CHAPTER 8

INTERNAL CONTROLS

I. PURPOSE

This chapter presents the underlying principles and reasons for internal control systems and reviews areas where internal controls should be present.

II. DEFINITION

Internal controls are those mechanisms or measures built into the sub-recipient's management system to provide checks and balances within all the operations of the organization, from decision making to authorization to the recording process.

III. OBJECTIVES

The objectives of internal controls are to safeguard the sub-recipient's/contractor's assets and to assure that they are used solely for authorized purposes. Implicit within the concept of internal controls is the promotion of operating efficiency and the prevention and avoidance of any conflict of interest, real or apparent, in the management of the contractor's assets. More specifically, internal controls:

(1) Are the means of maintaining effective control and accountability over funds, property, and other assets, (i.e., checking the adequacy and reliability of the accounting data).

(2) Ensure the fiscal integrity of financial transactions and compliance with prescribed policy and the terms and conditions of the funding source.

(3) Are a measure of the effectiveness of the financial management.

IV. CONFLICT OF INTEREST

- ❑ Sub-recipients/contractors must be vigilant not only to avoid any conflict of interest but the appearance of conflict of interest. The perception by the public that an unfair advantage has been gained from the use of public funds reflects poorly on the sub-recipient/contractor and the funding source and could jeopardize the activity. Therefore, sub-recipients/contractors are required to disclose in writing to DHCD any possible conflicting interest or appearance of impropriety of any party immediately upon knowledge of such possible conflict. DHCD will then render an opinion, which shall be binding on all parties.

- ❑ Sub-Recipients are required to follow the HUD Program Requirements set forth in 24 CFR 84, 85, 92, 570, and 576.

V. AREAS OF APPLICABILITY

Internal controls should be present and evident throughout all areas of the management of the organization including the following areas:

(1) Accounting records – ideally a double entry accrual system.

(2) Revenue management - including bank accounts, cash receipts and disbursements, expenditures and petty cash.

(3) Budget management

(4) Procurement of goods and services

(5) Property management disposal and maintenance

(6) Personnel management

(7) Service provision

(8) Management and supervision process

(9) All reporting systems

(10) The timely and appropriate resolution of audit and monitoring findings and recommendations.

VI. CHARACTERISTICS

To be adequate, internal controls must include or reflect:

(1) Appropriate segregation of functional responsibilities

(2) Prior authorization system

(3) Timely recording of all transactions or activities

(4) Sound business practices at all levels of the organization

(5) Employee competence commensurate with responsibilities

(6) Pre-determined methods for the periodic testing and evaluation of fiscal and management practices and the adherence to established policy which should include review by individuals other than those responsible for the particular transactions under evaluation, (i.e., internal, and external audits.

VII. MEASURES

The degree or extent of the internal controls appropriate to a given contractor are determined by its size, the resources at its disposal, the level of risk involved in its operations, and the agencies to which it must answer. Regardless of the mixture of these elements within the organization, no sub-recipient can afford to ignore the necessity of implementing internal controls measures.

- The greater the number of phases of any significant activity in the hand of any on person, the lesser the control management has over its operations and the greater the risk exposure of the contractor.

- For further information on internal controls, non-profit organizations, institutions of higher education, and hospitals should refer to OMB Circular A-110, Attachment F and local governments should refer to 24 CFR Part 85.

VIII. FINANCIAL MANAGEMENT

OVERVIEW

- The following sections will cover the financial management components of the uniform administrative requirements, cost principles and audit requirements as they apply to sub-recipients of CDBG, HOME, ESG and other federal funds administered through DHCD.

- Sub-recipients that are governmental entities (including public agencies) are required to comply with the following uniform administrative requirements:

  (1) Certain provisions of 24 CFR Part 85 "Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments"; and

  (2) OMB Circular A-87 "Cost Principles for State, Local and Indian Tribal Governments"; and

  (3) OMB Circular A-133 "Audits of States, Local Governments and Non-Profit Organizations."

- Non-profit sub-recipients are required to comply with the following uniform administrative requirements:

  1) Specific provisions of the uniform administrative requirements of OMB Circular A-110, as implemented in 24 CFR Part 84 "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations."

  2) OMB Circular A-122 "Cost Principles for Non-profit Organizations"; and

  3) OMB Circular A-133 "Audits of States, Local Governments and Non-Profit Organizations."

- Standards for Financial Management Systems

  In accordance with 24 CFR Parts 85 and 84, Sub-recipients must have financial management systems in place that provide effective control over and accountability for all funds, property and other assets.

The systems must identify the source and application of funds for federally-sponsored activities, including records and reports that:

(a) Verify the "reasonableness, allowability and allocability" of costs; and

(b) Verify that funds have not been used in violation of any of the restrictions or prohibitions that apply to the federal assistance through the use of budget controls and adequate accounting records.

(c) Permit the accurate, complete, and timely disclosure of financial results in accordance with HUD reporting requirements or for sub-recipients reporting requirements.

(d) Minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by the recipient or sub-recipient.

A. Internal Controls

- ❑ The soundness of any organization's financial management structure is determined by its system of internal controls.

- ❑ Internal controls are the combination of policies, procedures, job responsibilities, personnel and records that together create accountability in an organization's financial system and safeguard its cash, property and other assets.

  Through its system of internal controls, an organization can ensure that:

  - Resources are used for authorized purposes and in a manner consistent with applicable laws, regulations and policies
  - Resources are protected against waste, mismanagement or loss; and
  - Information on the source, amount and use of funds is reliable, secured and up-to-date and that this information is disclosed in the appropriate reports and records.

  The basic elements of an internal control system include:

  - An organizational chart setting forth the actual lines of responsibility of personnel involved in financial transactions
  - Written definition and delineation of duties among key personnel involved in financial transactions

An accounting policy and procedures manual that includes:

- Specific approval authority for financial transactions and guidelines for controlling expenditures
- A set of written procedures for recording of transactions and a chart of accounts

Adequate separation of duties so that no one individual has authority over a financial transaction from beginning to end. In other words, one person should not have responsibility for more than one of the following functions:

- Authorization to execute a transaction
- Recording of the transaction
- Custody of the assets involved in the transaction
- Hiring policies ensuring that staff qualifications are commensurate with job responsibilities
- Control over assets, blank forms and confidential documents so that these types of documents are limited to authorized personnel only
- Periodic comparisons of financial records to actual assets and liabilities (i.e., reconciliation). In cases where discrepancies are found, corrective action must be taken to resolve such discrepancies

B. Budget Controls

- ❑ Sub-recipients must have procedures in place to compare and control expenditures against approved budgets for CDBG, HOME, ESG or other federally funded programs/activities through DHCD.
- ❑ A sub-recipient must:

  1) Maintain in its accounting records the amounts budgeted for eligible activities;
  2) Periodically compare actual obligations and expenditures to date against planned obligations and expenditures, and against projected accomplishments for such outlays; and
  3) Report deviations from budget and program plans, and request approval for budget and program plan revisions.

C. Accounting records

Sub-recipients are required to have accounting records that sufficiently identify the source and application of funds provided to them.

1. To meet this requirement, an organization's accounting system should include at least the following elements:

   - Chart of accounts – This is a list of account names and the numbers assigned to each of the account names. The names provide a description of the type of transactions that will be recorded in each account (e.g. an account titled "cash" denotes that only transactions affecting cash should be recorded in that account). The account number is required by most accounting software programs and is assigned to an account name to group similar types of accounts. For example, all asset accounts will begin with a "#1" and all liability accounts will begin with a "#2". A typical chart of accounts will generally include the following categories: assets, liabilities, net assets/fund balance, revenues and expenses.

   - Cash receipts journal - A cash receipts journal documents, in chronological order, when funds were received, in what amounts and from what sources.

   - Cash disbursements journal – A cash disbursements journal documents, in chronological order, when an expense was incurred, for what purpose, how much was paid and to whom it was paid.

   - Payroll journal – A payroll journal documents payroll and payroll related benefit expenses on salaries and benefits, including distinguishing between categories for regulatory purposes.

   - General ledger – A general ledger summarizes, in chronological order, the activity and financial status of all the accounts of an organization. Information is transferred to the general ledger after it is entered into the appropriate journal. Entries transferred to the general ledger should be cross-referenced to the applicable journal to permit the tracing of any financial transaction.

   - All journal entries must be properly approved and supported.

2. Accounting records must be supported by sourced documentation that shows that costs charged against awarded federal funds were:

   - Incurred during the effective period of the agreement with HUD or with the sub-recipient;

   - Actually paid out (or properly accrued);

   - Expended on eligible items; and

   - Approved by the appropriate official(s) within the organization.

3. Source documentation must explain the basis of the costs incurred and the actual dates of the expenditure. For example:

   - Source documentation for payroll would include employment letters, authorizations for rates of pay, benefits, time, and attendance records.

   - Source documentation on supplies would include purchase orders or purchase requisition forms, invoices from vendors, canceled checks made to vendors, information on where the supplies are stored and the purpose for which they are being used.

4. Sub-recipients must ensure that their accounting records include reliable, up-to-date information on the sources and uses of awarded funds, including:

   (a) Amount of federal funds received
   (b) Current authorization of funds
   (c) Obligations of funds
   (d) Unobligated balances
   (e) Assets and liabilities
   (f) Program income; and
   (g) Actual expenditures broken down by the grant program and year for which the funds are derived and the activity on which the funds were used.

D. Cash Management

- ❑ Sub-recipients are required to have procedures in place to minimize the amount of time that elapses between receipt of awarded federal funds and the actual disbursement of those funds. This requirement is intended to curtail unnecessary drawdowns of funds and minimize the cost of financing the program by the Federal government.

  There are three general methods available to transfer awarded federal funds from the U.S Treasury to recipients (or from the recipient to a sub-recipient):

  Reimbursement method – The reimbursement method entails a transfer of funds to the recipient (or sub-recipient) based on actual expenditures of the sub-recipient prior to the receipt of funds.

  Cash advance method – The cash advance method involves the transfer of funds to the sub-recipient to meet obligations before actual cash disbursements have been made.

  Working capital method – The sub-recipient is advanced cash to meet its estimated disbursements for an initial period. After the initial period, the sub- recipient will receive cash on a reimbursement basis. This method is used when the sub-recipient lacks sufficient working capital

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Requirements concerning cash management include the following:

- Sub-recipients must include accurate information in drawdown requests.

- Funds drawndown erroneously must be returned. (This includes funds drawndown under the cash advance method where the expenditure of funds is delayed.)
- Disbursement of funds must occur in a timely manner. While there is no explicit time period, the general rule is that payment must take place within three business days of deposit of federal funds. If payment takes longer than three business days, written justification should be maintained in the files.

- If grant advances are placed in an interest-bearing account, interest income must be remitted to the U.S. Treasury. (However, interest amounts up to $250 per year may be retained by the sub-recipient for administrative expenses.)

- Program income (other than program income deposited in a revolving fund) must be disbursed prior to the drawdown of additional funds from the Treasury (or, in the case of sub-recipients, from the recipient).

- Program income in a revolving fund must be disbursed for the activity for which the fund was established before additional requests are made for new funds.

E. Cost Principles

Look At Your Agency And Ask....

Does our agency have a clearly defined set of standards and procedures for determining the reasonableness, allowability and allocability of costs incurred that is consistent with OMB A-122?

Does your agency know which specific types of expenditures are prohibited under the funded program?

1. <u>Cost Reasonableness</u>

- ❑ According to the basic guidelines in OMB Circulars A-87 (state and local governments) and A-122 (nonprofits), a cost is allowable under the CDBG, HOME, ESG or other federal programs, if it is necessary, reasonable and directly related to the grant.

- ❑ This standard applies equally to such items as salaries and administrative services contracts, as well as to real property and equipment purchases or leases, travel, and other administrative expenditures.

- In determining the reasonableness of a cost, consideration must be given to:

  (a) Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization for the performance of the awards;

  (b) The restraints or requirements imposed by such factors as generally accepted sound business practices; arm's length bargaining; federal and state laws and regulations; and terms and conditions of the award;

  (c) Market prices for comparable goods or services;

  (d) Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees and clients, the public at large and the government; and

  (e) Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.

2. Cost Allowability

   - OMB Circulars A-87 (state and local governments) and A-122 (nonprofits) provide basic guidelines for determining whether a cost is allowable.

   - To be allowable under CDBG and other federal programs, cost must meet the following general criteria:

     (a) Be necessary and reasonable for proper and efficient performance and administration of the federal award (see above);

     (b) Be allocable to the federal award under the provisions of the OMB circulars;

     (c) Be authorized or not prohibited under state or local laws or regulations;

     (d) Conform to any limitations or exclusions set forth in the OMB circulars, federal law, terms and conditions of the federal award, or other governing regulations as to types or amounts of cost items;

     (e) Be consistent with policies, regulations and procedures that apply uniformly to both federal awards and other activities.

     (f) Be determined in accordance with generally accepted accounting principles;

(g) Not be included as a cost or used to meet cost sharing or matching requirements or any other federal award in either the current or a prior period, except as specifically provided by federal law or regulation;

(h) Be the net of applicable credits (that is, any credits such as discounts or price adjustments must be deducted from the total costs charged); and

(i) Be adequately documented.

- The OMB circulars also specify exactly which costs are allowable and which are unallowable.

3. Cost Allocation

- As mentioned previously, costs charged to CDBG, HOME, ESG, or other federal programs must also be allocable to that particular program. A cost is allocable if it:

  (a) Is treated consistently with other costs incurred for the same purpose in like circumstances (i.e., sub-recipients must treat costs consistently for all grant programs)

  (b) Is incurred specifically for the funded program;

  (c) Benefits both, the funded program and other work and can be distributed in reasonable proportion to the benefits received

  (d) Is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown

- Any costs allocable to a particular federal award or cost objective (such as CDBG) may not be charged to other federal awards to overcome funding deficiencies, to avoid restrictions imposed by law or the terms of the federal award, or for other reasons.

- In accordance with the OMB Circulars A-87 and A-122, the composition of direct and indirect costs must be clear (*see* below).

4. Direct Costs VS. Indirect Cost - A Closer Look

- Direct costs are those that are specifically identified with a particular cost objective (e.g., a specific CDBG program or activity). Direct costs are assigned to the specific activity for which they were incurred.

- Indirect costs are those that are incurred for a common joint purpose benefiting more than one cost objective (program or activity) and that are not readily assignable to the cost objectives that benefit from the expenditure. Some examples of indirect costs are administrative and accounting salaries, and facility maintenance.

- Indirect Costs – OMB Circular A-87 (State and Local Government) OMB Circular A-87 requires that governmental entities support indirect costs with a cost allocation plan or an indirect cost proposal prepared in accordance with the circular. Indirect cost should be allocated in a manner which will result in the grant program bearing its fair share of total indirect costs.

- A cost allocation plan is required if the local governments has indirect cost resulting from centralized services that will be charged to federal awards.

- A cost allocation plan, for the purposes of local governments, refers to a description of a process whereby services provided on a centralized basis (e.g., motor pools, computer centers, purchasing and accounting services) can be identified and assigned to benefited activities on a reasonable and consistent basis.

- Refer to Attachment C of OMB Circular A-87 for additional information.

- An indirect cost proposal is required if the local government has indirect costs resulting from centralized services that will be charged to federal awards and other indirect costs originating in various departments/agencies carrying out federal awards.

- An indirect cost proposal is the documentation prepared by a governmental entity to substantiate its request for the establishment of an indirect cost rate. This rate, expressed in percentage terms, is applied to direct costs in order to determine the amount of reimbursement a sub-recipient can obtain for indirect costs.

- Indirect cost proposal must be prepared in accordance with Attachment E of OMB Circular A-87. The circular provides two methods for determining the indirect cost rate.

5. Simplified allocation method:

- Used when the local government's major functions benefit from its direct costs to approximately the same degree.

- Calculated by separating the local government's total costs for the base period (e.g., fiscal year) as either direct or indirect, and dividing the total allowable indirect costs by an equitable distribution base (total direct costs, direct salaries or other equitable distribution base).

6. Multiple allocation base method:

Used when the local government's major functions benefit from indirect costs in varying degrees.

Calculated by separating costs into distinct groupings. Each grouping is allocated to benefiting functions by means of a base which best measures relative benefits. An indirect cost rate must be developed for each grouping.

- Indirect cost proposals must be completed within six months after the close of the local government's fiscal year, and must be accompanied by a prescribed certification.
- Indirect Costs — OMB Circular A-122 (Nonprofits).
- Under OMB Circular A-122, there are three methods nonprofits are required to utilize for allocating indirect costs. Each method is applicable to certain specific circumstances.

7. Simplified allocation method:

- Used when a nonprofit organization has only one major function, or where all its major functions benefit from its indirect costs to approximately the same degree.
- The indirect cost rate is calculated by separating the organization's total costs for the base period (e.g., fiscal year) as either direct or indirect, and dividing the total allowable indirect costs by an equitable distribution base (total direct costs, direct salaries or other equitable distribution base).

8. Multiple allocation base method:

- Used when major functions benefit in varying degrees from indirect costs.
- Costs are separated into distinct groupings, and each grouping is then allocated to benefiting functions by means of a base which best measures relative benefits. An indirect cost rate must be developed for each grouping.

9. Direct allocation method:

- This method may be used for those non-profits that treat all costs as direct costs except general administration and general expenses.
- These joint costs are prorated individually as direct costs to cost objectives using a base most appropriate to the particular cost being prorated. The base must be submitted to and approved by the federal agency that provides the largest dollar value of funds to the nonprofit.
- A written agreement is executed between the non-profit and the approving federal agency signifying the approval of the proposed indirect cost rate.