

## CHAPTER 7.0: AUDITS

Even if your agency had its own internal sources of funds, you would still want to have some independent review of your financial and program results to let you know whether you were making adequate progress toward your goals and objectives, and that you were not wasting funds. GAO has stated that you, as a subrecipient of the CDBG Entitlement program, share a joint responsibility with your grantee to ensure that Federal program resources are applied “efficiently, economically and effectively to achieve the purposes for which the resources were furnished.”<sup>1</sup> The financial and performance audits discussed in this chapter are designed to assure that grantees and subrecipient agencies meet this mutual responsibility and are accountable to the public. In particular:

1. **Financial audits** are designed to provide an independent opinion on whether your agency’s financial statements present in a fair manner actual operating results in accordance with accepted standards, and whether your agency has complied with specific financial requirements in terms of systems and procedures.
2. **Performance audits** provide an independent point of view on the extent to which your agency has faithfully, efficiently and effectively carried out its operations, and achieved the intended results or benefits of its programs.

In general, a formal IPA audit sits at the third rung of a four-rung examination ladder. The first rung corresponds to your own internal bookkeeping systems and procedures that enable you to compile operating results for a given period of time and give you a chance to compare your agency’s financial and program results for that period, as a whole, to your goals and objectives. The second rung corresponds to an outside accountant’s compilation and review of your operating data for a given period. However, at this level, the review is still informal and may not result in the accountant’s formal opinion as to the reliability and accuracy of the results.

The third level of examination, discussed in this chapter, corresponds to the formal IPA audit that must be performed anytime your agency expends \$500,000 or more in Federal funds in a year. Its primary goal is to determine whether your agency has adequate systems in place to assure that:

- Goals and objectives are met.
- Resources are safeguarded.

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<sup>1</sup> U.S. General Accounting Office, Government Accounting Standards (U.S. Government Printing Office: Washington, D.C., 1988) pp. 1-4.

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- Laws and regulations are followed.
- Reliable data are obtained, maintained, and accurately disclosed.

This level of review should always result in a formal opinion of the accuracy and reliability of the data presented as expressed in a management letter.

The fourth level of audit corresponds to detailed evaluations by the GAO or HUD's OIG that are designed to improve the productivity of Federal agencies and programs by identifying and correcting poor management practices among these agencies and their grantees and subrecipients. These types of audits are not discussed in detail here, but, if you are interested, your grantee or local HUD office should be able to provide you with information on GAO and OIG procedures and standards.

This chapter summarizes Federal requirements for IPA audits of subrecipients subject to the provisions of the Single Audit Act. It discusses general audit requirements, internal control and compliance reviews, audit reports, auditor selection and procurement, audit costs, and audit review and resolution procedures. The intent is not only to summarize the procedures necessary to comply with Federal requirements, but also to show that an IPA audit gives you an excellent opportunity to measure the strengths and weaknesses of your program so you can improve your performance.

#### **AS YOU READ THIS CHAPTER, THINK ABOUT ...**

1. *What kind of audit* your agency is required to perform, and whether multiple funding sources are involved (Federal, non-Federal).
2. Based on prior financial reviews or audits, whether you feel your agency has *sufficient control* over its financial situation and its CDBG-related activities.
3. Whether there are any particular *financial or program concerns* you feel should be addressed as part of your next audit.
4. What *files, records, or procedures should be organized and updated* before your next audit, so that the auditor might be more efficient in collecting and organizing the data and giving you important feedback on financial and program results.

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#### 7.1 General Audit Requirements

**Subrecipients that expend \$500,000 or more** in total Federal financial assistance<sup>1</sup> in a year are responsible for obtaining **an independent audit** in accordance with the Single Audit Act of 1984 and OMB Circular A-133 as referenced at 24 CFR 84.26 and 85.26. The computation of the total of such assistance includes all Federal funds received by the entire entity, and not just the department or division receiving the CDBG funding. For purposes of determining the amount of Federal assistance expended, all Federal assistance shall be considered, including that which is received directly from a Federal agency, or passed through a state or local government, or through non-profit organizations, or any combination thereof.

If a subrecipient expends **less than \$500,000 per year** in Federal financial assistance, it is exempt from Federal audit requirements. However, the subrecipient must still have records available for review by HUD, the grantee, or GAO, and there also may be separate state or local laws prescribing additional audit requirements.

**If a subrecipient has expended more than \$500,000 in a year under only one Federal program, the auditee may elect to have a program-specific audit conducted in lieu of a single audit.** (*A single audit is an audit that includes both the entity's financial statements and the Federal funds it has expended.*) If the subrecipient elects this option, the auditor(s) will perform the compliance testing for the individual grant program in accordance with OMB Circular 133, Subpart B—Audits §\_\_\_\_.235 Program-specific audits.

If a subrecipient in turn provides \$500,000 or more of its Federal financial assistance in a year **to another subrecipient**, the providing subrecipient must ensure that this second subrecipient has complied with the relevant audit requirements and applicable laws and regulations. It must also issue a management decision on audit findings within 6 months after receipt of the audit report and ensure that the subrecipient takes appropriate and timely corrective action (see OMB Circular A-133, Subpart D, §\_\_\_\_.400 Responsibilities, paragraph [d]).

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<sup>1</sup> “Federal financial assistance” means assistance provided directly by a Federal agency to a recipient or a subrecipient or through a recipient to a subrecipient to carry out a program or activity. Such assistance may be in the form of:

- Grants.
- Loans.
- Contracts.
- Cooperative agreements.
- Loan guarantees.
- Property.
- Interest subsidies.
- Insurance.
- Direct appropriations.
- Other non-cash assistance.

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Subrecipients will be responsible for providing the auditor with a summary schedule of any prior audit findings, whether corrective action was taken, and the status of corrective actions not yet completed.

#### 7.2 Internal Control and Compliance Review

The Single Audit Act requires, among other things, that the independent auditor determine and report on whether the organization or governmental entity has **internal control systems** to provide reasonable assurance that it is managing its Federal assistance programs in compliance with applicable laws and regulations. (See also OMB Circular 133, Subpart E—Auditors, §\_\_.500 Scope of audit, paragraph (c).) The auditor will perform tests of these controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance.

The auditor will also conduct **compliance testing**. (OMB Circular 133, Subpart E—Auditors, §\_\_.500 Scope of audit, paragraph (d).) For the CDBG program, the auditor will examine a sample of transactions to determine whether:

- The amounts reported by the subrecipient as expenditures were for allowable services, and the records show that those who received benefits or services were eligible to receive them.
- Applicable limitations (such as ceilings on administrative costs, or funding for public services, as well as allocations for activities to principally benefit low- and moderate-income individuals) were met.
- The subrecipient's financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared.
- Program income received was properly recorded and used before drawing additional grant funds.
- The expenses claimed by the subrecipient are in accordance with the applicable cost principles and uniform administrative requirements.

#### 7.3 Audit Reports

Following the completion of the audit, an audit report must be prepared. (See OMB Circular 133, Subpart E--Auditors, §\_\_.505 Audit reporting.) The audit report must contain at least the following (assuming that it is a single audit as opposed to a program-specific audit):

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- **An opinion as to whether the subrecipient’s financial statements** are presented fairly in all material respects, and **an opinion as to whether the schedule of expenditures of Federal awards** is presented fairly in relation to the financial statements taken as a whole.
- **A report on the subrecipient’s internal control related to the financial statements and major programs.** The report would be expected to identify the significant internal accounting controls and those controls designed to provide reasonable assurance that Federal programs are being managed in compliance with applicable laws and regulations.
- **A report on compliance containing:** an opinion as to whether each major Federal program was being administered in compliance with applicable laws and regulations; a statement of positive assurance for those items tested; negative assurance for those items not tested; a summary of all instances of noncompliance; and, identification of total amounts questioned.
- **A schedule of findings and questioned costs,** where applicable.

The audit must generally be completed within 9 months after the end of the audit period and the report submitted within 30 days of receipt of the auditor’s report(s). The subrecipient shall submit to the Federal clearinghouse designated by OMB the data collection form used in the audit along with a copy of the reporting package. It shall also submit a copy of the reporting package to HUD and the grantee.

A subrecipient should maintain copies of audit reports on file for a minimum of 4 years from the date of their issuance. Similarly, the subrecipient should ensure that its auditor maintains copies of the audit work papers for a minimum of 4 years from the date of the report issuance. If there remain unresolved audit issues at the end of this 4-year period, the subrecipient should notify the auditor in writing to extend the retention period.

#### 7.4 Auditor Selection/Procurement

In arranging for audit services, subrecipients must follow the procurement requirements found in 24 CFR 85.36 or 24 CFR 84.41-48, as applicable. Small audit firms and audit firms owned and controlled by minorities or women must have the maximum practicable opportunity to participate in audit contracts.<sup>2</sup>

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<sup>2</sup> See OMB Circular A-133, §\_\_.305.

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In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control review, and price.

#### 7.5 Audit Costs

The costs of audits made in accordance with the applicable regulations are allowable charges to Federal assistance programs. These charges can be treated as either a direct cost or an allocated indirect cost. In regard to the latter, the percentage of costs generally charged to Federal assistance programs for a single organization wide audit should not exceed the percentage that the subrecipient's Federal funds represent of total funds expended by the entity during the applicable year. The percentage may be exceeded, however, if appropriate documentation demonstrates higher actual costs.

#### 7.6 Audit Review and Resolution

As noted in the preceding section, the reports from any independent audits must be forwarded by the subrecipient to the grantee (in its role as the entity providing the funds), who will review all such reports to determine whether they meet all relevant standards and are acceptable.

A subrecipient must establish a system to ensure a *timely and appropriate resolution* to audit findings and recommendations. This system must address both independent audits performed relative to the Single Audit Act and audits completed on the subrecipient's operations by the HUD OIG, GAO , or other governmental bodies.

A subrecipient's first step in the resolution of an audit is the preparation of its "Management's Response" to the findings and recommendations contained in the audit report. In its response, the subrecipient should provide:

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#### For findings/recommendations with which the subrecipient agrees:

- Information on the actions it has taken (or plans to take) to correct the specified noncompliance or financial system deficiencies.

#### For findings/recommendations with which the subrecipient does not agree:

- The basis (including relevant documentation) for the subrecipient's belief that an audit finding or recommendation is inaccurate or inappropriate.

Typically, the Management Response is due within 30 days from the subrecipient's receipt of an audit report. If, in its Management Response, the subrecipient disagreed with any of the audit findings or recommendations, the grantee will re-examine the points in question to determine whether any revisions to the report's findings/recommendations are warranted. It will then issue a Management Decision concerning the finding or recommendation.

For those audit findings and recommendations with which the subrecipient agrees, and for any disputed findings or recommendations in which the subrecipient's challenge is not upheld (in the grantee's management decision), the next step in the resolution process is the implementation of procedures to prevent the deficient conditions from re-occurring. In general, action to correct findings or to implement recommendations must be completed within 1 year of the issuance of the audit report. The grantee may perform a site visit or require documentation that the corrective action procedures have been implemented, or may require the subrecipient's independent auditor to report whether the subrecipient has implemented the prior year's corrective action and/or recommendations.

A **“repeat finding”** (a deficiency or area of noncompliance which appears in more than one successive audit for a subrecipient) will be viewed very seriously by a grantee and can often result in special conditions being attached to the subrecipient's CDBG funding or other sanctions.

Occasionally, the findings from an audit will result in **“questioned costs.”** A subrecipient's costs associated with its CDBG funding may be questioned for the following reasons:

- There is inadequate documentation to support the expenditure or the amount of cost charged to the grant.
- The expenditure does not appear to be related to the grant project.

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- The cost was incurred outside the effective period of the Subrecipient Agreement or was a program expense incurred by the subrecipient before environmental review clearance was achieved.
- The expense is unallowable under the program regulations and applicable cost principles.
- The cost required the prior approval of the grantee, and no prior approval was obtained.

**To resolve a questioned cost**, the subrecipient must:

- Provide the missing documentation to support the expenditure and amount.
- Offer detailed explanation of how the cost relates to the grant program.
- Seek retroactive approval for an expense that required prior approval (which the grantee may or may not give).

If a subrecipient is not able to resolve a questioned cost to the satisfaction of the auditor and/or grantee, the expense will be **disallowed**. A disallowed expense for which Federal funds were originally used must be reimbursed from non-CDBG/non-Federal funds. On occasion, such reimbursements can be repaid on a payment schedule negotiated with the grantee or the other relevant officials (e.g., HUD/OIG representatives).

**Exercise for Chapter 7.0 — Audits**

**Circle the Correct Answer**

1. A non-profit subrecipient that has expended \$35,000 in Federal financial assistance in a year from multiple Federal programs must have:
  - (a) An audit of its entire operations.
  - (b) A program-specific financial audit for each Federal award.
  - (c) Either (a) or (b).
  - (d) No audit is required.
  
2. A non-profit subrecipient that has expended a total of \$550,000 in Federal financial assistance in a single year, but only from one Federal program, must have:
  - (a) An audit of its entire operations.
  - (b) A program-specific financial audit for the Federal award.
  - (c) Either (a) or (b).
  
3. Which of the following are necessary components of a financial audit report under the Single Audit Act?
  - (a) An organizational chart or description of the entity's organizational structure.
  - (b) Financial statements and schedule of Federal assistance.
  - (c) An inventory of non-disposable property.
  - (d) An itemization of personnel positions and salaries.
  - (e) An evaluation of internal control systems.
  - (f) A report on compliance.
  - (g) An assessment of the entity's efficiency and effectiveness in its operation of the Federal program(s).
  
4. A subrecipient may procure independent audit services from any source of its choosing.

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**TRUE**

**FALSE**

5. Cost considerations must be the dominant factor in the selection of auditors.

**TRUE**

**FALSE**

6. Since the Single Audit Act mandates a single audit for non-profit subrecipients that expend a total of \$500,000 or more in a single year from multiple Federal programs, the non-profit can charge the full cost of the audit to those Federal programs.

**TRUE**

**FALSE**

*The answers are on next page.*

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#### Exercise for Chapter 7.0 — Audits (continued)

#### Answers to questions from preceding pages

1. “(d).” No audit is required because the subrecipient expended less than the \$500,000 in total Federal assistance that triggers the requirement for an audit.
2. The subrecipient may have either type of audit.
3. “(b),” “(e),” and “(f).”
4. **FALSE.** Subrecipients must follow procurement rules in either the Federal Acquisition Regulation or in 24 CFR Parts 84 and 85, as applicable.
5. **FALSE.** Cost should only be a selection factor when the other selection criteria such as the qualifications and independence of the firms being considered have been met.
6. **TRUE.** Since the audit is a mandated Federal requirement, the Federal programs can pay the full cost of the audit.