Maryland Governor's Grants Office Presents:

SUBRECIPIENT MONITORING & MANAGEMENT training and materials presented by Chris Lipsey, U.S.Dept of Agriculture (USDA)

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INTRODUCTION

I. What is Subrecipient (or Subgrantee) Monitoring?

A. In Federal law and regulation, a **"grant"** is a transfer of money, property, or something else of value from a Federal awarding agency to a non-federal entity under a Federal program, thereby enabling the latter to carry out that program's public purpose. The non-federal entity receiving the grant is the **"grantee."** If the grantee awards a portion of its grant to another non-federal entity for the purpose of carrying out work under the grant, that award is a **"sub grant"** and the entity receiving it is a **"sub grantee."** Some Federal literature calls a grantee that awards sub grants a **"pass-through entity (PTE)**."

B. *Webster's New Collegiate Dictionary* gives several definitions of the verb "to monitor." Two of them collectively come close to describing our subject: "**3**: to watch, observe, or check esp. for a special purpose **4**: to keep track of, regulate, or control the operation of."

C. When we put it all together, our "special purpose" is the successful operation of Federal assistance programs in accordance with applicable laws, regulations, etc. A State agency or other PTE achieves it by "watching" and "observing" sub grantees, and by "keeping track of" and "regulating" their work under their sub grants.

II. Why do we care about sub recipient monitoring?

A. It's required by regulations.

For example:

1. USDA departmental regulations at 7 CFR section 3016.40(a) provide that "Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity."

2. Regulations of the National School Lunch Program at 7 CFR section 210.19(b)(4) provide that "Each State agency shall require that [sub recipients] comply with the applicable provisions of this part. The State agency shall ensure compliance through audits, administrative reviews, technical assistance, training[,] guidance materials or by other means."

B. We'll be held accountable for it.

If we award sub grants and have an audit in accordance with OMB Circular A-133 (which we'll discuss shortly), the Federal Government's guidance to auditors making A-133 audits directs them to test our compliance with sub grantee monitoring requirements.

C. We're morally obligated to monitor.

In many Federal assistance programs, sub grantees are "where it's at." It's at that level that program benefits and services are generally delivered, thereby creating financial obligations for the Federal Government and ultimately for the taxpayers. The Federal Government is also exposed to the most risk at that level because:

1. **A lot of money goes to sub recipients.** In Federal Fiscal Year 2006, for example, our agency spent about $12 billion for cash and commodity assistance under the National School Lunch Program and related Child Nutrition Programs. That $12 billion did not include funding to primary grantees (State agencies) for their State-level administrative costs; it all went to the sub grantees. **Someone needs to make sure all that money gets used for the right purposes and that the benefits get to the right people.**

2. **The money goes to a large number of entities**. For example, the National School Lunch Program and School Breakfast Program operate in over 101,000 schools under the oversight of approximately 21,000 school districts and other governing bodies. Such a prodigious number of participating entities creates many opportunities for human error, misunderstanding, and occasionally outright fraud. **Someone needs to ride herd on all those program operators in order to keep them out of trouble.**

Given the foregoing, the sheer magnitude of Federal assistance programs exposes the taxpayers' money to the risk of loss or misuse. Because sub grantees are at least one step removed from direct Federal oversight, officials of State agencies and other PTEs have the primary responsibility for overseeing them. Monitoring by State agencies and other PTEs is the taxpayers' first line of defense against loss or misuse of their resources.

In that regard, I learned an expression in the Army: "You can delegate authority but not responsibility." Delegation is getting one's own work done through others. If my boss delegates duties to me, she remains responsible to her boss for ensuring those duties are carried out. Likewise, a State agency or other PTE remains responsible for ensuring that its sub grantees properly carry out Federal assistance programs and account for Federal funds sub granted to them for that purpose. Awarding subgrants does not transfer to the sub grantees the PTE's own

responsibility for the sub granted resources; it's all part of the PTE's grant from its own awarding agency. Remember, the PTE is the one that has the relationship with the Federal awarding agency, and its sub grantee monitoring program may be examined in its federally-required audits.

Having said all that, I'd like to orchestrate this session in three modules. First, I'd like to set sub grantee monitoring in its context by giving some "refresher training" on Federal grants management generally. Then I'd like to describe the principal monitoring tools available to us. In Module 3, we'll take a more detailed look at how one of those tools—audits—can help us monitor.

MODULE 1 – THE GRANTS MANAGEMENT CONTEXT

I. Introduction.

When a Federal awarding agency gives you money or something else of value, it always comes with strings attached. The Federal Treasury is not Santa Claus. Unlike Santa's gifts, a grant is a conditional gift. It comes with various terms and conditions, and you establish your ownership of the resources the Government gave you by using them in accordance with these terms and conditions. The resources are not yours until you have done so. If you fail to do so, Federal Appropriations Law obligates the Federal awarding agency to recover the resources it had previously made available.

The same principle applies when you award Federal resources to sub grantees. Therefore, it's critically important that you know the terms and conditions yourself and that you effectively communicate them to your sub grantees.

II. Terms and Conditions.

The terms and conditions of Federal grants and subgrants may be broadly classified by their scope: government-wide and program-specific.

A. Government-Wide.

Certain laws and other authoritative sources that affect grants management are government-wide in scope. The Office of Management and Budget (OMB) gives Federal awarding agencies guidance on implementing these requirements by issuing **circulars**. Once a Federal awarding agency has adopted the contents of an OMB circular in its **regulations**, the circular becomes binding on that agency's grantees and their sub grantees.

In recent years, OMB has been seeking to minimize the volume of verbiage that a grantee or sub grantee must wade through in order to identify all applicable terms and conditions. The centerpiece of this effort has been the re-packaging of OMB circulars in regulatory form. OMB is setting up the circulars in Title 2 of the Code of Federal Regulations (2 CFR). Federal grant-making agencies will then add their agency-specific or program-specific tweaks to the general rules posted by OMB. The outcome will be that each Federal grants management requirement will be stated just once rather than repeated in multiple sets of regulations.

The significance of this effort for our discussion here is that each circular will now have a CFR citation. As I mention each circular, I'll give first its circular number and then its citation in Title 2 of the CFR.

Now for the general rules themselves. They fall into four broad categories.

1. General Management Rules.

   These are the uniform administrative requirements that apply across-the-board. Examples include rules on grant payment methods, the treatment of program income, the identification of eligible matching contributions, standards for making procurements with Federal funds, standards for managing property acquired with Federal funds, record retention requirements, financial reporting requirements, etc. These rules are found in the following documents:

   a. The A-102 "Common Rule."

      "Common rules" are regulations that all two-dozen Federal grant-making agencies issue simultaneously in order to ensure their uniformity. In March 1988, the old OMB Circular A-102 (*Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments*) was replaced with an A-102 Common Rule. Each Federal grant-making agency has codified it in its own regulations. For example, USDA codified it at 7 CFR Part 3016; the Department of Health and Human Services (DHHS) cites it at 45 CFR Part 92; the Department of Education published it at 34 CFR Part 80; and so forth.

   b. OMB Circular A-110 (2 CFR Part 215).

      This document (entitled *Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*) gives administrative requirements for grants to universities and not-for-profit organizations (NFPOs) that roughly parallel those given for State and local governments in the A-102 Common Rule. USDA has codified A-110 at 7 CFR Part 3019; DHHS has codified it at 45 CFR Part 74; and the Department of Education has codified it at 34 CFR Part 74.

2. Allowable Cost Rules.

   These are the general rules for charging costs to grants, thereby billing the Government for the costs. They spell out what we'll pay for, what we won't, what we may pay for with prior approval, what a grantee or sub grantee must do in order to claim reimbursement for shared costs, etc. They are found in the following documents:

   a. OMB Circular A-21 (*Cost Principles for Educational Institutions*) (2 CFR Part 220) gives allowable cost rules for grants to universities.

   b. OMB Circular A-87 (*Cost Principles for State, Local, and Indian Tribal Governments*) (2 CFR Part 225) gives allowable cost rules for grants to State, local, and tribal governmental units.

c. OMB Circular A-122 (*Cost Principles for Non-Profit Organization*s)(2 CFR Part 230) gives allowable cost rules for grants to NFPOs.

3. Audit Rules.

OMB Circular A-133 (*Audits of States, Local Governments, and Non-Profit Organizations*) sets requirements for complying with the Single Audit Act of 1984, as amended. Any State or State agency, local governmental entity, university, or NFPO that had expended $500,000 or more in Federal funds during a fiscal year must obtain an audit covering that period. To be acceptable, the audit must conform to requirements spelled out in the Act and A-133. We'll talk about A-133 audits in greater detail in Modules 2 and 3 of this program. USDA has codified A-133 at 7 CFR Part 3052.

4. Suspension/Debarment Rules.

An entity that has been suspended or debarred from doing business with the Federal Government is posted to a database called the Excluded Parties List System (EPLS). Before engaging that entity in a "covered transaction" involving Federal funds, we must either check the EPLS to make sure that entity is not listed there, or satisfy ourselves about the entity's status by other means spelled out in the suspension/debarment rules. This requirement applies to Federal agencies, grantees, and sub grantees; however, contractors are not required to determine the status of their subcontractors. The suspension/debarment rules are given in a common rule which USDA has codified at 7 CFR Part 3017.

B. <u>Program-Specific</u>.

Apart from the program's authorizing statute, program-specific terms and conditions are found in program regulations and/or the grant/subgrant agreement. We have both scenarios in our agency.

1. On the one hand, our large programs are administered through <u>entitlement and formula grants</u> to States. These programs' regulations can be quite voluminous and prescriptive. They represent the evolution of applicable law and the correction of loopholes over several decades. Because virtually everything is spelled out in program regulations, our agreements with the State administering agencies do little more than bind the State agency to administer the program(s) according to regulations and binds us to provide the necessary funding.

2. On the other hand, our <u>discretionary grants</u> are covered by sketchy legislative authority and no regulations. The key authoritative document is the grant agreement. This document binds the grantee to follow government-wide terms and conditions, and spells out any additional requirements specific to the grant. Since each such grant funds a unique project, the grantee's narrative description of that project is an integral part of the agreement. Thus, most program-specific rules governing our discretionary grants are contractual rather than statutory or regulatory.

C. Application.

There have been prolonged debates about the relative authoritative status of government-wide vs. program-specific rules. My understanding from our program lawyers is that we must read them collectively, and look for interpretations that reconcile the two. For example:

1. The A-102 Common Rule and A-110 give generic rules for terminating a sub grantee's participation in a Federal assistance program, while the regulations governing the Child and Adult Care Food Program (CACFP), administered by our agency, prescribe a serious deficiency process that a State agency must complete before terminating a sub grant. The State agency must complete that process before applying the generic rules on termination.

2. Program-specific rules may entitle a sub recipient to an administrative appeal process before the PTE takes administrative action against it under the government-wide rules.

D. Where do we find all this stuff?

1. OMB's Grants Management Web Site.

You can access this site at www.whitehouse.gov/omb/grants. The site will give you several menu choices: Circulars, Forms, Links, Policy Statements, etc.

a. To locate the allowable cost and audit circulars, choose "Circulars." When the list of circulars comes up, scroll down to the ones on allowable costs and audits.

b. To locate the Suspension/Debarment Common Rule, choose "Policy Statements." Then scroll down to "Government-wide Guidance on Suspension/Debarment and Drug-Free Workplace." To find out if a prospective sub grantee or contractor is suspended or debarred, you can check the EPLS at www.epls.gov.

2. Code of Federal Regulations (CFR).

You can access the CFR by entering the Government Printing Office web site at www.gpo.gov. First select "Most Popular Resources;" then "Executive;" then "Code of Federal Regulations;" then "Browse and/or search the CFR." This last choice will bring up a list of CFR titles. USDA's is Title 7, the Education Department's is Title 34; DHHS's is Title 45; etc. Scroll down to the desired title. Each Federal grant-making agency's codification of the A-102 Common Rule is available under its respective CFR title. You can find OMB's re-packaged version of A-110 in Title 2.

III. The Appropriate Instrument.

Before we get into monitoring compliance with the rules applicable to grants and subgrants, we need to make sure we're using the correct type of agreement. Many State

agencies call their subgrant agreements "contracts," but that term is actually a misnomer. A grant or subgrant is a contractual instrument, but it creates an assistance relationship between the parties. The appropriate legal instrument for creating assistance relationships has been a longstanding issue in the Federal Government. There are two principal authoritative sources for sorting it out.

A. Grants and Cooperative Agreements Act of 1978.

This legislation clarified what kind of contractual instrument was proper for what kind of transaction. The Act identified three kinds of instruments:

1. An agency awards a **grant (or sub grant)** when: (a) the purpose is to support or stimulate a public purpose; and (b) no significant involvement by the awarding agency is contemplated. The awarding agency's role is generally one of oversight, involving such functions as awarding, monitoring, enforcing, etc.

2. An agency awards a **cooperative agreement** when: (1) the purpose is to support or stimulate a public purpose; and (2) significant involvement by the awarding agency is contemplated. The awarding agency expects to be working alongside the cooperator in carrying out the public purpose spelled out in the agreement.

3. An agency awards a **contract** in order to procure goods or services for its own use. A contract forms a procurement relationship rather than an assistance relationship; the agency awarding it contemplates no public or altruistic purpose except insofar as it will use the purchased goods and services to carry out its own responsibilities under grants and cooperative agreements. The recipient of a contract is called a "**vendor**" or "**contractor**." rather than a grantee, sub grantee, or cooperator. Contracts awarded under grants, sub grants, and cooperative agreements must conform to the procurement requirements spelled out in the A-102 Common Rule or A-110, as applicable.

B. Section 210 of OMB Circular A-133.

Whether a contractual instrument creates an assistance relation ship with a grantee/sub grantee/cooperator, or a procurement relationship with a vendor/contractor, is frequently not clear-cut. The murkiness may be exacerbated if both assistance and procurement instruments are administered by a PTE's contracting office and thus appear nearly identical in form. One must often study the contractual instrument itself in order to make this determination. Section 210 of OMB Circular A-133 gives guidance on distinguishing subgrantees from vendors.

1. An entity with the following attributes is almost certainly a vendor:

   a. The entity operates in a competitive environment;

   b. Its normal business operations include the kinds of goods or services purchased by operators of Federal programs;

c. It sells the same kinds of goods or services not only to operators of Federal programs but to many different purchasers; and

d. It is not required to carry out Federal program compliance requirements (such as eligibility determination, allowable costs, matching, program reporting, etc.).

2. On the other hand, attributes of a subgrantee include:

a. Carrying out the mission of a Federal program rather than selling goods or services;

b. Making eligibility determinations according to program criteria;

c. Making other program-specific decisions; and

d. Doing these things according to program compliance requirements.

C. Illustrative Case.

A case we resolved in our agency illustrates the need to interpret an entity's agreement in order to determine the type of relationship it created. In this case, the outcome of our analysis determined how the entity could meet the A-133 audit requirement. As you know, an entity that operates only one Federal program may elect to obtain a program-specific audit of that program, which will generally be less expensive than a single (organization-wide) audit.

The entity in this case was a church whose day care activity was assisted by a grant from us under the Child and Adult Care Food Program (CACFP). To comply with A-133, the church engaged an auditor to make a program-specific audit of the CACFP. However, the auditor found that the church's day care center also received, from the city human services agency, funds that had originated in other Federal programs. These included the Employment & Training component of the Special Nutrition Assistance Program (SNAP, formerly known as the Food Stamp Program), and several programs administered by the Administration for Children and Families (ACF), an agency of the DHHS. He then questioned whether the day care center must treat those funds as additional Federal awards. If they had in fact been Federal awards, then the day care center would have been viewed as operating multiple Federal programs and required to obtain a single (organization-wide) audit.

We obtained the day care center's agreement with the city and other documentation, and consulted officials of the city, State, and the ACF/DHHS. Our analysis of this information revealed that:

1. The center's agreement with the city did not transfer to the center any responsibilities for compliance requirements under the Federal programs in question. Rather, it: (a) enumerated the center's hours of operation, services provided, fee schedule, etc.; and (b) bound the center to accept dependents of the city's clients under the aforementioned Federal programs into its day care.

2. The city used the center (and many similar centers) to provide day care for the dependents of its clients under the aforementioned Federal programs.

The center had nothing to do with the programs themselves; it simply billed the city for day care services and the city charged the costs to the programs in which the parents of the children in question participated.

3. The center sold day care services to the city on the same basis as it sold them to the general public. Dependents of the city's program clients received the same services as all other children.

4. The center did not apply for an agreement with the city under any Federal program. Rather, the city maintained an inventory of day care providers and referred its clients to the providers whose location, hours, proximity to home or work, etc. would best meet their needs. The city required that each client make the initial contact with the day care provider and enroll her child; they felt this procedure would cultivate skills that would eventually enable the client to become self-sufficient.

Given these facts, reaching a conclusion that the day care center's relationship with the city was one of procurement rather than assistance was a "slam-dunk." Accordingly, the center was deemed a vendor to the city rather than a sub grantee; the city's payments to the center were not Federal awards; the center's Federal awards were limited to its CACFP funding from us; and the center could proceed with its program-specific audit. **The moral of the story is that program operators must be careful to use the right kind of contractual instruments for transactions in which they engage.**

[BREAK]

MODULE 2 – OUR ARSENAL OF MONITORING TOOLS

As this portion of the program will demonstrate, I do not agree with many of my colleagues who view monitoring as limited to audits and on-site reviews. To me, rather, monitoring is the totality of a State agency's (or other PTE's) relationship with its sub grantees. Our arsenal of monitoring tools includes, but need not be limited to, the following:

I. Screening.

I like to call this "pre-award monitoring." By that, I mean that State agencies and other PTEs set the stage for post-award monitoring efforts during the application and award process.

A. Establishing a Record on the Subgrantee.

The PTE must capture all the information it will need in order to:

1. Determine the applicant's eligibility for a subgrant under the applicable program. For example, a State agency administering the National School Lunch Program must obtain sufficient information to determine that an applicant is a "school" as defined in program regulations.

2. Determine that the applicant is neither suspended nor debarred.

3. Facilitate post-award monitoring. For example, a PTE should ask a first-time subgrantee for information on other Federal programs it operates

and/or whether it has ever had an A-133 audit. Such information enables the PTE to enforce the A-133 audit requirement.

B. Establishing Special Award Conditions.

The PTE may use the information it captures in the subgrant application process to designate a subgrantee "high risk" and impose tighter administrative requirements until the risk conditions are corrected. The government-wide rules in the A-102 Common Rule and in A-110 authorize a PTE to do this. The applicable passages are codified by USDA at 7 CFR sections 3016.12 and 3019.14. Of course, a PTE that imposes special award conditions must: (1) monitor the subgrantee's compliance with those conditions as well as with all the "regular" terms and conditions that we discussed in Module 1; and (2) take appropriate administrative action if the subgrantee disregards the special award conditions.

II. Training and Technical Assistance.

We can't hold sub grantees accountable for program compliance until we've explained what's expected of them. Therefore, regulations require State agencies and other PTEs to instruct their sub grantees in government-wide and program-specific requirements. Specifically:

A. Government-Wide Requirements.

1. Section 400(d)(1) of A-133 requires a State agency or other PTE to identify Federal awards to sub grantees by Catalogue of Federal Domestic Assistance (CFDA) number and title, fiscal year, name of Federal agency providing the funds, etc.

   a. "CFDA" stands for "Catalogue of Federal Domestic Assistance." This document enables individuals and organizations to locate Federal programs that may respond to their needs. It gives a description of each program; outlines eligibility requirements; and explains how and where to apply.

   b. The CFDA number is a unique five-digit number assigned to each Federal program. For example, the CFDA number for the National School Lunch Program is 10.555. The first two digits identify the program's Federal awarding agency; the CFDA numbers of all USDA programs begin with "10," and the CFDA numbers for all DHHS programs begin with "93."

   c. CFDA numbers are used throughout the grants community to identify programs, regardless of whether different entities or localities refer to a program by its official title or by some other name. As we shall see, each program's CFDA number is essential to meeting the A-133 audit requirement. It will also be instrumental in complying with the Federal Financial Accountability and Transparency Act (FFATA), the scope of which will soon be extended to sub grants.

2. Section 400(d)(2) of A-133 directs State agencies and other PTEs to inform sub grantees of requirements imposed upon them by Federal regulations and of any incremental requirements imposed by the PTE.

B. Program-Specific Requirements.

Program regulations may also require a State agency or other PTE to provide training on program requirements and technical assistance to sub grantees. For example, regulations of the National School Lunch Program at 7 CFR section 210.19(a)(4) require State administering agencies to "ensure compliance through audits, administrative reviews, technical assistance, training, guidance materials or by other means."

C. Techniques of Training & Technical Assistance.

As that regulation suggests, vehicles for training sub grantees may include formal conferences and training sessions, the distribution of instructional materials, telephone contacts, e-mail exchanges, etc.

D. Continuous Effort Needed.

Training and technical assistance are never-ending jobs for a PTE because:

1. Federal program regulations that a PTE must explain to its sub grantees are frequently revised;

2. Sub grantees often experience turnover of personnel. The local program coordinator who knew where all the bones were buried may retire, leaving the PTE with the chore of breaking-in a new person.

3. Work under sub grants is often done by educators, care-givers, researchers, or others who may not be as "management-oriented" as the PTE's own staff. While they are passionate about their missions and expert at what they do, many are fitted neither by training nor by temperament to be business managers and financial analysts. The PTE needs to tech them those skills.

III. Data Analysis.

A. In General.

Routinely analyzing data on sub grantees can reveal anomalies that may be indicative of problems. At a minimum, you receive financial reports or claims for reimbursement from your sub grantees; you may receive programmatic data as well. You should study this information to detect patterns and trends. For example, is a sub grantee claiming reimbursement at a rate that suggests they are either at risk of burning up the sub grant prematurely, or claiming more reimbursement than their progress reports suggest they have the costs to support?

B. Example: School Meals Programs Participation Data.

I am not aware of any government-wide pronouncement that explicitly directs a State agency or other PTE to perform any specific operations on any particular program data. However, program regulations may set program-specific data

analysis requirements. In our agency, for example, program regulations at 7 CFR section 210.8(b)(2) set such a requirement for State agencies administering the National School Lunch Program. Sub grants under this program are funded by multiplying the number of lunches served each month by applicable per-lunch payment rates called "rates of reimbursement." Sub grantees report the number of lunches served at no charge (i.e., free), at reduced price, and at the full price (i.e., "paid"); the State agency does the math and pays the sub grantees.

The reimbursement rates for lunches served free or at reduced price are much higher than the rates for paid lunches, making these categories the most likely to be intentionally overstated. Therefore, the aforementioned program regulation mandates that each State agency compare the number of lunches each sub grantee claimed at free and reduced-price rates with the number of children the sub grantee had approved for lunches in those categories for the month of October, multiplied by the number of days of operation, multiplied by an attendance factor. A material discrepancy between the results of this calculation and the number of free and reduced-price lunches a sub grantee actually claimed needs to be checked out.

IV. A-133 Audits.

As we noted in Module 1, OMB Circular A-133 requires any State, local, or tribal governmental unit, NFPO, or university that expends $500,000 or more in Federal funds during a fiscal year to obtain an audit covering that fiscal year. A-133 prescribes the nature and scope of such audits. Since audits are a major (and expensive) monitoring tool, I'd like to spend some time talking about them.

A. What are audits?

An audit is a professional examination of a business entity's published financial or other information for the purpose of **expressing a professional opinion** on the information's fairness and conformity to applicable standards. For example, corporations whose stock is publicly traded are required by law to issue financial statements for use by interested parties (stockholders, lenders, Federal and State regulatory agencies, etc.), and to obtain annual audits of the information published therein. (We'll talk more about financial statements in Module 3.) The auditor's opinion gives **reasonable assurance** that users of the financial statements can rely on the audited information in making decisions about their relationships with the auditee.

Likewise, Federal and State grant-making agencies need such assurance regarding their grantees' or sub grantees' compliance with the terms and conditions of their awards. We've already noted that giving the taxpayers' money or something else of value to a sub grantee to carry out a public purpose exposes the Federal Government to the risk that these resources may not be used for the intended purpose, or in accordance with all applicable compliance requirements. To be sure, the State agency receives sub grantees' claims, reports and other declarations. Until the sub grantees are audited, however, these declarations remain un-validated **assertions**. Auditors test these **assertions**, thereby giving **reasonable assurance** that the State agency and other users can rely on them in making decisions.

This seems a suitable point to clarify the distinction between reasonable assurance and **absolute assurance**. Auditors are neither infallible nor omniscient; they can never provide an iron-clad guarantee that users can rely on the audited information. They can only make their examinations in accordance with the standards of their profession, which are designed to provide reasonable assurance. For example, they inspect samples of documents chosen according to methodologies designed to generate representative subsets of the auditee's total dataset. There is never 100-percent assurance--only reasonable assurance--that the one transaction involving massive fraud got swept up in the sample. I've heard a speaker at conferences assert that he could provide such absolute assurance, but that it would entail inspecting every document the auditee generated during its fiscal year and cost more than the auditee could afford.

B. What's the significance of an **auditor's opinion**?

1. In General.

An opinion is the highest level of assurance an accountant can give. Other categories of public accounting services are available, but they do not entail as much work or require the accountant to take as much responsibility as do audits. By expressing opinions, the auditors declare publicly, on the record, that they have done enough work to know that users of their reports can rely on the audited information in their decision-making. The auditors make this declaration with knowledge that their work must be able to withstand professional scrutiny and even litigation. That's why auditors often use the term "opinion-level work."

2. Specific Opinions.

When studying an audit report, you must be sure to note the opinion the auditor expressed. It may be:

a. Unqualified.

This means the auditor believes users can rely on the auditee's financial statements or other audited assertions. It is also known colloquially as a "clean opinion." This is the opinion that all auditees want to get, and that gives users of the audit report the most comfort. Auditors express this opinion by simply stating that:

"In [their] opinion, the financial statements [of the auditee] present fairly, in all material respects, the financial position of [the auditee] as of [date], and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America."

b. Qualified.

This means the auditor could have issued an unqualified opinion **"except for"** some material misstatement or **"subject to"** the outcome of some ongoing issue that remains unresolved as of the end of the fiscal year. An example of the latter may be ongoing

litigation that could end at some future date with a large judgment against the auditee.

c. Adverse.

This means not only that the auditor was unable to issue an unqualified or qualified opinion, but that he/she knows that such an opinion would have been unwarranted. An auditor expressing such an opinion would expressly state that the auditee's financial statements **do not** present the auditee's financial condition fairly. Problems with the audited information must be very severe to induce an auditor to express an adverse opinion.

d. Disclaimer.

This means the auditor could not express an opinion. Examples of circumstances that may produce this outcome include the auditee having fragmentary records, the auditee denying the auditor access to records, etc.

C. What conditions apply to making audits?

1. Auditors must meet **professional qualification** standards.

Only persons meeting professional qualifications can make audits. The public accounting profession is heavily regulated. Specifically:

a. Professional bodies such as the American Institute of Certified Public Accountants (AICPA) establish qualifications and State Boards of Accountancy set licensing requirements. To make A-133 audits, one must be either a licensed certified public accountant or a member of a State or local governmental audit organization (such as the Office of the State Auditor).

b. All State Boards of Accountancy set continuing professional education requirements in order to obtain reasonable assurance that auditors keep their skills up-to-date.

2. Auditors must perform their duties according to **professional standards of practice**.

a. Standards of practice set by such organizations as the AICPA are known as Generally Accepted Auditing Standards (GAAS).

b. Generally Accepted Governmental Auditing Standards (GAGAS) published by the Governmental Accountability Office (GAO) add another layer of professional standards for audits of governmental agencies and programs. The GAO's publication on GAGAS is known colloquially as the "Yellow Book."

c. A-133 adds yet another layer of standards for audits made in compliance with A-133. Auditors must explicitly state in their reports that they made their audits according to these standards.

3. Auditors must be **independent** of their auditees.

   Auditor independence is critical to the credibility of audit reports. If auditors are truly independent, there is the presumption that they have conducted their examination objectively and reported results that users can rely on. If they are not independent, they cannot express an opinion and must issue a disclaimer instead.

   Auditors run the risk of impairing their independence if they perform non-audit services (such as consulting) for their auditees. In the aftermath of the scandal involving ENRON and Arthur Andersen, the professional standard-setting bodies have revised their pronouncements in order to strengthen the firewall between allowable non-audit services and activities that may impair an auditor's independence. Auditors can always perform routine services such as giving advice on implementing audit recommendations, answering technical questions, or providing training. However, they cannot become so involved in the auditee's decision-making process that they place themselves in the position of: (1) auditing their own work; or (2) providing consulting services significant to the subject matter of the audits they are engaged to make.

4. Auditors must apply **professional judgment**.

   The auditor performs whatever audit procedures he/she deems necessary for gathering evidence to support an opinion. For example, the size of a sample needed to achieve a given level of confidence that the sample is representative of the population from which it was drawn is a matter of auditor judgment.

5. An A-133 audit report is a **public record**.

E. How do the auditors know what we expect them to audit?

We tell them WHAT to audit, but rely on their professional standards and professional judgment to tell them HOW to audit. Our vehicles for telling them **what to audit** include:

1. A-133 itself.

   Section 500 of A-133 gives the required scope of an A-133 single audit. It consists of:

   a. **Examination of the auditee's financial statements, leading to the expression of an opinion (or disclaimer of opinion) on whether they are presented fairly, in all material respects, in accordance with Generally Accepted Accounting Principles (GAAP).** We'll talk about the financial statements in more detail in Module 3.

   b. **The auditee's system of internal control.** "Internal control" refers to the policies, methods, and procedures established by the auditee in order to obtain reasonable assurance that: (1) Assets and information are safeguarded and used only for authorized

purposes; (2) External reports (including financial statements) are prepared correctly; and (3) There is compliance with applicable laws and regulations. An example of an internal control technique from our daily lives is the password-protection of electronic records. Because A-133 requirements build on GAGAS requirements, this dimension of the audit must cover internal controls over both the preparation of the auditee's financial statements (a GAGAS requirement) and the auditee's compliance with the terms & conditions of its major Federal programs (an A-133 requirement).

By **"major Federal programs,"** we mean those programs that expose the auditee, the PTE, and ultimately the Federal Government to the greatest risk. The risks may involve the volume of Federal dollars involved, the auditee's experience operating the program, the nature and amount of oversight provided by the State agency or other PTE, etc. Auditors must perform risk assessments on individual programs in order to identify those that will be identified as major.

c. **Examination of the auditee's compliance with the terms & conditions of its major Federal programs, leading to the expression of an opinion (or a disclaimer of opinion) on whether the auditee complied in all material respects.** This is a big deal; we attach such importance to testing compliance that we require auditors to perform opinion-level work in doing so.

Only major programs are tested for compliance. Section 320 of A-133 identifies 14 **types of compliance requirements**, such as allowable costs, cash management, eligibility, matching & cost sharing, procurement, reporting, etc. The auditor must test the auditee's compliance with those of the 14 types of compliance requirements that apply to each of the auditee's major Federal programs.

2. The Compliance Supplement.

OMB has issued a document giving guidance on auditing compliance with the terms & conditions of an auditee's major Federal programs. This document is called the **Compliance Supplement**. The Single Audit Act requires OMB to update the Compliance Supplement annually.

The Compliance Supplement gives generic guidance on auditing compliance with the 14 types of compliance requirements identified in A-133, and internal controls over such compliance. It also presents write-ups on those Federal programs deemed most likely to be designated major and tested for compliance.

A program write-up in the Compliance Supplement states the program's mission; describes how the program works; refers the reader to applicable statutory and regulatory authorities; identifies additional sources of program information (such as awarding agency web sites); and gives

program-specific guidance on the applicable types of compliance requirements. The 2008 Compliance Supplement contains write-ups on 167 categorical programs.

F. What must a State agency do to implement A-133?

Obtaining a required A-133 audit is a sub grant term & condition just like any other. Therefore, sections 400(d)(4) through (6) of A-133 require a State agency or other PTE to:

1. Identify those sub grantees under its oversight that have A-133 audit requirements;

2. Train those sub grantees on A-133 audit requirements;

3. Make sure they obtain the required audits; and

4. Follow-up on the audit results by: (a) making management decisions on audit recommendations; (b) ensuring sub grantees implement the corrective action set out in the management decisions; and (c) establishing claims against sub grantees where appropriate.

All of these requirements raise implementation issues for State agencies and other PTEs. We'll now discuss some of these issues individually.

G. Identifying sub grantees with A-133 audit requirements.

In order to do this, a State agency or other PTE must identify every Federal program in which the sub grantee participates and the amount of Federal funds it expended under each.

1. If a sub grantee has had at least one A-133 audit, this requirement is a "no-brainer;" the State agency or other PTE need only check the sub grantee's record in the database maintained by the **Federal Audit Clearinghouse (FAC)**. Section 320(d) of A-133 requires each auditee to submit the required audit reporting package to the FAC. In addition to the audit report itself, the reporting package includes a data collection form (designated the SF-SAC). Page 3 of the SF-SAC is a matrix in which the auditee lists all its sources of Federal funding by CFDA number, program title, whether the auditee received the funding directly from a Federal agency or via a PTE, whether the program was designated a major program, etc. After the FAC accepts an audit reporting package as compliant with A-133, they post the data captured on the SF-SAC to their database. You can access the FAC database at www.harvester.census.gov/fac/.

2. If the sub grantee has never had an A-133 audit, the problem becomes more complex. For example:

   a. Some State educational agencies have tried to do this by tracking all Federal funding their sub grantees receive from them alone. This approach captures many funding sources, such as the FNS Child Nutrition Programs and educational programs such as Title I, No Child Left Behind, Vocational Education, etc. The problem is

that it misses two critical classes: Federal awards from State agencies other than Education, and direct Federal awards. For example, many institutions operating the CACFP as sub grantees of State agencies also receive awards under the Head Start Program directly from the ACF/DHHS. Consequently, this approach entails the risk of letting some sub grantees with A-133 audit requirements slip through the cracks.

b. Perhaps the least burdensome approach is to ask the sub grantees themselves about their Federal funding as part of the application process. We noted this approach in our earlier discussion of pre-award monitoring. The risk there is that the sub grantees may not recognize some funds as Federal in origin, especially if the funds reach the sub grantees through one or more PTEs. That's a good reason for all awarding agencies, at all levels, to identify awards to their clients by program title and CFDA number!

H. Training sub grantees on A-133 audit requirements.

1. General.

As with any other sub grant term & condition, the State agency or other PTE must notify sub grantees what the requirement is and provide guidance on how to comply. The sub grantee's responsibility to comply with A-133 should also be enshrined in the sub grant agreement.

2. Training on Auditor Procurement.

Section 305 of A-133 directs auditees to procure audit services according to the procurement standards spelled out in the A-102 Common Rule and A-110. Given the importance and cost of audits and widespread concerns about audit quality, it is important that a State agency or other PTE train its sub grantees on procuring audit services. Specific topics may include:

a. Method of Procurement. We get what we pay for. Using a procurement method that locks us into selecting the low bidder heightens the risk of getting mediocre or marginal products. Therefore, we recommend using the competitive negotiation method of procurement for audit services, rather than the sealed bid method. This method enables the procuring entity to consider quality factors as well as price while orchestrating a competitive procurement.

Under the competitive negotiation method, the sub grantee solicits proposals; evaluates the proposals; negotiates with the most highly rated proposers; and makes the award on the basis of price **and other considerations**. A-133, section 305(a) promotes this approach to auditor procurement by instructing program operators to consider the following factors in evaluating proposals for audit services: responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and

technical abilities, the results of external quality control reviews of the proposers, and price.

b. Audit Procurement Contract. The National Intergovernmental Audit Forum has recommended that program operators form contracts with their auditors covering the services to be provided. Without a contract, the customer must rely on an engagement letter prepared by the auditor. A contract may be more enforceable.

c. Contract Duration. The National Intergovernmental Audit Forum has also recommended that program operators use multi-year contracts for audit services. A new auditor's first year with an auditee entails a learning curve, as the auditor learns about the auditee's organization, internal control system, etc.; and the auditor must build the related cost into the price charged for the audit. The subsequent years of the contract would be less expensive because the auditor would be applying knowledge acquired the first year. Thus, a three-year contract may be less expensive than three consecutive annual contracts to provide the same service.

d. Checking for Suspended/Debarred Status. A State agency or other PTE must be sure to instruct its sub grantees that have A-133 audit requirements to check the suspension/debarment status of prospective auditors. While the suspension/debarment rules generally exclude procurement transactions in amounts less than $25,000, that exclusion does not apply to engaging auditors to provide federally-required audit services. Auditor procurement is covered **regardless of dollar amount.** That's how important the Federal Government believes auditor procurement is.

I. Coordinating With Other Stakeholders.

While no regulation says so, we believe a State agency will get more out of required A-133 audits by reaching out to other A-133 stakeholders. Specifically, we recommend that they:

1. Educate auditors on program compliance requirements.

   The State agency should not only teach its sub grantees about audits, but also teach the auditors about the programs. Using the Compliance Supplement as a basic text, one could elaborate on its descriptions of how the programs work, explain what violations of key compliance requirements sub recipients typically commit, and show how State reviewers have detected them. The State agency could also invite auditors to its regular training sessions for sub grantees.

2. Maintain liaison with audit organizations, such as the:

   a. State Auditors Office,

   b. State CPA Society, and

   c. State Board of Accountancy.

The State Auditors Office is a co-stakeholder with the State agency in its need for quality audits, and may actually make the audits in some States. The other two organizations can be portals through which the State agency can reach the audit community in the State.

V. Administrative Reviews.

A. What are they?

Administrative reviews are visits by staffers of the State agency or other PTE to the premises of a subgrantee in order to inspect the subgrantee's program operations and gauge its compliance with subgrant terms & conditions.

B. How do administrative reviews differ from audits?

1. The standards for reviews are set by program regulations and State decisions rather than by OMB circulars and professional standards of practice.

2. The scope of administrative reviews can be both broader and more flexible than the scope of an A-133 audit. Reviews can cover program requirements not listed in the A-133 audit Compliance Supplement. For example, such National School Lunch Program matters as nutritional requirements, overt identification of children eligible for free or reduced price lunches, and Civil Rights compliance would be outside the scope of an A-133 single audit but within the scope of an administrative review. States can tailor the scope of reviews to meet their monitoring needs.

3. Independence is not an issue. State monitors differ from auditors in that they generally have ongoing oversight relationships with the sub grantees they review. They can provide technical assistance and review program compliance (that is, be both "good cop" and "bad cop") in the same visit.

4. Anyone the State deems qualified can make a review. Generally, no standard professional certification or other credential is required. However, knowledge of program requirements is essential. If sub grantee staff perceive that they know more than the reviewer, they'll think the reviewer is stupid.

C. Why do we need administrative reviews if we have audits?

Program regulations may require administrative reviews as well as audits. In addition, reviews offer advantages that make them an essential counterpart to audits. For example:

1. Reviews are "real time" where audits are retrospective. A State agency reviewer can detect and correct deficiencies right now, before the auditors come after fiscal year-end to write them up.

2. Reviews can cover compliance requirements that do not lend themselves to auditing. We've already noted one salient example: nutritional requirements for school lunches. No school lunch is reimbursable if it fails to meet these requirements, but the knowledge needed to make that

determination falls outside most auditors' skill set. Many State agency reviewers are nutritionists by trade and can readily gauge a sub grantee's compliance with nutritional requirements.

D. Where does it say State agencies must make administrative reviews?

While government-wide pronouncements do call for monitoring, I am not aware of any that specifically require State agencies and other PTEs to make on-site reviews of their sub grantees. Program regulations, however, often do. For example, FNS program regulations at 7 CFR section 210.18 set detailed requirements regarding the scope and frequency of National School Lunch Program reviews, as well as requirements for following-up on any deficiencies noted by reviewers.

VI. Agreed-Upon Procedures Engagements.

Section 230(b)(2) of A-133 authorizes State agencies and other PTEs to arrange for agreed-upon procedures (AUP) engagements at sub grantees that do not have A-133 audit requirements.

A. What's an AUP engagement?

An AUP is a public accounting service but it is not an audit. Accordingly, the person performing the procedures is called a "practitioner" rather than an auditor. An AUP engagement differs from an audit in that:

1. The practitioner's client is the entity contracting for the procedures. For example, the State agency may be the client who engages the practitioner to perform the procedures on a subgrantee under the State agency's oversight.

2. The client, not the practitioner, is responsible for determining the procedures to be performed and for their sufficiency in meeting the client's needs.

3. The practitioner's role is limited to performing the agreed-upon procedures and reporting the results.

4. The practitioner does not express an opinion. In fact, he/she is expressly prohibited from doing so.

5. Because the AUP are crafted to meet the client's specific needs, use of the report is restricted to the client and any other entities identified in the report. An AUP report is not a public record.

6. Applicable professional standards are the AICPA's Statements of Standards for Attestation Engagements (SSAE) rather than SAS.

B. How are AUP engagements relevant to monitoring?

A State agency can use AUP engagements to obtain information about sub grantees that are not required to obtain A-133 audits. Section 230(b)(2) of A-133 authorizes State agencies and other PTEs to engage practitioners for AUP engagements, provided they satisfy the following conditions:

1. The scope of such an AUP engagement is restricted to five of the 14 types of compliance requirements. Most of these five are program-specific. They include activities allowed or unallowed, allowable cost rules, eligibility of individual beneficiaries and sub grantees, matching requirements, and reporting. State agencies and other PTEs cannot expand the scope of AUP engagements in order to circumvent the $500,000 threshold for A-133 audit requirements.

2. State agencies and other PTEs must arrange for these engagements and pay for them with Federal and/or State funds. They cannot direct sub grantees to fund the work, as they can with A-133 audits.

3. The State agency must still make all administrative reviews required by program regulations. AUP engagements are not a substitute for required programmatic reviews. However, State reviewers should consider the results of AUP engagements in determining the scope and timing of reviews.

VII. Summary: Sub recipient Monitoring Accountability Issues:

A. Did the State agency or other PTE identify sub grants to its sub grantees by categorical program title, CFDA number, and Federal funding source?

B. Did the State agency provide technical assistance in order to train subgrantees on program requirements?

C. What analyses did the State agency make on sub grantees' claims for reimbursement before approving them for payment?

D. Did the State agency make the administrative reviews required by program regulations? Did the State agency make any additional site visits as needed. How were such needs identified?

E. How did the State agency identify sub grantees required to obtain A-133 audits and make sure they did so? How?

F. Did the State agency use AUP engagements as a monitoring tool? If so, did they use them in accordance with the conditions spelled out at 7 CFR section 3052.230(b)?

G. Did the State agency follow-up on the results of administrative reviews, A-133 audits, and AUP engagements of its sub grantees? Was their corrective action documented by management decisions, corrective action plans, etc.? Was their corrective action completed in a timely manner?

H. Did the State agency establish claims to recover Federal funds shown by audits, reviews, and other monitoring tools to have been improperly disbursed to subgrantees? Did the State agency collect these claims in a timely manner?

[BREAK]

MODULE 3 – FOCUS ON AUDITS

In this module, we'll consider what assurances we get from a subgrantee's A-133 audit and how they aid us in monitoring.

I. Auditor's Opinion on the Auditee's Financial Statements.

A. What are Financial Statements?

Financial statements are documents that a business entity publishes in order to report its financial condition and the financial results of its operations to interested parties. An entity that prepares and publishes financial statements about itself is called an **"issuer"** of financial statements. Issuers include for-profit organizations; not-for-profit organizations (NFPOs); universities; and State, local, and tribal governments.

B. Why do we care about financial statements?

1. In General.

a. Financial statements give us financial information about the issuer that aids us in making decisions about beginning or continuing a relationship with the issuer. Examples of financial statement users include:

(1) The Board of Directors of a for-profit organization or a NFPO, who need to gauge the organization's financial health.

(2) Investors who contemplate buying shares in a for-profit corporation or bonds issued by a State or local government. They seek assurances that the corporation is financially sound and that the governmental borrower will be able to refund their money when due.

(3) Banks seeking insights into the financial health of prospective borrowers, in order to assess the risk of lending money to them.

(4) **Underwriters** of bonds issued by State and local governments. Underwriters purchase the entire bond issue from the issuer and market it to investors, so they need assurances regarding the issuer's financial health.

(5) Donors who contemplate making donations to NFPOs. They need assurances about the financial health and responsibility of the prospective donees.

(6) Governmental regulators, who need financial information about the organizations for which they have oversight responsibility.

b. Issuers must disclose sufficient information that users of their financial statements can make informed decisions. Therefore, financial statements must conform to prescribed form and content requirements. The uniformity imposed thereby enables users to

compare the financial information on different issuers. For the most part, the form and content of financial statements are set by GAAP. Their conformity to GAAP must be validated through audits.

2. Specific Application to Grants Management.

As a State administering agency or other PTE, you are responsible for monitoring the sub grantees under your oversight in order to secure their compliance with program requirements and their safeguarding of program funds. This responsibility gives you the same concerns about your relationship with your sub grantees that investors, lenders, donors, etc. have regarding their relationships with other financial statement issuers. You likewise have the same need for financial information about the sub grantees. Little of the information in a sub grantee's GAAP financial statements is truly program-specific; nevertheless, the financial statements give you insights about the issuing organization as a whole that have implications for its successful operation of the program(s) for which you are ultimately responsible.

C. What financial statements are required, and how do they aid us in monitoring?

1. The Balance Sheet.

a. What is it?

An issuer uses the **Balance Sheet** to report its **financial position** as of a point in time. That point is generally the end of the issuer's fiscal year. By "financial position," we mean whether the organization is financially sound or is tottering on the brink of bankruptcy. The Balance Sheet measures the issuer's financial position by identifying:

(1) The issuer's assets. **Assets** are things of economic value that the issuer owns. Examples include cash, investments, accounts receivable, inventories, equipment, and real property.

(2) Claims against the assets. Priority goes to the satisfaction of creditors' claims, which are called **liabilities**. After creditors' claims are satisfied, the residual portion of the assets belongs to the issuer. This portion is known as "stockholders' equity" in for-profit organizations and as "**net assets**" in governmental organizations and NFPOs.

The exact title of the Balance Sheet depends on the type of organization that issues it. State and local governments call it the **Statement of Net Assets**, while NFPOs call it the **Statement of Financial Position**.

b. How can we use it in monitoring?

We can draw conclusions about the issuer's solvency and liquidity by studying its Balance Sheet. That, in turn, may influence a decision to impose special award conditions, make an administrative review, expand the scope of reviews already planned, arrange an agreed-upon procedures engagement, etc. Examples of analyses we can perform include:

(1) The Current Ratio. This test gives us insight into the issuer's **solvency** (that is, its ability to pay its bills as they fall due over the course of a fiscal year). We compute the **current ratio** by dividing the issuer's **current assets** by its **current liabilities**. Current assets include cash and other assets (short-term investments, accounts receivable, and inventories) that we can reasonably expect the issuer to convert into cash or consume in operations during the fiscal year. Current liabilities (as opposed to long-term liabilities) are bills that must be paid during the current fiscal year.

There is no universally-prescribed current ratio that will make all accountants and financial analysts comfortable. Suffice it to say that a very low ratio may suggest a lack of solvency, while a very high ratio may indicate that the issuer is tying-up liquid assets that could be used in operations.

(2) The "Acid Test," or "Quick Ratio." This is a more stringent test that measures the issuer's short term **liquidity**. By "liquidity," we mean the issuer's ability to quickly raise cash in order to pay bills promptly, take advantage of discounts offered by vendors, maintain a good credit rating, etc. While the issuer may be solvent on an annual basis, there may be rough patches within that period when the normal cash flow from operations is insufficient to meet current bills.

We perform this test by dividing the sum of the issuer's "**quick assets**" by the issuer's current liabilities. Quick assets consist of cash and cash-equivalents (short-term investments and accounts receivable that can be quickly converted into cash if the need arises). We exclude inventories from this calculation because they are converted into cash only through use in operations; they are therefore too illiquid to qualify as cash-equivalents.

2. The Operating Statement.

a. What is it?

The Operating Statement reports the financial results of the issuer's operations during its fiscal year. It thus sheds light on how the issuer got from last year's Balance Sheet to this year's. The

issuer measures its financial results of operations by subtracting its **expenses** from its **revenues** to compute the proverbial "bottom line" (whether the issuer made or lost money). For that reason, the operating statement of a for-profit organization is often called a profit-and-loss (P&L) statement. A State or local government or a NFPO calls this report a **Statement of Activities**.

(1) Revenues are reported by source. Taxation and fines & penalties are revenue sources unique to governmental issuers. Examples of revenue sources available to both governments and NFPOs include donations, grants, fees for services, and investment revenue (interest, etc.).

(2) Expenses (or **Expenditures** in the case of many governmental issuers) can be reported along several dimensions. Key examples include:

(a) By object class. "**Object Class**" refers to what they bought, such as wages & salaries, fringe benefits, supplies, etc.

(b) By function. A **Functional Classification** of expenses focuses on why they bought it. The issuer reports how much of its total expenses benefited each major function of the organization. For example, the major functions of a NFPO may include program services, management & general administration, and fundraising.

b. How can we use it in monitoring?

(1) The Bottom Line. The obvious concern is what the bottom line looks like; did the issuer's operations generate a surplus or a deficit, or did the issuer literally break even? However, users cannot analyze the bottom line in isolation from such considerations as:

(a) State & local governments and NFPOs differ from for-profit organizations in that they were formed for purposes other than to generate large profits. State and local governments exist to provide public services according to applicable laws and regulations. NFPOs exist to carry out their tax-exempt purposes, which may be charitable, scientific, religious, educational, etc. Narrative information is often more useful than the bottom line in gauging these issuers' success in carrying out their missions. Governments are required to meet this need by including a Service Efforts and Accomplishments piece in their financials.

(b) A surplus or a deficit may have been planned, rather than resulting from poor accounting, inadequate internal control, or over-spending. The issuer may have incurred substantial start-up costs in order to initiate an important new program, but made up the resulting deficit by borrowing or drawing on cash reserves.

(2) Patterns and Trends. Studying the issuer's bottom line over the course of several fiscal years may yield more meaningful insights. A consistent pattern of deficit spending may indicate problems, such as a NFPO over-spending or failing to generate sufficient revenue. If such pattern-and-trend analysis suggests the NFPO is in financial trouble, its handling of its sub grants may warrant greater scrutiny.

3. The Statement of Cash Flows.

a. What is it?

An issuer uses this document to report its sources and uses of cash.

b. How does it help us in monitoring?

The significance of the Statement of Cash Flows is that:

(1) Some expenses reported on the Statement of Activities do not entail the payment of cash. Equipment **depreciation** is a familiar example of a **non-cash expense**.

(2) Cash reported on the Balance Sheet can be generated by activities other than operations. For example, the issuer could have borrowed money to fund an equipment purchase. This is considered a **financing activity** rather than an operational one. Because the purchase would benefit operations of future fiscal years, it would also be viewed as an **investing activity**.

Given the foregoing, the Statement of Cash Flows is needed to complement the Balance Sheet and Statement of Activities. Without it, the issuer's reporting of its financial condition is incomplete.

4. The Statement of Functional Expenses (NFPOs only).

a. What is it?

Certain NFPOs are required to issue the **Statement of Functional Expenses** . A NFPO uses this document to report the distribution of its expenses of the fiscal year just ended among three broad functional categories: program services (by program), management and general administration, and fundraising. The

Statement takes the form of a matrix that cross-references these functions with the NFPO's expenses categorized by object class.

b. How does it assist us in monitoring?

Examples of insights obtained from analysis of this report include:

(1) What percentage of the NFPO's total expenses directly benefited its program services? Since the NFPO's mission is to deliver these services, we would expect a disproportionate share of the NFPO's expenses to fall into this category.

(2) What percentage of the NFPO's total expenses benefited fundraising? A low percentage, coupled with a healthy bottom line, may suggest that the NFPO raises funds efficiently. This, in turn, suggests that the NFPO is more likely to be a **going concern** to which we would feel comfortable awarding sub grants.

5. Notes to the Financial Statements.

a. What are they?

This is where the issuer reports information that lends itself to narrative rather than tabular presentation. For example, the Notes include a summary of the issuer's significant accounting policies.

b. How do they help us in monitoring?

Some key note disclosures include:

(1) Related-Party Transactions. When studying the financial statements of a sub grantee, you should be particularly alert for **related-party transactions**. These are transactions between the sub grantee entity and persons who are in a position to exercise undue influence over the sub grantee's business decisions. For example, Federal securities legislation requires commercial issuers to disclose loans by the corporation to directors, officers, and major stockholders.

In the arena of Federal assistance programs, officers of NFPOs operating some FNS programs, and their relatives, have been known to lease office space in buildings they own to the programs. While that is not expressly prohibited, such **less-than-arm's-length transactions** require close scrutiny. This is because:

(a) They may hold greater potential for abuse and collusion than the sub grantee's regular **arm's-length transactions** with its customers and vendors; and

(b) Federal allowable cost rules prohibit the sub grantee from charging the program more than the program would have paid in an arm's-length transaction with an outside party.

(2) Contingencies. A **contingency** is "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to [the issuer] that will ultimately be resolved when one or more events occur or fail to occur." Perhaps the most familiar example of a contingency is ongoing litigation whose outcome may generate a large monetary judgment against the issuer.

Depending on the probability and magnitude of the judgment, the issuer may be required to disclose it in the Notes or recognize it as an expense in the Statement of Activities. If a sub grantee discloses a contingency that could generate a large financial loss, it may raise questions whether the sub grantee will remain a going concern or continue to have sufficient resources to operate its sub grants successfully.

6. Schedule of Expenditures of Federal Awards (SEFA).

a. What is it?

This document is required of issuers that must obtain A-133 audits. The SEFA shows the issuer's sources of Federal funding by program title, CFDA number, Federal awarding agency, pass-through entity, and the amount expended under each program. It must reconcile with the financial statements, and auditors must express opinions on it "in relation to the basic financial statements taken as a whole."

b. How does it help us in monitoring?

This information can help us identify: (1) the sub grantee's sources of Federal funding, and (2) the Federal agency responsible for negotiating the issuer's indirect cost rates. Under the Federal allowable cost rules, the agency with the largest dollar volume of direct funding (not sub grants) to a program operator is that entity's cognizant agency.

C. How do we get sub grantees' audit reports and financial statements?

1. If the sub grantee's A-133 audit **had findings in sub grants you awarded**, section 320(e)(1) of A-133 requires the sub grantee to submit a copy of the audit reporting package to you.

2. If there were **no audit findings in sub grants you awarded**, section 320(e)(2) of A-133 authorizes the sub grantee to submit written notification to that effect in lieu of the audit reporting package. Section 320(f) of A-133 then directs the sub grantee to provide a copy of the audit

reporting package to you upon request; however, it's not clear to me whether this passage contemplates a PTE "requesting" all its sub grantees to routinely submit their audit reporting packages or whether it simply authorizes the PTE to obtain sub grantee audit reports as needed on a case-by-case basis. Therefore, I'd suggest that you include a "request" for the audit reporting package in your sub grant agreement. That would make it a contractual requirement.

II. Other Components of the A-133 Single Audit.

A. Auditor's Opinion on Compliance With Terms & Conditions of Major Federal Assistance Programs.

As we noted in Module 2, the auditor is required to express such an opinion or disclaim an opinion. An example of such opinion language would be:

"In our opinion, **except for** the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the New School District's compliance with the requirements of the National School Lunch and School Breakfast Programs regarding beneficiary eligibility, the New School District **complied**, in all material respects, with the requirements referred to above that are applicable to each of its major Federal programs for the year ended June 30, 2008."

The auditor would report the auditee's specific violation(s) of rules for determining beneficiary eligibility in the Schedule of Findings and Questioned Costs, which we'll get to in a moment. What's noteworthy here is that:

1. The auditor must express the opinion on compliance, NOT in the aggregate, but with regard to each of the auditee's major Federal programs.

2. The violation(s) in this case were deemed sufficiently serious that the auditor qualified his/her opinion on compliance. Therefore, this report should be a red flag to the State administering agency!

B. Report on Internal Control.

As we noted in Module 2, an auditor is required to study the auditee's system of internal control as it affects both the financial statements and the auditee's compliance with the terms & conditions of its major Federal programs. The significance of internal control over compliance is that the auditee could get an unqualified opinion on compliance for the fiscal year under audit, but have internal control weaknesses that would raise questions about the auditee's future compliance. Systems of internal control are vulnerable to decay over time unless the organization's management strongly enforces their observance and updates them as needed. An auditor's report on internal control over compliance might read (in pertinent part) as follows:

"Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed

below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses….We consider the deficiencies in internal control over compliance described in the accompanying Schedule of Findings and Questioned Costs as items 20081-6 and 20081-7 to be significant deficiencies…."

A State agency or other PTE should note the following points about this report:

1. The auditor **did not express an opinion**. Rather, the preceding paragraph of this report states that the auditor "considered [the auditee's] internal control over compliance with the requirements that could have a direct and material effect on a major Federal program in order to determine our auditing procedures for the purpose of expressing an opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express [such an opinion]." A-133 does not require opinion-level work on internal control.

2. Because the auditor did not do opinion-level work on internal control, the report acknowledges that the auditee could have had other internal control weaknesses that the auditor did not detect. We call this a "negative assurance."

3. Internal control weaknesses are reported as findings in the Schedule of Findings and Questioned Costs on the same basis as findings of noncompliance.

C. Schedule of Findings and Questioned Costs.

This document provides the detail of the audit findings. It covers findings in financial statement presentation, internal control, and compliance. Where applicable, the auditor reports the dollar impact of each finding (that is, questioned costs) according to criteria set out in A-133. This Schedule is the starting point for your determination of required corrective action and your establishing a claim against the auditee.

D. Summary Schedule of Prior Audit Findings.

This document reports the status of findings from prior audits that had not been brought to closure since the previous audit. It is prepared by the auditee. However, section 510(a)(7) of A-133 requires the auditor to report any instance in which the Schedule materially misrepresents the status of a prior year finding. You should study this document to see if what the auditor found differs from what the sub grantee has been telling you about the status of its corrective action.

E. The Management Letter.

Auditors use The Management Letter to communicate "good management suggestions" to the auditee. It is not an integral part of the audit report. You should nevertheless study the Management Letter because auditors have been known to hide actual deficiencies in it rather than reporting them as findings in the audit report itself.

CONCLUSION

I was asked by the Governor's Grants Office to discuss sub grantee monitoring, and have tried to do so. At the risk of sounding redundant, most program activity takes place at the sub recipient level. Clearly, the most effective way to minimize the risks associated with it is to establish a strong sub grantee monitoring system. Such a system should synthesize the available tools into a comprehensive program that makes them all hang together.

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