

## CHAPTER IV

### FINANCIAL MANAGEMENT REQUIREMENTS

#### 1. INTERNAL CONTROLS.

- a. Definition. Internal controls are the organizational plan, methods and procedures adopted by the recipient to ensure that resources are properly used and safeguarded, and that necessary information is provided to recipients and FTA managers.
- b. General. FTA payments to a recipient are made electronically to meet the Federal share of eligible expenses under a project.

Execution of an FTA award for a project obligates the recipient to use funds it receives as specified in the grant or cooperative agreement. This creates a vested interest by the United States in unused grant or cooperative agreement balances, any improperly applied funds, and property or facilities purchased or otherwise acquired under the grant or cooperative agreement whether funds are received by the recipient as an advancement or by reimbursement.

Recipients and their subcontractors or partners are responsible for establishing and maintaining adequate internal control over all their functions affecting implementation of a project.

For proper management of projects, each recipient must use these controls in all of its operating, accounting, financial and administrative systems. To assure proper accountability for grant or cooperative agreement funds, internal controls must be integrated with the management systems used by the recipient to regulate and guide its operations.

- c. Objectives. Resources must be used in accordance with applicable state, local, and Federal laws, regulations and policies, and the grant or cooperative agreement. Resources must be safeguarded against waste, loss, and misuse. Reliable data on resource use and safeguards must be accumulated, maintained and fairly disclosed in reports to the recipient's management and FTA. A proper system of internal controls will help the recipient to:
  - (1) Operate efficiently and economically;
  - (2) Keep obligations and costs within the limits of authorizations and legal requirements, consistent with accomplishing the purpose of the project;
  - (3) Safeguard assets against waste, loss and misuse;
  - (4) Ensure timely collection and proper accounting of the recipient's operating and other revenues; and
  - (5) Assure accuracy and reliability in financial, statistical and other reports.

- d. Necessary Elements. Certain conditions are necessary to achieve these objectives and meet the standards discussed in this chapter. Each facilitates the recipient's use of internal controls. These are:
- (1) Reasonable assurance that internal controls are an integral part of the recipient's management systems;
  - (2) Existence of a positive and supportive attitude among recipient's managers and employees;
  - (3) Assignment of internal control functions to competent and experienced employees;
  - (4) Identification of specific internal control objectives to assure that needs is identified and that valid controls are planned and implemented;
  - (5) Adoption of internal control policies, plans and procedures that reasonably assure their effectiveness, such as organizational separation of duties and physical arrangements such as locks and fire alarms; and
  - (6) The recipient should conduct a regular program of testing to identify vulnerabilities in the internal control system.
- e. Standards of Internal Control and Audit Resolutions.
- (1) General.
    - (a) Recipient management policies that govern project implementation must be clearly stated, understood throughout the organization and conform to applicable legislative and administrative requirements.
    - (b) The recipient's formal organization structure must clearly define, assign and delegate appropriate authority for all duties.
    - (c) Responsibility for duties and functions must be defined within the organization to assure that adequate internal checks and balances exist. Recipients should pay particular attention to authorization, performance, recording, inventory control and review functions to reduce the opportunity for unauthorized or fraudulent acts.
    - (d) A system for organizational planning should exist to determine financial, property and personnel resource needs.
    - (e) Written operating procedures should be simply stated, yet meet the recipient's operating, legal and regulatory requirements. In developing its procedures, the recipient should consider such factors as feasibility, cost, risk of loss or error, and availability of suitable personnel. Other important considerations are the prevention of illegal or unauthorized transactions or acts.

- (f) The recipient's information system must reliably provide needed operating and financial data for decision-making and performance review.
  - (g) Proper supervision must be provided and performance must be subject to review of an effective internal audit program.
  - (h) All personnel must be properly qualified for their assigned responsibilities, duties and functions. Education, training, experience, competence and integrity should be considered in assigning work. All staff must be held fully accountable for the proper discharge of their assignments.
  - (i) Expenditures must be controlled so that equipment, goods and services are acquired and received as contracted for (as to quality, quantity, prices and time of delivery). Authorizations for expenditures must conform to applicable statutes, regulations and policies.
- (2) Financial Management Systems. Minimum requirements of a recipient's financial management system are contained in 49 C.F.R. Section 18.20 and Section 19.21. Minimum requirements of a recipient's financial management systems are contained in the Common Grant Management Rule, at 49 C.F.R. Section 18.20 and Section 19.21. NOTE: States may follow their own state laws and procedures for expending and accounting for grant or cooperative agreement funds.

For other than state recipients and sub-recipients, each recipient and sub-recipient must establish and maintain an adequate financial management system that provides for:

- (a) Financial Reporting - Accumulation and reporting of accurate, current and complete financial information for each project;
- (b) Accounting Records - Records that identify the source and application of funds for activities supported by the grant or cooperative agreement. These must include information about Federal awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays and income;
- (c) Internal Control - Control and accountability for all funds, property and other assets, including safeguards against unauthorized use;
- (d) Budget Control - Comparability of actual outlays with budgeted amounts for each activity financed by the grant or cooperative agreement. Where appropriate, unit cost information should be provided for productivity comparisons;
- (e) Allowable Cost - Procedures for determining reasonableness, eligibility and proper allocation of costs as required by OMB Circular A-87, "Cost Principles for State and Local Governments;"

- (f) Cash Management - Procedures that assure the shortest elapsed time between receipt of funds from U.S. Treasury and recipient disbursements. Payment received from FTA must be disbursed within three business days. If not disbursed within three days, funds become excess funds and must be returned to FTA. (See Chapter III for additional information regarding payment procedures.) These requirements apply to prime recipients as well as sub-recipients; and
- (g) Source Documentation - Procedures that assure timely and appropriate resolution of audit findings and recommendations. Accounting records must be supported by documentation such as cancelled checks, paid bills, payrolls, time and attendance records, and contract and sub-recipient award documentation.

## 2. **COST ALLOCATION PLAN/INDIRECT COST PROPOSAL.**

- a. General. Under federally funded grant or cooperative agreement programs, recipients may incur costs of both a direct and indirect nature. A cost allocation plan is required if a recipient desires to charge indirect program-related costs to an FTA project.
- b. Definitions.
  - (1) Direct costs are those that can be identified specifically with a particular project. These costs may be charged directly to a grant or cooperative agreement project.
  - (2) Indirect costs are those that are incurred for a common or joint purpose benefiting more than one cost objective;
    - (a) Not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved; and
    - (b) Originating in each of the recipient's operating or organizational units (as well as those incurred by others in supplying goods, services, and facilities to each unit).

Examples of indirect costs are operation and maintenance of buildings and expenses of other non-project related management and their immediate staff. Principles and standards for determining costs applicable to grants, cooperative agreements, and contracts with recipients that are state or local agencies are presented in OMB Circular A-87, and the appropriate Department of Health and Human Services (DHHS) publications. (Cost principles for educational institutions are presented in OMB Circular A-21, while cost principles for private nonprofit organizations are presented in OMB Circular A-122.)

- c. Types of Plans. There are two types of cost allocation plans presented in OMB Circular A-87.

- (1) The first plan covers the distribution of costs of support services provided by a state/local government to its operating agencies and is referred to as a state or local government-wide central service cost allocation plan.
- (2) The second plan covers distribution of costs within an individual recipient or contractor (i.e., operative) agency, including costs of services allocated to it under the state or local government-wide central service cost allocation plan, for all work performed by that agency. This second type of plan is commonly referred to as an indirect cost plan.

DHHS brochure, ASMB C-10 contains questions and answers regarding cost allocation plans and sample formats for both plans. This document is available with updates and changes through the Government Printing Office by subscription, or on the DHHS web site at: <http://www.os.dhhs.gov/progorg/GrantsNet/index.html>. It provides the implementation guide for A-87 and may be reproduced without permission.

- d. Preparation of Plan. Recipients who intend to seek FTA reimbursement for indirect costs must prepare a cost allocation plan and/or indirect cost rate plan.
  - (1) Purpose. The purpose of the plan is to guide the recipient's allocation of costs, assuring that:
    - (a) All activities of local government departments or state agencies have been considered;
    - (b) Distribution of indirect costs is based on a method(s) reasonably indicative of the amount of services provided;
    - (c) Services provided are necessary for successful conduct of Federal programs;
    - (d) Costs incurred are reasonable;
    - (e) Costs of state or local centralized government services may be charged in conformance with government-wide cost allocations plans; and
    - (f) Costs claimed are allowable in accordance with OMB Circular A-87, as applicable.
  - (2) Steps in Plan Development. Four steps are basic in preparing a cost allocation plan:
    - (a) Identifying costs of each type of service to be claimed;
    - (b) Determining the users of the service;
    - (c) Determining the method for allocating each type of service cost to users; and

- (d) Mathematically allocating these costs to users.

Once FTA or another cognizant Federal agency has accepted a recipient's cost allocation plan or indirect cost rate proposal, the recipient must update it annually. The update should be retained and made available for review at the time of the grantee's organization-wide audit.

- e. Cognizant Federal Agency. Cognizance is generally assigned to the Federal agency that provides the predominant amount of dollar involvement with a recipient organization within a given state or locality. (OMB has assigned cognizant audit agencies for state and local Governments -- Federal Register, 1-6-86.). The cost allocation plan/indirect cost rate proposal should be submitted to the "cognizant" or "lead" Federal agency when:
- (1) The recipient is working on its first assistance project or has not previously had a cost allocation plan/indirect cost rate proposal reviewed and accepted;
  - (2) The recipient has made a change in its accounting system, thereby affecting the previously approved cost allocation plan/indirect cost rate and its basis of application; or
  - (3) The recipient's proposed cost allocation plan/indirect cost rate exceeds the amounts and rates approved for the previous year(s) by more than ten percent.

In other instances, the recipient should forego submission of its annual cost allocation plan/indirect cost rate proposal directly to the cognizant agency, retaining the documents for future review. In accordance with OMB Circular A-133, this review will be accomplished at the time of the organization-wide audit of the recipient.

If DOT is the cognizant agency, cost allocation plans should be sent to FTA for DOT review unless the Federal Highway Administration (FHWA) is the primary awarding agency. In that case, the plans should be sent to FHWA with a copy to FTA.

- f. Costs Supported. Formal accounting records to substantiate the propriety of eventual charges must support all costs in the plan. The allocation plan of the recipient should cover all applicable costs. It should also cover costs allocated under plans of other agencies or organizational units that are to be included in the costs of other federally sponsored programs. To the extent feasible, cost allocation plans of all agencies rendering assistance to the recipient should be presented in a single document.
- g. Plan Content. The cost allocation plan should contain, but not necessarily be limited to, the following:
- (1) The nature and extent of services provided and their relevance to federally sponsored programs;
  - (2) Items of expense to be included; and

- (3) Methods to be used in distributing cost.
- (4) Individual position or group classifications for direct staff services;
- (5) The annual salary rate or salary range for each position classification, with estimated average salary charged to the project for each rate;
- (6) The estimated period of service as provided by each position classification, estimates of percentage of time each position will devote to the project, and the estimated cost of each;
- (7) The nature and extent of services provided by each position classification;
- (8) Details of other direct charges including the nature of charges and estimated costs; and
- (9) All categories of indirect costs, proposed methods, and the basis for allocating them to the project, total indirect costs, and the estimated amount to be charged to the project.

It is important to note that although personnel services should be estimated on a percentage-of-time basis for planning purposes, only actual time charged to the project as supported by adequate time sheets will be eligible for reimbursement.

- h. Plan Approval. Most transit agencies are under the cognizance of the U.S. Department of Transportation. Whenever the cognizant agency gives prior approval to a government-wide cost allocation plan or indirect cost proposal, such approval is formalized, distributed to all interested Federal agencies, and applicable to all Federal grant and cooperative agreements in accordance with OMB Circular A-87.

### **3. COST STANDARDS.**

- a. General. Recipients must follow the guidelines contained in OMB Circular A-87 (state and local governments), in determining whether project costs are allowable or unallowable. Project costs must specifically relate to the purpose of the grant contract and the latest approved project budget. Care must be exercised when incurring costs to ensure that all expenditures meet the criteria of eligible costs. Failure to exercise proper discretion may result in expenditures for which use of project funds cannot be authorized and, therefore, disallowed by audit.
- b. Allowable Costs. General. The criteria that govern the eligibility of project costs are discussed below. These criteria are drawn from OMB Circular A-87. To be allowable under a recipient program, costs must:
  - (1) Be necessary and reasonable for proper and efficient administration of the Federal assistance program, be allowable under the principles contained in the OMB circulars and except as specifically provided in this circular, not be general expenses required to carry out the overall responsibilities of state or

local governments; authorized or not prohibited under state or local laws or regulations;

- (2) Be authorized or not prohibited under state or local laws or regulations;
- (3) Conform to any limitation or exclusions set forth in the principles, Federal laws, or other governing limitations as to types or amounts of cost items;
- (4) Be consistent with policies, regulations, and procedures that apply uniformly to both federally assisted and other activities of the unit of government of which recipient is a part;
- (5) Be treated consistently through application of generally accepted accounting principles appropriate to the circumstances;
- (6) Not be allowable or included as a cost of any other federally financed program in either current or prior periods;
- (7) Be net of all applicable credits.

#### **4. PROJECT INCOME.**

- a. General. FTA's project income polices are governed by 49 C.F.R. Part 18, the Common Rule, and apply to all FTA planning and projects governed by this circular, except for approved projects that contain specific terms and conditions to the contrary.
- b. Accountability. Recipients must account for project income in their accounting system, which is subject to audit. The accounting system must be capable of identifying project income and the purpose for which it was used.

#### **5. FINANCIAL REPORTING REQUIREMENTS.**

- a. General. FTA uses the Milestone/Progress Report to monitor project funds through FTA's transportation electronic award and management system. Note that payment can be withheld for failure to submit either financial or narrative reports in a timely manner.
- b. Disclosure Criteria. The following criteria are basic to full disclosure in financial reports by recipients:
  - (1) All essential financial facts relating to the scope and purpose of each financial report and applicable reporting period should be completely and clearly displayed in the reports.
  - (2) Reported financial data should be accurate and timely. The requirement for accuracy does not rule out inclusion of reasonable estimates when precise measurement is impractical, uneconomical, unnecessary, or conducive to delay.

- (3) Financial reports should be based on the required supporting documentation maintained under an adequate accounting system that produces information that objectively discloses financial aspects of events or transactions.
  - (4) Financial data reported should be derived from accounts that are maintained on a consistent, periodic basis; material changes in accounting policies or methods and their effect must be clearly explained.
  - (5) Reporting terminology used in financial reports to FTA should be consistent with receipt and expense classifications included in the latest approved project budget.
- c. Milestone/Progress Reports. Electronic financial status reporting is required for all research and technology projects covered under this circular, unless otherwise specified by the project manager. These quarterly reports can be submitted electronically or in paper format, also. These reports are to be submitted for all non-construction and construction projects on an accrual basis.

## 6. ANNUAL AUDIT.

- a. General. OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations" and provisional OMB Circular A-133 Compliance Supplement of May 1998 provides the requirements for annual audits of grant or cooperative agreement recipients. Both documents are available on the OMB web site at [www.whitehouse.gov/WH/EOP/OMB/Grants/](http://www.whitehouse.gov/WH/EOP/OMB/Grants/).
- b. Requirement. FTA recipients are required to obtain the services of an independent auditor to conduct a single audit each year in conformance with OMB Circular A133, except where a State statute or regulation provides for a single biennial audit.
- c. Purpose. The purpose of the single annual audit report is to determine whether the recipient:
  - (1) Has prepared financial statements that fairly present its financial position and the results of its financial position and the results of its financial operations in accordance with generally accepted accounting principles;
  - (2) Has in place internal accounting and other control systems to provide reasonable assurance that it is managing Federal financial assistance programs in compliance with applicable laws and regulations; and
  - (3) Has complied with laws and regulations that may have a material effect on its financial statements and on each of its major Federal assistance programs (as defined according to the sliding scale discussed in A-133).

The annual single audit is to be performed by an independent auditor who is required to determine and report on whether the recipient has internal control systems that reasonably assure it is managing Federal assistance programs in compliance with

applicable laws and regulations. Review of a proposed contract for the services of an independent auditor can be arranged through FTA with the recipient's cognizant Federal auditor.

Recipients are required to determine whether certain sub-recipients spend Federal assistance funds they receive in accordance with applicable laws and regulations. Audit judgment concerning the recipient's determination is left to the independent auditor.

Sufficient copies of the single audit reports (one for file and one for each Federal agency with findings) should be sent to the Audit Clearing House, 1201 E. 10th Street, Jeffersonville, IN 47132.

- d. Resolution of Audit Findings. Recipients and sub-recipients are responsible for prompt resolution of all audit findings and recommendations. This responsibility requires that the recipient:
- (1) Promptly evaluate the report;
  - (2) Determine the appropriate follow-up actions and establish a date for their completion; and
  - (3) Complete all required actions within the established period of time.

The recipient must resolve deficiencies or opportunities for improvement identified in an audit. The resolution of audits begins with FTA's Financial Management Oversight (FMO) report to the recipient and continues until the recipient corrects identified deficiencies, implements needed improvements or demonstrates that the findings or recommendations are not valid or do not warrant management action.

The audit is not resolved until FTA concurs in the documentation of steps taken to implement any needed corrective actions. The status of outstanding audit findings and recommendations should be monitored and reported by the recipient in quarterly progress reports and, where appropriate, significant events reported.

## **7. THIRD PARTY CONTRACT AUDITS.**

- a. Responsibility for Audit. Recipients must ensure that project-assisted activities are carried out effectively and efficiently. Audit of third party contracts is an important tool available to recipients in meeting this obligation. The recipient as part of its own management process may initiate a third party audit. For example, consultant, engineering or service contracts commonly include provisional overhead (burden) and General & Administrative (G & A) rates that need to be verified by audit for the applicable contract periods. Contract audits may also be requested by FTA to ascertain that payments were made in conformance with the terms of the contract, or for other purposes. Finally, the firm conducting the recipient's single annual audit may recommend audit of a third party contract.

- Auditors who are independent from the third-party contractor must conduct third party contract audits.
- b. Outside Audit Services. Many FTA recipients assign proposal evaluation and contract monitoring duties to their own auditors or financial management personnel. However, some do not have qualified personnel within their organization to conduct this kind of audit review. They must obtain these services elsewhere. Two available sources for audit services are qualified independent accounting firms and contract auditors from agencies and departments of the Federal Government. Private firms usually are able to initiate the audit sooner after the recipient's request than a Federal agency can, but in some cases, a continuing Federal audit function is maintained at contractor locations and can be used for audit of FTA recipients' third party contracts. In other cases, an audit by a Federal agency may best serve the overall government interest.
  - c. Costs. Costs of third party contract audit and proposal evaluation are eligible for reimbursement by FTA as a direct or indirect charge in accordance with OMB Circular A-87. FTA recommends that recipients seek guidance from the cognizant Federal auditor before negotiating audit contract agreements. (Cognizant Federal audit is earlier described under Annual Audit in this chapter).
  - d. Contracting for Audit Services. In contracting with a private firm for an independent audit, recipients should follow standard procedures for third party contracts. Recipients should direct requests for Federal audit assistance to FTA.