Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards

The Role of Internal Control, Documenting Internal Control, and Determining Allowability & Use of Funds

INTRODUCTION

The 'Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards' (2 C.F.R §200), which is often referred to as the "Uniform Guidance," became effective for new and continuation awards issued by the Department on or after December 26, 2014.

The guidance provides flexibility in the use of federal funds but elevates the role of internal controls (§200.303) to institute a stronger infrastructure of accountability. As a result, Department grantees must:

- Establish and maintain effective internal control over federal awards and provide reasonable assurance that federal funds are managed in a way that is compliant with federal statutes, regulations, and the terms and conditions of the federal award.

- Evaluate and monitor the non-Federal entity's compliance with statutes, regulations and the terms and conditions of Federal awards.

- Take prompt action in the event of an incidence of noncompliance.

- Take reasonable measures to safeguard protected personally identifiable information and other information the Federal awarding agency or pass-through entity designates as sensitive.

Further, grantee internal control systems should comply with the guidance provided in 'Standards for Internal Control in the Federal Government' (also referred to as the "Green

Book") issued by the Comptroller General of the United States or the 'Internal Control Integrated Framework', issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

To support grantee installation, assessment, and demonstration of an internal control system the Department developed this guidance.

DEFINING INTERNAL CONTROL

Internal Control represents those processes by which an organization assures operational objectives are achieved efficiently, effectively, and with reliable, compliant reporting. The five components of internal control are as follows:

- A <u>Control Environment</u> that sets the tone for the organization. This influences the control consciousness of staff and is the foundation for all other components of internal control.

- A <u>Risk Assessment</u> process that involves the identification and analysis of relevant risks to the achievement of objectives, and forming a basis for how the risks should be managed.

- <u>Control Activities</u> that include the policies and procedures that help ensure management directives are carried out and documented.

- <u>Information and Communication</u> systems or processes that support the identification, and exchange of information in a way and time frame that enable people to successfully carry out their responsibilities.

- <u>Monitoring</u> processes used to assess the quality of internal control performance over time.

ASSESSING LEVEL OF CONTROL REQUIRED

Internal control is not new to the financial world, though it may be new to many working with grants implementation. To build capacity, the Department has developed a comprehensive tool kit to help entities conduct an initial self-assessment and develop successful strategies.

<u>Where to Begin</u>

Internal control exists in one form or another within every entity that is attempting to accomplish at least one objective. Internal control is simply the name for the mechanism(s) entities use to accomplish their objective(s). In other words, internal control "comprises the plans, methods, policies, and procedures used to fulfill the mission, strategic plan, goals, and objectives of the entity."[1]

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[1] U.S. Government Accountability Office (GAO), "Standards for Internal Control in the Federal Government," (the Green Book), page 5, *available at* http://www.gao.gov/assets/670/665712.pdf (last checked August 17, 2015).

Although internal control exists within most entities, there is a high degree of variability from one entity to another with respect to their amount of internal control documentation. Unsurprisingly, there tends to be a positive correlation between the amount of internal control documentation and the size of an entity. At a certain point, the volume of internal control documentation will grow large enough that an entity will realize it should create a reference document. This reference document is often referred to as an entity's "internal control plan" or "internal control program," however, for purposes of this guidance, it is referred to as an entity's "internal control system."

The information below was designed to help grantees document their internal control system. Documenting the internal control system strengthens a grantee's ability to assert, with reasonable assurance, that their grant is being managed in compliance with federal statutes, regulations, and the terms and conditions of the grant award.

DOCUMENTING YOUR INTERNAL CONTROL SYSTEM

An internal control system is "a continuous built-in component of operations…integral to all processes management uses to guide its operations."[2] A well-documented internal control system includes a narrative that describes how an entity expects to accomplish its goals and objectives through the use of plans, methods, policies, and procedures. It is a dynamic document that should be updated regularly to reflect new priorities, policies, and/or requirements (e.g., corrective actions taken in response to audit findings, etc.).

Below are seven steps that should help an organization document their internal control system:

1. Define Goals and Objectives;
2. Identify All Assessable Units;
3. Detail the Control Environment;
4. Prioritize and Document Business Processes;
5. Identify Risks and Describe Control Activities;
6. Link Progress to Process; and
7. Implement an Internal Control Evaluation Routine.

While it is the responsibility of management to maintain an effective internal control system, the success of the seven-step process depends on widespread participation by personnel located throughout the organization.

Defining Goals and Objectives

At the outset of establishing an effective internal control system, management should identify the key goals and objectives of the entity in terms that are specific, measurable, achievable, results-focused and time-delimited.

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[2] *Id.* at 5-6.

Identifying All Assessable Units

Management should identify the assessable units that together comprise the grantee. In most cases, the assessable units within a grantee are those functional units identified on an organizational chart. Typically, each functional unit ~ assessable unit ~ is responsible for carrying out the mission and responsibilities of the Department.

Detailing the Control Environment

Once the assessable units are defined, management should detail the control environment for each. The control environment for an assessable unit consists of its mission, responsibilities, organizational structure, and goals and objectives (short- and long-term). Detailing the control environment for each assessable unit within an organization provides management with a more granular view of numerous aspects of the overall control environment of the organization. This is important because, as stated in the Green Book, the "control environment is the foundation of [an organizations] internal control system."[3]

Prioritizing and Documenting Business Processes

It is easy to become overwhelmed by the volume and complexity of activities performed throughout an entire organization (e.g., budget planning, grant reporting, payroll, etc.). To simplify the task of documenting and monitoring internal control, management should identify the activities performed by each assessable unit and group them into business processes or sub-processes. A business process is **a group of interrelated activities or tasks that achieve a specific result in support of an organization's objectives**.

Breaking down complex or large business processes into sub-processes might become necessary to effectively convey the various risks and/or control activities associated with the process.

Some very large assessable units engage in a multitude of activities and documenting each business process would not be cost beneficial. Therefore, management should determine which business processes best convey the story or "business activity" and should be documented and which to exclude.

Whether a business process must be documented should be based on its relationship to an assessable unit's goals, objectives, and risk tolerances. The more essential a business process is to achieving an assessable unit's goals and objectives, the more likely it is that the process should be documented (and vice versa).

Once management has identified and prioritized the business processes within an assessable unit, they must determine how those processes should be documented. Business process documentation should be thorough. **The level of detail necessary to describe an organization's internal control system is determined by the complexity of its systems**.

To make efficient use of resources, documentation should focus on high -level activities, rather than on each activity within a process. In some cases, existing documentation, such as step-by-

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[3] *Id.* at 7.

step procedures, can be condensed into a few sentences describing the process. The goal is to convey enough information about each business process so that the risks are recognized and mitigated.

Identifying Risks and Describing Control Activities

For an internal control system to be effective, management should identify the inherent risk in each documented business process. Inherent risk is **the risk to an entity prior to considering management's response to the risk**. Some inherent risk will likely be applicable to each business process within an organization. Inherent risk is often revealed by asking questions like:

- What can go wrong?

- How could we fail?

- How do we know whether we are achieving our objectives?

- On what information do we rely most heavily?

- What is our greatest legal exposure?

- Does past experience highlight any areas of particular concern (e.g., audit findings, fraud, etc.)?

Once the inherent risk to a business process has been identified, management should describe the methods (i.e., control activities) currently in place to manage them. Note that practitioners (auditors, government officials, etc.) may refer to "internal controls," when in fact they are referring to "control activities."

Control activities are **documented actions management establishes to serve as gatekeepers to assure that objectives are achieved**. Control activities occur at all levels and functions. They include a wide range of diverse activities such as training, approvals, authorizations, verifications, reconciliations, performance reviews, segregated duties, security measures, and the creation and maintenance of appropriate documentation. In summary, a control activity has the following characteristics:

- It addresses the risk in question

- Is required by the organization (i.e., addressed in policies and procedures)

- Is embedded in the operational functions (e.g., has occurred within the last 12 months)

Linking Progress to Process

In addition to identifying the control activities associated with each business process, management should also list the goals and objectives each business process supports. Many

goals and objectives will likely be supported by one or more business processes.

Implementing an Internal Control Evaluation Routine

Once the risks and control activities within each business process have been identified, management should implement an internal control evaluation. Evaluations can be routine, periodic, or random.

Management should briefly describe their evaluation of those control activities. The evaluations may change from year to year, just as the risks and controls may change over time. The goal of the description is to convey the most recent actions management took to ensure the control activities associated with each business process are: (1) effectively designed, (2) operating as intended, and (3) effectively mitigating the applicable risks.

If the evaluation reveals that the control activities for a particular process do not satisfy one or more of these three conditions, management should describe the severity of the problem and the action steps being undertaken to resolve the issue(s).

SOME PROCESSES WHERE INTERNAL CONTROL COULD BE CRUCIAL

Determining Allowability

When confronted with an issue related to a recipient/sub-recipient's use of funds a reviewer only has the documentation to tell the story. If the reviewer can reconstruct the story of a particular use of funds then clear determination is possible. The more difficult it is to reconstruct the story, the more you will have to rely on other mechanisms to ensure proper use of funds.

Documentation/Internal Controls — 2 CFR §§2 00.302(b)(7)- 200.303 & 34 CFR § 76.730(e)

- Establish and maintain effective internal controls over purchasing, procurement, and inventory

- Document decisions and actions to demonstrating the implementation of reasonableness, necessity, allocability, and compliance with requirements

- Records to facilitate an effective audit.

Factors Affecting Allowability of Costs — 2 CFR §200.403

Generally a cost is reasonable if it is:

Reasonable in its nature, and does not exceed that which would be spent by a 'prudent person' (A 'prudent person' is a person who conducts themselves in a manner that is consistent with how other people of prudence, discretion and intelligence, manage their affairs.)

- Necessary for the performance of the Federal Award

- Conforming to limitations/exclusions in the law or the Uniform Guidance

- Comparable to market prices for the geographic area

- Treated consistently as a direct, rather than indirect, charge

- Accounted for in accordance with Generally Accepted Accounting Principles

- Consistent with State/local procurement rules

- Not included as a cost or used to meet cost sharing or matching requirements

- Adequately documented

Reasonable Costs — 2 CFR §200.404

In determining reasonableness of a given cost, you must consider:

- Whether the cost is of a type generally recognized as ordinary and necessary for the performance of the Federal award

- The requirements imposed such as: sound business practices; Federal and/or State laws; and terms and conditions of the Federal award

- Market prices for comparable goods or services for the geographic area

- Whether Individual acted with prudence in the circumstance considering their responsibilities to the non-federal entity, its employees; grant beneficiaries; the public; and the Federal Government

- The degree to which the non-Federal entity follows established practices and policies regarding the incurrence of costs

Allocable — 2 CFR § 200.405

Generally a good or service is allocable if it is:

- Assignable to a particular cost objective
- Purchased for a particular award
- Necessary to implement the objectives of the grant

If a cost **proportionally benefits** two or more projects or activities, that cost should be allocated to the projects based on the benefit received.

Prior Written Approval — 2 CFR § 200.407

Under any Federal award, the reasonable ness and allocability of certain items of costs may be difficult to determine — in these cases a non-Federal entity may seek prior approval from the cognizant agency in order to avoid a disallowance.

Circumstances that specifically require prior approval:

- Cost Sharing
- Program Income
- Revision of budget and program plans
- Fixed amount sub-awards
- Direct Costs
- Compensation
- Entertainment costs
- Equipment
- Exchange Rates
- Fines/penalties/damages

- Fund raising/Investment
- Good/Services for personal use
- Insurance
- Memberships/subscription
- Organization costs
- Participant support costs
- Pre-award costs
- Rearrangement costs
- Marketing costs
- Travel costs

MITIGATING STRATEGIES

Using the results of your risk assessment activities —a requirement under 2 C.F.R §200.331— you can identify those processes/process components that require additional control activities to mitigate the risk presented. Those additional controls are called compensating controls. Compensating controls are a type of control used to discover, prevent, and or mitigate mistakes.

Mitgating Controls

Segregation of duties is an internal control designed to prevent error and fraud by ensuring that at least two individuals are responsible for the separate parts of any task. Fraud and error are risks in approval of use of funds processes. To mitigate that risk, an entity may have:

- One employee responsible for ensuring allowability based either on program law or uniform guidance,

- One person to do the accounting portion of the job, and

- One person responsible for signing the checks.

Segregation of duties can be difficult for businesses with small staffs. Compensating controls, in this case, may include maintaining and reviewing decision making logs and supporting documentation.

TOOL KIT

The Department Developed an Internal Control Tool Kit in addition to this guidance. The tool kit can be found at

http://www2.ed.gov/policy/fund/guid/uniform-guidance/index.html

The toolkit includes:

- A "quick check" document that can facilitate an initial self-assessment.

- A second tier self-assessment to hone in on problematic areas.

- An example of a procurement flow chart which includes a series of questions you might ask yourself in assessing a aspects of an example procurement process. These questions are illustrative of the type of analysis you should conduct. In determining the allowability of expenditures involving Federal funds.

- A glossary of terms, common language, associated with the internal controls field.

- Template to use as a starting point in documenting the organizations internal control system.