **GAO Audit Responsibilities**

As discussed in chapter 1, the General Accounting Office is independent of the executive agencies and reports to Congress, although information is furnished to the President and the Office of Management and Budget on request. Under several laws, the General Accounting Office has obtained broad audit authority and responsibilities. This is evidenced by an examination of pertinent laws.

- The Budget and Accounting Act of 1921 authorized the comptroller general to investigate all matters relating to the receipt, disbursement, and application of public funds.
- The Government Corporation Control Act of 1945 expanded the audit authority to wholly owned government corporations and required audits in accordance with the principles and procedures applicable to commercial corporate transactions under rules and regulations prescribed by the comptroller general.
- The Legislative Reorganization Act of 1946 gave the comptroller general authority to make an expenditure analysis of each agency in the executive branch, which would enable Congress to determine whether public funds have been economically and efficiently administered and expended.
- The Federal Property and Administrative Services Act of 1949 required the General Accounting Office to audit all types of

property accounts and transactions at such times and in such manner as it deemed necessary.

- The Accounting and Auditing Act of 1950 required that the financial transactions of each executive, legislative, and judicial agency be audited by the General Accounting Office. These audits were to be directed toward determining (1) the extent to which accounting and related financial reporting fulfill the purposes specified, (2) whether financial transactions have been consummated in accordance with laws, regulations, or other legal requirements, and (3) whether internal financial control over operations is adequate.

With respect to specific federal programs, the audit responsibilities of the General Accounting Office are contained in the numerous laws by which Congress has authorized and appropriated funds for the programs.

The General Accounting Office itself has not called on other governmental audit agencies or the public accounting profession for direct assistance in conducting their audit responsibilities. GAO does review the audit efforts of public accountants and state and local government auditors to assess the adequacy of the coverage and to determine where the scope and depth of these audits are sufficient to minimize duplicate audit coverage by the General Accounting Office.

### **GSA Audit Responsibilities**

Until May 1973 the Office of Management and Budget promulgated the executive branch governmentwide policy with respect to audits. This policy was enunciated in OMB Circular A-73. Since that time, when this function was transferred to the General Services Administration, OMB A-73 has been replaced with Financial Management Circular (FMC) 73-2, which has essentially the same contents.

In addition, FMC 73-2 contains the general policies for audit by executive branch agencies. Among other items, the circular requires that agencies establish procedures for the determination of audit coverage, frequency, and priority, giving consideration to the following criteria: newness, changed conditions, or sensitivity of the program; dollar magnitude and duration; extent of federal participation; management needs; prior audit experience with the program; adequacy of audit reports prepared by others; results of other audits or evaluations; legislative requirements or congressional recommendations; and availability of audit resources.

Additionally, the circular encourages audit cross-servicing agree-

ments to minimize duplication and increase coordination between the audit functions of the many agencies.

Federal agencies are directed to avoid unnecessary effort and to use all acceptable audit work. The circular states that reports by nonfederal auditors may be used in the place of federal audits when the reports and workpapers are available for review by the agencies, the audits are performed in accordance with generally accepted auditing standards, and the audits meet the requirements of federal agencies.

## Kinds of Federal Audits

The audit function of a federal agency is generally described according to the organizational relationship of the audited activity to the agency—that is, internal or external. In this context, internal audits are audits of operations within the agency, whereas external audits are made of operations outside the agency.

The role of the General Accounting Office is to insure that both types of operations are being audited in addition to making its own audit of the agency and its operations.

*Internal Audits* Internal audits are examinations of an agency's affairs, activities, and programs, generally by auditors who are agency employees. The scope and method of performing such audits varies with the desires of management, the applicable laws and regulations, and the complexities of the assignments.

Although internal audits as a rule are performed by federal auditors, there is no legal restriction against an agency's seeking the assistance of a public accounting firm in conducting such an audit. In fact, public accountants have conducted internal audits of federal agencies, although not as often as external audits.

*External Audits* External audits are examinations of the affairs of organizations that are not part of a federal agency, such as grantees, contractors, and borrowers under government programs. External audits generally are made by federal auditors as well as others. The scope and method of performing such audits depend upon the nature, interest, and the complexities of the activity. External audits are performed directly by federal agencies or agency auditors and by other governmental audit groups, state auditors, state legislative auditors, or qualified public accountants.

The General Accounting Office has made a determination as to who it deems should be considered qualified public accountants. In

a letter (B-148114) dated September 15, 1970, to the heads of federal departments and agencies, the GAO stated that audits conducted for the purpose of expressing an opinion on financial reports of governmental organizations "shall 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." This position was reaffirmed by the GAO in May, 1975.

*Relationship to GAO Audits* The review of the adequacy of the system of internal control, including audits of each federal agency, is an important part of the General Accounting Office's statutory audit responsibilities. While there are numerous common areas of responsibility of the General Accounting Office and a federal agency, certain basic objectives and reporting responsibilities differ.

In its audits, GAO reviews the agency's entire control mechanism, including the arrangements for internal audits and other forms of inspection, appraisal, and evaluation. Where warranted, the agency auditors' work will be relied on and made appropriate use of in the GAO examinations.

The nature of the agency auditors' work is specifically provided for in the Budget and Accounting Procedures Act of 1950, which states that each executive, legislative, and judicial agency's financial transactions are to be audited by the GAO and that "the Comptroller General shall give due regard to generally accepted principles of auditing, including . . . the effectiveness of accounting organizations and systems."

The GAO interest also extends to the degree of agency management concern for the work of its auditor and particularly in the audit findings and recommendations. Normally, there is little duplication in the work of the agency's auditor and the General Accounting Office. The auditor's work is part of the agency management's pattern of operation and control, whereas the GAO review is an independent appraisal of the manner in which agencies discharge their responsibilities and of the effectiveness of their control systems, which includes audits.

## Federal Agency Audit Standards

Until 1972, federal agencies had relied upon the generally accepted auditing standards issued by the American Institute of Certified Public Accountants for performance measurement yardsticks. Be-

cause of the high degree of relevance to the work of federal auditors, these AICPA standards were adopted by most major audit agencies of the government, including the General Accounting Office. Since 1972 the comptroller general's new *Standards for the Audit of Governmental Organizations, Programs, Activities & Functions* have been used.

### **Development of Government Audit Standards**

Under the direction of the General Accounting Office, an inter-agency, intergovernmental work group was established in 1969 with the objective of developing audit standards that could be applied to federal grant programs no matter what type of organization performs the audit and no matter whether the audit is done by one or several groups. The findings titled *Standards for the Audit of Governmental Organizations, Programs, Activities & Functions*, were issued by the comptroller general in June 1972. (Reprinted in January 1974 with minor revisions.)

The group contemplated that complete coverage should be provided for the audit of federally assisted programs and therefore sought to develop standards that embraced four broad areas: (1) fiscal and accounting operations, including controls over financial and property resources and financial reporting; (2) compliance with applicable federal, state, and local laws, regulations, and requirements; (3) identification of opportunities for greater efficiency and economy in the activities being audited; and (4) evaluation of the effectiveness and accomplishments of programs and expenditures.

### **Audit Definitions**

The GAO *Standards for Audit* describe not only work 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.

Included in the *Standards for Audit* are the following definitions:

The emphasis on the financial and compliance aspects of the Federal audit standards is to have the auditor determine (1) whether financial operations are properly conducted, (2) whether the financial reports of an audited entity are presented fairly, and (3) whether the entity has complied with applicable laws and regulations.

The emphasis on auditing for economy and efficiency has as its objective the determination of whether the entity is managing or

utilizing its resources (personnel, property, space, etc.) in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organizational structure.

The emphasis on program results is directed toward ascertaining 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 which might yield desired results at a lower cost.

The GAO *Standards for Audit* apply to audits of all government organizations, programs, activities, and functions—whether performed by federal, state, or local government auditors, independent certified public accountants, or others. The standards also apply to both internal agency audits and audits of contractors, grantees, and other organizations. These standards parallel the generally accepted auditing standards of the AICPA. However, some are much broader in scope and should be fully understood by any certified public accountant undertaking an engagement in accordance with such standards.

### **Analysis of Audit Standards**

Although the GAO standards are similar to those of the AICPA, there are differences. A summary of the general standards, examination and evaluation standards, and reporting standards follows, together with a discussion of the important variances from generally accepted auditing standards.

The GAO *general standards* are similar to the auditing standards published by the AICPA, since the two audit disciplines are parallel. The general standards are concerned with the auditor's qualifications and the nature of his work, but include standards for an audit of much broader scope than would be contemplated in attesting to financial statements. Of the four general GAO standards that follow, the first is of particular concern.

1. The full scope of an audit of a governmental program, function, activity, or organization should encompass: (a) an examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations; (b) a review of efficiency and economy in the use of resources; (c) a review to determine whether desired results are effectively achieved. In determining the scope for a particular audit, responsible officials should give consideration to the needs of the potential users of the results of that audit.

2. The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required.
3. In all matters relating to the audit work, the audit organization and the individual auditors shall maintain an independent attitude.
4. Due professional care is to be used in conducting the audit and in preparing related reports.

It should be noted that the AICPA does not have a standard related to the first of the GAO general standards. This is because the profession's standards were developed for application to the audit of financial statements, whereas the first of the GAO general standards applies to nonfinancial matters as well.

The government's *examination and evaluation standards* apply to all the activities an auditor performs in his examination, survey, or review, other than the preparation of the report. These standards describe the auditor's objective and subjective evaluations in providing financial, compliance, and operational information to report users. Again, the standards are broader than those of the AICPA and require that auditors be responsible for a wider scope. The following are the examination and evaluation standards.

1. Work is to be adequately planned.
2. Assistants are to be properly supervised.
3. A review is to be made of compliance with legal and regulatory requirements.
4. 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.
5. Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor's opinions, judgments, conclusions, and recommendations.

While most of these standards are similar to the AICPA's, the third standard is a departure. However, CPAs are concerned about their clients' compliance with legal and regulatory requirements as part of their consideration of the adequacy of disclosure.

*Reporting standards* refer to report transmission, preparation, content, and quality. Of particular significance is the standard relating to the distribution of the audit report to parties other than the organization or client arranging or requiring the audit. As mentioned earlier, extreme caution must be exercised when accepting audits that must be performed in complete accordance with these gov-

ernmental standards. The GAO reporting standards include the following:

- 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, be clear and complete enough to be understood by the users.
  - Present factual matter accurately, completely, and fairly.
  - Present findings and conclusions objectively and in language as clear and simple as the subject matter permits.
  - 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 bases 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 actions 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, function, 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 as to whether the information in the financial reports is presented fairly in accordance with generally accepted accounting principles (or with other specified accounting principles applicable to the organization, program, function, or activity audited), applied on a basis consistent with that of the preceding reporting period. If the auditor cannot express an opinion, the reasons therefor should be stated 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, and material changes in accounting policies and procedures, along with their effect on the financial reports, shall be explained in the audit report.

The GAO reporting standards differ considerably from those of the accounting profession and should receive careful study before any engagement is accepted that requires unqualified compliance with the government's standards.

### **AICPA Recommendations on Governmental Standards for Audit**

In November 1973 the AICPA committee on relations with the General Accounting Office reviewed the *GAO Standards for Audit* in an effort to help independent certified public accountants to a better understanding of these standards, their effect on the practice of auditing today, their relationship to generally accepted auditing standards, and their application to the GAO's broader definition of auditing.

In its discussion of *Standards for Audit* the committee points out:

A simple comparison of the GAO standards with the ten generally accepted auditing standards adopted by the membership of the AICPA and set forth in Section 150 of the Statement on Audit-

ing Standards No. 1 does not disclose the impact of the GAO standards on auditing. Such a comparison shows a marked similarity, but the GAO standards go further. The primary impact of the GAO standards is in the way the scope of auditing is expanded beyond examinations leading to the expression of opinions on the fairness of financial presentation to include audits for compliance, efficiency, economy, and effectiveness.

In summary, the committee reached the following conclusions with respect to the standards that are applicable to the certified public accountant.

- The GAO's broader definition of an audit requires that the public accountant reach an agreement with the prospective client on the criteria that are to be used for evaluating economy, efficiency, and effectiveness.
- Public accountants should be cautioned to define carefully, in the engagement agreement, the scope of each engagement and the method of reporting.
- For scopes of audit beyond the examination of financial presentations, the public accountant should ascertain whether criteria are available for use in reviewing compliance with laws and regulations and in evaluating efficiency and economy of operations and program effectiveness.
- The need, availability, and cost of nonaccounting expertise should be determined in advance and a decision reached on how the work of the experts will be used in the report.
- The GAO standards do not contemplate that the public accountant will express an opinion concerning the economy and efficiency of operations or program effectiveness. In reports covering such matters, the accountant should limit his opinion to the fairness of presentation of the financial information.
- Because the broader scope audit will presumably require more time, care should be taken to provide for sufficient time to complete the engagement.

In total, there are at least three groups of reporting standards or requirements that a public accountant might have to comply with in conducting audits for a federal agency. In addition to the GAO standards, an agency might require that the audit be done in accordance with the accounting profession's generally accepted auditing standards and procedures. Further, the agency may develop and require adherence to a specific audit guide that would constitute the scope of work to be performed by the public accountant. It would not be unusual to observe all these reporting requirements in an audit engagement contract with a federal agency.

## Audits by Federal Agencies

As mentioned earlier, federal audits can be grouped into two broad general categories: internal and external. In recent years, governmental agencies have turned to the public accounting profession for assistance in performing both types of audits. This section focuses on the more common internal and external audits performed by or for federal agencies.

### **Purpose and Organization of Federal Audit Function**

Every federal agency is required to establish an audit function that will provide the valuable service of reviewing, appraising, and reporting on compliance with management's plans, policies, procedures, practices, and regulations. The activities audited include those under the direct control of agency employees as well as those of contractors, grantees, and other recipients of federal funds or beneficiaries of federal guaranty programs.

The audit function is usually independent of the officials who are directly responsible for the activities or operations being audited. To provide this independence, the audit function is generally responsible to the highest practical organizational level, preferably the agency head or a principal official reporting directly to the agency head.

The complete audit function could reside within a single organization, but many agencies split the function into two entities—the internal audit staff and the external audit staff—perhaps supplemented by public accountants. Regardless of the specific organizational alignment, for the most part the audits required are the same for all federal agencies.

### **Types of Internal Agency Audits**

In addition to reviewing, appraising, and reporting on an agency's adherence to or compliance with laws, regulations, and prescribed policies and procedures, the internal audit also addresses such matters as these:

- Procedures, whether officially prescribed or merely followed, which are ineffective or excessively costly.
- Duplication of effort by employees or between organizational units, which decreases overall efficiency.
- Performance of work that serves little or no useful purpose.

- Inefficient or uneconomic use of automated data processing equipment.
- Overstaffing in relation to work to be done.
- Faulty buying practices.
- Procurement and accumulation of unneeded or excess quantities of property, materials, or supplies.
- Wasteful use of property, supplies, or other resources.

Most agency internal audits include annual reviews of such matters as are noted in the following sections.

*Audit of Payroll Costs* The objective of a payroll audit is to determine that an agency's functional organizations having responsibility for personnel matters such as the appointment, payment, transfer, or termination of employees are adhering to agency policies and procedures and that the agency's personnel practices are in accord with the promulgations of the General Accounting Office, Civil Service Commission, and Office of Management and Budget.

A typical payroll audit might entail selecting a subjective or statistical sample of employee personnel actions or changes involving new appointees, regular employees, and terminated employees for the following purposes: (1) to examine personnel changes during the period under audit to determine compliance with agency policies and regulations; (2) to scrutinize timekeeping procedures, recording of employee attendance, authorization and taking of vacations and sick leave, and supervisory approvals; (3) to verify the authenticity of payroll deductions and insure that appropriate employee and supervisory approval has been obtained; (4) to test-check the labor cost distributions to ascertain whether the accounting is accurate and whether the payroll has been correctly recorded in the agency's account; and (5) to witness the distribution of paychecks or make a payoff, in the case of a cash payroll, to determine that payroll expenditures are made to authorized personnel.

The scope of the annual review may vary, but the audit of an agency's payroll expenditures is arranged to insure that all aspects of the payroll process were audited within a given time period or cycle.

*Audit of Travel and Transportation Costs* The objective of an audit of an agency's travel and transportation expenditures is to determine the extent of compliance with the standardized government travel regulations. Typically, the audit examines (1) compliance with the agency's implementing regulations by selecting a sample of ex-

pense vouchers submitted by employees who have performed official travel during the period under audit; (2) the manner of computing per diem costs, mileage expenses claimed for personal automobiles, the cost of automobile rentals, and the class and cost of public transportation utilized; (3) the manner in which management approval is obtained for advance authorization of travel as well as approval of reimbursement claims for travel expenses; (4) the practices of awarding, accounting for, and liquidating travel advances and the use and control over government transportation requests; and (5) the method and accuracy of recording travel and transportation costs in the agency's accounting records.

Federal agencies are particularly concerned with the manner in which public monies are spent for services such as travel and transportation. This concern is probably related to the opportunity for abuse and personal gain that does not exist with respect to other types of federal expenditures.

*Audit of Obligations and Expenditures* Most internal audits of federal agencies include a review of the unliquidated obligation account balance at the end of each fiscal year and an examination of the appropriation expenditures for the year just ended. This audit determines whether the agency's financial controls are adequate and checks on the incurrence of obligations and the expenditure of funds in accordance with the criteria of the Anti-Deficiency Act (31 USC 665).

Of equal importance to both the audit staff and the agency's financial personnel is the validity of the unliquidated obligations balance being reported at year end to the Treasury Department and the Office of Management and Budget. This balance must be determined on the basis of the law and facts, guided by Section 1311 of Public Law 663 (31 USC 665).

Should violations be found, the laws make it mandatory that such violations, and the reasons for them, be reported by the agency head to the General Accounting Office, the President, and Congress.

*Audit of Accounts and Reports* Periodically, federal audit staffs schedule a review of accounting policies and procedures and compare them to the actual practices to learn the extent of compliance or deviation. A sample of transactions is constructed, with each kind of expenditure transaction traced in detail, from origination to ultimate payment. Among the points checked are adherence to the prescribed chronology of approvals, use of proper forms, recording in the agency's accounts, and accuracy of supporting documentation.

Additionally, internal audits are concerned with the accuracy and completeness of the information appearing on the various financial and statistical reports. These audits seek to determine the consistency of the data being reported and, where applicable, the uniformity of the data among several organizations. Tests are made to ascertain that activities and organizations are adhering to established reporting policies, procedures, and data definitions and that the information reported is supported with the appropriate basic documentation.

*Audit of Imprest or Petty Cash Funds* Unannounced audits are made annually of imprest or petty cash funds to determine that the funds were properly used, protected against loss or misuse, and accounted for. Violations must be reported promptly by the agency head to the Treasury Department disbursing officer who advanced the funds and who is responsible for adjusting the accountability records and establishing reliability.

The audit of an imprest or petty cash fund is directed to tests such as these: verifying the authenticity of the authority of cashiers and any designated alternates; physically counting and reconciling the cash on hand as well as checking receipts and other documents evidencing disbursements to the authorized amount of the fund; examining the type and purpose of the expenditures made through the fund; evaluating the turnover of the fund balance to assess the adequacy of the funded amount; determining that expenditures are in accordance with prescribed policies and procedures; and evaluating the internal and physical controls for safeguarding the fund.

Typically, the money for these funds is advanced by the Treasury Department, to which a periodic accounting must be made. For each expenditure from the imprest or petty cash fund, an entry is made in the agency's records and a reimbursement is then made by the agency to the fund, thus returning the balance to the amount advanced from the Treasury.

*Audit of Procurement Activities* An agency's procurement activities are subject to regular internal audits to determine whether the contracting officials are procuring the required supplies and services in accordance with agency policy and procedures and the applicable procurement regulations. An internal audit of an agency's procurement activities could include tests of these activities: the manner in which the procuring activities or operations determine their needs for outside goods or services; the thoroughness with which estimates of the cost of the desired goods or services are determined; the adherence to the agency's policies and procedures for reserving

funds for the contemplated procurement and obtaining the necessary and timely authorizations; the extent to which effective competition is sought to insure that the agency receives the desired goods or services at minimum cost; the application of sound contract pricing review and cost analysis procedures and techniques to determine that the amount of any contract was determined in accordance with applicable procurement regulations and represents a fair and reasonable expenditure; and the contract administration procedures, including monitoring of performance, submission of reports, payment of invoices, liquidation of advances, control of government property, and administrative closeout of the contract.

This audit is generally made at the procurement function's location in the federal agency, although there may be an occasion for field visits or site reviews to verify the existence of or a condition surrounding a contract award or procurement. Also included in the internal audit of procurement activities might be an examination of small purchase orders (less than \$10,000 at the present time) issued by agency employees.

*Audit of Grant Programs* Should the agency be responsible for awarding grants, internal audits are made periodically to evaluate or assess the administration of these grants. The audit could have such objectives as the following: evaluating the process by which grant applicants are solicited or obtained; assessing the adequacy of the grant application review process and the procedures for selecting successful grantees; and testing the adequacy and appropriateness of the agency controls over the execution of the grant, funding of the grantee, monitoring its performance, controlling any government property in its possession, and closing out the grant project at completion.

While field visits might be required or tests could be made at a grant project, typically, the internal audit is conducted at the agency responsible for issuing or administering the grants. The dollar magnitude of many federal grant programs demands continual internal audits of such activities.

*Audit of Property* The government holds title to enormous inventories of goods, supplies, equipment, buildings, fixtures, and other properties. The manner in which these properties are procured or acquired, stored, controlled, used, and disposed of are the subject of periodic internal audits. The properties could be under the control of federal employees or in the possession of contractors or grantees. So long as title is held by the agency, it must see that the properties are adequately protected and properly utilized.

An internal audit would address such matters as whether the purchase, transfer, use, and disposal of properties were properly accounted for in the records of the agency; whether the controls over the receipt, use, and disposal of the properties were adequate; whether periodic physical verification of the inventories of properties was thorough and effective; and whether the capitalization and depreciation policies used by the operating activities are appropriate.

As mentioned, the internal audit of property could be of sufficient scope to include review of the property under the direct control of the agency as well as agency property in the possession of its contractors and grantees.

The foregoing summary listing of types of internal audits performed by federal agencies is illustrative and not all-inclusive; many internal audits are more appropriately concerned with nonfinancial issues and systemwide reviews of policies, procedures, practices, and controls.

### **Types of External Agency Audits**

An external audit is an audit of an organization outside the federal agency. Audits of an agency's contractors, grantees, borrowers, or beneficiaries (such as a recipient of a loan guaranty) are classified as external audits.

The interrelationship of external and internal audits varies with the nature, size, and organization of the agency. A smaller agency might have both types centered in a single audit organization; a larger agency might divide internal and external auditing to the extent that the two have different directors who in turn report to different agency officials.

The role of an external audit, whether performed by the agency audit staff or certified public accountants or others, is to assist the agency officials in the execution of their functions, meet the financial accountability requirements of the agency, and satisfy top management as to the manner in which subordinates and external organizations are implementing program objectives.

*Audit of Contracts* Contracts are audited to determine whether the contractors are complying with requirements for the goods or services being supplied to the agency. In the award and administration of negotiated contracts, audits are usually made of a contractor's requests for cost reimbursement; the timeliness, completeness, and accuracy of data used in pricing negotiations; and activities generating costs that affect an agency's interests. Such auditing enables an agency to appraise a contractor's financial responsibility and to



provide information needed in contract negotiation and administration. There are also other reasons for making audits of contracts.

- Most contracts are awarded by negotiation, often without the benefit of competition.
- Fixed-price contracts lack the right to audit the basic price, but may contain provisions for price adjustment, redetermination, escalation, or incentive adjustments which must be examined to determine the overall reasonableness of the price being paid to a contractor.
- Cost-reimbursement contracts must be audited to insure that the contractor is reimbursed only for actual costs and to place some restraint on the incurrence of exorbitant costs.
- Contractors may be in possession of government-owned property, equipment, and materials, which gives the government an interest in the quality of the controls exercised over these properties.
- By the Truth in Negotiations Act (Public Law 87-63), contractors are required to furnish cost or pricing data to federal agencies for use in the negotiation of contract prices and certify to the accuracy, completeness, and currency of the data; and agencies have the right and duty to examine the basis for such data.

Prior to contract award, the agency might elect to conduct a *pricing review* of the elements of the proposed price. Such a review entails a verification of all elements (the estimates for material, labor, overhead or burden, travel costs, other direct costs, general and administrative expenses) to the bases from which the estimates were computed and where possible to the related cost experience to perform similar efforts.

If the agency has had limited experience with a prospective contractor, a *preaward* survey might be made to determine the adequacy of the prospective contractor's systems of accounting, internal controls, and project or contract management. During such a review, an agency might ask other federal agencies about their experiences with the contractor.

During or after a contract, an agency might *audit the costs* incurred and charged to the contract, test the supporting documents and accounting procedures for each cost element, determine whether the costs were allowable under the applicable procurement regulations and under the terms of the contract, then compare the initially proposed costs with the negotiated and actual costs to assess the reasonableness of the initial proposals.

Generally, contract audits are made of proposals for fixed-price and cost-reimbursement contracts and of allowable costs incurred or claimed on cost-reimbursement contracts. These audits are concerned primarily with the adequacy of cost accounting systems and billing procedures as well as whether the costs included in proposals or claims are allocable to and otherwise proper for reimbursement.

*Audit of Grants* Grant audits are made of an organization or government involved directly or indirectly as a grantee in operating a program, service, or activity sponsored by the federal government. The distinction between contract and grant audits depends on the type and conditions of the agreement. Generally, a grant entails a lesser degree of control; in most instances, the organization receiving the grant is a partner in the funding of the project because of a cost-sharing or local or matching-share requirement.

As a matter of practice, federal agencies require that grant recipients be fiscally responsible organizations capable of insuring that funds are adequately controlled, properly expended, and correctly reported. This fiscal competence is usually determined through the following audits or examinations.

- A *preaward survey* may be made of the prospective grantee's systems of internal controls and accounting and of the cost controls exercised under other grants.
- A *postaward survey* may be made within 90 days after the award to insure, early in the grant period, that the grantee has effective administrative procedures and that the systems of internal control and accounting are operating as predicted and the minimum acceptable grant accounting criteria are being met.
- A *periodic audit*, usually made annually, consists of a financial audit and a compliance examination. The financial audit is made of the costs charged to the grant. The compliance examination evaluates adherence to the general and special conditions of the grant agreement. The specific areas usually covered by the annual audit could include the following:
  - Test of selected transactions and observations of the accounting and internal control systems to ascertain that these systems are adequate.
  - Verification that the costs incurred under the grant are within the total approved budget or within cost category budgets (salaries, travel, supplies, and so on).
  - Determination that the costs charged to the grant are in accordance with the budget.

- 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 documented evidence.

External audits of grantee programs could be done by federal, other governmental, or public accountants. By far the greatest federal use of certified public accountants has been in the area of grantee audits. Public accountants are retained to perform audit services in two ways: (1) the firm is selected by a grantee that has received funds for accounting and auditing services in its budget, and (2) a contract is issued by the federal agency direct to the public accounting firm.

Many agencies adhere to the practice of permitting the grantee to select a public accounting firm but retain the right of disapproval. A more direct relationship for providing accounting and auditing services to the government is under a contract issued by the agency to the public accounting firm. It should be understood that in cases where an accounting firm is retained by the grantee, the federal agency is also considered the firm's client in addition to the grantee for purposes of reporting under the grant. In cases where the firm is retained by the federal agency, its contractual responsibilities are only to the agency.

### **Other Federal Audits**

In addition to financial examinations, federal agencies conduct two other types of reviews, either as part of the financial audit or separately: compliance examinations and operational or management audits. Either of these could cover an agency's internal activities or external organizations that receive federal monies.

*Compliance audits* are not audits in the sense of attesting to the reasonableness of a financial statement but are designed to determine the extent of adherence to agency policies, procedures, and regulations as well as to applicable laws. Such audits are made periodically. Often compliance audits are made at the same time as the financial audit, and the results of both are incorporated into the same audit report.

*Operational audits* have been the subject of considerable discussion in recent years. To a limited degree, some agencies have performed such audits; to a lesser degree, some have retained public accounting firms to make the audits.

Briefly, an operational audit is concerned with what has been accomplished or achieved with the funds, manpower, or other assets; in short, it checks the demonstrated results.

Because of the government's increased use of public accountants for audits and evaluations of grant programs at the state and local levels, accounting practitioners should be cognizant of the various descriptives used for operational audits. Essentially the same audits have been performed by internal auditors and some agencies for years. In fact, many practitioners deny that operational audits differ in any significant respect from thorough internal audits.

It is often difficult to distinguish a material difference between current definitions for operational audits, performance audits, management audits, effectiveness audits, and program audits. Yet, it should be noted that such audits are clearly a step beyond the historical financial or compliance audits made by federal auditors and public accountants. Definitions by several authors appeared in a recent compendium by the Association of Government Accountants (formerly the Federal Government Accountants Association) on this subject, for example:

Management-type auditing is an independent, objective, analytical and critical appraisal or examination of the manner and effectiveness of carrying out responsibilities.

Management (or operational or performance) auditing would be concerned primarily with the efficiency and economy with which resources are managed and consumed.

Program auditing would be concerned mainly with inquiring into the results or benefits being achieved by an organization and evaluating whether programs are meeting the objectives set by the legislature or other authorizing bodies.

The terms performance auditing or operational auditing are usually used to establish a distinction between auditing of accounting and related records for the purpose of expressing professional opinions on financial statements and auditing which examines the operating, managerial or administrative performance . . . of an activity or organization beyond that required for the audit of the accounts.

I see it [operational auditing] as an independent appraisal by the auditor of the manner in which an organization is conducting itself in carrying out the responsibilities assigned to it by Management.

Thus it appears that a consensus might classify an operational audit as an evaluation of the results of what has been achieved with the money, manpower, or materials expended or consumed by an organization.

## Procedure and Method of Federal Audits

Federal audit staffs and other organizations performing audit services for a federal agency generally adhere to the following procedures, methods, and protocol in conducting audits.

*Preliminary Survey* If the area is to be subjected to an initial audit or examination, the audit staff makes a preliminary survey during which background information is obtained concerning the agency's programs, the types of contracts or grants issued, applicable laws, regulations, policies, and so on. This phase includes extremely limited tests and probings of financial transactions and administrative practices, so that the scope of the forthcoming audit can focus on those financial matters and administrative practices that appear weak or could have an adverse impact on a federal program or activity. Often the survey or review is performed before a visit is made to the audit site.

It is an accepted practice to audit by exceptions; that is, few agencies have sufficient staff to audit all operations. Audit attention is therefore directed to known managerial weaknesses and items critical to the continued success of the program or activity. If an assumed weakness is not found during the survey, no further effort will be expended on the matter. Audit tests and probes might be made of other areas.

*Entrance or Preaudit Conference* The audit staff schedules a conference at the outset of an audit or review to explain the objectives and anticipated scope of the forthcoming audit and say that whether it is expanded or contracted depends on the conclusions stemming from later audit probes. Additionally, the time-phasing of the audit and the period of audit are discussed.

*Managing the Audit* There is generally an audit guide containing some background data and reference materials about the agency to be audited, the policies to be followed, the general scope of work to be performed, and standards of performance. The planning of audit work usually focuses on pinpointing the areas to be covered, developing a systematic schedule of work, assuring a desired level of audit quality and uniformity, and making the best use of manpower.

Federal audit agencies prepare and adhere to an audit program for each specific audit. This program is used to channel, effectively utilize, and control the efforts of the individual auditors. It outlines and discusses such matters as the scope and objectives of the specific

audit, the method of selecting a sample of transactions for review, known deficiencies and weaknesses that must be probed, the extent of tests to be made, the nature of corroborating evidence to be obtained in the event of weaknesses, and perhaps the matters to be discussed at the exit conference held at the conclusion of the audit.

*Testing of Transactions and Reports* The auditor examines and tests accounting and other records, as well as the related procedures underlying the agency's management information system and controls, to establish the reliability of the data used by management for internal purposes and for external reports. The purpose and usefulness of internal reports are reviewed to ascertain whether the reports are responsive to the real needs of users, to avoid producing repetitive reports that no longer serve any useful purpose, and to avoid distributing reports to persons who have no use for them.

Additionally, the auditor examines financial transactions, including the receipt and disbursement of funds, to the extent necessary to evaluate three aspects: (1) the adequacy of the agency's prescribed policies and procedures related to such transactions; (2) the adequacy of the related internal controls; and (3) compliance with agency policies and procedures as well as applicable laws and regulations.

The internal auditor examines receipts and expenditures arising from agency activities to ascertain whether they are fully accounted for. In a compliance audit, the emphasis is on reviewing the program's requirements and testing to determine whether the requirements were executed in practice. On the other hand, an operational audit is concerned with measuring what had been achieved with the money spent.

*Exit Conferences* Most audit agencies require that an exit conference be held with the management of the audited organizations. At this meeting the auditor discusses the deficiencies and weaknesses noted, as well as recommendations, and seeks the concurrence of these program officials on the facts surrounding the circumstances. Should there be any disagreement with the expressed facts or with any conclusions, clarification is obtained at this time to keep erroneous statements from being made a matter of record in a published audit report.

*Audit Reports* The facts surrounding any observed weaknesses or deficiencies, as viewed by the audit staff, are reported in a formal audit report along with the audit staff's conclusions and recommendations for corrective or preventive actions.

The preparation of an audit report is a critical element in the audit process, since it is through the report that the auditor communicates his observations, findings, conclusions, and recommendations. All significant findings are brought to the attention of the management in a form to facilitate effective use of the information. Federal audit reports are generally submitted to the management officials responsible for the operations or activities audited and for deciding what actions to take on reported findings and recommendations; the official to whom the auditor is functionally responsible; and other officials in the agency, particularly finance officials, who may benefit from the information in the reports.

All audit staffs try to make their reports meet the reporting criteria prescribed by the General Accounting Office, as follows:

- Factual matter must be accurately, completely, and fairly presented.
- Findings must be presented objectively and in language as clear and simple as the subject matter permits.
- Findings must be adequately supported by evidence in the audit working papers.
- Reports must be concise yet complete enough to be readily understood by the users.
- Information on underlying causes of deficiencies reported must be provided so as to assist in implementing proposals for action or devising corrective measures.

No standard format exists among the audit organizations of the federal government for transmitting the findings of compliance, internal, or operational audits. However, an adequate and informative report must contain the following elements, usually separated into sections: (1) introduction; (2) scope and objectives of audit and time period examined; (3) background information on the organization audited and other data needed to put the report in perspective; (4) summary of findings and recommendations, highlighting the factual discussions and recommendations appearing in more detail in the body of the report; (5) discussion of findings, recommendations, and conclusions, complete with tables, charts, graphs, and other data to detail the conditions and facts surrounding each audit observation; (6) identification of agency management with whom the audit findings were discussed together with any opinions articulated by management with respect to the audit findings.

Similarly, no standard format exists for reporting the findings resulting from the audit of contracts and grants. Because of the nature of grant and contract audits, however, the reports used by federal audit organizations are similar in content.

## Audits by the General Accounting Office

Understanding the role of the General Accounting Office is essential for certified public accountants who want to participate in public sector audits. As an auditor under contract to a federal agency or to one of its contractors or grantees, the public accountant could have his work come under the scrutiny of the General Accounting Office. In fact, in a wide variety of conditions, the General Accounting Office has unrestricted access to the working papers, audit reports, and records relating to an audit made for a federal agency or one of its operating agents.

The primary purpose of GAO audits is to make independent examinations for Congress into the manner in which government agencies are discharging their financial responsibilities. These responsibilities are construed as including expenditures of funds and uses of property and personnel for authorized programs, activities, or purposes.

Achievement of efficient, economical, and effective management is regarded by the General Accounting Office as a basic responsibility of each department and agency. The GAO audit approach is to review the organization, management, and control of each agency system; to identify weaknesses; to report on the conditions found; and to make recommendations for improvements. The audits of the General Accounting Office are related to four responsibilities: (1) auditing and reviewing the implementation of federal programs and the application of federal funds to these programs; (2) providing direct assistance to Congress, specifically by making special audits, surveys, and investigations at the request of congressional committees or individual congressmen; (3) prescribing the principles and standards for accounting in the federal agencies; and (4) at the request of agency heads, accountable officers, or government contractors, rendering legal advice and legal opinions, binding upon federal agencies, to the responsible agencies and to Congress, its committees, and individual members.

*Direction of GAO Audits* The General Accounting Office has wide discretionary authority to establish the directions that its reviews will take. Its audit resources are directed to areas where they can fulfill the greatest apparent need of the government, except as otherwise required by statute, external request, or other factors beyond the control of the General Accounting Office. Special audits, surveys, or investigations are sometimes initiated as the result of information obtained through the operations of the General Accounting Office's various divisions and offices or information volun-



teered by other organizations, employees, or private individuals. Specific factors considered in deciding to launch a GAO audit are statutory requirements, congressional requests, indications of congressional interest, areas of potential improvement in government operations, areas identified as deficient in management controls and operations, deviation of agency policies from congressional intent, and programs or activities with large expenditures, assets, or revenues.

*GAO Reports* Copies of an agency audit report are issued not only to the agency but also to the Congress and, on occasion, the President. The primary GAO responsibility is to keep the Congress informed of the results of its audits. This responsibility is clear in the legislative history of the Budget and Accounting Act of 1921, which states that the General Accounting Office audits will serve to inform Congress at all times as to the actual conditions surrounding the expenditure of public funds in every department of the government.

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